PERSPECTIVES ON THE GLOBAL AND DOMESTIC ECONOMIC ENVIRONMENT

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to the Volkswagen South Africa Strategic Conversation Dinner,

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Thank you for the opportunity to lead in the strategic conversation this evening. We have come through a difficult few years, and the road ahead is likely to be just as challenging.

Right now there seems to be a small breathing space that might allow a better assessment of where the world is today. We have seen three elements of the global crisis come together, namely sovereign debt, a banking crisis, and the crisis of weak growth and rising unemployment, particularly among the young. There is also the increasing recognition that what is occurring is not simply a very deep economic crisis, but a fundamental shift in the balance of forces in the world. This is likely to take time to unfold, but significant changes are taking place, with the growing voice and economic power of emerging markets being heard more loudly.

The global financial crisis is still with us, although it does appear that some of the worst case global scenarios may have been avoided or perhaps merely delayed. But even the optimistic scenarios for Europe are not good news as fiscal adjustments, bank deleveraging and the weight of the cumulative impact of the crisis thus far take hold. For this reason the outlook for the South African economy is not as bright as it could be, unless a concerted effort is made to do something different. Currently the domestic economy is characterised by rising inflation and slowing growth, which is a difficult combination for policy-makers to deal with.

This evening I will give a perspective on aspects of the global and domestic economic backdrop. I will spend some time on the European situation, as the context within which we operate, formulate policy, adopt strategies is critical to enable all of us to ensure that South Africa is able to take advantage of what opportunities exist, and take appropriate measures to try to protect us from the ravages of the global crisis. From a South African perspective, what happens in Europe is important, given the trade links that we have with the region. Although the percentage of South African manufacturing exports to Europe have declined over the past few years, at around 30 per cent it is still an extremely important trading partner.

In recent months there have been progressive downward revisions by analysts of the global growth outlook. The IMF, in its latest World Economic Outlook, also downgraded its forecast for world growth to average 3,3 per cent in 2012, and 3,9 per cent in 2013. There are still significant risks to the global environment, but the intensity and immediacy of these risks may have been reduced somewhat with the recent agreement on the Greek bail-out which has helped to prevent a disorderly default. This agreement is expected to allow for Greece to roll-over its debt that is maturing this month.

It would be premature to think that the European crisis has been resolved as there are a number of interrelated and mutually reinforcing dimensions which mean that uncertainty remains. Although the risks from the sovereign debt crisis appear to have been reduced for the meantime, questions about the sustainability of the solution persist, particularly in the light of the fact that the European authorities have emphasised that the Greek bail-out model is not a precedent. The Portuguese economy is also under stress, and we could still see a repetition of the Greek crisis being played out there in the coming months. In the absence of a clear commitment to deal with a possible Portuguese crisis, the risk of contagion to other more systemically important economies, such as Italy and Spain, will increase. Although some of the peripheral European countries are relatively small, they have a combined sovereign debt of around US$1 trillion, with a significant proportion being held by European banks.

The actions to resolve the Greek debt problem have involved significant losses to private sector bond-holders, many of which are European banks. In terms of the agreement, bond holders will accept losses in excess of 70 per cent of the value of the debt. Partly as a consequence of these developments, European banks are now undercapitalised, with estimates ranging between US$300 billion and US$400 billion. This has resulted in significant deleveraging by European banks, with indications of them selling assets in order to achieve their required ratios. This credit crunch in Europe is being exacerbated by the need to meet new capital requirements of raising the Tier 1 capital asset ratio to 9 per cent by June 2012. There are concerns that European bank lending could decline by around US$3 trillion over the next 18 months.

The interbank market is also dysfunctional in Europe, reflecting the lack of trust between banks. The ECB has attempted to alleviate the situation with the establishment of the Long Term Refinancing Operation (LTRO) facility, which has to date granted an estimated US$1,35 trillion in loans to banks at low interest rates. There is some evidence that a significant proportion of this money has gone in to purchasing sovereign debt, but it is still too early to say how much will go to lending to households and businesses.

The credit crunch is likely to reinforce the negative growth outlook for the region, and will in turn have its own negative feedback loop. The Euro area is expected to contract by around 0,5 per cent this year, and the European Commission expects negative growth in 8 of the 17 Eurozone countries this year. These countries include Belgium, Greece, Spain, Italy, Holland, Austria and Portugal. Widespread fiscal consolidation, even in countries with relatively strong fiscal positions such as Germany, has contributed to the negative growth outlook. A number of countries, such as Spain, Portugal and Ireland are attempting to reduce their deficit to GDP ratios by around 3 per cent per year for the next two years, and Italy by about 2 per cent per year. The negative growth outlook raises doubts about the ability of the Greek economy to adjust to the fiscal austerity that is being imposed on it. The economy

has contracted by about 15 per cent in the past two years, and is expected to contract by a further 4,4 per cent this year, while unemployment has increased from 7,7 per cent in 2008 to almost 20 per cent.

At the root of these problems is a balance of payments crisis within the euro area between northern and southern Europe. The loss of competitiveness experienced by the southern European countries and their consequent balance of payments deficits has in effect been financed by borrowing from the Northern Europeans. This is not sustainable indefinitely. Under normal circumstances the adjustment would be facilitated through exchange rate depreciation, but with this option ruled out, a more difficult path of "internal devaluation", involving absolute reductions in wages and expenditure, has to be followed. The more reluctant the surplus countries are to increase their consumption of Southern European goods, the more difficult the adjustment becomes and the more politically unpopular these measures become in the deficit countries.

Apart from the European situation, prospects for other parts of the global economy appear to be more promising, but risks remain. The US economic growth has surprised on the upside in recent months, but fears remain that this nascent recovery could be short-lived. In particular, there are risks that political conflicts over fiscal policy ahead of the November elections could result in premature fiscal cutbacks, which, according to some estimates could have the potential to reduce US growth by up to two percentage points.

There are also indications that the Chinese economy may be slowing, but the Chinese authorities have the ability and resolve to intervene strongly to prevent a so-called hard landing. One region with a more favourable outlook is sub-Saharan Africa, which is expected to grow by around 5,5 per cent this year. South Africa's financial and trade links with Africa have been increasing in recent years, and the continent is fast becoming the major destination for our manufactured exports. During the financial crisis, Africa was relatively

protected from the fall-out, given the predominance of intra-regional trade, and South Africa would do well to encourage further two-way trade and investment with the region.

One of the consequences of the global crisis has been the severe social dislocation that has accompanied it, and it is questionable how long such pain can be endured. The recent protests on the streets of Athens and general popular opposition raises questions as to whether or not the latest initiatives are politically sustainable. History is replete with examples of how circumstances similar to those described lead to political polarisation and the rise of nationalism and/or populism. This is happening in the context of a divided Europe, with no consensus on the appropriate solutions to the problems, and irresolute leadership reflected in weak and tenuous coalition governments.

The social problems are reflected in the spiraling of unemployment in some of the advanced economies. This is particularly the case when it comes to youth unemployment. In this respect South Africa is no longer unique, with its estimated unemployment rate of 23,9 per cent, and youth unemployment at around 50 per cent. The negative trends in Europe in particular are quite dramatic. In the beginning of 2008 the unemployment rate in the European Union was 6,9 per cent and the unemployment rate amongst the youth (i.e. persons below 25 years of age) was 15,9 per cent. In January 2012 the unemployment rate in the EU was 10,7 per cent, while youth unemployment measured 22,4 per cent. The number of unemployed youth totaled 5,5 million.

There are some stark divergences within the region, with overall unemployment ranging from 4,0 per cent in Austria, to 23,3 per cent in Spain, and youth unemployment ranging from 7,8 per cent in Germany to 48,1 per cent in Greece and 49,9 per cent in Spain. As a rule of thumb, the youth unemployment rate is between 2 and 3 times are high as the total unemployment rate. Of the 27 EU countries, 20 of them have youth unemployment rates of 20 per cent or more, and 7 of these are in excess of 30 per cent. This phenomenon is of particular concern, as the longer people remain out of work, the less likely they are to ever

work, or work again. The unemployment get deskilled, demotivated and disaffected, leading to the attendant social hardships and drain on society.

It is also not just Europe where unemployment has become a problem. US unemployment measured 5 per cent before the crisis, and peaked at around 10 per cent before declining to current levels of around 8,5 per cent. Youth unemployment is currently 16,0 per cent. In the UK, youth unemployment – at 22,2 per cent – is close to the 1 million mark.

The problem of youth unemployment in the advanced economies is exacerbated by an ageing population which is putting strain on fiscal positions. The current low interest rate environment in these economies will make it even more difficult for private pension funds to generate adequate returns for this ageing population, with potential financial demands on governments. This factor has resulted in an extension of the working age in a number of countries, which makes it even more difficult to solve the youth unemployment problem, with the associated fiscal demands at a time when such programmes are being scaled back. The potential adverse social consequences of these developments are profound.

The underlying lesson for South Africa from all of this is the importance of generating sustained and employment-generating growth that is needed to attend to the growing inequalities. It is also clearly preferable, particularly in the short run, to improve a debt to GDP ratio by increasing GDP growth, as opposed to cutting down on the absolute level of debt. Fiscal consolidation that is done too quickly could cause growth to decline, and this will cause the debt metrics to deteriorate and result in a negative debt spiral. When fiscal sustainability is called into question, the challenge is to find a balance between such fiscal consolidation and the need for growth.

As I have indicated, South Africa's growth outlook in the short to medium term will be impacted to a significant degree by global developments. Domestic economic growth in

2011 measured 3,1 per cent following growth of 3,2 per cent in the final quarter of the year. The growth forecasts for 2012 range between 2,5 per cent and 3,0 per cent, with the latest forecast of the Bank being 2,8 per cent. This followed successive downward revisions during 2011 as the European crisis intensified.

Since the 2009 recession, growth has been driven primarily by household consumption expenditure, which is clearly an undesirable and unsustainable growth path. Emphasis must be given to ensure that growth is driven by investment. There are, however, signs that investment expenditure growth is gathering pace, and this will be reinforced if the proposals around increased infrastructure expenditure are followed through on. According to the latest budget, public sector projects totaling R845 billion have been approved for the MTEF period. This emphasis on infrastructure investment is appropriate as it is likely to contribute to improved economic efficiencies and helps with the alleviation of existing bottlenecks in the economy. But the focus on infrastructure is not new, and the plans have often not met expectations, particularly since the 2010 World Cup. For example in 2009/10, only 83 per cent of the amounts budgeted for infrastructure was spent. In 2010/11, this had declined further to 68 per cent.

Importantly, it is not only the government and state-owned enterprises that need to invest. Michael Spence, the respected growth theorist, in his book “The Next Convergence”, has shown that countries which have sustained growth rates of around 7 per cent or more for 25 years generally have government and public sector investment ratios of between 5 and 7 per cent of GDP, and total investment rates of at least 25 per cent of GDP. Why emphasise a target of 7 per cent growth per annum? Because a consistent growth rate of 7 per cent will allow for a doubling of income every 10 years, whereas a growth rate of 3 per cent will take 24 years to double incomes. South Africa’s gross fixed capital formation as a percentage GDP averaged around 15,5 per cent in the decade from 1994 and then accelerated to peak at around 23 per cent in 2008. This positive trend coincided with economic growth rates in excess of 5 per cent and a decline in the unemployment rate to 21,9 per cent by the fourth quarter of 2008 . Since the crisis, this investment to GDP ratio has declined and in 2011

averaged around 19 per cent. Between 1994 and 2007, government and public sector investment averaged 4,4 per cent of GDP, but since 2008 it has averaged 8 per cent.

We can conclude from this that the lack of investment is not simply a problem of government failure to invest. Private sector investment has also been lacking. But government does have an important role to play in providing the environment conducive to private sector investment. For example, a notable area where private sector investment has been severely lacking is in the mining sector. This may be due in part to uncertainties created by the regulatory environment, and lack of investment in rail infrastructure which has impeded the ability of the mines to get the ores to the ports. This also illustrates how government investment does not necessarily crowd out private sector investment. To the contrary it can also crowd in investment, as in this example.

Michael Spence sums it up appropriately as follows: “Put bluntly, growth requires investment, and that means present sacrifice for future gain. The job of leaders is in part to get everyone on board, to build a consensus behind a forward-looking vision, underpinned by a growth and development strategy that is credible. Multiple classes of participants and organized stakeholders need to be willing participants. These include labour, unions, businesses and entrepreneurs, civil society organizations, and households at various levels in the income distribution.”

It is not only investment in fixed capital that is essential. Human capital is as important, if not more so. It is generally recognised that South Africa’s schooling situation is seriously lacking in various respects, but of equal concern is the lack of training for technical skills. It is an indictment, for example, that South Africa needs to import skilled artisans such as welders. Germany has a very well established system of apprenticeships, but South Africa has gone backwards in this respect. Not only does an undertrained and undereducated workforce constrain economic growth, it reinforces the cycle of unemployment and widening inequalities. As Michael Spence has noted, in a world in which knowledge and

connectivity are increasingly the basis for value creation, failures in the educational system are the surest form of exclusion there is.

It would be inappropriate for me to conclude without saying something about monetary policy and inflation, and the contribution monetary policy can make to the growth and employment trajectory. We know that unemployment has serious socioeconomic consequences, but so does high inflation. It is difficult to find examples in history where sustained economic growth and high inflation went hand in hand. But it is easy to find glaring examples of high inflation contributing to socioeconomic dislocation. The inter-war years in Germany, Latin America in the 1980s, and closer to home in Zimbabwe in the previous decade are good examples. Zimbabwe got no advantages out of the hyperinflation, but it created severe hardships, and the Zimbabwe dollar has now disappeared. The burden of inflation gets borne by those who lose their jobs through this, and by those who are unable to hedge themselves against the ravages of accelerating price increases. These are generally the poor and often even the middle classes, whose savings and pension funds would have been rendered worthless.

It is not only hyperinflation that is the problem. Even moderate inflation is bad for the poor and for workers. An annual inflation rate of 10 per cent for example, which is regarded by some as acceptable, means that a worker receiving R1000 per month will need to be earning R2590 in 10 years time simply to be no worse off. With a 20 per cent inflation, this amount would need to be R6,190 per month, and with a 25 per cent inflation, the required break-even income would be R10,000. The higher the inflation rate, the more purchasing power would be lost between bargaining rounds. In the latter case, workers will have lost a quarter of their purchasing power by the time of the next wage adjustment. If left unchecked, high inflation tends to breed higher inflation.

Apart from its redistributive effects, high and variable inflation also tends to undermine long-term investment, so it is important that inflation is kept under control, and monetary

policy is best placed to do this. But in trying to stem high inflation, monetary policy may have negative short run effects on economic growth. Conversely, monetary stimulus will only impact on cyclical growth. Therefore there has to be sensitivity on the part of policy makers to the state of the business cycle. This is what the essence of flexible inflation targeting is: that if inflation is outside the target, there is some flexibility with respect to the time horizon within which inflation is brought back to within the target, in order to smooth the cyclical adjustment. Monetary policy can help growth by providing a stable and low inflation environment conducive to investment, and by providing short-term stimulus, but it does not determine the underlying growth potential of the country. This is the domain of other policies and where the focus on infrastructure and other structural reforms is critical.

Monetary policy is currently facing the challenge of a rising trend in inflation and a slowing domestic economy. According to the macroeconomic forecast of the Bank, inflation is expected to peak at around 6,6 per cent in the second quarter of this year and then to decline moderately before returning to within the target range by the end of the year. But there are a lot of uncertainties related to this outcome. Upside risks are seen to be coming from international oil prices, particularly in the context of elevated tensions in the Middle-East relating to the Iranian nuclear programme and associated sanctions. Administered prices also remain a concern, with the tendency for prices in many instances to be set without regard to the inflation target. However recent developments, including the below-inflation tariff increase granted to the ports, the reduction in the proposed e-toll tariffs and the reduction in the electricity tariff increase granted to Eskom are encouraging.

The rand exchange rate could pose and upside or downside risk, depending on global developments. The rand tends to depreciate when there are heightened risk perceptions in Europe, as investors tend to seek so-called safe havens. But these flows tend to reverse as risk perceptions improve. Currently the markets appear to be taking a more positive view of global developments and this has been reflected in the recent appreciation of the currency. However, as I indicated earlier, this can change very quickly.

Until recently, core inflation – that is inflation excluding petrol, electricity and food - was relatively subdued, reflecting the absence of significant demand pressures in the economy. In general, monetary policy can do little to combat the impact or first round effects of inflation that is driven by exogenous shocks. However the most recent data seem to suggest that inflation is becoming more generalised, and may reflect the emergence of demand pressures. This is something that the Bank will monitor very carefully.

At this stage, monetary policy remains relatively accommodative, given the challenging growth environment, with real policy interest rates slightly below zero. As I have outlined earlier, raising the growth potential requires a concerted and sustained investment boost in the economy. An accommodative monetary policy environment is only part of this story, and as responsible monetary policy makers, we recognise that keeping inflation under control must be done with due regard to the possible impact on employment and growth. At the same time, maintaining price stability remains central to our mandate, and price stability should be part of the societal consensus that is essential for the successful implementation of a forward-looking sustainable growth strategy.

Thank you.