South African Reserve Bank

Address by Daniel Mminele, Deputy Governor, South African Reserve Bank, at the inaugural "South Africa Tomorrow" conference, New York, 9 October 2013

1. Introduction

Good morning ladies and gentlemen and thank you to the Johannesburg Stock Exchange and UBS for creating this opportunity for us, as South African policy makers and business leaders, to interact with New York investors to share some thoughts on the challenges and opportunities facing the South African economy.

The theme of the conference is "South Africa Tomorrow". Of course there cannot be "tomorrow" without "yesterday" and "today". I therefore thought that, before going into challenges and opportunities, and given that South Africa is approaching the 20th anniversary of the advent of democracy, it might be useful to first touch on the economic performance of South Africa since 1994, to reflect on what has been achieved. I will then talk about current challenges and opportunities and conclude with a brief update on recent monetary policy developments.

2. South Africa's economic performance since the advent of democracy

When reflecting on the 19 years since democracy, it is apparent that as a country, South Africa has achieved much and undergone significant transformation in the political, social and economic spheres as we became part of the global community. In 1994, the South African macroeconomic situation was marked by instability. In the decade prior to 1994, the country had suffered exceptionally poor economic performance. Public finances were stretched, the fiscal deficit was at an all-time high, public debt was on the rise at close to 50 per cent of GDP and official foreign exchange reserves were in negative territory as we had greater dollar liabilities than what we owned in foreign assets.

Following the historic election in 1994, there was a great deal of enthusiasm of a pending dramatic change in the country's macroeconomic situation, but there were also doomsayers predicting chaos, which were proven wrong. South Africa did enjoy somewhat of a growth revival post-1994, with great strides made on the macroeconomic front, in particular with regard to fiscal and monetary policy. There was greater macroeconomic stability and the country enjoyed longer upswings in the business cycle, such as the economic upswing post September 1998, which was the longest post-war expansion in the history of South Africa.

On average, real GDP growth measured 0.8 per cent in the period between 1985 – 1994, increasing to 3.2 per cent in the period between 1995 – 2012, reaching an all-time high of 7.6 per cent in the first quarter of 1996 (and touching a record low of -6.30 per cent in the first quarter of 2009 as the global financial crisis spilled over to our real economy). Prior to the global financial crisis, between 2002 and 2008, South Africa grew at an average of 4.5 per cent year-on-year, its fastest expansion since the establishment of democracy in 1994. This improvement in growth performance was associated with a marked improvement in overall domestic expenditure, consisting primarily of fixed investment expenditure (-2.3 per cent of GDP to 5.1 per cent) and household consumption expenditure (1.5 per cent of GDP to 3.7 per cent), mainly supported by rising disposable income, a growing black middle class, progressively stronger domestic economic activity as well as South Africa's increased attractiveness as an investment and tourist destination. Government had to tighten the reins on spending, although in real terms government expenditure increased, assisted by improved and more efficient tax collection, a widening fiscal base, strong economic growth and low and stable inflation. Fixed investment expenditure improved sharply in the period from 1994 and as a proportion of GDP reached a peak of almost 24 per cent in 2008 from around 15.4 per cent in 1994. Fixed investment as a percentage of GDP has slowed since to just over 19 per cent.

The structure of the South African economy has also undergone some changes. The tertiary sector increased its share of output from around 60 per cent in the early 1990s to almost 67 per cent in 2012, while the share of the primary sector declined from around 13 per cent to 10 per cent. The secondary sector's contribution to overall GDP remained relatively stable except for the manufacturing sector which faced major adjustments due to the opening up of the economy and rapid trade liberalisation. Nonetheless, the manufacturing sector's fortunes were helped along by strong domestic demand. Manufacturing currently contributes approximately 17 per cent to GDP and accounts for almost a quarter of the secondary sector.

South Africa adopted an inflation-targeting monetary policy framework in 2000, which contributed to a decline in the level and volatility of inflation and nominal interest rates, and also ushering in a new era of transparency and accountability for the central bank, thereby enhancing its credibility. South Africa is fully integrated into international financial markets and its own domestic financial markets have grown and developed in terms of sophistication, depth and liquidity. Well-developed financial markets have helped to boost growth and improved the country's resilience against external shocks, benefits which we as a country can attest to. The sophistication of our markets is borne out by the ranking we received in the latest World Economic Forum's Global Competitiveness Index's 8th pillar of financial market development – South Africa was ranked first in terms of the regulation of securities exchanges and legal rights; second for the availability of financial services and financing through the local equity market; and third for the soundness of its banks. South Africa also has a relatively well developed derivatives market, dominated by foreign exchange and short-term interest rate products. The JSE is ranked among the top 20 in the world in terms of size. Due to the size and liquidity of our bond markets, we have also over the years been included in a number of bond indices tracked by international investors, such as the JP Morgan Emerging Market Bond Indices and the Citi World Government Bond Index.

Alongside well developed financial markets, South Africa has a highly-developed financial infrastructure and well-developed mobile technology. Such attributes help to increase access to financial services, reduce poverty and inequality and should stimulate job creation.

As many of you will know, South Africa also has a sound banking sector, which because of a prudent and rigorous financial regulatory framework, well-supervised institutions, strong leadership and good risk management systems at financial institutions, weathered the global financial crisis well. At no point during and after the financial crisis was it necessary to undertake any extraordinary or unconventional operations in the domestic money markets, and our interbank market functioned without any liquidity constraints or other disruptions. Nor did it become necessary to support any of our banks with public funds.

South Africa is ranked in a number of competitiveness reports. The 2013/14 World Economic Forum Global competitiveness report ranks South Africa 53 of 148 countries, to be second in place among the BRICS countries, with China ranked ahead at 29. The 2012 Emerging Markets Opportunity Index based on research by international advisory firm Grant Thornton ranked South Africa in the top 15 worldwide. Overall, South Africa was ranked 14 out of 26 emerging economies, with China, India, Russia and Brazil claiming the top four spots. The Africa Competitiveness Report, which reviews the degree of competitiveness of Africa's economies, rates South Africa first overall in terms of economic competitiveness out of 38 African countries and South Africa takes the lead in financial market development, technological readiness, market size, business sophistication and innovation. The World Bank Report on Doing Business ranked South Africa 39 out of 185 countries, well ahead of its peers.

South Africa is also held in high regard for its good corporate governance. In a report released in 2010, Fitch Ratings considered South Africa to be relatively mature compared to its emerging market peers in terms of corporate governance. In terms of its institutions, South Africa also performed well in the Global Competitiveness Index, ranking first for ethical behaviour of firms; efficacy of corporate boards and protection of minority shareholders. South Africa performs particularly well in a number of areas: quality of institutions; intellectual property protection; property rights; efficiency of legal framework; and for the accountability of its private institutions. These rankings are a clear indication that South Africa's economic and financial potential has been recognised and valued.

The overall improvement in economic performance has enabled the country to improve the living conditions of millions of South Africans and for good progress to be made in increasing access to education and healthcare. Remarkable strides have also been made in providing housing, water, sanitation and refuse removal services to millions of people. Similar to Brazil and Mexico, South Africa has an extensive and well-targeted social security system which is making a significant dent in the level of poverty. While unemployment remains high, the proportion of people in employment has grown since the late 1980s, with about four million additional people in employment today.

3. Challenges and Opportunities

Let me now turn to challenges and opportunities, which given the backdrop I have just provided, South Africa is well-placed to confront and exploit. It comes as no surprise that the challenges that South Africa grapples with are precisely those areas in which we are ranked relatively poorly in the World Economic Forum's Global competitiveness report. There is a huge disparity in relation to issues that South Africa is ranked well in and those where we have not scored so well in. By contrast to our favourable financial market development ranking, on labour relations, job creation and skills development, and labour market efficiency we are ranked rather poorly and face significant challenges.

As pointed out in the National Development Plan, South Africa's most serious challenge lies in the "very poor" quality of its educational system (ranked 146th). There is no doubt about the need to raise educational and vocational training standards. This is necessary for a more efficient labour market and to be able to tackle the country's high unemployment rate of around 25 per cent and youth unemployment which is just over 50 per cent. Poor education, especially in light of the manner in which the economy's structure has changed, means that jobs go unfilled even though people cannot get employment, pointing to a high structural component to the unemployment rate.

Another challenge is the low domestic savings rate, which results in South Africa having to rely on capital flows to help fund its budget and current account deficits. Here the challenges lie in both the relatively shallow recovery in advanced economies (resulting in low external demand) and supply disruptions in the domestic economy as a result of protracted labour disputes. And while a flexible exchange rate will serve as a shock-absorber and facilitate the necessary adjustments, the recent depreciation in the exchange rate of the rand will probably lead to a somewhat slower rate of compression in the current account deficit than normally would be the case, because of the challenging outlook for export sectors as a result of these domestic and external factors. However, the financing of the current account deficit has to date not presented a significant challenge, with South Africa continuing to attract capital flows even against a more challenging global environment for capital flows to emerging market economies.

Another impediment to investment growth has been insufficient power generation capacity, which is being addressed with the construction of new power stations. When they come on stream, even though somewhat delayed, they will contribute to the removal of a significant bottleneck.

These challenges have been reflected in the country's sovereign ratings which have been downgraded in the most recent past. Fortunately, most role players in South Africa understand the urgent need for the speedy implementation of the National Development Plan, which, as you heard this morning, provides a coherent approach to developing strategies to tackle these challenges, by way of facilitating faster and more inclusive growth. The NDP has been adopted by the government and by all parties in parliament as the framework to guide South Africa's future path.

When it comes to "South Africa tomorrow" and from my interactions with the policy makers and business leaders from South Africa here today, I am convinced that, without downplaying the challenges, they see more and place more emphasis on opportunities. Allow me to elaborate on some of these opportunities.

When one looks through the short term headwinds, there are myriad opportunities and positives about South Africa's longer-term growth prospects. Our mineral wealth is ranked in the top five in the world. We have favourable demographics with a young population that has a growing working age cohort. We have a growing middle class and an urbanising population, which is a positive feature for demand for goods and services. Despite the current significant challenges I alluded to earlier, the educational standards of our population are improving with the proportion of people with degrees rising by about 4 per cent a year. Our country is one of the fastest growing tourism destinations in the world.

Infrastructure has been placed at the forefront of government's agenda to enhance economic efficiency, stimulate economic growth and job creation, and support regional integration. Approximately R640 billion has already been spent in past three years on infrastructure, and it is planned that over R800 billion will be spent over next three years to improve access to export markets and reduce costs. A Presidential Infrastructure Coordinating Committee facilitates the removal of blockages in some parts of government, which include insufficient implementation capacity and weak project development and planning.

Another opportunity for South Africa lies in the fact that we live in a dynamic and expanding region with abundant business opportunities on our continent. No longer the hopeless continent, Africa is playing an increasingly important role in the global economy. The continent is expected to be among the world's most rapidly growing economic regions going forward, propelled by, amongst others, a growing, younger, and more affluent population, rapid urbanisation, significant resources, for instance the recent significant gas finds in Mozambique, Tanzania and Namibia, and a developing financial services sector. There is increased macroeconomic stability and vastly improved macroeconomic management contributing to declining levels of inflation and sovereign debt. This can only be positive for South Africa, which is in a prime position to interact with these countries and tap into these opportunities. To borrow a line from one of our banks “some call it Africa, we call it home”. South African financial institutions and corporates are uniquely placed to take advantage of developments on the African continent and have indeed been doing so in various markets.

There are also plenty of opportunities inherent in South Africa’s involvement in both BRICS and the G-20. As a small and open economy, being part of these formations provides an opportunity to influence key international policies that could have an impact on our own economy. “Under the BRICS, the New Development Bank initiative is aimed at mobilizing resources for infrastructure and sustainable development projects in BRICS and other emerging economies and developing countries. The New Development Bank presents an interesting contribution to the global economy - by facilitating the transition to new poles of growth and demand, helping to rebalance global savings and investments, and channelling excess liquidity to productive use, while also fostering reform in the existing multilateral financial institutions – changes from which all of us, in the developed and developing world alike, will benefit.”[1] The Contingent Reserve Arrangement (CRA) is another BRICS project and an important piece of the global financial safety net arrangements and should boost confidence in the ability of BRICS countries to prevent or effectively deal with liquidity or balance of payments pressures and thereby further strengthen financial stability.

Within the G-20, South Africa has the opportunity to influence, together with its BRICS partners, the agenda setting and important policy decisions, whether they relate to financial regulation or the global economy. These policies can and do impact on our economy, the region and the continent - not only through spillovers but also because we need to adopt some of these policies if we are to remain globally relevant and competitive. One example is the Basel III financial regulations and the various requirements that this comprises. Here we are well-advanced in our commitment to incorporate the new regulations into national law. Basel III became

[1] A New World’s New Development Bank, May 2013, Nicholas Stern, Amar Bhattacharya, Mattia Romani, Joseph E. Stiglitz

effective at the beginning of this year. SA banks are well positioned to meet the Basel III capital requirements as they are phased in. The SARB has created a committed liquidity facility to help banks meet the requirements under the Basel III liquidity coverage ratio. A new Financial Markets Act became effective in April 2013 and will enable the implementation of OTC derivatives reforms, and preparations are also under way to move to a Twin Peaks system of financial regulation, which will streamline and strengthen the domestic regulatory system and enhance prudential regulation of the non-bank financial sector.

Trade linkages have been and continue to be strengthened among emerging markets. Between 2000 and 2011, merchandise exports between developing economies grew by more than 650 per cent in current prices, while merchandise exports from developing economies to high-income economies grew by less than half that amount. By 2011, about 30 per cent of total merchandise exports from developing countries went to other developing economies, while exports to high-income economies fell from 80 per cent in 2000 to about 67 per cent in 2011.[2] In South Africa, a large proportion of manufactured goods are destined for advanced economies. However, we have also seen an increased share of trade of emerging market countries with South Africa, highlighting the growing importance of these economies to South Africa. South Africa's export structure to BRICS member countries shows significant diversification and the negative trade balance has halved over the last four years. South Africa's exports to BRIC partners grew from 6.2 per cent of total exports in 2005 to 16.8 per cent in 2011, whereas its imports from the BRIC countries represented 13.6 per cent of total imports in 2005 and 20 per cent in 2011.

Clearly, there are significant opportunities, and even the many challenges we face present increased opportunities for the country. South Africa recognises that where the biggest challenges lie is also where the biggest opportunities lie. South Africa can draw on its considerable economic potential, its stable public finances, its strong

[2] What does World Development Indicators tell us about South-South trade, The World Bank Data Blog, July 2013

macroeconomic and institutional framework, a strong corporate sector and well developed and sophisticated financial markets. And of course a respected and independent judiciary, a free press, the rule of law, regular and credible elections, democratic local government and a highly regarded auditor general's office will all help to underpin any efforts in this regard.

4. Monetary Policy

As I draw to a conclusion, I would not feel like I have done my job if do not talk at least briefly about monetary policy in South Africa and give you an update on recent developments.

The last Monetary Policy Committee (MPC) meeting was held less than a month ago, at a time when expectations were rife that the Federal Reserve Bank would commence with asset tapering. As you all know, such expectations of slower asset purchases had resulted in massive volatility in financial markets, and currencies of emerging market countries depreciated substantially. When the decision was announced of no tapering, we saw significant volatility in our financial markets, and the rand exchange rate moved from levels of R10.50 against the USD in early September to levels of around R9.50, only to then retreat to current levels of around R10 – significant moves in the space of less than a month. In addition to international factors, recent developments in the exchange rate also reflected some domestic challenges in the mining and manufacturing industries. This is compounded by the wider current account deficit, which registered 6.5 per cent of GDP in the second quarter of this year. All these factors, both foreign and domestic, have implications for portfolio flows to South Africa and it is precisely these flows which have helped us to finance our twin deficits. While the US for now may be battling with issues other than the unwinding of quantitative easing, this remains a reality although postponed for now. The current account deficit, although expected to narrow in coming months, is unlikely to narrow significantly given the infrastructure programme of government which is highly import intensive, and challenges on the export side including weak commodity prices.

The depreciation in the rand exchange rate has impacted the inflation forecasts of the Bank. As noted in the previous MPC statement, the inflation forecast for 2014 and 2015 was raised to average 5.8 per cent and 5.4 per cent respectively, from previous forecasts of 5.5 and 5.2 per cent, while the 2013 forecast remained at 5.9 per cent. Underlying inflation is also moving higher, owing to the lagged effects of the depreciation in the exchange rate and rising unit labour costs.

For a while now, our policy decisions have had to balance the diverging needs of slowing growth with rising inflation in a global environment riddled with uncertainty and volatility. Not an easy task for an inflation targeting central bank. It was quite clear that the inflationary pressures facing the economy were not of a demand driven nature, but rather supply side shocks and therefore, in the absence of these pressures becoming entrenched, it has been possible to maintain the repo rate at 5 per cent, a steady level since July 2012. Recent wage negotiations have generally settled above inflation, and the impact on inflation will be dependent on productivity levels. Food inflation has also been on the rise, although the downward trend in international food prices has to some extent offset the impact of the weaker rand.

We continue to believe that the recent breach of the 6 per cent upper level of the inflation targeting range will be temporary, but are concerned about the impact of asset purchase tapering and local developments as they impact the exchange rate of the rand and ultimately prices. Consequently, the MPC assesses the risks to the inflation outlook to be on the upside. As previously indicated, we stand ready to take appropriate policy measures within our flexible inflation targeting framework to ensure that we react appropriately to the changing environment.

Thank you