RISKS AND CHALLENGES FACING THE GLOBAL ECONOMY

Address by Mr T.T. Mboweni,
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Honoured guests
Ladies and gentlemen

1. Introduction

Thank you for the invitation to address the Mail and Guardian business breakfast this time round. As you are all aware, South Africa is very much part of the global economy. This is particularly, evident on the economic front, where foreign investment and trade flows have increased quite significantly since the advent of democracy. For example, the ratio of exports and imports as a percentage of GDP increased from 42 per cent in 1994 to 63 per cent in 2006. Thus, it goes without saying that South Africa is not insulated from developments in the rest of the world. On the contrary, we are constantly reminded, almost on a daily basis, of our links with the global community of economies, as developments on world financial markets feed through to our domestic markets.

In my remarks to you this morning I will look at recent international economic developments and consider the risks and challenges facing the global economy and their implications for the South African economy.

2. Recent global economic developments and prospects

The world economy has been expanding at a strong rate over the past few years. According to estimates by the IMF, the world economy grew by 5,4 per cent last year, following the 4,9 per cent recorded in 2005. In fact, the growth rate during the last five years averaged 4,5 per cent making it the highest in more than three decades.

There are some important characteristics of the recent growth performance of the global economy. Firstly, it is clearly evident that world growth is now less dependent on the US economy. This is particularly the case when one considers the economic performance of the developing world. The average growth rate for developing and emerging countries as a group increased to around 7 per cent in the last five years from an average of 4,5 per cent in the preceding period. Growth performance in sub-saharan Africa has also improved. The region recorded growth of 5.7 per cent in 2006, marking the third consecutive year of growth in excess of 5 per cent. Secondly, despite the pickup in economic activity, inflation trends have been fairly subdued across most countries of the world. Part of the explanation for this development rests with the increased levels of globalisation that currently characterise the global economy. There is little doubt that the integration of countries like China and India into the world economy has not only had a positive effect on overall global growth, but has also

had a dampening effect on global inflation.

Current projections show that macroeconomic developments in general are expected to remain favourable. For example, world growth is expected to moderate somewhat to 4.9 per cent over the next two years and inflation is expected to remain under control with world inflation approximating 3,5 per cent over the next two years. There are some risks and challenges however, accompanying these favourable projections. Let me now briefly turn to some of these issues.

3. Global inflation risks

While the risks to world inflation may have moderated somewhat over the last six months, there are indications that renewed inflationary pressures could stem from capacity constraints in many countries as output gaps narrow. Although productivity growth has helped to dampen inflationary trends in many countries, the significant increases in economic activity over the last couple of years have led to production in many countries being close to, and in some cases exceeding the potential output level. The South African economy has grown by 5 per cent in each of the last three years, a level that we consider to be slightly above potential. In addition, capacity utilisation rates in manufacturing have increased to levels of around 87 per cent. Thus, all indications are that domestic capacity constraints have increased recently and when coupled with the narrowing of the output gaps internationally, the impact of these developments on the domestic inflation outlook requires close monitoring.

The price of crude oil has increased quite significantly over recent years. The average price of North Sea Brent crude increased from US$38 in 2004 to US$55 in 2005, reaching US$65 for 2006. Increased global demand and the perceived impact of geopolitical influences on global supply have been the dominant factors influencing oil prices. Geopolitical tensions have renewed in early 2007 thus causing a rebound in the price of brent crude oil from around US$58 per barrel in January to around US$68 per barrel in April thus, underscoring the volatile nature of the market.

High and volatile oil prices pose a significant risk as is clearly evident from recent inflation outcomes in South Africa. Petrol price changes over the past few months have mainly reflected the volatility in international oil prices and exchange rates. Petrol price developments are currently playing an important role in the less favourable outlook for domestic inflation. Persistently high and rising oil prices could cause higher inflationary expectations to become more entrenched, thus increasing the probability of a further tightening of monetary policy. While recent surveys indicate that inflation expectations remain relatively well anchored at levels consistent with the inflation target band in South Africa, we cannot afford to become complacent, vigilance is required of a central bank at all times.

While oil prices have received much of the attention, the prices of other commodities, most notably metals and minerals have been much stronger over the last year. Last year saw a strong upward shift in the prices of both precious metals (gold, and the platinum group) and base metals (all the others, but especially copper, aluminum, iron, zinc, nickel, tin, and refined products such as steel). The price of base

metals continued to increase more significantly in 2007 with copper, aluminum and zinc reaching 7, 11 and 3-month highs respectively, while lead and nickel touched new all-time highs in April this year.

Commodities are increasingly being seen as a beneficial addition to traditional diversified investment portfolios. This is due to the fact that it has generally been uncorrelated to other asset classes while healthy growth in China and other developing economies, is expected to keep prices strong. In short, it would appear that commodities have become a much more sought after ‘new’ asset class for many portfolio managers. This has led to robust commodity returns, but has also left commodities prey to herding behaviour, making them more volatile and in fact, more correlated with other asset classes.

However, commodity price increases are somewhat of a double edged sword for South Africa. On the export side, it contributes to increased exports and economic growth. On the other hand, rising commodity prices could offset the positive terms of trade effect and lead to an increase in import prices and hence domestic inflation.

A further threat to the inflation outlook emanates from buoyant housing markets in many countries which have also served to fuel domestic demand. There have been significant increases in consumption expenditures as a result of increased wealth effects emanating from rising house prices. South Africa is no exception. It is true that the low global interest rate environment has had much to do with these developments. However, the current tightening of monetary policy has given rise to concerns that a decline in residential investment could have wider adverse impacts on the rest of the

economy. More specifically, problems related to the sub-prime mortgage market in the US have raised concerns about the probable adverse impacts of developments in the housing market on the rest of the US economy and on the rest of the world. While current indications are that these concerns may have dissipated somewhat, policymakers need to remain vigilant given the impact of asset price movements on macroeconomic developments.

4. Global financial market developments

Against the background of favourable global economic developments over the past few years, global financial markets have experienced a sustained rally. Global equity markets in particular have performed strongly, with markets in Japan and Europe outperforming those in the United States. Emerging markets also benefited from continued inflows into their financial markets, and spreads continued to tighten while equity prices rose further. The EMBI+ spread has witnessed a steep decline over the past year, having broken below the record low 160 basis points threshold not too long ago. While the spread has spiked in times of increased risk aversion, it has in all the cases moved back to the pre-volatility levels, even surpassing previous lows. The MSCI emerging market equity index rose by almost 30 per cent in 2006 and by approximately 7 per cent thus far in 2007. Emerging market credit ratings have also improved since the end of 2004, marginally to below BB+, while there were 38 sovereign rating upgrades compared to only two downgrades.

Despite this positive view of emerging markets, risks remain as markets have been prone to contagion effects and reversals in

response to various developments. There has been a fair amount of turbulence in financial markets over the past year, the causes of which have varied. In May 2006, concerns surrounding inflationary pressures in the US economy caused a sell-off in emerging markets. At that time, the market seemed to be of the view that central banks in general were behind the curve when it came to fighting inflation. As a result, expectations of a more aggressive monetary policy tightening by the major central banks removed some of the allure of emerging market assets. It also resulted in an unwinding of the so-called carry trades.

This unwinding of so-called carry trades gained momentum again in February and March 2007. This time it occurred against the background of concerns surrounding a possible recession in the US while the Bank of Japan’s interest rate increase in February 2007 also resulted in investors unwinding their short yen positions. The abrupt decline in the Shanghai stock market, following speculation that China may introduce a capital gains tax on shares and expectations of tighter monetary policy in China propelled the sell-off to gain momentum,

Fortunately, these periods of increased risk aversion and sell-offs in riskier assets, including emerging markets, have been relatively brief with markets rebounding soon thereafter. This can most likely be ascribed to the fact that many regions, with the exception perhaps of the US, are experiencing much improved and healthy growth environments, driven to a significant degree by China and India. With the prolonged period of healthy global growth, strong capital inflows, substantial increases in foreign exchange reserves and improving terms of trade, emerging markets have witnessed robust expansion with limited inflationary pressures. Emerging markets have exploited

the opportunity to expand their share of the global economy and become less dependent on the US. Nevertheless the bouts of volatility indicate the vulnerabilities and risks to which these countries are exposed.

5. Domestic financial market developments

On the domestic front, the equity market has exhibited phenomenal performance over the past few years, with the South African All-share Index (Alsi) increasing from around 10 500 at the start of 2002 to over 28 000 in April 2007. Equity prices were mainly driven by rising commodity prices, especially gold, platinum and copper, which resulted in increases in the resources, gold and platinum indices. However, good economic fundamentals including steady interest rates in a low inflation environment and strong economic growth also played a major role in the demand for equities by non-residents and contributed to broad-based increases in share price indices across all sectors. In comparing South Africa's equity market with the MSCI emerging market index, the Alsi follows much the same path as the emerging market index.

The domestic bond market has also rallied significantly over the past few years, despite the recent increases in the repo rate. Domestic government bonds have been supported by the exchange rate of the rand, low international bond yields, inflation remaining within the target range and a general lack of supply of government bonds in the market. The yield on the R157 bond declined from 12 per cent in 2002 to under 8 per cent in April 2007.

South Africa's foreign currency denominated debt, as measured by the South African EMBI+ sub-index narrowed from over 270 basis points in 2002 to its current level of approximately 70 basis points. South Africa's individual foreign currency denominated bonds, have all witnessed a significant narrowing in spreads from time of issuance. The 10-year global bond, for example, which was issued at a 195 basis points in May 2005, is currently trading at around 80 basis points.

The rand has been influenced positively by the substantial inflows into the bond and equity markets, and the significant improvement in South Africa's foreign exchange reserves position. However, the combination of being one of the most liquid of the emerging market currencies and having a relatively wide deficit on the current account of the balance of payments has meant that the rand remains vulnerable to changes in international developments and sentiment. Nonetheless, demand for rand remained strong as reflected in the strong increase in turnover in the foreign exchange market. The average daily turnover against rand doubled since 2002 from USD6 billion to over USD12 billion. According to the latest BIS Triennial Survey, the rand's share of total currency distribution in global currency markets increased from 0,5 per cent in 1998 to almost one per cent in 2004. Volatility in the domestic currency market has been on a declining trend since 2001 - implied volatility declined from almost 50 per cent in 2002 to 13 per cent in March 2007.

6. The outlook for global growth and markets

So far, financial market corrections have been relatively well contained and brief, even against the background of a slowing US economy. This can most likely be attributed to what appears to have

been a rebalancing of global growth and the adoption of appropriate economic policies. With regards to the latter aspect, there is little doubt that monetary policy has been fairly successful in containing inflationary pressures across the globe.

Strong growth elsewhere is expected to partly shelter emerging markets from a US slowdown. The effects are likely to be less severe than have been in the past, as the rest of the world has become more resilient to a US slowdown with reduced dependence on the US consumer. However, adverse developments in the US could affect equity markets, particularly investor sentiments towards emerging market assets.

A further risk to global markets is that of the unwinding of yen carry trades. As noted earlier, in February 2007 markets reacted adversely to the Bank of Japan's decision to raise interest rates by 25 basis points. In particular, the high-yielding currencies suffered the most, as investors unwound their long positions in these currencies and reduced their short positions in the yen. However, at this stage, the market is pricing in a modest scenario of interest rate increases. Similarly, in China, with fixed investment and economic growth exceeding expectations, the authorities have signaled their intentions of cooling down the economy. However, there are market concerns that further policy tightening could adversely impact on Chinese and world economic growth. Given the prominent role of China in the world economy today, investor perceptions about Chinese prospects have implications for global markets. Thus, it is becoming evident that Chinese economic policy is no longer about China but the global economy. This was evident during the third week of April 2007 when

global markets came under renewed pressure, albeit briefly, following the fourth increase in China's banking sector cash reserve requirement this year. The People's Bank of China increased the cash reserves requirement from 10,5 per cent to 11,0 per cent, in addition to three interest rates increases effected over the past year.

Of course, global imbalances remain a key challenge. The April 2007 World Economic Outlook published by the IMF projects that imbalances are unlikely to fall much over the short term, and therefore continued large cross-border net capital flows will be needed to finance the current account imbalances at their present levels. A disorderly adjustment of these imbalances could result in a sharp depreciation in the US dollar, thereby impacting negatively on global economic growth. It is not clear whether under these circumstances the rand would find itself moving with the dollar, or in the opposite direction. Much will depend on how world growth and risk perceptions are affected in such a scenario. However, at this stage a disorderly unwinding of these imbalances appears unlikely.

7. Conclusion

Currently the world economy is characterised by generally strong growth and low inflation. This favourable scenario has also benefited emerging markets, which are now starting to play a larger and more crucial role in the global economy. Nonetheless, as we have seen on a number of occasions, markets are susceptible to changes in sentiment. Thus far, negative developments stemming from changes in sentiment has generally been brief. However, sustained market moves could lead to a deterioration of growth prospects. Global imbalances and the

unwinding of these remain a key concern. The resilience of markets to these imbalances has continued to confound many analysts, with participants still debating how and when these imbalances will correct and the impact thereof on financial markets and the global economy.

From a South African perspective, the sustainability of our current positive growth experience is dependent in part on this positive international environment. Sound macroeconomic policies are essential in ensuring the continued attractiveness of South Africa as an investment destination, and monetary policy will continue to play its role in this respect. While exogenous factors are outside the direct influence of domestic monetary policy, their impact through second round effects cannot be ignored. We have to remain alert to the risks inherent in the international environment and retain the flexibility to react appropriately to global and domestic challenges.

I thank you. Are there any questions?