



South African Reserve Bank

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## **An overview of the South African economy and markets**

Keynote address at the SACCI Annual Convention, by Dr Monde Mnyande, Chief Economist and Advisor to the Governor, South African Reserve Bank, 15 October 2010.

### **Introduction**

Ladies and gentlemen, I must admit that I indeed feel honoured to be here and to address the largest business chamber in South Africa, consisting of fifty (50) member associations across all sectors and regions. I am glad to say that, under the auspices of Governor Gill Marcus' outreach programme, the Bank held a bilateral meeting with the South African Chamber of Commerce and Industry (SACCI) earlier this year. The meeting was a laudable success in that it was a launch pad for building a meaningful relationship between our two institutions.

This relationship between SACCI and the Bank epitomises the Bank's ideal of creating platforms for the much-needed exchange of economic information on a regular basis. Opportunistically, these platforms, commonly known as the 'Outreach Programme' allow for economists of the Bank to have a feel of real business and social dynamics by visiting factories; enhancing the stakeholders' understanding of the Bank, in the frame of what the Bank can and cannot do in this economy.

More broadly, these platforms also form the basis for co-operating and collaborating closely in the interest of maintaining the integrity of economic data used for monetary policy decision-making. Thus far, interaction has taken place with a wide range of interest groups and organisations, and includes economists and analysts, as well as

representatives of agriculture, mining, manufacturing, commerce, labour, political parties and international analysts and investors. The programme will continue to be a priority for the Bank, and ways of further expanding and enriching the interaction will be explored.

For this important event, I have been tasked to focus my remarks mainly on an overview of the South African economy and markets. In response to a question of how the economy is performing, an economist responded “not as bad as some say today, not as good as many project next year”. This response mainly reflected the typical economic environment that displays mixed developments, which in turn affect the views and the outlook of the economy by the business sector, households, governments and trade unions, among others.

### **Domestic economic developments**

To start off on a positive note, it is mostly encouraging to inform you that the downward phase of the business cycle in the domestic economy has ended and that the country has entered an upward phase of the growth cycle. The challenge for us at this stage, however, is to determine the point at which the cycle turned around. Needless to mention that the duration of the recent downward phase was, in all probability, shorter than the previous one in 1998.

Despite the downshift in growth rates of most developed economies, South Africa's domestic activity has over the period of six months to June 2010 shown much resilience. Over this period, the country's real output grew by 3,9 per cent mainly lifted by the plausible performance of the manufacturing sector. The activities in the manufacturing sector reflected the fluctuations in the utilisation of production capacity, which was fairly subdued in 2009 before recovering gradually in 2010.

The rebound in manufacturing production benefited the output of electricity to levels slightly higher than a year ago. After facing a challenge of declining production in the past two years, mining output scraped back almost half of the lost production incurred

during the recession and currently continuing to foster growth within the sector. The tertiary sector, that is commerce, hotels, restaurants and transport among others, received good impetus from the country's hosting of the FIFA World Cup tournament.

While applauding the good performance of the domestic economic activity over the past six months, one cannot avoid the probable impact of the downshifts in most developed and some developing economies on our country. The local mining sector has since the second quarter of 2010 started to feel the brunt of the contraction of industrial growth in most of the BRIC<sup>1</sup> countries as their inventory cycle and policy stimulus faded away. In addition, the sector had to deal with production stoppages resulting from domestic industrial action and routine maintenance.

Over the same period, growth in the manufacturing sector was somewhat restrained by the decline in Purchasing Manufacturing Index (PMI) of some key trading-partner countries. One can almost suggest that, although positive, growth in the South African economy still faces some hurdles stemming from external and domestic factors. This is evident in the latest growth rate of 3,2 per cent recorded in the second quarter of this year. In the latest Reuters poll most economist have forecasted a growth rate of 3,2 and 3,3 per cent for remaining quarters of 2010 respectively.

Despite the muted growth for the remainder of 2010, the mood of domestic environment is often encouraged by the release of the sentiment indicators such as those published by your institution, SACCI. According to your views the business confidence recorded its highest reading of 87,6 in August 2010 supported by nine of thirteen sub-indices. It is partially on such basis that we remain optimistic that domestic growth will continue to be resilient.

Regarding domestic demand, the ongoing strong recovery in final consumption expenditure by households and sustained robust growth in spending by general government led to a modest increase of 7,8 per cent in real gross domestic expenditure during the six months to June of 2010. The countercyclical approach of

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<sup>1</sup> Brazil, Russia, India and China

national government policies adopted to respond to the subdued domestic demand continued to put a strain on government's budget balance. The latest projections of the budget balance will be presented later this month by the Minister of Finance in his *Medium-Term Budget Policy Statement*.

Favourable wage settlements, lower interest rates and positive wealth effects, related to further share and house price recoveries, improved consumer sentiment and robust growth in expenditure by households on durable and semi-durable goods in the first half of the year. Looking forward, household consumers are expected to remain positive and resilient, especially after adjusting to the NCA provisions and enduring the impact of the recession, job losses and decline in house and share prices. Investment by the private sector contracted further, albeit at a slower pace, in the first half of 2010 suggesting the resumption of capital formation by some companies.

The increase in domestic demand was reflected in the moderation of savings by the household and corporate sectors, as well as the simultaneous increase in credit extended to them by the commercial banks. In the twelve months to July 2010, credit extended to the corporate sector registered its first positive growth rate. Overall growth in credit extension recovered from negative growth rates recorded for the larger part of 2009, but still fall far from the peak of 2007 and 2008.

As far as the external sector is concerned, real exports of goods and services grew at an annualised rate of 18 per cent in the second quarter of 2010. South Africa's exports benefited from increased trade with key trading partners including China, India and countries in the euro area. Real imports of goods and services reflected the continued recovery in domestic expenditure and rose in the first and second quarters of 2010. South Africa's trade balance with the rest of the world reverted to a surplus in the second quarter. In addition, the significant narrowing of net service, income and current transfer payments to non-residents, the deficit on the current account of the balance of payments declined to 2,5 per cent in the second quarter.

Due to the inconsistent growth patterns of the key trading-partner countries, the domestic trade activity with rest of the world, as published by Customs and Excise declined, pointing to a narrower trade surplus in the third quarter of 2010. The Trade Activity Index (TAI) published by yourselves indicates that the index fell from 49 in July 2010 to 45 in August. For the same period the Trade Expected Index (TEI), which gives a six-month outlook, declined in anticipation of tighter trade conditions in the build up to the first quarter of 2011.

Emerging markets around the world have experienced increased capital inflows as global institutional investors, such as pension funds, adjusted their portfolios to hold more emerging-market bonds. South Africa comprises about 10 per cent of one of the more popular emerging-market bond indices in which institutional investors are investing. Cumulative non-resident net purchases in the bond market increased significantly in 2010, totalling around R70,0 billion. Notwithstanding, the subdued cumulative net purchases of shares by non-resident investors in the recent months of 2010, the All Share Index is only 3 400 points shy of the May 2008 peak of 33 233.

Although there may be reversals of the inflows eventually, thus far the financial market conditions continued to reflect non-residents' interest in the domestic economy. However, the trend in net non-residents' inflows into the equity and bond markets since August 2010 shows a then expected bottoming of the interest rate cycle and their concern of probable losses in the event of currency weakness.

As you might all know, these inflows come at a cost of paying out dividends and interest to foreign investors, exerting further pressure on the current-account balance. In addition, these have the tendency to cause the appreciation of the currency of recipient countries. The current debate among the recipient countries including ourselves revolves around seeking some appropriate and workable strategies to deal with the impact of these capital inflows on our currencies without diminishing the benefits of funding the domestic current-account deficits. While some firms locally benefited handsomely from these developments, a number of exporters we have interacted with and import-competing firms have understandably found it hard to

operate in an environment characterised by high and volatile currency, in addition to other factors affecting their daily operations.

### **International economic developments**

Domestic economic developments are informed by international economic developments. It may therefore be useful to say a few words on international developments. The global economic outlook remains fragile, with relatively robust expansion in emerging-market countries while many developed countries report slowing economic growth. The International Monetary Fund's (IMF) view is that a sustained, healthy recovery rests on two rebalancing acts. The IMF deems internal rebalancing (with a strengthening of private demand in advanced economies while allowing for fiscal consolidation), external rebalancing (with an increase in net exports in deficit countries, such as the US, and a decrease in net exports in surplus countries, notably emerging Asia) as key requirements for a sustained recovery.

Last week the IMF warned that high unemployment, public debt and fragile banking systems pose risks to global prosperity, urging policy-makers to take bolder steps to ensure a sustained recovery. Governments from a number of countries have in the meantime tasked the IMF with calming the recent outbreak of tensions over currencies amid signs that they are already triggering a protectionist backlash. Some countries stand accused of keeping their currencies undervalued to boost exports, while low interest rates in developed countries are blamed for propelling capital flows into emerging markets.

The IMF and policy-makers worldwide have an important role to play to help ensure that progress made towards rebalancing is heightened and, although it is ultimately the responsibility of countries to act, the IMF, the G-20 and other multilateral institutions can assist by speaking out effectively about key global economic challenges, thereby marshalling support for action.

## **The outlook for inflation and domestic economic growth**

The Bank has been confronted by considerable international challenges over the past two years and the objective has been to respond quickly and appropriately in a flexible operating style. After the global financial crisis had intensified in late 2008, central banks around the world loosened their monetary policy stances significantly. South Africa generally followed this trend, and between December 2008 and September 2010 the repo rate was reduced by a total of 600 basis points to a level of 6 per cent per annum.

After again breaching the upper limit of the inflation target range for technical reasons in December 2009 and January 2010, inflation has moved back to within the target range on a sustainable basis since February 2010. The quarterly inflation projections of the core inflation forecasting model of the Bank, presented to the MPC in September 2010, showed that targeted inflation was expected to reach a low point of 3,7 per cent, on average, in the third quarter of 2010. Inflation was expected to remain within the inflation target range until the end of the forecast period, averaging 4,8 per cent in 2011 and measuring 5,1 per cent in the final quarter of 2012.

The major downside risk to the domestic inflation outlook remains the exchange rate of the rand, which has been impacted upon significantly by the capital inflows responding to the low interest rate climate in advanced economies. This is likely to persist as long as monetary policy remains extremely accommodative in advanced countries.

According to the Bank's forecast presented at the MPC meeting in September 2010, output growth is expected to average 2,8 per cent in 2010, rising to around 3,2 per cent in 2011 and 3,5 per cent in 2012.

## **Conclusion**

Although the increase in economic activity appears to be fragile in a number of economies, the underlying global economic recovery proved to be well underway as monetary policy measures adopted in advanced countries to stem the effects of the recession, remain in place. Evidence seems to suggest that some of these major economies are contemplating a second round of quantitative easing to counter another avalanche of liquidity. This means that policy rates in these countries are expected to remain lower for longer and reinforcing the capital inflows to domestic markets.

The Bank is very aware of the impact of both the current level and volatility of the rand on the economy, particularly the manufacturing, export and import-competing sectors. The Bank continues to respond in a considered manner and will, as always, be mindful of its primary objective and mandate given by the government. Discussions with the National Treasury about the various options available to address these issues, as well as the availability of resources to do so are ongoing. While a range of levels has been proposed by various stakeholders, I want to reiterate the Governor's message in yesterday's Monetary Policy Forum in Pretoria, that the Bank does not target specific a level for the rand as it is very difficult to define with precision the degree of over- or undervaluation of an exchange rate at any particular point in time.

The approach when assessing this should be guided by a sense of when the value is clearly not consistent with equilibrium, which itself changes from time to time. It is important to understand that it is extremely difficult for monetary authorities and indeed very costly for the Bank and country (taxpayers) to achieve a particular range of a weaker currency, and that any actions would also have to be consistent with the inflation target, as there is no point in having a weaker currency if the benefits to some sectors are simply eroded by higher inflation. Thank you.