South African Reserve Bank

The South African situation: Opportunities and challenges

Address by Mr Francois Groepe,
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1. Introduction

Ladies and gentlemen, good morning.

It is an honour and a pleasure to address this year's Africa Investor Conference, and I would like to thank my hosts, ICBC and Standard Bank, for the invitation.

The timing of this conference is highly appropriate, as were the discussions that have already taken place regarding the challenges facing African economies amid pedestrian global growth, low commodity prices, increased geopolitical risks, and a high degree of market uncertainty, particularly following the decision of the United Kingdom to leave the European Union ('Brexit').

The African continent, however, continues to offer attractive opportunities for growth and development, provided appropriate policies are pursued to address these challenges. South Africa is no exception.

This morning, I shall examine the current economic conjuncture in South Africa and highlight those developments which make us hopeful that improvement lies ahead. I will also consider how this may affect the outlook for monetary policy, before concluding with some remarks on our country's sovereign rating outlook.

2. International and local challenges to the South African economy

The African continent in general, and South Africa in particular, have not been immune to the challenges faced by the global economy. These include a gradual but sustained slowdown, since the start of the decade, in real global demand for South African exports, in particular from China, as well as a major downward adjustment in the prices of our major commodity exports. These developments have eroded real export growth, incomes, and to some extent also corporate profitability in some sectors of the economy.

Internal challenges have in recent years unfortunately compounded South Africa's economic problems. These include electricity supply constraints, a slow expansion of rail and port capacity, skilled labour shortages, and the high incidence of labour conflicts. This situation has been exacerbated by the recent drought as well as various socio-economic and political factors that have eroded consumer and business confidence. In 2015, agricultural production contracted by an average of 5,9 per cent, and it was still falling in the first quarter of this year.

This conjunction of unfavourable international and internal factors has, unsurprisingly, weighed on domestic economic activity. Real GDP contracted by 1,2 per cent (quarter-on-quarter, annualised) in the first quarter of 2016, and by 0,2 per cent on a year-on-year basis. This was the first negative reading since the 2009 recession. It continued a decelerating trend which has seen real GDP growth slow from 3,2 per cent in 2011 to 1,3 per cent last year. In May, the South African Reserve Bank revised its 2016 growth forecast to 0,6 per cent from 2,2 per cent a year earlier. This growth slowdown is partially structural, reflecting, among other things, the subdued pace of private-sector fixed-capital accumulation since the most recent global financial crisis. The Bank estimates that potential GDP growth will be 1,5 per cent this year, down from 2,1 per cent in 2013.

The first-quarter GDP data has also highlighted the weakness of both internal and external demand for South African goods. In addition to a marked decline in fixed investment by private corporations, household consumption expenditure contracted by 1,3 per cent in the first quarter of 2016 (quarter-on-quarter, annualised), the biggest drop since the 2009 recession, as the mix of rising inflation, higher debt service costs, and a lack of net job creation weighed on both purchasing power and sentiment. On the external side, real exports of goods and services fell by 7,1 per cent in the same quarter, after a relatively subdued 4,0 per cent average gain in 2015. This weakness in real exports is of particular concern as it exceeds, on balance, the pace of moderation in international demand for goods and services. Thus, despite the marked depreciation of the real effective exchange rate of the rand since 2011, South African exporters have struggled to stabilise their market share.

3. Some reasons for cautious optimism

So, where do we go from here?

There is no denying that the economic environment facing South Africa will remain difficult, at least in the short term. Most international forecasters agree that global growth will remain tepid this year. In its latest Global Economic Perspectives, for example, the World Bank projects world GDP to expand by only 2,4 per cent this year, the same as in 2015, and by only 2,8 per cent next year. At the same time, many commodity markets – including some of South Africa’s key export commodities – continue to suffer from excess supply, limiting the potential for a price recovery even as global demand shows signs of a moderate pickup. Geopolitical and financial uncertainties remain a major risk. Just last week, we saw how, in response to Brexit, many emerging-market currencies, including the rand, suffered a burst of volatility, which could add a risk premium in South African and other emerging-market asset markets.

Furthermore, the oft-debated concern about the slowing trend in productivity growth in advanced economies will probably not fade in the near term. This concern has found an echo in South Africa, where annual average labour productivity growth has slowed from 2,7 per cent in the 2000s to 1,4 per cent in the last five years – mostly a consequence of a poorer performance in total factor productivity. It may seem paradoxical to observe such a parallel in South Africa, considering that, as an emerging economy, the country still has plenty of room to 'catch up' with more advanced economies. Nonetheless, a slower pace of global innovation and efficiency gains may affect those South African industries operating close to the 'technological frontier', via more subdued transfers of technology.

Finally, we should acknowledge that South Africa has to contend with more limited macroeconomic policy space. I shall return to monetary policy later. Nonetheless, it should suffice to say that, with policy rates 200 basis points higher now than they were at the start of 2014, funding conditions are not as accommodative for private borrowers as they were before we embarked on our gradual tightening cycle. We have observed, for instance, that interest costs on household debt amounted to 9,7 per cent of disposable income in the first quarter of 2016, up from a low of 8,5 per cent in the third quarter of 2012. As for fiscal policy – which will be discussed in more detail later this morning – the need to stabilise public debt amid weak growth has led to net tax increases both in last year's budget and in the current one, while the pace of public spending growth has also been tightened.

Nonetheless, while we guard against undue optimism, the proverbial 'green shoots' of a recovery may be starting to appear. Although still well below par, the average prices of South Africa's major commodity price exports are off their early-2016 lows. At the same time, the recent fading of El Niño conditions in the South Pacific raises hopes of a more normal agricultural season in 2016/17. If that does turn out to be the case, we could be looking at both a rebound in farm production and lower agricultural prices.

Such a reduced drag from drought conditions and falling resource prices should significantly ease the downward pressure on corporate profits, which may have troughed already. In the first quarter of 2016, the gross operating surplus in the economy as a whole picked up to 3,8 per cent year on year from 1,5 per cent in the previous period, the second successive increase after six consecutive quarters of deceleration. At the same time, high-frequency indicators such as the Barclays PMI and the manufacturing production data for April suggest that the second quarter has started on a more solid footing.

Admittedly, many of these developments relate to the so-called ‘base effects’ and are no guarantee that, once these effects have worn through, we will witness a sustained, stronger momentum in the South African economy. However, several – and more fundamental – patterns do suggest that the country should be relatively well placed to take advantage of a gradually improving global economic environment, notwithstanding the possible negative implications of the Brexit. For example, continued growth in the bank deposits of the corporate sector – 8,6 per cent year on year as of April – suggests that, despite its eroded profitability, the South African corporate sector is not facing the kind of liquidity pressure that typically preceded past recessions. In fact, bank lending to corporations is also rising at a fairly dynamic pace, pointing to some expansion in niche sectors such as renewable energy and commercial property.

Households, for their part, have managed to achieve some deleveraging over the prolonged period of low interest rates. Thus, while the rate of home and vehicle repossessions has risen in recent quarters, it is still relatively low by historical standards. Banks themselves continue to display solid capital adequacy, liquidity coverage and profitability ratios, suggesting that the risk of a sudden ‘pull-back’ in lending to the private sector is quite limited at this stage. The lack of obvious imbalances in property markets, as residential house prices appear to be largely in line with underlying fundamentals, equally reduces the risk of ‘home-grown’ financial or banking stress.

The South African Reserve Bank last month released the results of its common scenario stress test which was designed to assess the soundness and resilience of the South African domestic banking sector. The test included all the domestic systemically important banks. A formal approach to risk identification and scenario design was followed, and the banks were exposed to four adverse scenarios, including a protracted recession and a period of excessive financial market volatility. The results of the exercise confirmed that South African banks were adequately capitalised to withstand significant credit losses throughout the stress scenarios, even before taking into account any mitigating action by their management teams.

After the Brexit referendum, financial markets in emerging-market economies were exposed to significant levels of volatility. The South African Reserve Bank and National Treasury have been monitoring these developments and their possible implications for South Africa. In a subsequent statement, the Minister of Finance, Mr Pravin Gordhan, reassured the public that the banking and financial institutions in South Africa were well placed to withstand any Brexit-related financial shocks. The South African financial system, including the banks and the regulatory framework which governs them, is resilient and robust and this had been clearly demonstrated during the global financial crisis.

Furthermore, we are starting to see tentative signs that export-orientated and import-competing sectors may be starting to benefit from exchange rate depreciation. The most encouraging sign has been observed in the vehicle industry, where shipments abroad increased by 20,5 per cent (in volume terms) in 2015 while the first few months of 2016 have shown a continuation of this upward momentum. The merchandise trade balance has improved, with a cumulative deficit of R18,7 billion in January to April compared with R32,0 billion in the same period a year earlier.

4. How monetary policy adjusted to the situation

Some may ask: “Isn’t there a risk that the consecutive interest rate increases implemented by the South African Reserve Bank over the past year may nip this recovery in the bud?” As I’ve mentioned earlier, we must appreciate that ‘policy space’ in South Africa has narrowed. I would, however, like to expand on the Bank’s monetary policy stance and how it interacts with the business cycle.

Clearly, the situation that we have faced in the past couple of years – a combination of slowing real economic growth and accelerating price pressures –

is not one that central banks particularly enjoy dealing with. Demand fell short of potential and our estimates show that the output gap remained negative in 2015 and is likely to widen somewhat this year. Yet inflation accelerated, driven by exchange rate depreciation and a number of supply side factors, including drought and electricity supply constraints. Despite a slightly improved forecast in May, inflation is still expected to remain above the upper end of the target range until the third quarter of 2017 – and the risks to this forecast were assessed to be on the upside. In light of our flexible inflation-targeting mandate, we needed to ask ourselves a number of questions, including:

- How strong and durable would the drivers of inflation prove to be?
- To what extent should we take the weak state of the economy into consideration?
- To what extent would the persistence of the output gap limit the pass-through from exchange rate depreciation to domestic prices?
- How big was the risk that this unusually large depreciation (51 per cent in nominal effective terms since the end of 2010) would unanchor inflation expectations?

Indications of a lower exchange rate pass-through to inflation have been encouraging. If we look at the core rate of inflation (i.e. headline inflation excluding food, petrol and energy), it has accelerated by 2,6 percentage points since it bottomed in early 2011. By contrast, in response to the previous cycle of significant exchange rate depreciation (58 per cent between 2006 and 2008), core inflation increased by 7,9 percentage points. This suggests that the lack of dynamism in consumer demand as well as the absence of a credit boom or of significant wealth effects seem to have limited the ability of producers and retailers to pass through cost increases to the end consumer. Yet, because this reduced pass-through, which incidentally is not unique to South Africa, is not yet fully understood, we cannot become complacent and assume that it has become a permanent feature of our economic landscape. The pass-through has not been constant over time; just as it fell, it could rise again.

The role of inflation expectations therefore becomes paramount. Historically – in part because of the major structural changes the economy went through in the last 50 years and in part because of a long period of high and volatile inflation (from the 1970s to the 1990s) – price expectations in South Africa appeared to be adaptive, as reflected in the behaviour of price and wage setters, be they businesses or organised labour. The introduction of inflation targeting in 2000 helped, over time, to reduce the volatility and adaptive nature of inflation expectations. Expectations have, in recent years, been relatively stable, although around the upper end of the 3-6 per cent target range. This 'upward bias' in expectations limits the margin of manoeuvre of the South African Reserve Bank, insofar as any sizable shock to prices can easily create a situation where inflation settles above the target range for an extended period of time.

This was indeed the risk that emerged over the past few years – and which forced the Monetary Policy Committee (or MPC) of the Bank to act. As our projections have shown, in particular from January 2016 onwards, in the absence of further action, inflation would exceed its targeted range for lengthy periods of time over the forecast horizon. Accordingly, the MPC felt the need to move to a less accommodative stance. Thus, the repurchase rate was increased from a low of 5 per cent in January 2014 to 7 per cent as of May, including a cumulative increase of 75 basis points in the first quarter of this year. I would like to emphasise, however, that this pace of increase was more gradual than in previous tightening cycles. Furthermore, when expressed relative to both actual and expected inflation, the *real* policy rate is still relatively low by long-term historical standards. Thus, monetary accommodation has been partly removed, but without moving to an outright restrictive stance.

5. Inflation and policy outlook

As I've mentioned before, the combined effects of the drought and exchange rate depreciation have pushed up the rates of both headline and core inflation over the past six months – and this despite the dampening effect from lower international oil prices. Headline inflation rose from a low of 3,9 per cent in February 2015 to as high as 7,0 per cent a year later before retreating to 6,1 per cent in May. Core inflation, which had trended modestly downwards for most of 2015, rose from 5,1 per cent last November to 5,5 per cent as of May. Some of this acceleration reflects a pass-through of foreign-exchange depreciation to the prices of goods. However, the evidence varies according to specific categories, suggesting that this pass-through is far from homogeneous.

In light of these relatively encouraging developments, and taking into account the moderate rebound in the rand from its early-2016 levels, the South African Reserve Bank has been able to lower its projection for core inflation, albeit only somewhat: whereas it expected a peak of 6,5 per cent in the third and fourth quarters of 2016 at the MPC meeting in March, the Bank expects core inflation to peak at 6,2 per cent around the same period before retreating to 5,1 per cent by the end of 2017. Any sign that underlying price pressures remain contained would facilitate the task of the Bank in dealing with the current conflicting risks facing real economic growth and inflation.

Of course, vigilance will be needed in the coming quarters, as the secondary effects of earlier shocks (in particular on the exchange rate) are still being felt – and there is no guarantee that inflation expectations will remain stable. So far, evidence on these fronts is mixed. Expectations for CPI inflation one year ahead – as measured by the Bureau for Economic Research among analysts, businesses and unions – drifted marginally higher over the past year but, at 6,2 per cent, they are still very close to the 6,0 per cent average of the past five years. Break-even inflation expectations, derived from inflation-linked government bonds, are significantly higher (around 7,0 per cent as of 21 June for the five-year rate), but this measure is highly volatile and sensitive to exchange rate fluctuations.

As for wage developments, it is encouraging to note that the Andrew Levy measure of average annual wage settlements, at 7,8 per cent in the first quarter of 2016, is little changed from the 7,7 per cent gain observed on average in 2015. However, several key wage negotiations lie ahead, with a possibility that wage demands may take cognisance of the recent acceleration in inflation. With respect to both inflation expectations and labour costs, the next few months could be crucial.

6. Investment-grade ratings, the rand, and inflation

One important element in securing the stability of inflation expectations, in part because of the influence it is likely to have on the level and volatility of the rand, will be the ability of South Africa to maintain its investment-grade rating – and this leads me to my concluding points.

I do not need to stress how thoroughly the South African Reserve Bank has been monitoring the evolution of South Africa's sovereign debt ratings. A sovereign rating can have an impact on monetary policy because of how it influences the availability and cost of external financing, the yields on domestic debt and, in turn, the performance of the rand – both in absolute terms and relative to its emerging-market peers. South Africa, being a structural net capital importer, needs to secure the best possible 'terms and conditions' under which it accesses global sources of funding. Any adverse developments on this front would probably further complicate the challenges of weak growth and rising inflation that the Bank has to deal with currently.

This said, while investor and media attention will probably be on South Africa again come the time of the next rating reviews, there are several reasons which make us confident that, provided the right policies continue to be put in place, our country can retain its investment-grade rating. As I've highlighted earlier, economic growth, which has been a key concern of the rating agencies, is showing signs of bottoming. At the same time, while public debt as a share of GDP is only expected to stabilise in 2017/18, the 2016 budget has put in place genuine elements of fiscal consolidation and the discipline shown by central government in recent years to stick to its expenditure targets should facilitate the achievement of these fiscal goals.

Furthermore, as far as the country's external liabilities are concerned, it is encouraging to see that they have declined, in absolute dollar terms, over the past four quarters, breaking a lengthy upward trend. This improvement is partly due to the exchange rate-induced decline in the dollar value of rand liabilities held by non-residents. External debt has also declined relative to GDP and to the exports of goods and services. For example, as a share of exports, external debt stood at 118,9 per cent at the end of December 2015, down from a peak of 124,6 per cent three quarters earlier. A further positive side-effect of rand depreciation has been the improvement in South Africa's net international investment position: as most investments by non-residents in South Africa are rand-denominated, in contrast to investments by South African residents abroad, the currency effect more than offset the net incurrence of new liabilities required to finance the current-account deficit. Thus, as at the end of 2015, the net investment position stood at a positive 17,8 per cent of GDP, compared to the 2,8 per cent in the previous quarter.

7. Conclusion

To conclude, I would just like to emphasise once again that notwithstanding the challenges that the South African economy currently faces, we should equally not fall into excessive pessimism. The underlying corporate and financial structures of our economy remain solid; there are no major impediments to a proper allocation of resources. And provided that the right policies continue to be put in place, there is no reason to doubt the country's ability to gradually return to a stronger economic growth path. The National Development Plan provides the right framework for addressing the structural challenges that have so far precluded a stronger and more inclusive pace of development; it is important that it gets implemented. By ensuring that inflation remains under control and that the financial sector remains healthy, the South African Reserve Bank intends to fully contribute towards these development goals.

Thank you.