South African Reserve Bank

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South Africa's adjustment path

Good morning, ladies and gentlemen.

Thank you for the opportunity to share a few thoughts with you today.

Last year, we had a Goldilocks global economy. Inflation started picking up in the advanced economies, and in emerging markets, it was generally in line with targets. Growth was stronger, but without much evidence of overheating. Growth was also widely shared – most economies were accelerating. The world economy felt just right.

As you know, at the end of the Goldilocks story a family of bears comes home. Our Goldilocks tale has taken the same direction. The synchronisation of global growth has broken down this year, with the United States (US) surging ahead while other countries slow down. With unemployment at very low levels, the Federal Reserve has been raising rates, just as they told us they would. The combination of stronger US growth and higher rates has appreciated the dollar.

This combination of factors has posed challenges for emerging markets. It has interrupted capital flows and prompted wide-scale currency depreciation. Countries with substantial stocks of foreign-currency debt have seen their balance sheets deteriorate. Inflation pressures have generally intensified.

Unlike Goldilocks, however, most of us in emerging markets weren't caught napping when the bears showed up. We had frameworks in place to handle such challenges. In particular, most of us could rely on flexible exchange rates to absorb the initial shock. This works best when countries have avoided contracting excessive foreign-currency debt, as in the South African case. In these circumstances, the best thing one can do is to leave the foreign exchange markets to find its equilibrium.

It is well understood that currency depreciation creates inflationary pressures. But many emerging market countries have strong central banks who can deal with this problem. Given the credibility accumulated by these institutions, inflation expectations have stayed anchored in most emerging markets.[1] Emerging markets have also been buffered by substantial stocks of foreign exchange reserves. It is clear that most countries are vastly better positioned than they were during the 1997/98 crisis.

Certainly, a few countries have been sorely tested by events this year, and the International Monetary Fund has been called into action. Most emerging markets, however, should be able to get through without experiencing financial crises or crippling sudden stops.

The more difficult question is this: how will countries adjust to the ever-changing global circumstances, and what does this mean for their growth and development trajectories? Let me set out some challenges/difficulties.

First, a number of countries are running sizeable deficits on their fiscal and current accounts. Countries with larger deficits have tended to experience more currency depreciation this year, which speaks to their vulnerability to changing global financing conditions – especially higher interest rates. Reducing this vulnerability will require deficit reduction, as well as changes in the composition of spending that benefit long-run growth and therefore improve countries' future capacity to repay debt. This adjustment process is likely to be difficult, both for political economy reasons and because macroeconomic adjustment can hurt short-term growth, specifically via reduced demand or through import compression. Rebalancing is therefore inevitable….

[1] This point was made in the latest International Monetary Fund *World Economic Outlook*, chapter 3. See https://www.imf.org/en/Publications/WEO/Issues/2018/09/24/world-economic-outlook-october-2018#Chapter%203.

Second, there are pockets of prominent emerging market countries where growth has stalled. Looking back over the past two decades, the 2000s were an era of unprecedented growth for emerging markets. The share of economies converging on rich-country living standards also reached new highs, demonstrating that this was more than simply ‘a China story’ or ‘an India story’ – important though those countries are. This record of success survived the global financial crisis, but only by a few years. From approximately 2013, emerging markets began to slow steadily, and some experienced protracted recessions. Outside of Asia, the emerging market story is now largely about subdued growth, and some countries are talking about lost decades. We need to find a way back to growth.

The third problem follows when politics catch up with economics. In advanced economies and emerging markets alike, dissatisfaction with economic outcomes has generated political developments that would have been very unlikely, if not unthinkable, even half a decade ago. Sometimes these reactions have made things worse, or threaten to do so, creating a vicious circle of bad economic decisions and further political disaffection.

These problems – macroeconomic disequilibria, stalled growth and political feedback loops – add up to a difficult set of circumstances for the emerging markets. Today, I would like to talk about how we might navigate them. Given my brief, I am going to focus on South Africa’s experience and outlook, although I think that this framework is useful for thinking through the broader emerging market challenges.

Macroeconomic rebalancing

Since the 2013 ‘taper tantrum’, South Africa has undergone a substantial macroeconomic adjustment. In particular, the current account has narrowed from nearly 6% of gross domestic product (GDP) in 2013 to 2.4% last year. This change came largely from the trade account, which has registered surpluses in 8 of the past 10 quarters. Our services account has followed a similar trend, and is now roughly balanced.

By contrast, our income and current transfers account has remained in deficit. This is in part because of transfers to our neighbours in the Southern African Customs Union, amounting to roughly 1% of GDP annually. The balance reflects income payments, driven by high yield differentials on our foreign liabilities when compared with our foreign assets. A growing stock of sovereign debt held by foreigners has been an especially important contributor to these income payments. The overall income deficit stands at about 3% of GDP, of which close to 1.5 percentage points is coming from interest payments on sovereign debt.

The fiscal balance has changed less than the current account deficit, at least at a headline level. The latest *Medium Term Budget Policy Statement* indicates a fiscal deficit of 4% of GDP for the 2017/18 financial year. This is better than the 2012/13 figure of 5%, but it is still large – both in absolute terms and relative to previous projections. The change in the primary balance has been more dramatic, narrowing from 2.3% of GDP in 2013 to 1% in the latest financial year. But this number is still negative, so the debt stock is not yet stabilising.

As a central bank governor, I try not to say too much about fiscal policy – not least because I would like to reciprocate the courtesy that other authorities show us by respecting the independence of monetary policy. Let me therefore just reiterate three crucial points made by our Minister of Finance, Mr Tito Mboweni, in his recent address to Parliament.[2] To quote directly:

> We must choose a path that stabilises and reduces the national debt. We cannot continue to borrow at this rate.
>
> We must choose to reduce the structural deficit, especially the consistently high growth in the real public-sector wage bill. New fiscal anchors may be required to ensure sustainability, in addition to the expenditure ceiling.
>
> We must choose public-sector investment over consumption.

This is an extremely clear statement of intent to improve the fiscal balance, and to do so in a way that favours investment and is therefore good for longer-term growth. We are clearly well past the point where we could hope to crowd in investment simply by raising spending and boosting demand.

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[2] See http://www.treasury.gov.za/documents/mtbps/2018/speech/speech.pdf.

With rising long-term interest rates, credit rating downgrades and tax increases, the case for fiscal stimulus based purely on spending aggregates is well past its sell-by date. Government cannot keep on dissaving.

Ultimately, South Africa remains a low-saving economy. We can improve savings rates, especially through fiscal policy, but we are not going to be a high-saving economy for the foreseeable future. For this reason, we need to get to a position where we can safely and sustainably fund investment demand in excess of local savings. Instead of bemoaning a weak current account, we need to develop a strong capital account.

Getting there is likely to require larger capital inflows into equities and direct investment, and less into government bonds. One attraction of these investments is that when growth weakens, profits decline and outflows diminish, which keeps the current account under control in low points of the business cycle. Another, perhaps more critical, advantage is that these kinds of inflows help growth. Attracting investment of this nature is central to the President's growth vision, as was articulated most recently at the Investment Summit he had convened last week in Johannesburg. Reducing government's appetite for borrowing is a priority for our new Finance Minister.

To sum up this discussion: South Africa is still a country with significant twin deficits. They are smaller than they were in 2013, but they are still relatively large. Their scale is a source of vulnerability, as is their composition. Going forward, we need to reduce our fiscal deficits, and we need to ensure that our borrowing is more productive.

We are not saying we need to keep our current account deficit as small as possible. One does not come to an investor conference in New York to say that capital inflows are a source of vulnerability and that we don't want them. If I believed that, I wouldn't need to be here. Rather, we want to get to a position of capital account strength, in which South Africa attracts investment because it has good growth prospects and because it provides an institutional environment that gives investors security and predictability.

The challenge of stalled growth

South Africa's economy is likely to grow by just 0.7% this year. Earlier in the year, we expected growth to be meaningfully stronger. The SARB's March forecast was for 1.7% growth, and the MPC's assessment was that the risks to this forecast were to the upside. In the short term, those hopes have been disappointed.

More fundamentally, 2018 is likely to be our fifth consecutive year of negative per capita growth, given population growth of about 1.6%. These sorts of growth rates are well below our longer-run average of 3% or so, let alone the rates of above 5% targeted by the National Development Plan.

Some of the blame for this weak growth can probably be attributed to global factors, including the declines in commodity prices and weak growth in our traditional trading partners. However, domestic growth has remained subdued despite a cyclical upturn in the global economy. The South African economy has also failed to accelerate despite a large improvement in our terms of trade, which reached an all-time high late last year. This suggests that the causes of weak growth are chiefly domestic in nature.

Some degree of blame attaches to shocks like drought or strikes in specific sectors, but these cannot explain why growth has stayed low for several years. Instead, one of the primary causes of weak growth has been the severe decline in South African governance in recent years – a period of political decay which is only now coming to an end. This episode – known throughout South Africa as 'state capture' – involved a hollowing out of institutions and, in many cases, the looting of public resources for private gain. One of its many consequences was a large decline in business and consumer confidence. This, in turn, has contributed to investment stagnating over the past five years.

'State capture' has also been a major factor in our fiscal woes, both because it burdened the state with corrupt and fruitless expenditure, and also because it is seriously undermining its capacity to collect taxes. As the Commissions of Enquiry conclude their work we will draw lessons regarding vulnerabilities in our institutional and governance frameworks and work towards further strengthening of our institutions.

There are several reasons to expect better growth over the medium term. One is the backlog of investment I have just referred to: our investment levels are now under 20% of GDP, and it would make sense for firms to begin investing more, in the first instance simply to catch up with depreciation, now that the domestic environment has improved.

A second pro-growth factor is better household balance sheets. Unlike its emerging market peers, but like many advanced economies, South Africa had a housing boom in the mid-2000s. This has left households carrying a large debt stock – a burden which has been weighing on their ability to consume. However, households have achieved significant deleveraging since then, and the debt-to-income ratios are now back to 2006 levels and close to longer-term averages. Although it is very difficult to specify when we will pass the tipping point, we are probably close to, or even at the end of, the deleveraging cycle.

A third factor favouring growth is the scope for further reforms. We have already seen a great deal of energy and initiative from government around key issues such as raising employment and investment. As an economy, we are still a long way from the efficiency frontier in a range of areas, perhaps mostly in our network sectors. This, to mix metaphors, leaves an impressive amount of low-hanging fruit available, should we develop an interest in picking it.

Interactions between politics and economics

This brings me to my third and final topic: the interaction of politics and economics. As you all know, forecasting economic events is hard, but predicting the interactions between political and economic events is all but impossible. Once something has already happened, we are all quite good at stitching together a causal narrative that makes that outcome seem inevitable. Sadly, our ability to explain the past is much stronger than our capacity to prophesy the future.

One of the great challenges is guessing what will happen politically when a country's growth stalls. A plausible outcome is that bad economic performance, and all that it entails, will produce a populist rejection of incumbent elites and policies.

Another plausible outcome is that bad economic performance will empower the reformers already in government, who are therefore known quantities. This seems to be the way South Africa is going. Of course, South Africa has its share of populists who want to do radical things. But it is increasingly clear that the centre will hold. We have strong institutions, and we have the better arguments. We cannot stop some people from saying populist things, but we can win the policy debates – and we are winning. Bad economic outcomes, in this case, seem to be supporting better policies.

Conclusion

In conclusion: this is a difficult moment for emerging markets. After a long run of success, we are now confronting a range of serious challenges, including excessive macroeconomic imbalances, stalled growth and difficult politics.

As all of you will know, from your years of experience investing in emerging markets, the asset class is marked by volatility. You are here because the returns can be high, but you also acknowledge that there can be low moments. Had you been more risk-averse, you would have the good returns emerging markets offered.

In truth, and as has been said in other contexts, we are probably not as good as we look when we are winning, but we are also not as bad as we seem when we are losing. The past few years have been difficult ones for South Africa, as for many other emerging markers, but there is a respectable case to be made that things will get substantially better. We can achieve macroeconomic rebalancing that favours investment and growth.

We aspire to growth rates nearer our historical trend levels, and once we achieve that, we can get ambitious about faster growth rates. We are recovering from a period of self-inflicted injuries, and there are good growth opportunities that we can exploit when we have recovered our health. Our politics have taken a reformist turn, which should permit a constructive response, rather than a destructive reaction, to the disappointments of the recent past. I am confident that South Africa tomorrow will be better than South Africa today.

Thank you.