Lesetja Kganyago: Overview of the South African economy

Address by Mr Lesetja Kganyago, Governor of the South African Reserve Bank, at the 96th annual ordinary general meeting of shareholders, Pretoria, 29 July 2016.

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1. Governor's address

The past year has again been a challenging one for the Bank against the backdrop of a hesitant recovery in the global economy and a slowing domestic economy. While the recent decision by the UK to leave the European Union (Brexit) has raised the risks to the outlook, the extent of the spillover effects are still unclear. Much will depend on the speed and terms of the disengagement. At this stage we do not know which of a number of possible scenarios will unfold.

The financial markets have stabilised following the initial volatile response to the decision. However, it is likely that growth in the UK, and to a lesser extent in the EU, will be negatively affected, as a protracted period of uncertainty is expected to undermine both business and consumer confidence. As a consequence, growth forecasts have already been revised down. This comes at a time when the eurozone growth prospects, although still muted, had improved steadily during the past year, partly in response to European Central Bank monetary stimulus.

The US economic recovery appeared to be more sustained during the past year with consistent improvements in the labour market. This was despite a slowdown in the first quarter, which was viewed as temporary. The performance of the economy improved since then, but some negative spillovers from Brexit are expected. Despite sustained fiscal and monetary stimulus in Japan, economic growth was marginally positive.

While the past year was slightly more favourable for advanced economies, the same cannot be said for emerging markets, although there were divergent experiences. The growth slowdown in China continued, accompanied by increased volatility in domestic financial markets. This was partly in response to policy changes and persistent concerns regarding the stability of the financial sector. The slower growth continued to impact negatively on commodity prices, further complicating the outlook for commodity-producing emerging markets. More recently, the economy appears to have responded to renewed stimulus measures, and risks of a hard landing have abated. This has also helped to stabilise commodity prices. Both Brazil and Russia slid into recession during this period and continue to contract. By contrast, India experienced high growth following a number of structural reforms.

The slowdown in sub-Saharan Africa, in response to lower commodity prices and severe drought conditions in the southern part of the region in particular is of some concern. In its recent World Economic Outlook update, the IMF downgraded sub-Saharan growth for 2016 by 1,4 percentage points to 1,6 per cent. This follows a number of years of growth rates averaging around 5 per cent. The region has become a major export destination for South African manufactured goods, and a growth slowdown could impact negatively on these exports.

Global inflation has remained benign over the past year in response to weak global demand, declining oil and other commodity prices, and falling food prices. The downward trend in oil prices that began in mid-2014 continued amid a supply glut and weak demand. Prices have recovered somewhat from multi-year lows of below US$30 per barrel in January following supply disruptions in a number of countries and curtailment of investment and output in others. Although prices are expected to rise in the medium term, the trajectory is expected to be moderate, in line subdued global demand.

The second half of last year was dominated by speculation regarding the timing and speed of US monetary policy normalisation. This uncertainty continued to contribute to global financial market volatility as perceptions kept changing. Once it became clear that the first move was likely to be in December, attention became focused on the timing of the next moves. However, uncertainties regarding the state of the US labour markets, low inflation and heightened global risks led the US Fed to take a cautious approach, and no further tightening transpired. More recently, in the wake of the Brexit decision, market expectations of US interest rates have been scaled down significantly.

Whereas the UK had previously been expected to be one of the first of the advanced economies to raise policy rates, disappointing growth outcomes and low inflation meant an unchanged policy stance during the past year. Following the Brexit vote, there are now expectations that policy will be loosened in the near future. Monetary policies in the eurozone and Japan remained accommodative during the past year, and are expected to persist for some time.

The changing expectations of US monetary policy in particular has had implications for the pattern of global capital flows. The delay in normalisation and global search for yield has seen a resumption of capital flows to emerging markets, reversing the negative trend observed during the second half of 2015.

The rand exchange rate has been sensitive to these developments, with elevated levels of volatility. Since the time of the previous AGM the rand depreciated on a trade-weighted basis by about 8,5 per cent. However, it traded in a wide range of between R12,70 and R16,90 against the US dollar. This volatility was not only externally generated: domestic developments, including the fallout from the political events in December last year; the risks of a sovereign ratings downgrade; the wide current account deficit and the declining growth were important contributors to these trends. Whereas a downgrade was avoided in June, similar concerns are likely to re-emerge later in the year when the next reviews are scheduled.

The domestic economy was characterised by a persistent slowdown during the past year, driven by weak consumption and investment expenditure growth. The agricultural sector was particularly hard hit by the worsening drought. The economy grew by 1,3 per cent in 2015, and the outlook for the economy remains constrained, particularly following the contraction of 1,2 per cent experienced in the first quarter of this year. Nevertheless we expect that to have been the low point of the current growth cycle. The Bank forecasts economic growth of zero per cent in 2016, rising to 1,1 per cent, and 1,5 per cent in the coming two years. These growth rates are insufficient to make significant inroads into the deteriorating unemployment numbers. The direct effect of the Brexit decision on domestic growth is expected to be marginal in the short term, while the longer term impacts will depend on the outcome of the negotiations and the impact on global growth generally.

Inflation averaged 4,6 per cent in 2015, and was within the target range in each month of the year, reaching a low point of 3,9 per cent in February. A large part of this favourable trend was driven by a temporary respite from lower international oil prices. Since January 2016, however, inflation has breached the upper end of the target range, and is expected to remain above target until the third quarter of next year. In the absence of domestic demand pressures, these adverse inflation trends have been driven primarily by supply side factors. These include the exchange rate, drought-induced food price increases, and a reversal of the favourable oil price shock.

In response to these inflation pressures, the Monetary Policy Committee continued with its moderate tightening cycle that began in January 2014. Since July 2015 the repo rate increased by a cumulative 125 basis point, to 7,0 per cent in March 2016. The combination of a steady downward growth trend with upside risks to inflation compounded the dilemma facing monetary policy. At the last two MPC meetings, in May and July, moderate improvements in the inflation outlook and a moderation of the upside risks to the inflation outlook gave the MPC room to pause in the interest rate cycle. The MPC emphasised the continued data-dependence of future moves, as the factors that gave rise to the moderation of these risks could reverse very quickly. Although the MPC remains ready to respond to renewed inflation pressures, it remains mindful of the weak state of the economy and will continue to support the economy to the extent possible within its flexible inflation targeting remit.

The expanded mandate of the Bank gives it responsibility for financial stability and this has been a key focus area during the past year. The Financial Sector Regulation Bill has been tabled in parliament, and it is expected to be promulgated during this year. The Bill assigns responsibility to the Bank to protect and enhance financial stability. The proposed Prudential Authority is taking shape, but pending finalisation of the legislative framework. This process has already had significant resource implications for the Bank. At the microprudential level there has been the successful resolution of the African Bank curatorship, and the creation of the “good bank” which commenced operations in April 2016. The domestic banking system remains sound and well capitalised.

Whilst the Bank is an institution not driven by profit, the strength of the financial position of the Bank is important for its independence. I am pleased to report that the Group continued to be profitable in this past financial year. The Group recorded an after-tax profit of R1,58 billion compared with a profit of R0,63 billion in the previous financial year. The bulk of the profit is attributable to the Bank with an after tax profit of R1,51 billion, up from R0.34 billion in the previous year. This improvement in the financial position of the Bank was attributable mainly to the increase in accommodation to banks and unrealised profits due to declining global bond yields and the depreciation of the rand against major currencies. The depreciation increased the rand value of the interest earned from investing the country’s foreign-exchange reserves. Operating costs declined due to a reduction in the banknote order which lowered the cost of new currency. This decline was partly offset by higher staff costs. As we have emphasised in the past, the Bank does not have a profit-maximising objective and its operations are conducted in the broader interests of the country, in pursuit of its mandate and responsibilities. Nevertheless, we will continue to implement strict internal financial controls to ensure economy and efficiency of the Bank’s operations.