

# **PERSPECTIVES ON THE ECONOMIC AND FINANCIAL ENVIRONMENT FOR EXPORTERS**

**Keynote address**

**by Mr T T Mboweni, Governor of the SA Reserve Bank**

**at the annual symposium of the**

**Cape Pomological Association**

**Stellenbosch**

**Tuesday, 3 June 2008**

Ladies and gentleman

Thank you for your kind invitation to deliver the keynote address at your annual symposium. The deciduous fruit industry is characterised by participation of numerous small and large entrepreneurs, and ranges from farming activities to the processing, packaging and distribution of deciduous fruit. A significant amount of this output is exported, and therefore it is appropriate to be talking about the economic environment facing exporters. It is probably not necessary to tell this particular audience that exporters are likely to be facing a particularly challenging environment going forward.

## **Contribution of agriculture to the South African economy**

The Deciduous Fruit Trust estimates that the Western Cape has more than 2 000 deciduous fruit farmers, ranging from very small entrepreneurs to well-known large farming businesses. Farming activities in the Western Cape provide nearly 100 000 employment opportunities, and the employees in turn support nearly 400 000

dependants. Apart from fruit production, the subsequent processing and distribution of deciduous fruit also contributes directly and indirectly to economic activity in the Western Cape. The Trust has also estimated that every increase of R 1 million in final demand for deciduous fruit creates an equivalent of 115 job opportunities through the production and distribution chain.

In terms of the overall scale of economic activity in South Africa, the contribution of the agricultural sector is comparatively small. The contribution of agriculture, forestry and fishing to gross domestic product (GDP) was about 2,3 per cent in 2007, down from 2,8 per cent the previous year, with the agriculture sub-sector contributing about 80 per cent of this figure. However, these figures conceal the importance of agriculture in certain regions of our country. In the Western Cape the contribution of agriculture, forestry and fishing to the regional GDP is some 40 per cent larger than the national average, as the Western Cape accounts for nearly one quarter of the contribution of agriculture, forestry and fishing to domestic GDP. Fruit exports currently account for about 2 per cent of our total exports.<sup>1</sup>

Despite its relatively small direct contribution to economic activity in the country, the agriculture sub-sector must be gauged against its broader contribution to economic activity. Considering the strong domestic linkages of the agricultural sub-sector with many suppliers and service-related industries in the South African economy, the contribution of this sub-sector was substantially higher at just over 6 per cent of economic activity in 2006.

---

<sup>1</sup> Statistics South Africa

## **Global financial markets and global growth**

Internationally the financial and economic environment has become considerably more uncertain since the advent of the financial system instability in the United States of America, caused in the main, but not only by the sub-prime mortgage crisis. Much has been written about this crisis, which is in essence the lending of money for purchasing residential property to borrowers with marginal or no creditworthiness during a period of low but variable interest rates and rising house values. This business model was clearly unsustainable, and once interest rates increased, delinquencies increased, fuelling a downward spiral of property prices and increased foreclosures. To compound matters, the mortgages were securitised and held by institutions around the world, so the financial market turmoil has not confined to the US. The International Monetary Fund estimates that total potential losses to financial institutions as a result of the sub-prime crisis could be close to USD 1 trillion. However, it would seem that South African financial institutions have no material exposure to the sub-prime problems.

The difficulties in the US housing market has had a significant negative impact on consumer demand in the US, despite significant interest rate reductions by the US Federal Reserve and fiscal policy initiatives. A consequence of these developments has been a significant worsening of global growth outlook, which is not good news for exporters and the global economy. The latest IMF forecasts are for global growth to average 3,7 per cent in 2008, compared to their previous forecast in

September 2007 of 4,8 per cent.<sup>2</sup> The advanced economies are expected to grow by 1,3 per cent, and the US by 0,5 per cent. The euro area, which is an important export destination for South African products is now expected to grow by 1,4 per cent, compared to 2,1 per cent in the previous forecast. It is of concern that the risks are seen to be on the downside and growth is only expected to improve marginally in 2009.

On the positive side, our trade with emerging markets has been increasing, particularly with Asia, and these economies, while slowing, are still expected to experience relatively robust growth. The IMF expects growth in the emerging-market and developing economies to average 6,7 per cent in 2008, down from the September forecast of 7,4 per cent. Developing Asia is expected to grow by 8,2 per cent, with Chinese growth expected to exceed 9 per cent.

It is interesting to note that whereas previous crises have often originated from emerging-market economies, these economies have so far proven to be relatively resilient in the face of the current financial market turmoil. Improved fundamentals, abundant reserves and strong growth rates have all helped to sustain flows into emerging market assets. However, there are macroeconomic vulnerabilities in a number of countries that make them susceptible to a deterioration in the external environment - in particular countries with current account deficits financed by private debt or portfolio flows, and countries in which domestic credit has grown rapidly. Emerging markets are, therefore, by no means isolated from the turmoil in developed markets. The de-coupling hypo thesis is not supported.

---

<sup>2</sup> World Economic Outlook, April 2008, Washington

Real GDP growth in Africa is expected to be a relatively robust 6,3 per cent. The African continent accounted for some 3,7 per cent of the export value of the deciduous fruit industry in 2007, while the United Kingdom and Northern Europe accounted jointly for some 75 per cent of industry exports. Given the proximity of Africa, also in comparison to our major competitors in the fruit export business, there is no reason why exports to Africa cannot increase considerably in coming years. Increasing such exports is one of the near-term challenges facing the industry, as African countries share the concerns of developed countries about sustained food supply.

### **Global commodity and food price developments.**

In addition to financial market and growth uncertainties in certain parts of the world, we currently also see substantial increases in commodity prices, particularly oil and food. International oil prices have more than quadrupled since the beginning of 2004, and in fact have more than doubled since January 2007 when North Sea Brent Crude averaged a little above US\$50 per barrel following a 2006 peak of around US\$70 per barrel. This is clearly not good news for anyone except those who are making massive profits. Agriculture is directly affected through the increased costs of diesel and fertilisers (input costs). This relative price increase is not expected to be reversed significantly any time soon, and most analysts expect international oil prices to remain elevated. We in South Africa have the additional impact of movements in the rand exchange rate which has exacerbated the impact.

However there is good news for the agricultural sector in that the commodity boom has extended to agricultural prices as well, albeit with a

lag. The rising trend in international food prices accelerated in 2008. According to a recent World Bank study, U.S. wheat export prices increased by 18 per cent in the first quarter of 2008, while Thai rice export prices increased by 54 per cent in the same period.<sup>3</sup> This came on top of an 181 per cent increase in global wheat prices over the 36 months to February 2008, and an 83 per cent increase in overall global food prices over the same period. However not all sectors of agriculture have benefited to the same extent as some of the seed crops. While crops such as maize are more homogenous, fruit in particular is subject to other factors such as income changes, quality, taste changes, market access, and more competitive markets.

Several factors have contributed to the increase in food prices. As mentioned earlier, farmers have recently been exposed to a whole host of increases in the prices of productive inputs, particularly oil, which also increase the cost of agricultural production. Linked to the level of oil prices has been the increased demand for corn as an input into the biofuels industry. Increasing the capacity for the production of biofuels as a replacement for expensive crude oil is seen as an important alternative source of energy. Increased biofuels production has increased the demand for maize, oilseeds, palm oil and sugar. This increase in demand for alternative usage has reduced the available supply for human consumption. The jury is still out about the potential benefits to be derived from the biofuels industry.

At the same time it would seem that the demand for food has grown in emerging economies such as Brazil, China, India, Russia and South

---

<sup>3</sup> Rising food prices: Policy Options and World Bank responses: Background note for the Development Committee meeting, April 2008.

Africa owing to improved standards of living in these and other countries. On the supply side adverse climatic conditions have contributed to lower agricultural output in some parts of the world, with concomitant price increases. In as much as agricultural produce is used in the food production chain, rising feed prices (input costs) resulted in increases in the cost of animal production and, ultimately, meat prices. A number of countries have responded by restricting the export of certain categories of food, which simply compounds the global problem. We are supposed to be promoting and not hindering international trade. That has been the burden of the Doha round (WTO negotiations).

This combination of factors has contributed to world-wide concerns about sustained food supply and food security. It is quite ironic that as recently as 2005, a Food and Agricultural Organisation (FAO) report warned that 'the long-term downward trend in agricultural commodity prices threatens the food security of hundreds of millions of people in some of the world's poorest developing countries where the sale of commodities is often the only source of cash'.<sup>4</sup> Clearly there has to be a balance between food supply sustainability and affordability.

### **Global and domestic inflation.**

Until recently, global inflation appeared to be relatively under control despite the food and energy price developments. According to the IMF, world inflation averaged 4 per cent in 2007 and is expected to increase to 4,8 per cent this year, although many analysts expect this to be higher. However emerging market economies are expected to

---

<sup>4</sup> FAO Press Release (15 February 2005) of the FAO Publication: The State of Agricultural Commodity Markets (SOCO 2004), Geneva

experience even higher inflation because of the higher weight of food in their consumption baskets. Inflation is therefore expected to increase to average 7.4 per cent in the developing economies. Food price inflation is much higher than overall headline inflation in many countries, including South Africa.

World-wide inflation has been accelerating over the past year in the midst of slower global economic growth. In the 1970s similar conditions of slower growth combined with accelerating inflation resulted in stagflation – despite recessionary conditions, many economies suffered inflation. One current challenge facing many economies is to prevent the development of similar unfavourable conditions. For this reason we have seen divergent policy responses. In some countries, such as the US, Canada and the United Kingdom, interest rates have been decreased recent months. However the higher inflation has seen a tighter monetary policy stance in a number of countries including Sweden, China, Russia, Brazil, Iceland, Australia and South Africa. Over the next few months we are likely to see increasing numbers of countries trying to contend with higher inflation pressures and lower growth. The road ahead is going to be bumpy.

Domestically, year-on-year CPIX inflation has accelerated during the past few months, and reached 10,4 per cent in April of this year. In response, the Monetary Policy Committee of the Bank has increased interest rates by a cumulative 450 basis points since June 2006. Food and petrol prices are the main contributors to inflation, but in recent months, more generalised price pressures have emerged as well. Food prices increased at a year-on-year rate of 15,9 per cent in April, while petrol prices increased by around 30 per cent. According to our most



recent forecast, inflation is expected to persist above the inflation target of 3-6 per cent, and is not expected to return to within the range before the end of 2009. Unfortunately we see the risks to this forecast to be significantly on the upside. So exporters are likely to continue to face an environment of rising costs and high interest rates in the short term. We remain committed, however, to bringing inflation down to within the target range in the medium term.

### **Exchange rate issues**

South Africa runs a sizeable current account deficit on its balance of payments. This implies that we import more from the rest of the world than we export. For 2007 this deficit amounted to 7,3 per cent of GDP. This deficit has been sustainable because foreign investment attracted to the country has exceeded the deficit on the current account. Given our strong infrastructural expenditure programme and high crude oil prices, our import demand is expected to remain strong. This means that we have to continue to rely on continued capital inflows, or else we need to improve our export performance. Clearly, from a sustainability perspective the latter would be preferable. Unfortunately our export performance has not kept up with imports, despite the significant increase in commodity prices.

Over the past few years, when the economy was growing at rates above 5 per cent, the bulk of net capital inflows were into the equity markets. The sustainability of these flows is, however, not only dependent on domestic developments. In the final quarter of 2007 we experienced significant net sales of bonds and equities by non-residents as a result of global risk aversion in response to the turmoil in global credit markets.

These sales intensified in January and February as electricity supply constraints contributed to negative perceptions of our growth prospects. These developments impacted on the exchange rate which depreciated by about 20 per cent on a trade weighted basis in the first quarter of 2008. It has since recovered somewhat, but is nevertheless about 12 per cent weaker than at the beginning of this year.

Fruit and wine exports are particularly sensitive to exchange rate movements, and one of the consequences of the current financial market turmoil is that there has been a considerable amount of exchange rate volatility in international markets in general. Since the beginning of 2008, for example, the US dollar has depreciated by about 6 per cent against the euro. So even if there were no domestic issues, the rand would still have experienced some volatility.

The weaker exchange rate has generally been welcomed by exporters. Of significance perhaps is the fact that while since the beginning of the year the rand has depreciated by about 10 per cent against the US dollar, the Chilean peso has appreciated by around 4 per cent against the dollar. Given that Chile is a major competitor of South Africa in the European fruit market in particular, these developments are seen to give our fruit farmers a significant competitive advantage.

It is sometimes argued by some commentators and researchers that a weaker exchange rate is in the long-term interest of the export sector. This is a fallacy. No industry can build a long-term business strategy on a one-way bet on the exchange rate of the currency, or on the basis of short-term nominal exchange rate movements. The immediate benefits of a lower exchange rate for exporters are soon offset by the increased

costs of imported productive input such as petrol and chemicals, while cost increases can also feed into higher inflation with all its negative consequences. A weaker exchange rate is usually a sign of high inflation, and unless the inflation problem is addressed, it can set in motion an exchange rate and inflation spiral. In short, a weaker exchange rate can only benefit exporters if the exchange rate change is not offset by cost increases. During times of exchange rate volatility, however, management of exchange rate risk does become a challenge for exporters.

Emphasis should however be made here that the South African Reserve Bank does not intervene to try and manage the level of the exchange rate. In an inflation targeting context, the exchange rate must be determined in the market. We would of course prefer to see a stable and competitive currency, but the best we can do is to contribute to this through prudent monetary policy which focuses on achieving and maintaining low inflation which should prevent a continuous depreciation of the currency. Stable macroeconomic policies also contribute to more stable capital inflows, and our higher level of gold and foreign exchange reserves should also make the currency less vulnerable to speculative attacks.

The exchange rate is only one aspect of competitiveness in the fruit industry where quality issues are paramount. Other challenges relate to the industry commitment at many levels to ensure compliance with international best practice and commercial guidelines, for instance GlobalGAP. This includes compliance with quality and safety standards, traceability, domestic legislation, and social and ethical conduct. As compliance has a technical and financial impact on emerging farmers, a

challenge facing the industry is the rendering of support and assistance to ensure their export readiness and compliance with the strict requirements. Unfortunately compliance costs are very high and it seems that producers have not yet received tangible benefits for compliance in the form of a premium on their products.

### **Concluding comments**

Internationally, concerns currently focus on the availability and prices of food, and in particular of basic staple commodities such as maize and rice. Although the availability of food domestically may not be a concern at this point, as noted earlier, South African food prices have increased considerably. South Africa is dealing with a problem of food affordability, rather than food availability.

This has serious implications for poor people and the unemployed, as their spending on food as percentage of total spending is much larger than is the case with the middle and high income groups. Food accounts for more than 50 per cent of the spending basket of the low income group, compared to some 17 per cent of the spending of the highest income group, and some 20 per cent of the overall CPI basket. Agribusiness can make a contribution to affordability by containing price increases as far as possible, as is indeed also the case for all other productive sectors in the economy in our quest to contain inflation. Cost containment will also help to ensure the international competitiveness of agricultural exports.

The deciduous fruit industry is an important contributor to the regional GDP of the Western Cape. It is therefore befitting to wish the industry

and its many role players the best wishes for success from all of us at the Bank. Your important role in the domestic economy is never underestimated and we wish you good harvests, a mild climate with sufficient timely rainfall, a healthy crop and international good prices at a level supportive of your business and the South African economy.

Thank you very much.