South African Reserve Bank

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Economic prospects for 2017

1. Introduction

Good afternoon, ladies and gentlemen.

And to the co-hosts of this networking lunch, allow me to express my gratitude for creating the opportunity for us to interact today. It is not often that I find myself in the Eastern Cape, addressing a business gathering such as this one.

I was intrigued to learn a few things about this city, such as the fact that it is home to the only dodo egg in existence and that a remarkable number of our national sports heroes hail from here. The German influence is also quite evident, as reflected by some of the names given to the suburbs and surrounding towns, such as Berlin and Hamburg.

Today I would like to engage you on economic developments and some of the main themes which I believe will shape the year ahead for the global and domestic economy. But before I do that, I would like to briefly touch on conditions in this region.

2. Economic situation and developments in the Eastern Cape

The Eastern Cape, also known as the Adventure Province and the Province of Possibilities, is an important contributor to South Africa's economic fortunes. The province is home to around 12 per cent of South Africa's population and makes up around 8 per cent of South Africa's GDP[1], making it the fourth-largest contributor to GDP.[2] The Eastern Cape economy is characterised by the dominance of the secondary and tertiary sectors, with the manufacturing industry accounting for almost 14 per cent of the province's GDP, while trade and finance contribute approximately 20 per cent each. The automotive sector is an important contributor to manufacturing, accounting for 30 per cent of manufacturing employment and 32 per cent of manufacturing gross value added, generating 51 per cent of the country's motor exports and producing half of South Africa's passenger vehicles.[3]

Unfortunately, the latest growth statistics for the province are disappointing. On a quarter-on-quarter basis, the national economy expanded by an annualised rate of 0,2 per cent in the third quarter while the Eastern Cape economy contracted by 0,3 per cent. On a year-on-year basis, the South African economy grew by 0,7 per cent while the Eastern Cape economy grew by 0,6 per cent.[4]

Comparing the Eastern Cape to other regions, the province has experienced one of the lowest growth rates in recent years. The decline in its economic activity can mainly be attributed to the manufacturing and trade sectors. This slowdown has mimicked the trend in the national economy, which witnessed a contraction in the manufacturing sector of 3,2 per cent quarter on quarter in the third quarter of 2016 compared to the 8,1 per cent quarter-on-quarter expansion in the previous quarter.

[1] gross domestic product
[2] Eastern Cape Department of Economic Development, Environmental Affairs and Tourism
[3] Province of the Eastern Cape website, www.dedea.gov.za
[4] Eastern Cape Socio Economic Consultative Council, *Provincial economic growth*, December 2016

The latest unemployment statistics from the Quarterly Labour Force Survey show that the number of people employed in the Eastern Cape grew by 5 000 over the fourth quarter of 2016. At the same time, the number of job seekers grew by 9 000, thus resulting in a slight increase in the unemployment rate: it rose by 0,2 of a percentage point to 28,4 per cent in the fourth quarter of 2016 from the third quarter of 2016. Unemployment in the Eastern Cape is thus above the national unemployment rate of 26,5 per cent, which in itself is unacceptably high. Youth unemployment is even higher, with the national figure at 35,6 per cent. And considering that the Eastern Cape is said to have the lowest absorption rate of just over 30 per cent, this means that the challenges in finding a job for the youth in the province are even more daunting. I was, however, very interested to read about the success of the East London industrial zone, which has grown rapidly in the past two years to now account for almost 3 500 direct manufacturing and services jobs, at a time when the manufacturing sector has been struggling considerably. We need more initiatives of this nature to address the unemployment problem in this province.

Of promise are the processes put in place by national government to revive rural economies. Here, for example, I refer to the investment programmes in Special Economic Zones and Agri-Parks as well as the training initiatives underway for the youth in the Eastern Cape. The province has also been a strong beneficiary of investment in renewable projects. The Coega Development Corporation has an optimistic outlook for the province in terms of investment, with investment growth expected to reach an estimated R44,6 billion in 2020. Furthermore, the establishment of the Beijing Automobile International Corporation automobile manufacturing plant and other major investment projects within the Coega Industrial Development Zone bodes well for the province.

However, much more needs to be done to sustainably raise growth in the Province of Possibilities. The Coega Development Corporation predicts that the province's economy should perform better going forward, but it is expected to reach a rate of only 2,3 per cent by 2020[5].

[5] *The Eastern Cape socio-economic analysis and forecast 2016*, A Coega Development Corporation Publication

3. Themes that shaped the global economy in 2016

At the beginning of 2016, the International Monetary Fund (IMF) forecast that global economic activity would increase by 3,4 per cent for the year, with advanced economies projected to grow by 2,1 per cent and emerging market and developing economies (EMDEs) by 4,3 per cent.[6] Fast-forward to a year later and the actual outcomes have been weaker, with the projection for 2016 global growth now lowered to 3,1 per cent, advanced economies downgraded to 1,6 per cent and EMDEs to 4,1 per cent.

A number of themes and events shaped the economic and financial market landscape during 2016, and I would like to briefly touch on a few of these.

At the start of the year, one of the key risks was that of a possible hard landing in China. There were concerns around whether China would achieve an orderly rebalancing of its economy towards domestic consumption and away from export-driven growth while at the same time dealing with rising financial imbalances and concerns about a potential property bubble bursting. While these risks have not disappeared, they did not materialise as feared and, thus far, Chinese authorities seem to have managed to continue supporting economic activity while navigating the complex transition. China's economy has undergone a structural shift, where consumption's share of GDP has increased to over 50 per cent from just over 35 per cent in 2012. Although China's rebalancing has been negative for commodity exporters, one cannot deny that, in the long term, it could open a path towards more sustainable and balanced growth, and if successful in dealing with domestic challenges, China could contribute to reviving global optimism. It is interesting to note that, in January 2016, the IMF forecast for China's growth for 2016 was 6,3 per cent; this number has since been revised to 6,7 per cent.

[6] International Monetary Fund, *World Economic Outlook Update: Subdued Growth, Diminished Prospects, Action Needed*, January 2016

The UK[7] referendum was the next major event, where the outcome was somewhat of a surprise. The decision to leave the European Union (also known as Brexit) prompted a strong negative reaction from UK financial markets, at least initially. In other parts of the world, financial markets took the news in their stride, bar a few knee-jerk reactions. I would agree with the sentiments that this muted global reaction to Brexit is testament to the much-strengthened financial systems in the aftermath of the latest global financial crisis, although one cannot discount the actions of the advanced economy central banks who stepped in and offered liquidity support to financial markets at the time. Although the initial fallout from Brexit was relatively well-contained, going forward, as the rules of engagement are defined and the terms of the divorce are hammered out, not only will the implications for the UK become clearer, but Brexit will also be a key factor moulding Europe's economic, financial as well as political landscape.

The final major event of 2016 was the outcome of the US[8] presidential elections, once again largely unexpected. Many consider this outcome to be a reflection of the backlash against globalisation, and there is a concern that, over the course of 2017, elections in some of the key advanced countries could move in the same direction. Popular opinion has shifted towards a negative narrative, where globalisation is said to be creating unfair competition from foreign firms and labour, with the result that countries are increasingly turning inward.

Nonetheless, financial markets have shown resilience against a weak global backdrop. In 2016, we witnessed a historic rally in bonds, in the process raising some concerns over frothy valuations. Corporate bonds also benefitted from the decline in sovereign bond yields. And while it was a mixed bag with regard to currencies, the uncertainty and downside risks from the Brexit decision were certainly reflected in the exchange rate of the British pound. In general, however, the US dollar gained ground on expectations of a higher policy rate. EMDEs regained their allure as emerging market currencies were among the best performers across foreign exchange markets. Commodity prices also recovered from their lows. Finally,

[7] United Kingdom
[8] United States of America

concerns around the risk of US policy normalisation possibly causing some dislocation in financial markets also turned out to be misplaced.

All in all, 2016 was a tough year, but one that was better than most of us had feared it would be.

4. A global economy that is expected to turn the corner in 2017[9]

The latest IMF *World Economic Outlook (WEO)*[10] projects a pickup in economic activity over the next two years, driven by EMDEs which are growing at well above the world average. Global growth for 2016 has been estimated at 3,1 per cent and is projected to increase to 3,4 per cent and 3,6 per cent in 2017 and 2018 respectively.

It is expected that advanced economies will experience a lift in activity from an estimated 1,6 per cent in 2016 to 2,0 per cent in 2018. The US in particular is projected to grow by 2,3 per cent in 2017 and 2,5 per cent in 2018, from an estimated 1,6 per cent in 2016. Much of this pickup in growth is premised on expectations of fiscal stimulus, tax reforms as well as cuts in both personal and corporate marginal tax rates. Incentives to repatriate corporate profits held abroad are also likely. However, the timing as well as the actual size and mechanics of the fiscal stimulus are highly uncertain at this stage and implementation may take time. It is largely expected that the net stimulus will only take effect by 2018. On the other hand, trade policies and immigration reforms could offset these effects while there could also be a potential drag from a stronger dollar and higher longer-term interest rates.

Euro area growth is set to remain steady at 1,6 per cent in both 2017 and 2018. The European Central Bank will be slowing its purchases of bonds from April, and while monetary policy is set to remain accommodative, the decision to slow quantitative easing has already seen the trend towards increasing negative yielding debt reverse, such that more recent numbers point to a deceleration from around US$13 trillion in

[9] Unless indicated otherwise, all the forecasts in this section are taken from the International Monetary Fund *World Economic Outlook Update* of January 2017.
[10] International Monetary Fund, *A shifting global economic landscape*, January 2017

2016 to US$9 trillion more recently. Fiscal authorities appear to be increasingly open to providing fiscal support and implementing structural reforms. However, the potential banking problems in Italy and the rising political risks associated with a number of upcoming elections, including in Germany and France, will likely weigh in. In the UK, the economy has so far proved relatively resilient against Brexit risks, but this is unlikely to be the case going forward; indeed growth is projected to slow from 2,0 per cent in 2016 to 1,4 per cent in 2018. The UK growth forecast for 2017 was revised up by 0,4 per cent in the latest *WEO Update*, to 1,5 per cent.

By all accounts, the deflation fears which once gripped the advanced world, apart from Japan, seem to be abating. This is partly due to the increase in oil prices following the agreement among OPEC[11] members and several other major producers to limit supply.

Emerging markets are set to accelerate from an estimated growth of 4,1 per cent in 2016 to 4,8 per cent in 2018. As the IMF points out, this projection largely reflects a gradual normalization of conditions in a number of large economies that are currently experiencing macroeconomic strains. China is expected to grow by 6,5 per cent in 2017, as a policy bias of easy fiscal policy and accommodative monetary policy is expected to remain in place. However, the rapid expansion of credit, combined with insufficient progress in addressing corporate debt, raises the risk of a sharper slowdown or a disruptive adjustment. India is forecast to grow by 7,2 per cent in 2017, although this forecast was trimmed somewhat due to the government's decision to demonetise almost 90 per cent of the currency in circulation. This move induced a temporary negative consumption shock owing to cash shortages and payment disruptions. Both Brazil and Russia are expected to return to positive growth in 2017.

So while the global economy is expected to turn the corner this year, there are a number of risks that warrant attention. These include the possible shift towards inward-looking policies, the continued threat of a potentially severe slowdown in China, greater protectionism, a sharper-than-expected tightening in global financial

[11] Organization of the Petroleum Exporting Countries

conditions (as monetary policy in advanced economies is expected to be less accommodative going forward), and increased geopolitical tensions related to the rise of populism; and Brexit, amongst others. As much as a fiscal stimulus from advanced economies should be positive, the change to a less accommodative monetary policy stance in advanced economies, in particular the US, combined with a stronger US dollar, can have adverse consequences for emerging markets, including accelerating capital outflows and putting the rebound in emerging market economies in jeopardy. However, having said this, it is also true that emerging markets are more resilient than before as macroeconomic fundamentals have improved considerably and vulnerabilities have declined.

5. A domestic economy that is expected to recover in 2017

The domestic economy recovered from negative growth in 2009 to grow at 3,0 per cent in 2010 but slowed to 1,3 per cent in 2015. The challenges mounted such that, at the beginning of 2016, the South African Reserve Bank projected growth of 1,5 per cent for 2016. Some months later, the forecast was lowered to no growth at all. This more pessimistic outlook came on the back of continued disappointing growth outcomes as a result of a severe drought affecting the agricultural and manufacturing sectors, negative growth in the mining sector and a weaker-than-expected global backdrop, combined with political developments affecting business and consumer confidence. Subsequently, however, growth forecasts were revised higher to 0,4 per cent as the second quarter of 2016 delivered a positive growth surprise. This acceleration in growth was short-lived, however, as the third quarter witnessed a slowdown to 0,2 per cent.

The primary sector, which had experienced sustained contractions since the second quarter of 2015, saw a real production increase in the second and third quarters of 2016, although this recovery lost momentum in the third quarter. Agricultural production logged seven consecutive quarters of contraction as it continues to recover from a historically severe drought. The manufacturing sector has been very volatile, contracting by 3,2 per cent in the third quarter after growing by 8,1 per cent in the second quarter. The contraction was broad-based as this sector has been hampered by weak global and domestic demand, rising input costs and low business confidence. The construction sector is also under stress, while both retail trade sales and domestic new vehicle sales have continued their negative trend.

The employment outlook remains bleak – not surprising given the poor economic situation. The official unemployment rate stood at 26,5 per cent in the fourth quarter of 2016 – down from 27,3 per cent in the third quarter but still about 2 percentage points higher than a year ago.

Recent data suggest some downside risks to the 2016 economic growth forecast, such as a continued decline in business and consumer confidence as well as the contraction in mining output during both October and November. And while the Barclays Purchasing Managers' Index increased to just above 50 in January 2017, it had been in negative territory for five consecutive months.

Looking ahead, the most recent growth forecasts of the South African Reserve Bank suggest growth of 1,1 per cent in 2017 and 1,6 per cent in 2018. However, it should be noted that the recent monthly data for the fourth quarter suggest that there may be a downside risk to these forecasts.

It is clear that the deceleration in the South African economy has underlying structural causes. The economy's estimated potential growth rate has been revised downwards to approximately 1,4 per cent. Restoring growth rates to historical averages will require structural reforms, without which the economy is expected to expand at rates of between 1,0 and 2,0 per cent for the foreseeable future, generating little or no improvement in either employment or individual living standards – particularly when considered in the context of the 1,5 per cent annual population growth over the past decade. What is required is an increased focus on reforms in product and labour markets, an environment more conducive to increasing investment levels (particularly in the private sector), and better-quality education outcomes which are more consistent with the future needs of the economy. Ensuring better delivery by state-owned enterprises is also critical given the important role that these entities play in providing the infrastructure to support growth in the economy.

It is well known that South Africa has endured an environment of high inflation and low growth, a situation presenting a challenge to monetary policy authorities. The main priority for the South African Reserve Bank is price stability in the interest of balanced and sustainable growth. Faced with this situation, the Monetary Policy Committee (MPC) has increased the repurchase rate gradually since January 2014, by a total of 200 basis points, to the current level of 7,0 per cent. This hiking cycle was more gradual when compared to previous hiking cycles, responding to a more uncertain and volatile policy environment which, given the weakening growth outcomes, at times required the MPC to pause and carefully evaluate incoming data to inform future monetary policy moves.

During 2016, there was some upward pressure on consumer prices as these generally remained above the upper end of the 3-6 per cent inflation target range throughout the year. These upward pressures emanated from food price inflation, which increased by close to 12,0 per cent in the final quarter of 2016, the highest increase since 2009 when prices increased in excess of 15 per cent. The upward pressure on food inflation was mainly as a result of the severe drought experienced. The exchange rate of the rand also recorded substantial depreciations at times, such as that which occurred in December 2015 and January 2016, exacerbating the inflation outlook. Underlying inflation, as measured by core inflation (which excludes food, fuel and electricity), is at seven-year highs, which reflects some pass-through from a prolonged period of currency depreciation and pricing behaviour in product and labour markets.

The near-term outlook for inflation shows that prices are likely to remain elevated. The latest inflation forecast of the South African Reserve Bank shows that headline inflation may only return to within the target range during the final quarter of 2017, average 6,2 per cent for this year, and decelerate to 5,5 per cent in 2018. This forecast represents a deterioration from the previous MPC forecast of November 2016 and is mainly based on the assumption for higher international oil prices which impact on the domestic fuel prices and more than offset the more favourable exchange rate assumption. By contrast, the forecast for core inflation remains unchanged, averaging 5,5 per cent and 5,2 per cent in 2017 and 2018 respectively.

In the most recent MPC statement, published last month, we noted that the inflation forecast is a cause for concern but that the main drivers of this deterioration are supply-side shocks, in particular oil and food prices. As the MPC has noted time and again, its approach is to look through the first-round effects of exogenous shocks but at the same time to exercise vigilance on the possible emergence of second-round effects which could require a policy response.

In this regard, while oil prices have now risen from their low levels, various supply-side factors are expected to constrain these prices. Assuming normal weather patterns, food inflation is likely to have peaked at 12,0 per cent towards the end of 2016 and should decline following good rainfall and subsequent declines in spot wheat and maize prices. However, some upward pressure will remain, originating from the lagged response of meat prices to drought conditions. The more favourable rand exchange rate bodes well and, barring any significant depreciation pressures, it should help to offset some of the inflationary pressures in the forecast horizon. Indeed, the rand has been resilient and has strengthened considerably, at times to levels below R13,00 to the US dollar more recently.

It is against this background that the most recent MPC deliberations retained the view that we may be near the end of the hiking cycle. However, should risks emerge of second-round effects that undermine the longer-term inflation outlook, there may be a reassessment of this view.

Before I conclude, allow me to make a few remarks about a topic that has generated much interest during the last week, namely the outcome of the Competition Commission’s investigation into unlawful collusive practices among certain financial institutions in foreign exchange trading involving the South African rand, predominantly in major international financial centres. The South African Reserve Bank views the allegations that have been referred to the Competition Tribunal for prosecution in a very serious light and is of the view that those found to have violated the law should accept full responsibility for their actions and be held accountable, and corrective measures should be implemented. It is also important, however, that we do not jump to conclusions and allow the steps now initiated to be completed following due process. A resolution of this matter, without undue delay or prolonged uncertainty, is in the interest of our financial markets and banking system, as the allegations also involve a number of large and systemically important South African banks.

6. Conclusion

In conclusion, we are hopeful that the global economy has reached a turning point, that growth will now accelerate on a more sustainable basis, and that the threat of deflation in advanced economies will subside. It is important that the levers of fiscal policy, structural reforms and monetary policy are engaged in the appropriate mix so as to underpin the recovery and make it sustainable. The current geopolitical risks will need to be managed carefully so as to not undermine the recovery.

No doubt, 2017 will have its own set of challenges. Top of mind here is the impact of the rising anti-globalisation and trade-protectionist rhetoric, the changing monetary-fiscal mix which may present some challenges as the markets adjust to tighter monetary policy in the US, uncertainty regarding the Brexit negotiations, and the actual reforms and stimulus to be implemented by the new US administration. The IMF also highlights that underlying vulnerabilities remain among some large emerging market economies, including high levels of foreign currency denominated corporate debt, declining profitability, weak balance sheets, and thin policy buffers.

Domestically, a more favourable global backdrop will certainly help. Having reached the lower turning point in terms of growth and medium-term inflation prospects having improved overall in recent times, it will be important for us to capitalise on these encouraging developments and complement them with confidence-enhancing measures while being mindful of the risks and addressing them in a systematic and structured manner.

South Africa is a small and open economy, exposed to many risks beyond its control. This makes it imperative that, through a collaborative national effort, we do not get wrong that which is well within our control.

Thank you for your attention.