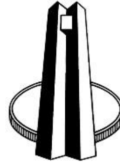

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at the SwissCham Southern Africa General Assembly

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Recent developments in South Africa: has the country turned for the better?

Introduction

Good evening, ladies and gentlemen, and thank you for the opportunity to address you tonight.

Switzerland and South Africa have close economic ties, and there are numerous opportunities to improve and expand on these.

The outlook for the South African economy has improved significantly over the past few months. Recent political developments have generated renewed business and consumer confidence, and investment prospects have been enhanced considerably.

However, a number of domestic challenges remain, and the global environment, while favourable, is becoming more volatile and increasingly unpredictable. From the perspective of the South African Reserve Bank (SARB), inflation appears to be under control, but there are incipient risks.

In my remarks this evening, I will highlight some of these domestic and global developments, and how we see them impacting on the South African growth and inflation outlook.

The South African political and economic landscape

The political and economic landscape in South Africa has changed remarkably since December 2017. At that time, both business and consumer confidence were at alarmingly low levels, and the economic growth outlook was very weak. Standard & Poor's had recently downgraded the country's local-currency debt rating to sub-investment grade, while Moody's[1] had placed the country on review for a downgrade to sub-investment grade. The rand exchange rate was trading at around R14.20 against the US dollar in the face of increased portfolio capital outflows. Long-term bond yields were at around 9.5% and risk premiums were elevated. The *Medium Term Budget Policy Statement* of October 2017 had signalled a departure from the fiscal consolidation path, contributing to these unfavourable conditions. Overshadowing this environment was the high degree of uncertainty regarding the outcome of the African National Congress (ANC) leadership electoral conference in mid-December.

Let us fast-forward four months or so to 2018. The ANC leadership outcome was well received, followed by a Cabinet reshuffle that contributed to restoring economic confidence and growth. The national Budget tabled in February reaffirmed government's commitment to the fiscal consolidation path, a move which has gone some way in restoring confidence in the country's commitment to sustainable public finances. There has also been a positive response to the new President's commitment and actions to start rooting out corruption in various spheres of society, particularly in government and state-owned enterprises.

Business confidence indicators improved, with the 'Expected business conditions' category in the Absa Purchasing Managers' Index surging in February to its highest level since 2001. Similarly, the FNB/BER[2] Consumer Confidence Index reached an all-time high in the first quarter of this year. Moody's affirmed the country's investment grade rating and changed the negative outlook to stable, preventing South Africa from falling out of the Citibank World Government Bond Index, an event that could have precipitated large-scale selling of South African government bonds by non-residents.

[1] Moody's Investors Service
[2] First National Bank / Bureau for Economic Research

The rand is currently trading at around R12.50 against the US dollar, after having appreciated to a low of around R11.60 in late February. There has been a resurgence of capital inflows against the emerging market trend, while credit default swap spreads have narrowed by over 50 basis points.

Economic growth outcomes surprised on the upside in the fourth quarter of 2017, and the growth outlook has improved. The key question is: is South Africa finally on the road to a sustained recovery? Furthermore, are these developments 'real' rather than just a reflection of ephemeral euphoria?

It has been a very positive start, and no doubt an important turning point for the country. But it is too early to declare that we are on a new growth trajectory. Most of the economic growth forecasts have been revised upwards, with the latest Reuters consensus forecasts expecting growth of 1.6% and 1.9% for 2018 and 2019 respectively, up by almost 0.5 percentage points since November last year, and a forecast of 2.3% for 2020. The SARB's growth forecast for 2018 has been revised upwards from 1.2% in November to 1.7% in March. Our model predicts a slight moderation to 1.5% in 2019 due to tax effects, but reaching 2.0% in 2020. The Monetary Policy Committee's (MPC) assessment is that the risks to these forecasts are on the upside.

The improved outlook is based, together with upward revisions to past economic data, on the strong improvement in confidence. Recent research conducted at the SARB[3] suggests that the collapse in levels of confidence in the past few years had shaved off around one percentage point from growth in both 2015 and 2016. In a similar vein, the National Treasury estimates that the rebound in confidence could add 0.4 percentage points to potential output. But a cyclical recovery based on a rebound in confidence, however welcome, is not enough. Raising potential output significantly and in a sustained way requires not just a commitment to structural reforms, but actual implementation. This should go hand in hand with increased fixed capital formation.

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[3] Theo Janse van Rensburg and Erik Visser (2017). 'Decoupling from global growth – is confidence becoming a scarce commodity?' *South African Reserve Bank Occasional Bulletin of Economic Notes*, October.

Underlying the subdued growth performance of the South African economy has been the weak trend in gross fixed capital formation, particularly by the private sector. Following two years of annual contractions, private-sector fixed capital formation grew by 1.2% in 2017 and by 9.9% in the final quarter of the year, mainly due to expenditure on transport equipment and machinery. It is still too early to tell whether this unexpected increase is the beginning of a positive trend. However, we do need to reverse the downward trend in the ratio of gross fixed capital formation to gross domestic product (GDP), which had declined to 18.7% in 2017, down from a peak of 23.5% in 2008. This is some way off the 25% target set in the National Development Plan.

The South African government has committed itself to a range of structural reforms, many of which are contained in the National Development Plan, which remains a 'living' document. Some of the necessary interventions require longer time frames, for example fixing the education system and ensuring broader skills development. However, a number of selected reforms have been identified as the so-called 'low-hanging fruit' – these could be implemented relatively quickly and yield high returns. According to the National Treasury, these reforms could increase potential output by two to three percentage points from the current estimate of 1.5%. Telecommunications reforms, which would entail the much-needed release of additional broadband spectrum, could add an additional 0.6 percentage points to potential output. Other reforms include lowering barriers to entry by addressing anti-competitive practices, transport sector reforms, and prioritising labour-intensive sectors such as agriculture and tourism.

In addition, there are reports of significant pent-up private-sector investment which has been waiting for increased policy certainty. A notable sector is mining, which has not seen any investment of significance for a number of years. Regulatory and policy uncertainty, coupled with disagreement around the new Mining Charter, has undermined one of the key sectors in the South African economy. According to the Chamber of Mines, the resolution of these issues could unlock a significant amount of investment capital.

Government has also expressed commitment to addressing the problems of poor governance at some of the major state-owned enterprises. In turn, these issues have resulted in costs borne by the broader economy and ultimately consumers. Governance issues are also of great concern to foreign investors, particularly those who already hold, or are considering buying, bonds of these corporations. The fragile state of Eskom's finances has potential fiscal consequences. All these issues need to be sorted out and have been identified as priorities. A start was made when the boards of some of these companies were changed and when audits of previous procurement decisions were conducted. Much work still needs to be done at the operational level to improve efficiencies and reduce costs. These corporations cannot simply rely on unsustainable tariff increases, as in the case of Eskom, or on further government bailouts, as in the case of South African Airways.

The role of the South African Reserve Bank

Achieving higher potential output growth is not within the power of the central bank. The SARB can, however, contribute to an improved environment in a number of ways. For some time, ratings agencies and investors identified South Africa's institutional strength as one of the stand-out features of its economy. The past few years have seen a steady erosion of some of our key institutions. Fortunately, there is now renewed focus on reversing this negative trend. In fact, this renewed focus is part of the reason forwarded by Moody's for retaining the country's investment grade rating. The SARB, specifically its independence coupled with its mandate on price and financial stability, is seen as an important part of the institutional strength of the country. We have vigorously and successfully defended attempts to undermine our independence and integrity, and we will continue to do so.

The SARB's longer-term role, as set out in the South African Constitution, is to achieve price stability in the interest of balanced and sustainable economic growth. As we have emphasised on numerous occasions, interest rate policy is not the appropriate policy lever to achieve higher potential output. However, lower inflation brings about lower nominal interest rates, and because of lower risk premiums, real rates can decline as well.

Low inflation also creates an environment that is more conducive for making investment decisions, which is essential for growth. Furthermore, a low-inflation environment protects the poor in particular; they are least able to protect themselves against the ravages of high inflation.

Although the SARB's key objective is price stability, we have explicitly adopted a flexible inflation-targeting framework, which implies that we are sensitive to the impact of any policy actions on cyclical growth. Our approach also recognises the importance of distinguishing between demand and supply shocks. In the event of significant exogenous supply-side shocks, we generally try to look through the first-round effects of these shocks and focus instead on how these shocks feed through to higher inflation expectations as well as higher wage and price setting.

At the same time, however, we recognise the importance of inflation expectations declining to lower levels. Unless the wage and price setters in the economy adjust their expectations lower, wage and price setting will be at higher levels, creating a self-fulfilling outcome of higher inflation. We would prefer to see inflation expectations anchored closer to the midpoint of the inflation target range of 3-6%.

Recent inflation developments have been generally favourable. Headline consumer price index (CPI) inflation moderated to 3.8% in March, its lowest level since early 2011. However, this benign environment is not expected to continue as the expectation is that the most recent reading was the low point in the current inflation cycle due to a combination of base effects and tax increases (including the VAT[4] and fuel levy increases) is expected to confirm that the most recent reading was the low point of the current inflation cycle. The SARB's most recent forecast was for inflation to average 4.9% this year, and 5.2% and 5.1% in the next two years respectively. So while headline inflation is currently well below the midpoint of the target range, the longer-term outlook is slightly above 5%.

[4] value-added tax

There are admittedly a number of other positive developments. First, core inflation (i.e. headline inflation excluding food, fuel and electricity) is more benign, indicative of subdued underlying demand pressures in the economy. Core inflation measured 4.1% in March and is forecast to average 4.6% this year and 4.9% in both 2019 and 2020.

Second, there has been a welcome decline in inflation expectations, as reflected in the survey conducted by the BER. For some time, these expectations had been stuck at around the upper end of the target range. In the most recent BER survey, however, the average declined by half a percentage point to 5.2% and 5.3% for 2018 and 2019 respectively. Similarly, the five-year-ahead inflation expectations declined to 5.3%, their lowest since they were first surveyed in 2011.

The SARB recognises, however, that one reading does not constitute a trend, and we would need to see further declines, or at least a stabilisation at these recent levels, to feel confident that inflation expectations have fallen on a sustained basis. Furthermore, to the extent that inflation expectations are backward-looking, it could take some time for these expectations to move to lower levels, particularly if actual inflation is expected to trend upwards from here on. In other words, it is too early to declare victory in our quest to anchor inflation expectations closer to the midpoint of the target range.

This improved inflation environment has contributed to a sounder macroeconomic environment, one where earnings are not eroded at an excessively fast rate. It has also afforded some room for monetary policy to remain accommodative for now and help foster improved economic growth. At the most recent MPC meeting, the repurchase rate (repo rate) was reduced by 25 basis points to 6.5%. With medium-term inflation expectations at just over 5%, this implies a real repo rate of around 1.5% compared with the SARB model's estimate of the current neutral rate of around 2%.

The MPC's assessment at that time was that the risks to the inflation outlook were more or less balanced. In its deliberations, most of the upside risks emanated from external sources. These risks are transmitted to the economy via the exchange rate and, by extension, to the risks to inflation.

As an inflation-targeting central bank, the SARB does not target the exchange rate but rather focuses on the second-round effects of exchange rate changes (in both directions) on the inflation outlook.

This implies that our assessment of the risks to the rand is an important, although certainly not the only, determinant of how we see the inflation trajectory going forward. At the March 2018 MPC meeting, when the rand was trading at around R11.80 against the US dollar, the exchange rate was assessed to be somewhat overvalued, and we viewed further appreciation potential to be somewhat limited. Since then, this view has been reinforced by a number of global developments that have clouded the outlook.

The global outlook and risks

For some time now, the global context has been relatively supportive and benign. Global growth has been picking up in a steady but synchronised manner, and global inflation has remained low, allowing monetary policies in the advanced economies to remain broadly accommodative. This environment, together with unusually low financial market volatility, has contributed to the continued strong capital flows to emerging markets.

There are, however, a number of indications that this Goldilocks period is probably over. Financial market volatility has re-emerged. Some investors appear concerned about potential upside inflation surprises in the US, which could usher in a considerably faster pace of normalisation than the one currently being signalled by the US Federal Reserve (Fed). Furthermore, fiscal expansion in the US could place additional upward pressure on both US short- and long-term interest rates, with negative spill-over effects on most emerging market currencies and bonds.

Additional risks to many emerging-market assets stem from the recent rise in oil prices and international trade tensions. The recent increases were underpinned by OPEC's[5] resolve to continue restraining supply in order to support prices. It is too early to tell whether the US shale oil producers, as the new swing producers in the market, will

[5] Organization of Petroleum Exporting Countries

respond in a meaningful way and either cap or moderate these increases. And while the trade conflict seemingly developing between the US and China is perhaps best described (for now) as a skirmish, it could easily develop into a larger-scale trade war. Any broader retreat from a multilateral, rules based global trade system would not leave emerging markets unscathed. Global value chains would be affected, while reduced risk appetite could undermine cross-border capital flows.

I should note that while these recent developments are likely to create challenges for South Africa and emerging markets in general, not all emerging market economies are equally vulnerable to higher advanced economy interest rates. In fact, it is generally accepted that most have become more resilient since the so-called 'taper tantrum' of 2013. Their macroeconomic fundamentals have generally improved, their real policy rates are generally higher, and their current account and fiscal deficits have narrowed. Inflation is within target in most of the inflation-targeting emerging markets.

In South Africa's case, our current account deficit has narrowed from its widest level of almost 6% of GDP in 2013 to 2.5% of GDP in 2017, while growth prospects have improved and positive policy signals should reduce the risk premium investors require in domestic assets. In that respect, we are encouraged that the recent weakening of the rand (from relatively strong levels) seemed more a reflection of dollar strength rather than idiosyncratic factors.

Conclusion

In the context of a supportive global environment, a strong financial sector and recent developments that reinforce the strength of South African institutions, our assessment is that South Africa's investment case remains compelling. The South African outlook is currently far better than has been the case for some time now. Enormous potential can be unlocked by further reforms and improved policy coordination, which will open up numerous investment opportunities for foreign investors in the country. In addition, Government remains committed to improving the investment climate, as highlighted in the Presidency announcement of our intention to host an investment conference around September 2018. As the South African Reserve Bank we support this through

ensuring a prudent and transparent policy approach which is consistent with our constitutional mandate.

I have no doubt that the trade and investment ties between Switzerland and South Africa can improve even further. SwissCham Southern Africa has been playing an important role in fostering these ties, and I wish you all the best in promoting trade and investment in our country.

Thank you.