South African Reserve Bank

Address by Gill Marcus,

Governor of the South African Reserve Bank,

to the FM Top Companies awards function

Johannesburg, 26 June 2013

Ladies and gentlemen,

Thank you for inviting me to address the FM Top Companies awards function. It is an honour to be part of a tribute to the best companies in our country. It is appropriate that, at a time when much of the economic news is gloomy, we hold our heads high and celebrate what is good about our country and our economy. South Africa has a sound economic foundation and hundreds, if not thousands, of firms and business leaders that are outstanding in any context. It is a major source of strength that South Africa has a large number of companies that continue to grow, innovate, employ people and generate revenue and export earnings for our country.

It is even more impressive that in times of very difficult and uncertain economic conditions, both globally and locally, many firms are performing so well. You and your firms are a significant reason why we can proudly say that while our economy faces many challenges, it is also highly resilient. We are here today to recognise these firms and their achievements.

The economic environment is a difficult one. The world is in its sixth year of crisis: a crisis that has repeatedly mutated, shifting its epicentre from a sub-prime crisis to systemic banking crisis; a liquidity, fiscal deficit and sovereign debt crisis. Measures taken to address each of these elements have had unintended consequences. Austerity measures have contributed to an unemployment crisis of immense proportions, particularly for the young. There will probably be at least one or two more forms of the crisis before we can safely say that recovery is sustainable. And even then, as we can see in the United States where there are signs of recovery, the measures that are outlined to be taken very cautiously and with considerable conditionality, such as a tapering off of Quantitative Easing, have also had unintended consequences.

As we have seen in recent days and weeks, the exchange rates of many emerging market economies have been impacted negatively by an outflow of capital. This development could well mark the start of a new mutation of the ongoing global crisis.

If things do not get any worse it will probably still take a number of years before the world is back to more normal growth and output gaps are fully closed. Even then, there is debate about whether that new normal would be at a lower rate of growth than in the past. All in all, it is a very uncertain and difficult decade for individuals, companies and countries.

South Africa's weak first quarter annualised growth rate of 0,9 per cent is, to some extent, consistent with what we see happening globally and in other emerging markets and these developments have, in part, contributed towards a weaker rand exchange rate. But domestic factors have also contributed. These have to do with lost production in the mining sector, instability caused by violent and often illegal strike action and persistent capacity constraints in infrastructure, electricity in particular.

The source of this vulnerability is primarily a large current account deficit, a high budget deficit, rising public debt and relatively low foreign exchange reserves as well as high household indebtedness and inflation close to the top of the target range - all suggesting limited room for fiscal or monetary support.

South Africa is actively taking measures to stabilise the labour relations environment led by President Zuma who, in his budget vote speech, set out concrete steps to diffuse labour tension and ensure that labour disputes are conducted peacefully and within our legal framework. President Zuma also focused on the structural reforms that are being implemented, within the framework of the National Development Plan, to ensure higher and more inclusive growth going forward.

Currently the financial markets appear to be confused about the monetary policy reaction function. This is not altogether surprising, as monetary policy is facing an extremely difficult dilemma. On the one hand, slowing growth with a downside risk, and the widening output gap should signal the need for further monetary accommodation, given the absence of significant demand pressures in the economy. These conditions have already resulted in the Bank being more tolerant of inflation at the upper end of the target range than would normally have been the case. This is consistent with a flexible inflation targeting framework.

On the other hand, we are seeing increasingly strong upside risks to the inflation outlook, primarily coming from exchange rate developments. Had these pressures been simply a result of excess demand pressures, the response would have been relatively straight-forward. But this is not the case.

There are a number of issues that we have to consider in our decision making: to what extent is the depreciation going to be sustained? Will the currency continue to depreciate, settle at current levels or has it overshot in which case it will strengthen at some stage? This is critical in terms of the extent of the pass-through to inflation. We have observed that the pass-through thus far has been far more muted than has been the case in previous episodes of currency weakness, possibly also a reflection of the weak state of the economy. We have to assess whether the pass-through remains as low as it has been, or will we reach a stage where the margins of importers can no longer be squeezed? Furthermore, if there is a spike in inflation as a result of the depreciation, is it a one-off increase that will pass through the numbers by next year, or will it generate a depreciation-inflation spiral? Most importantly, will inflation expectations remain relatively contained at current levels?

These are not easy issues to determine with confidence, and have been complicated by the strong market reaction to the suggestion that the US Fed may begin slowing the pace of its bond-buying programme.

Our core mandate remains price stability, so our primary objective is to keep inflation within the target range. Currently our forecasts (and those of nearly all private sector analysts) suggest that inflation is likely to remain at the top of the band or slightly above, and then to return to within the target range. The downside risks to the growth outlook would suggest that we should tolerate inflation at these levels.

However, the upside risks to the inflation outlook make further accommodation more difficult, but do not automatically imply a tightening of the monetary policy stance. This will be highly dependent on how we see the inflation trajectory unfolding in this very uncertain environment. In other words, it has become even more data dependent. There is of course always the danger that we are "behind the curve" and that we leave it too late (and this we will only know ex post). But at the same time, a sustained breach of the inflation target is not our central forecast, and the downside risks to growth imply that we would not want to be unnecessarily pre-emptive. This is the essence of the monetary policy dilemma, and requires a fine balancing act.

As already mentioned, South Africa's high quality firms are a key source of strength for the South African economy. South Africa is a vibrant, robust democracy with a sound Constitution that protects the rights of all citizens. This is essential for long term economic growth and for the fruits of that growth to be shared more equitably. There are several other economic foundation-stones which will help us navigate through these difficult times.

South Africa's macroeconomic policies are sound, clear and transparent. Our macroeconomic institutions enjoy a high degree of credibility and respect, both globally and locally. Flexible inflation targeting has helped anchor inflation expectations and has provided the Reserve Bank with some scope to support economic growth.

Allow me to list at least five additional strengths and opportunities for the South African economy:

- South Africa's emerging middle class is a source of strength, contributing to rising consumption, the creation of new firms and greater social stability.
- Our proximity to high growth African countries is already having a positive impact on our exports.
- Our natural resources, both mineral and natural beauty, provide huge potential for investment in mining, agriculture, tourism and niche manufacturing sectors.
- South Africa's financial services sector is a recognised strength, with the country ranked in the top three in the world in the regulation of securities exchanges, soundness of our banking sector and access to financial services as part of a considered policy of financial inclusion.

- The efficacy of our legal framework and the strength of our auditing and accounting capacity provide a conducive environment for the private sector to operate in.

I can list many more areas where steady progress is being made. These strengths are a cause for optimism for our economy and reflect the significant potential for growth, employment creation and shared economic prosperity for all in our country.

South Africa's infrastructure programme has the potential to crowd in the private sector to expand investment and employment. Investments in electricity, renewable energy, freight rail, ports, water, roads and telecommunications will enhance the capacity of the economy, enabling faster growth as well as improve the efficiency of private firms.

Two examples are worth mentioning here.

First, adequate electricity provision is critical. We know that at present we cannot grow at a rate much in excess of 3 per cent without hitting against electricity supply constraints. We are also aware that certain investment projects do not get off the ground because of lack of certainty of electricity supply. Thus new energy capacity must be brought on stream as soon as possible, and on-going investment in sustainable energy capacity remains an imperative. Second, we have invested in a world-class road infrastructure in Gauteng which has already had a major impact on economic efficiencies. According to an independent study, the overall average travel time on the N1 north road section between Buccleuch and the Old Johannesburg highway has been reduced by 50 per cent to 13 minutes. The improved travel time and travel speeds come despite a 28 per cent increase in traffic volumes since the implementation of the Gauteng Freeway Improvement Programme. Furthermore, petrol consumption has also declined as less time is spent idling on the highways, not to mention improved road safety and reduced vehicle running costs. The need for and benefit of such economic efficiencies brought about through an expanded infrastructure programme cannot be overestimated.

Investment in infrastructure is for the benefit of both current and future generations, and should provide the private sector with a longer term time horizon, encouraging private investment, which has been very weak over the past few years. We hope that the private sector will respond appropriately, and public-private partnerships should be promoted in the process. Growth in gross fixed capital formation is currently led by state owned enterprises, but for South Africa to reach its growth potential the private sector's role is essential. In general, the private sector contributes around two thirds of such investment. Gross fixed capital formation as a ratio to GDP presently stands at 19 per cent, down from a high of 23 per cent in 2008, and compared for instance with that of Indonesia, a fast-growing emerging market, where it stands at over 30 per cent.

South Africa's infrastructure programme will have benefits for many sectors in the economy. Going beyond South Africa, Africa's infrastructure investment increased from about US$10 billion in 2000 to about US$45 billion in 2010, and is set to rise to US$93 billion a year by 2020. South African construction firms are well placed to be an integral part of these opportunities in our region.

In the 1960s, Korean construction firms won large contracts to build roads in South East Asia. These firms sourced their inputs from South Korean manufacturers, providing the first growth stimulus for them. Similarly, South African construction firms can grow their order books globally and use a proportion of South Africa material and capital equipment, stimulating our manufacturing sector.

Long term growth requires a partnership between the public and private sectors, which requires a much longer horizon. Too often we are caught up in the paralysis of short-termism. A long term perspective requires policy certainty, trust in institutions and confidence in the longer term growth outlook. There is increased recognition within the private sector that sustainable earnings growth requires such a longer term horizon and the chase for short term returns is not always consistent with longer term sustainable growth.

At least some of our woes in the mining sector arise from a degree of short termism amongst all stakeholders in the sector. Before the era of global capital markets, mining companies were able to adjust to the volatility of commodity prices. When prices were high, they were able to accumulate cash on their balance sheets. They saved this money for times when prices would fall. More recently, shareholders penalised companies for keeping large piles of cash on their balance sheets. This resulted in large dividend payments. In turn, management took large bonuses when prices were high. Workers too demanded higher salary increases when commodity prices were high. When prices fell, mining companies made losses and there was no cushion. It becomes much more difficult for a company to raise capital when they are making losses. Similarly, management bonuses and workers' salaries are sticky.

The necessity of taking a longer term perspective does not just apply to shareholders and fixed capital investment. It also applies to human resource management. South African firms spend a lower proportion of their revenue training their staff than comparable firms in other countries. For all firms globally, staff development is a win-win investment helping to raise productivity and make work more meaningful and interesting for individuals. In a country such as ours where so many were denied adequate education, firms play a crucial role in training their staff. We need to remember that lack of education, or poor education, is the greatest exclusion there can be.

In many cases, it is not the absolute salary that workers feel aggrieved about. It is the lack of a career-path and opportunities to move up the ladder that is the source of frustration. Peter Drucker, one of the fathers of theories on management, wrote in *The New Realities* (1989): "Management's fundamental task is to make people capable of joint performance through common goals, common values, the right structure, and the training and development they need to perform and to respond to change".

To bring several strands of my talk together, I refer to two studies, one by the IMF and the other by the OECD, into how countries can avoid the middle income trap, which is defined as a period of slower growth or even stagnation when countries reach a GDP per capita of between US$5,000 and US$10,000 (in PPP terms).

These studies suggest that to break out of this middle income trap, countries need to move from being adapters of technology to being producers of technology. Countries that move up the value chain to capture a larger share of the intellectual property or innovation succeed in breaking the trap.

While South Africa's expenditure on Research and Development (R&D) has increased in the past decade, the country still lags its peers. R&D expenditure in South Africa amounts to about 0,9 per cent of GDP, well below the 2,3 per cent average for OECD countries. In most countries, about two thirds of R&D spending is undertaken by the private sector, but in almost all cases there are strong institutional links between firms, higher education institutions and science councils contributing to both higher levels of research spending and more domestic commercialisation of the ideas and innovations.

South Africa has many innovative firms that are able to compete with the best in the world. The most successful firms take a long term perspective, invest in their people and take innovation seriously. Allow me to quote Sipho Nkosi, the CEO of Exxaro: “We spend money on innovation and research and development because we believe that companies focusing on this will survive in the future and will have an advantage over those that don’t innovate.”

The studies referred to also suggest that the presence of local firms that have a global footprint are critical to this process. Countries that have firms with strong global brands are more likely to move up the value chain. This is partly because so much of the value addition in the world economy today rests in research and development, innovation, branding and marketing, and logistics and distribution.

How relevant is such a strategy for South Africa? On the one hand, South Africa has large numbers of poorly skilled people either unemployed or employed doing relatively low productivity jobs. On the other hand, we have sophisticated firms who operate at the cutting edge of global innovation with highly skilled staff.

South Africa needs to pursue both strategies. We must grow our mining, agriculture, manufacturing and tourism sectors where we have significant comparative advantage. Parts of these sectors are also labour intensive and require relatively low skilled workers. Growth in these sectors has the potential to create millions of jobs.

At the same time, South Africa needs its firms to develop brands and technologies that it can export. We are already well placed in many respects in telecommunications, banking, retail, brewing, construction and mining and we have firms with a significant global presence and strong brands. These firms generate significant export earnings for South Africa through the provision of knowledge services. For example, in 2011, South Africa exported US$7 billion worth of mining equipment and had a trade surplus of US$472 million in mining equipment. Such exports have strong backward linkages to our own manufacturing sector.

By 2050, the world will need to produce about 80 per cent more food than today to satisfy growing populations and rising food consumption. Africa contains the largest proportion of underutilised arable land on the planet.

This provides a huge opportunity for investment, not just in agriculture but in agro-processing, in water management, in roads and ports and in cold storage facilities. South African firms in the agricultural and agro-processing sector have the expertise, the knowhow and the capital to invest in food production and processing on the continent. Again, there are strong backward linkages between such investments abroad and jobs back home.

Ladies and gentlemen, yes these are difficult economic times. We have strong firms that significantly contribute to South Africa's economic development. From our perspective at the Bank, we will endeavour to maintain a sound and predictable macroeconomic framework and enhance our economic environment. South Africa's progress requires firms and businesses to become partners in development. Growing firms mean a growing economy and a growing economy is essential for firms to grow. These are mutually reinforcing developments.

I am inspired by the successes of South African firms domestically, on the African continent and globally.

We have high calibre business leaders who are smart, professional and innovative. We need closer ties and partnerships across our economy to raise our growth level and to make our growth more inclusive. Our appeal to you is to continue with your good work, take a longer term perspective and invest in people and technology to drive higher and more inclusive growth and reduce the unacceptably high income differentials. I am confident that through such partnership, drawing on our many strengths as a nation, South Africa will grow and continue to prosper.

Again, congratulations to all the winners of the awards.

Thank you.

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