Address by Francois Groepe, Deputy Governor

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at the Credit Suisse Economics and Strategy Conference, Cape Town,

11 October 2013

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1. Introduction

Good morning ladies and gentlemen and welcome to the fairest cape, or as Sir Francis Drake so named it, “the fairest Cape in all the circumference of the earth”.

Thank you to Credit Suisse for the invitation to address you at this year’s conference. The International Monetary Fund (IMF) annual meetings are drawing to a close, and both the World Economic Outlook and Global Financial Stability Report have already been released. There have also been a series of G-20 and BRICS meetings taking place alongside the annual meetings. I am quite sure that there is no lack of topics to discuss and quite high on this list, most likely, is the slowdown in emerging market economies, and the recent volatility in financial markets related to the possibility of asset tapering by the United States’ Federal Open Market Committee (FOMC). These are both issues which we watch closely, given the potential effect on South Africa’s economic prospects.

Given the title of the conference, I thought it may be useful to talk more generally around economic developments in emerging markets, touch on South Africa’s current account deficit and end-off with brief remarks on the monetary policy situation in South Africa.

2. Emerging markets start to sputter

Over the past five years, emerging market economies have been trying to deal with their new found status of being the main driver of activity on financial markets by virtue of these economies providing the impetus to global growth as advanced economies stuttered along. In general, capital flows into these economies were supported by both push (very accommodative monetary policy in advanced economies) and pull (stronger economic fundamentals in emerging market countries) factors. There was no shortage of liquidity and capital flowed into local currency bond and equity markets. With low growth and near zero policy rates in advanced economies, emerging markets naturally became a much more enticing proposition. The US economy seemed quite some way off from any kind of recovery that could prompt the Federal Reserve to reverse course on asset tapering, while both the euro area and Japan remained in the doldrums.

It would appear that the pendulum has now swung. Recent economic indicators would seem to suggest that there have been improvements in both the housing and labour markets in the US, and that the US economy may in fact provide the stimulus for global growth going forward. Even Japan is performing somewhat stronger with tentative signs that Abenomics may be supportive of growth and bringing to an end years of deflation. In addition, the euro area emerged from recession in the second quarter of this year. Are these recoveries in fact recoveries and if so, are they sustainable? Only time will tell, but there is the matter of the looming debt ceiling in the US, while the euro area, although out of recession remains very fragile.

These developments are reflected in the IMF's latest World Economic Outlook, which paints a somewhat different picture than it did at the start of the year, and portends that going forward, indeed the impulse to global growth is likely to come mainly from the advanced economies, in particular the US. World output for both 2013 and 2014 has been revised lower by 0.3 and 0.2 percentage points, respectively, to 2.9 and 3.6 per cent. Much of this downward revision, however, emanates from lower growth prospects in emerging markets, where growth for 2013 and 2014 has been lowered by 0.5 and 0.4 percentage points, respectively. Quite strikingly, there is a significant

lowering in growth forecasts for Developing Asia, in particular, India, followed by Latin America, while that for advanced economies have been left largely unchanged, save a minor downward revision in the US growth rate. It is important to note that despite this slowdown in emerging markets, they will continue to account for the bulk of global growth.

In contrast, Sub-Saharan Africa, which has displayed remarkable growth throughout the crisis, is expected to be amongst the strongest growing regions, with growth of 5.0 per cent and 6.0 per cent expected for 2013 and 2014, respectively. South Africa's growth expectations are less robust, with the IMF predicting growth of 2.0 per cent and 2.9 per cent for the same periods. The less robust growth in South Africa is partly a function of it being much more integrated into the world economy, through trade and financial linkages, thereby making it more vulnerable to developments abroad, both in advanced economies and emerging markets. In addition, there are domestic factors which constrain our ability to grow, such as rigidities in product and labour markets, high real wage growth, infrastructure bottlenecks particularly power and transportation and high levels of unemployment. There is no denying that these are very crucial issues which need to be addressed and that there is an urgency to implement the National Development Plan.

Although emerging market economies are expected to slow, the IMF notes that the anticipated slowdown is hardly "big" or unusual and in fact extremely mild compared to other slowdowns in earlier years. The WEO notes that a large part of the slowdown can be attributed to cyclical factors, in particular the fading of significant stimulus provided at the onset of the crisis; the decline in commodity prices and slowing in global export demand. In addition to cyclical factors, potential growth has also fallen, owing to structural impediments. It is interesting to note that among the BRICS economies, it is only China and Russia where the five-year ahead growth forecasts are markedly lower than the 1998 – 2013 average, which the IMF attributes to "less relevant" growth models.

Clearly, the push and pull factors I referred to earlier seem to be reversing. Not only is the economic situation in emerging markets looking less stellar, but uncertainty around asset tapering is causing volatility in capital flows and heightened financial market volatility, but with a clear bias to less inflows as compared to previous years.

We cannot predict how the market may react to the exit from unconventional monetary policy when it eventually arrives, although we have had perhaps a snippet of this. What we do know is that there are substantial risks that such an exit could create significant negative spillovers for emerging market economies. In a speech at Jackson Hole, Christine Lagarde[1], Managing Director of the IMF, posed the question "*how should non-unconventional monetary policy countries prepare and react to the exit from unconventional monetary policy?*" She outlined various measures and policies that can be used in this respect, namely:

- Exchange rate flexibility combined with some market intervention to moderate exchange rate volatility and short-term liquidity pressures;
- Micro- and macro-prudential measures to slowdown excess credit growth and prevent financial sector vulnerabilities;
- Capital flow management measures;
- Swap line facilities; and
- Utilisation of the various precautionary or liquidity facilities the Fund makes available.

As you all would be aware, South Africa has a flexible exchange rate regime and this has served as an important adjustment mechanism through the crisis. We did not implement any capital flow measures, neither did we intervene in the foreign exchange market, although we did, at times use the opportunity presented by strong capital inflows to build our reserves. In the event of disorderly movements in the rand exchange rate, careful consideration would be given to such measures, taking into account a cost/benefit analysis, expectations of likelihood of success and country specific circumstances.

[1] The Global Calculus of Unconventional Monetary Policies, Christine Lagarde, Jackson Hole, 23 August 2013

Lagarde highlights the importance of international policy coordination and cooperation to improve global outcomes. Bank of England, Deputy Governor Charlie Bean[2], in a panel discussion in Jackson Hole, did not necessarily believe that better coordination was a viable option, but instead called for clearer communication around policy intentions. The recommendation of the Committee on International Economic Policy and Reform[3], that large-country central banks should pay more attention to their collective policy stance and the global implications, and where appropriate should consider coordinated action to help stabilise the global economy in times of stress, seems reasonable. This did happen at the height of the crisis, when various advanced economy and emerging market central banks implemented swap line facilities with the US Federal Reserve Bank. In this respect, cooperation in various global groupings such as the G-20 and BRICS, becomes very important.

That clear communication from central banks is important, goes without saying. In a sense, although the comments in May of this year by US Fed Chairman Bernanke regarding possible asset tapering may have caused a great deal of mayhem in financial markets, it also helps to prepare markets for actual tapering, such that when it eventually arrives, it may have a less dramatic impact - a case of “sell the rumour and buy the fact”. Recent events have shown that some degree of tapering was priced into markets and therefore the actual action, may indeed be less market moving than expected. Certainly, the US Fed’s decision at the September 2013 meeting not to taper, for whatever reason - be it an unexpected tightening in financial conditions through the rise in Treasury yields, or concerns over the handling of the looming debt ceiling – was somewhat of a surprise to the markets, but once again highlights the importance of clear and credible communication, where practical.

[2] Deputy Governor for Monetary Policy at the Bank of England, Panel Remarks: Global Aspects of Unconventional Monetary Policies, Jackson Hole, 24 August 2013

[3] Rethinking Central banking, Brookings Institute, Washington DC, 2011

3. Unsustainable deficits?

Why is all this important for South Africa? The slowdown in emerging market economies, together with a still fragile euro zone economy, does not bode well for South Africa's growth going forward. We have seen a noticeable gain over the past number of years in South Africa's exports to other emerging markets, such that they now account for over 40 per cent of South Africa's merchandise exports. China became South Africa's largest trading partner in 2009. The slowdown in emerging market economies, in particular China, and the resultant impact on demand for commodities and commodity prices, has placed pressure on South Africa's exports, and this was reflected in second quarter balance of payments figures.

As in the past, this has once more thrown the spotlight on the sustainability of South Africa's external position. Assistant Governor of the Reserve Bank of Australia, Guy Debelle, noted that current account deficits have a pretty poor reputation, but went on to say that deficits are not always and everywhere a bad thing, notwithstanding the pejorative connotation of the word deficit[4]. The IMF[5] adds that a flexible policy framework – such as a flexible exchange rate regime, a higher degree of openness, export diversification, and coherent fiscal and monetary policies – combined with financial sector development could help a country with persistent deficits be less vulnerable to a reversal by allowing greater room for better shock absorption.

South Africa has been running current account deficits since 1994, with a deficit as high a 7.2 per cent being registered in 2008. It was only in the early 2000s that South Africa had small surpluses. The current account deficits in South Africa over the past few years can largely be related to the infrastructure programme, which we at the central bank continuously point out serve to improve capacity and hence the economic growth prospects of the country.

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[4] In Defence of current account deficits, Address at ADBI/UNISA Workshop on Growth and Integration in Asia, 8 July 2011

[5] Current Account Deficits: Is there a problem, 28 March 2012

Looking purely at the most recent figures, in the second quarter, South Africa recorded a current account deficit of 6.5 per cent of GDP. Although the weaker rand did lift the rand price of exports in volume terms, exports did not perform too well, despite a generally more favourable global environment. Exports were held back by weaker international commodity price and supply side constraints in some of the major sectors in the South African economy. The deterioration in the terms of trade further compounded matters.

With a low savings rate, made up largely of corporate savings, foreign capital to finance the deficits becomes even more important. Corporate savings declined in the second quarter owing to weaker operating surpluses linked to weaker commodity prices, and companies therefore finding themselves having to dip into savings. Combined with the decline in savings, there were widespread outflows of capital from emerging markets, which was also reflected on South Africa's financial account of the Balance of Payments. The financial account recorded a net inflow of capital of just over R39 billion in the second quarter of this year as compared to a net inflow of R56 billion in the first quarter. There was a net inflow of foreign direct investment while a net outflow of portfolio investments in the second quarter of 2013. Combined, the current account deficit and movements in the financial account resulted in moderate deficit in the overall Balance of Payments position which was further reflected in the weaker exchange rate.

Should we be overly worried about South Africa's current account deficit, especially in light of the slowdown in emerging markets and weaker capital inflows? Although the current account deficit is expected to take a little longer to adjust, and the slowdown in emerging markets may weaken an important source of demand for South Africa's exports, the depreciated rand may ultimately translate into a narrowing deficit, via the J-curve effect, benefitting both exporters and manufacturers competing against imports. The relatively unchanged Sub-Saharan Africa growth forecasts of 4.9 per cent and 6.0 per cent expected over the next two years could help underpin demand for South African exports. Furthermore, a growing US economy will be supportive of the global economy and may help to buffer the impact of slower growth in emerging markets. Monthly trade numbers, since the second quarter, have shown

an improvement in trade deficits. Furthermore, while asset tapering may constrain foreign portfolio inflows, this will hopefully not be too dramatic and buffered by local investor interest.

4. Monetary Policy

Monetary Policy across the globe is heading in different directions. Asset tapering by the US Fed, even though it did not happen in September, is still likely to happen sooner rather than later, while a number of emerging market countries have started to tighten policy. South Africa has maintained a steady repo rate since July 2012 when the repo rate was cut by 50 basis points to 5.0 per cent. We continue to face a dilemma, that is, trying to balance the risks of a weaker economy with that of a less favourable outlook for inflation.

Domestic economic growth, as measured by gross domestic expenditure, reflected a modest improvement in the second quarter, driven by an expansion in investment by the private sector, as well as a slight uptick in household consumption expenditure. The outlook for household consumption expenditure remains uncertain, as high wage settlements and positive wealth effects may be counterbalanced by low employment creation, high debt levels and rising administered prices.

At the most recent Monetary Policy Committee meeting, the Bank maintained its growth forecasts for 2013 of 2.0 per cent, and 3.3 per cent for 2014. The negative output gap has widened further, given that growth has been below the potential rate of 3.5 per cent. Therefore, demand driven inflationary pressures remain largely contained.

However, the Bank's inflation forecast has been steadily deteriorating. I should caution that the most recent deterioration in inflation forecasts, as reflected in the September MPC statement, was largely reflective of the weaker exchange rate of the rand at the time of the MPC meeting. The rand has appreciated since, but we are conscious that in this environment the significant amount of uncertainty relating to the tapering of the US Fed's asset purchase program means that volatility will likely

remain high. Wage settlements, food prices, and the exchange rate pose the most significant upside risks to the inflation outlook. Nonetheless, all else being equal, the breach of the inflation target band that we have observed in the last two readings is expected to be temporary, with inflation expected to decelerate as from the September reading.

With so much uncertainty and such divergences in monetary policy across the globe, it becomes difficult to navigate the waters. However, we remain committed to our mandate of securing low and stable inflation in the interest of balanced and sustainable growth. No doubt the task ahead will be challenging, but as always, it is important to keep calm and look through the noise.

I thank you and wish you a successful conference further.