Daniel Mminele: Recent economic and monetary policy developments in South Africa

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at a Breakfast Meeting hosted by Ethical Foundation for Leadership Excellence, Polokwane, Limpopo, 27 July 2016.

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1. Introduction

Good morning, ladies and gentlemen.

Thank you to the Ethical Foundation for Leadership Excellence for creating an opportunity for us to interact over this business breakfast today. Allow me to start by commending the Foundation on the important initiatives it has been undertaking since its official launch last year, to contribute to improved governance standards through ethical leadership excellence. I have been asked to give you an update on recent economic and monetary policy developments. Many studies have highlighted the economic and social costs of bad leadership in various spheres of society, and thus one should not under-estimate the important role that ethical leadership can play in addressing the economic challenges that the world, including South Africa, currently faces.

We strongly believe that the credibility and reputation of the South African Reserve Bank (SARB), which is very critical to our work, depends on excellent leadership. Thus the Bank pays particular attention to its own leadership. Having engaged for two years in a bank-wide authentic leadership training programme, to access and use reflective and coaching skills, the Bank is now embarking on leadership development customised for each management level.

We concluded the most recent of our Monetary Policy Committee (MPC) meetings less than a week ago, and my remarks today will be largely informed by our assessment from that meeting. After some points on the global backdrop, I will talk about recent economic and financial market developments in South Africa, and provide an update on monetary policy in this challenging economic environment. Before I conclude I will briefly touch on economic developments in the Limpopo province, relative to national trends.

2. Global economic developments

A week ago the International Monetary Fund (IMF) released the World Economic Outlook (WEO) update, which confirmed that the global economy continues to struggle to find momentum. The IMF noted lackluster growth in most advanced economies, low potential growth and a gradual closing of output gaps, while prospects remained diverse across emerging market and developing economies. Similarly, the G20 Finance Ministers and Central Bank Governors indicated over the weekend that the global economic recovery continues, but is facing challenges and downside risks, amid fluctuating commodity prices, high financial market volatility, geo-political conflicts, terrorism and refugee flows. While some of these factors have been with us for a number of years now, more recently, the downside risks facing the global economy have been compounded by the outcome of the British referendum vote, or Brexit, as it is more commonly referred to. As a result of Brexit, the global outlook for 2016–17 has worsened, as the vote added significant uncertainty to an already fragile global economic environment, and is likely to affect confidence and weigh negatively on consumption and investment. I should add that Brexit has also highlighted the importance of inclusive growth, an issue which was highlighted in the latest G20 communique.

The IMF noted that prior to Brexit, economic data and financial market developments pointed to an improvement in the outlook for a few large emerging markets and a modest upward revision to global growth for 2017 (0.1 percentage point). In the aftermath of Brexit, however, the IMF downgraded global growth projections by 0,1 percentage points for both 2016 and 2017 to 3,1 and 3,4 per cent respectively. Advanced economies were primarily responsible for the more pessimistic outlook, with the IMF revising the United Kingdom's 2017 outlook downwards by almost a full percentage point, while the euro area's outlook was downgraded by a lesser 0,2 percentage points.

With the exception of sub-Saharan Africa, where the IMF downgraded its outlook by over 1 percentage point for 2016, mainly on account of adverse developments in Nigeria and South Africa (the two largest economies), the outlook for emerging markets has generally remained steady, with stronger than expected recoveries in Russia and Brazil in the forecasts. Although the contribution of emerging markets to global growth has dwindled in recent years, they continue to account for around 58 per cent of global gross domestic product (GDP) and therefore remain significant.

Given that the Brexit outcome was generally unanticipated, the outcome was initially followed by heightened financial market volatility and renewed risk aversion. Emerging market economies were subjected to a strong negative impact from Brexit, however, the emerging markets most strongly affected have been those that are highly dependent on the EU as an export market, like South Africa. Notwithstanding the short term financial market volatility, financial markets have since recovered and asset prices have rallied. This development was supported by a good level of preparedness by major central banks and quick responses after the referendum, demonstrating readiness to act decisively in dealing with any fallout in the financial markets.

While there has been some reprieve in financial markets, it is to be expected that until Brexit negotiations have been completed or the likely outcome becomes clearer, there could be significant bouts of volatility and heightened uncertainty. This means that forecasts will be subject to further revisions as the impact of Brexit unfolds, and the respective positions of the negotiating partners are revealed. Heightened uncertainty is likely to spill over into financial markets, which usually means capital outflows from emerging market economies which are perceived to be more risky, as investors look for so-called safe haven assets. At the same time, however, Brexit appears to have swung the monetary policy pendulum more towards an even easier stance in advanced economies, and as such, in the short term we could still witness inflows into emerging markets as investors search for higher yields. The US Fed, which had embarked on a normalisation path for its monetary policy, may now slow down its pace, again adding to uncertainty and volatility. The results of their most recent deliberations will be announced tonight, and the markets are waiting to glean from their statements what the likely future trajectory of interest rates might be.

It has been argued that in sub-Saharan Africa, Brexit could potentially have severe repercussions given that the European Union is one of the region's biggest trade and foreign investment partners. South Africa's trade links are relatively small, but could suffer the most, given its strong investment and financial links with the UK and the relatively high integration of domestic markets with global financial markets. According to Moody's South Africa has been the largest recipient of UK foreign direct investment (FDI) in Africa, accounting for about 30 per cent of total UK investment in Africa in 2014.[1] Moody's further assert that given South Africa's lowest FDI levels in 10 years in 2015, Brexit-related uncertainty might delay investment decisions and introduce a downside risk to FDI inflows into South Africa.[2]

1 http://www.fin24.com/Economy/why-sa-is-most-exposed-to-brexit-impact-moodys-20160708.

2 http://www.focus-economics.com/countries/south-africa.

Market expectations of even easier monetary policy in advanced economies are reflected by the decline in long term government bond yields, across all maturities. Since the date of the referendum the yield on 10-year US Treasury bonds has declined by 19 bps, while the 10-year German bond yields and the UK bond yields are down by 12 and 57 bps respectively. The universe of negative yielding fixed income instruments is now around US$13 trillion, an unusual state of affairs that may harbour many risks for financial stability. Therefore there is a need for increased vigilance to guard against distortive allocations of capital and asset price bubbles.

Other risks facing the global economy include unresolved legacy issues in the European banking system; continued reliance on credit as a growth driver in China which heightens the risk of an eventual disruptive adjustment; and non-economic risks already mentioned earlier such as geopolitical threats and terrorism, amongst others.

3. Recent domestic economic and financial market developments

As noted in the recent MPC statement, the domestic economic growth outlook remains extremely challenging. Real economic activity in South Africa has contracted in the first quarter of 2016, declining at an annualised rate of 1,2 per cent, whilst also contracting on a year-on-year basis for the first time since 2009 when economic conditions were dominated by the effects of the global financial crisis. The poor performance in the first quarter reflected a further decline in the real output of the primary sector coupled with slower growth in the value added by the tertiary sector. Two key factors need to be mentioned in this regard, namely the unfavourable climatic conditions which had a considerable impact on the agricultural sector, and the challenging trading environment encountered by the mining sector. Together these two factors caused the primary sector to contract at a rate of 15,5 per cent in the first quarter of 2016.

Similarly concerning are trends in real gross domestic expenditure which declined at an annualised rate of 1,3 per cent in the first quarter. Contractions were recorded in real final consumption expenditure by households and real gross fixed capital formation, while growth in real final consumption expenditure by general government also slowed in the first quarter of 2016. Gross fixed capital formation contracted sharply in the first quarter of this year, the second consecutive contraction, and accounted for by both the private sector and general government. Confidence levels have deteriorated, as measured by the FNB/BER consumer confidence index, while the BER retail confidence index declined sharply in the second quarter. The deterioration in consumer confidence means that household consumption expenditure is likely to remain subdued, further exacerbated by high debt levels, rising costs of debt servicing, and slow employment growth. Consumption expenditure has been further constrained by the absence of significant wealth effects owing to the weak performance of asset markets, particularly the housing market. These factors have contributed to persistence of high rates of unemployment. In the first quarter of 2016 the official unemployment rate increased to 26,7 per cent. Annual losses in employment have been recorded in the manufacturing, private households, electricity, agriculture and transport sectors. Youth unemployment remains a serious challenge, having increased markedly to 54,5 per cent in the first quarter of 2016.[3] The unemployment challenge was emphasized by Mr David Lipton, First Deputy Managing Director of the IMF, in Johannesburg last week. In his speech he pointed to the limited progress on reforms to remedy the unemployment situation and recommended a fresh and energetic review of South Africa's policies, followed by action.[4]

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[3] SARB Quarterly Bulletin, June 2016.

[4] David Lipton. 2016. "Bridging South Africa's Economic Divide" Lecture given at the University of Witwatersrand. July 19.

Although the negative growth in the first quarter of this year is anticipated to have been the low point of the cycle, the recovery is expected to be weak. At the July meeting of the MPC, the SARB revised downward the growth projection for this year to zero per cent, from the previous projection of 0,6 per cent. In order to achieve a growth rate of zero per cent, the economy will need to grow by between 0.8 and 1.0 per cent in each of the three remaining quarters. For growth to be at 0.5 per cent for 2016, we would require growth of above 2 per cent for the remainder of the year. Furthermore, the SARB does not believe that a contraction in the second quarter is likely – a result that would tip the economy into a technical recession. The reasons for this are reasonably positive economic data thus far for the second quarter, in particular, the mining and manufacturing sectors are expected to add positively to growth, consistent with the Barclays PMI which has been above the neutral 50 level since March. In addition, the BER manufacturing confidence index also improved, while the real value of building plans passed is indicative of some improvement in the sector, particularly with respect to residential construction.

Looking further out, growth rates of 1,1 per cent and 1,5 per cent are forecast for the next two years, down from 1,3 per cent and 1,7 per cent previously. The Bank's estimate of potential output has been revised down marginally to 1,4 per cent in 2016, rising to 1,7 per cent in 2018.

Turning to the external sector, although the prices of some of South Africa's major exports such as iron ore and coal have recovered, the slowdown in the Chinese economy is generally expected to keep commodity prices depressed in the immediate future. Fortunately, whilst growth in merchandise exports remain subdued, the value of imports has edged only slightly higher, with increases in the value of imported capital and intermediate goods largely offset by lower imports of consumer goods. As a result, the country's trade deficit narrowed to R38 billion in the first quarter of 2016 from R41 billion in the fourth quarter of 2015.

South Africa's current account balance nonetheless deteriorated in the first quarter from 4,6 per cent of GDP in the fourth quarter of 2015 to 5,0 per cent of GDP. This outcome was largely as a result of the widening deficit on the services, income and current transfer accounts. South Africa's current account deficit leaves it vulnerable to short-term capital outflows if investors' risk perceptions and appetite were to be adversely influenced. South Africa relies on short-term private-sector capital inflows to finance its current account deficit and a decline in capital inflows will put pressure on the country's balance of payments.

4. Monetary policy

The SARB's primary mandate is to achieve and maintain price stability in the interest of balanced and sustainable economic growth.

In this respect, the SARB follows a flexible inflation targeting (IT) policy framework, where temporary breaches of the target can be tolerated in the interest of smoothing out fluctuations in the growth trajectory. However, the disappointing growth outcomes and outlook highlighted earlier have been accompanied by rising inflationary pressures. This has presented a challenging policy environment for the MPC.

The inflation rate, as measured by the increases in the consumer price index (CPI), was recorded at 6,3 per cent year-on-year in June 2016 compared to a 6,1 per cent in May 2016. The inflation rate has exceeded the upper band of the target since the beginning of the year averaging 6,3 per cent for the first 6 months of 2016. The main drivers were increases in the prices of food and non-alcoholic beverages which increased by 11,0 per cent in June, only slightly below the recent peak of 11,3 per cent in April. Goods price inflation measured 6,7 per cent, up from 6,6 per cent in May, while services inflation increased to 5,8 per cent from 5,7 per cent in May. The Reserve Bank's measure of core inflation, which excludes food, fuel and electricity increased marginally to 5,6 per cent compared with the 5,5 per cent annual increase in the previous month.

On the other hand, producer price inflation for final manufactured goods has been on a downward trend, declining from 7,0 per cent in April to 6,5 per cent in May mainly due to a moderation in price inflation of food, beverages and tobacco products. This was below the consensus forecast of 6,9 per cent but the impact of the drought is still evident in the increase in prices of agricultural products, particularly cereals and other crops as well as live animals and animal products.

Inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research, have remained anchored near or just above the upper end of the inflation target range. In the second quarter, average expectations for 2016 were 6,3 per cent, marginally up from 6,2 per cent. Average expectations for 2017 were unchanged at 6,2 per cent and were marginally down to 5,9 per cent for 2018. Average 5-year inflation expectations declined from 6,1 per cent to 5,9 per cent in the second quarter, with downward revisions by all groups. The yield differential between inflation linked bonds and conventional government bonds (break-even inflation expectations) declined across all maturities but remain elevated.

The latest inflation forecast of the Bank shows a marginal improvement compared with the previous forecast, although an acceleration in inflation is still projected for the second half of this year. Inflation is only expected to return to within the 3 – 6 per cent target range during the third quarter of 2017, averaging 5.5 per cent in 2018. According to SARB forecasts, inflation is expected to average 6,6 per cent in 2016 and 6,0 per cent in 2017, compared with forecasts of 6,7 per cent and 6,2 per cent at the MPC meeting in May. The expected peak, at 7,1 per cent in the fourth quarter of 2016, has been revised slightly down from 7,3 per cent due in part to lower administered price inflation (mainly petrol prices). An encouraging development is the moderation in the forecast for core inflation, from an average of 5,8 per cent in 2016 to 5,3 per cent by 2018. Whereas previously core inflation was expected to breach the upper end of the target range in the third quarter of 2016 for four consecutive quarters, a one-quarter breach, at 6,1 per cent, is now expected in the fourth quarter of this year.

A discussion on the inflation outlook would be incomplete without referring to developments in the exchange rate of the rand, one of the biggest risks to the inflation outlook. The recent volatility experienced by the rand exchange rate has been driven mainly by external factors and changes in global risk perceptions. Although the rand depreciated sharply in the immediate aftermath of the British referendum, it has reversed these losses. At the time of the most recent MPC meeting, the rand had appreciated against the major currencies, and on a trade-weighted basis, the rand had appreciated by 12,2 per cent. The rand has been supported by the global search for yield, the improvement in commodity prices, and also reacted to the unexpectedly large trade surplus recorded in May. Despite this recent strength, the rand remains vulnerable to possible changes in investor sentiment; changes in US monetary policy expectations; and domestic concerns including the possibility of ratings downgrades later in the year.

Other risk factors for inflation include increases in average wage growth in excess of inflation and productivity gains; elevated food price inflation; and potentially higher oil prices should global demand recover. On the other hand, a weaker global growth scenario could also imply that there may be a degree of downside risk to the international oil price assumption; a sharp decline in agricultural prices next year should favourable weather patterns transpire as forecast and the absence of demand pressures and weak consumption expenditure growth may also contribute to downside pressures.

As you will know, the MPC felt that local and international developments since our last meeting in May in relation to inflation and growth overall justified a pause in the hiking cycle at the July meeting. The situation will continue to be monitored closely as the risks to the inflation forecast are assessed to continue to be tilted to the upside, even if they have moderated somewhat recently. It remains to be seen if some of the favourable factors that contributed to the decision to keep interest rates unchanged will be sustained. This will require ongoing vigilance and careful analysis of incoming data and information, and the MPC will not hesitate to act when deemed appropriate.

As I move towards the end of my speech, please allow me to briefly touch on some economic developments in the Limpopo Province.

5. Limpopo Province

The growth performance of the province – like that of the South African economy – has been disappointing. The average growth rate for the period 2009–14 averaged 1,3 per cent as compared to the national average of 1.8 per cent.[5] Unfortunately, statistics are not available to assess the most recent economic growth performance of Limpopo in relation to the national growth rate. However, an assumption can be made that, given the dominant role of mining and agriculture in the province, developments will likely have mirrored national trends.

As for inflation developments, while the inflation rate in Limpopo has declined from 8,2 per cent in May 2016 to 7,4 per cent in June 2016, it is nevertheless still over 1 percentage point higher than the national average and significantly above the top end of the inflation targeting rate. This has both adverse welfare and competitiveness effects and is something that warrants attention at the provincial level particularly in terms of addressing the bottlenecks that are adversely affecting the price formation process in the province.

With an estimated share of national GDP of just over 7 per cent, Limpopo makes an important contribution to the economy of South Africa. The primary sector has always played a key role in the province, with its contribution growing from 17 per cent in 1996 to just over 27 per cent in 2014. This has in large part been due to the mining sector, with its contribution increasing from around 15 per cent in 1996 to around 25 per cent currently. Approximately, 41 per cent of South Africa's platinum group metals (PGMs), 90 per cent of red-granite resources and approximately 50 per cent of the country's coal reserves being located in the province. In addition, it has been found that antimony, a highly strategic mineral found in large quantities in China, is another of Limpopo's major assets[6]. In addition to mining, agriculture and tourism are the other pillars of the Limpopo economy, with the province having identified infrastructure development, industrialisation and manufacturing as potential new game changers that will enable it to achieve higher growth rates in the future.

The potential of this province is beyond question. The province is well-endowed with minerals. While the fortunes of the mining industry are subject to international commodity price movements, the policy challenge is to ensure that the potential benefits that could be derived from the natural resource endowment are optimized.

6. Conclusion

In conclusion, it is clear that the global and domestic economies face challenging times ahead, riddled with uncertainty which could exacerbate volatility and dampen confidence, and thus undermine consumption and investment required to support sustainable and balanced growth. What the impact of the added complication of Brexit will bring, will only become clear over time. While we may have little control over many of the external factors, we need to decisively tackle some of the local impediments that are well within our control through collaborative leadership from Government, business and labour. The SARB remains fully committed to making a constructive contribution in line with its mandate of achieving and maintaining price stability in the interest of sustainable and balanced economic growth.

Thank you.

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5 Statistics South Africa: available http://www.statssa.gov.za/?page_id=1854&PPN=P0441.

6 John Young, Investing in Limpopo, September 2013.