

**Presentation to Kagiso Trust by Dr Monde Mnyande,  
Chief Economist and Executive General Manager of  
the South African Reserve Bank, on recent  
economic developments  
in South Africa**

**30 May 2008**

**Chairperson**

**Board of Trustees**

**Distinguished guests**

It is more than just a privilege to address, among others, the custodians of policies, philosophy and ethics of this great institution, the Kagiso Trust.

The role of this body to the current political and economic challenges of the Republic remains as important now as it was when it was first established in May of 1985.

On my way to the United Kingdom last week, I surprisingly travelled with Ms B. Njobe, who politely instructed me to change my previous arrangements to come and debate some salient issues on the state of our economy. I hope to do so in less than 20 minutes and entertain your views and/or comments as to how you see the direction of this economy from your respective areas of interests.

The theme of last week's fifth Central Banks' Chief Economist Workshop at the Bank of England's Centre for Central Bank Studies was "The Nexus between macroeconomics dynamics and finance". About 30 Central Banks' Chief Economists and academics from developed and emerging countries

converged to exchange views on this almost classical paradigm or relationship between the financial sector and current economic growth.

The common worrying factor from the workshop participants seems to be the level of uncertainty in the global financial sector, following the recent international financial turbulence – that began in the United States – and its implications for the world economy.

Analysis presented seems to suggest that the consequences of the uncertainty to the world economy will more than likely be a protected slowdown in global economic activity.

Two of South Africa's major trading partners, the United Kingdom and the United States, confirmed in the meeting that the outlook for growth and inflation in their respective countries has deteriorated sharply over the forecast period. This was confirmed by the figures released earlier this week.

The news of slowing growth and raised inflation projections from most countries fuelled renewed worries regarding the inherent health and stability of the global financial system. Nevertheless, all is not doom and gloom – over the past 15 years authorities have taken numerous steps to increase the robustness of the system.

Raised inflation projections for most of our trading partners also come from international energy and food shocks.

Locally, South Africa's economic growth has performed fairly well in the last four years. The real economy has recorded growth rates of around 5 per cent per annum in each of the past four years.

On the prices front, inflation remained within the target range of 6 to 3 per cent for a protracted period, as CPIX inflation was within the range for a period of

43 months (slightly more than 3 years) up to March 2007. Thereafter it has unfortunately risen above the target range.

As expected this year, the South African economy lost steam in the first quarter of 2008. Performance was notably impacted by a series of supply-side shocks emanating from the international energy and food markets and domestic energy sector.

Compared to the past four years' performance, some moderation of economic growth is indeed anticipated for 2008.

### **Moderating factors**

Real value added by the secondary sector recovered in the fourth quarter of 2007, contributing to the 5,1 per cent real economic growth for 2007 as a whole. The unsettling performance of factory output in the first quarter of the year was partly influenced by scrambling for electricity. Along with weaker demand this suggests that the secondary sector of the economy will experience a significant slowdown this year.

Growth in the primary sector slowed sharply in the first quarter of 2008, as a contraction in mining production was recorded, due partly to shaft closures for safety reasons and to the adverse impact from Eskom's load shedding. Both these key employment generating sectors of our economy – the secondary (manufacturing) and primary (mining) sectors – have fallen prey to the severe power crisis experienced at the beginning of this year. Depending on the severity of continued electricity shortfalls, the likelihood of a below potential output performance this year remains high.

On the expenditure side, both household and government expenditure slowed in 2007 due to a number of factors, including among others, the current tight monetary conditions.

Despite the slowdown in overall spending, real gross capital formation or investment remained strong in 2007, with indications of continued momentum in the first quarter of 2008. Infrastructure development should result in sustained high levels of capital formation. Such investment spending is in our view destined to provide welcome momentum to growth in the medium to long term. Following the words of the Governor in his recent speech, we will after all see “better times” in the near term.

### **Leading indicator and inflation**

South Africa is still recording the longest expansion phase of the business cycle on record. The composite leading business cycle indicator points towards a slowdown in the economy. This is by no means signalling prospects of a recession, as some have inferred. Also, in my view the extent of the current slowdown would not warrant the determination of an upper turning point in the business cycle, at this point and time. Some evidence of a recovery in the medium term, as I have earlier suggested, indeed exists.

The current trend of the leading business cycle is informed mainly by opinion surveys, such as the business confidence index and interest rate sensitive demand-side indicators, such as vehicle sales.

Factors such as electricity supply disruptions, declining household spending, contracting business volumes and expectations of reduced company profits contribute to the current negative sentiment in the economy. Justifiably so – I must submit.

Inflation remains high due to petrol and food prices, among other factors, and the targeted CPIX inflation rate is currently 10,4 per cent, far above the target of 6 to 3 per cent. Wage settlements are drifting higher, as are inflation expectations. These present a challenge for the country and the Bank.

Inflation is, however, projected to decline towards the target range in the final quarter of 2009, as relatively tight monetary policies slow down underlying inflationary pressures. CPIX inflation is likely to remain quite high in the next few months – factoring in the recent trends in petrol prices and the under-recovery of underlying fuel costs.

### **External sector**

On the external accounts, merchandise imports continue to outstrip exports resulting in a sizeable trade deficit. The trade deficit has thus widened markedly in the first four months of this year.

Thus, the current-account deficit is likely to remain above 7 per cent of GDP in the first half of this year, largely reflecting the impact of capital goods imported. This may and should be viewed favourably going forward in terms of investment momentum and its contribution to growth. Regardless, the ratio at these levels is not viewed lightly or without due attention by the monetary authorities.

Despite global financial market instability, non-residents continue to find value in the South African domestic markets as evidenced by a general trend of net inflows into equities and debt securities, although sometimes with short-term reversals. This may be expected in a liquid, active market. Significant foreign direct investment inflows have been recorded in the first quarter of 2008. Unfortunately, in the short run, the yields on these securities coupled with other interest payments on the country's foreign debt continue to keep the services account's transactions on the external accounts in the red.

Continued accumulation of gross gold and other international reserves by the South African Reserve Bank contributes to a favourable international liquidity position. The gross reserves now exceed US\$34 billion, more than four times as much as in 2003.

## **On monetary developments and financial markets**

I submit that a less accommodative monetary policy stance and stricter lending standards have indeed contributed to a slowdown in credit extension by financial institutions.

High inflation and volatility of the exchange value of the rand have been reflected in high bond yields. Trading activity in both the equity and bond markets remain firm, regardless of the release of worse-than-expected inflation numbers.

Bond yields increased further to 11,50 per cent for the short-dated R153 and 9,82 per cent for the long-dated R157, yesterday. Compared to the current repo rate of 11,50 per cent the rate on forward rate agreements most recently amounted to 13,18 per cent, 13,20 per cent and 13,00 per cent for the 3 x 6, 6 x 9 and 9 x 12 FRA's, respectively. This indicates expectations of further increases in short-term rates.

Bond yields are also influenced by the current-account deficit and reliance on portfolio capital flows. We are aware that the market has also taken cognisance of the Bank's interest in underlying inflation (CPIX excluding food and petrol) which increased to 6,1 per cent most recently.

Higher commodity prices continue to lend support to the overall level of share prices.

Property prices have decelerated sharply on account of reduced affordability due to, among others, the simultaneous rise in house prices and interest rates.

## **Inflation outlook**

The outlook for CPIX inflation deteriorated substantially since the beginning of 2008, rising from 8,8 per cent in January to 10,4 per cent in April 2008.

The main risk to the inflation outlook emanate from recent movements in food price pressures and the escalation in fuel and energy prices. The recent trend in rising actual rates of inflation has also caused inflation expectations to accelerate sharply in the first quarter of 2008. This would most probably be reflected in higher salary and wage demands.

International Brent crude oil prices have increased from an average of US\$92,8 per barrel in January 2008 to US\$130,4 per barrel on 28 May 2008. Domestic petrol prices (95 octane petrol) have accordingly increased from R7,47 per litre at the beginning of January to R9,46 per litre in May and it is anticipated to increase further in June on the basis of the current under-recovery.

Food prices have risen substantially since the beginning of the year, reaching 15,9 per cent on a year-on-year basis in April 2008. The increase in food prices is broad-based and primarily reflects the rising trends in international grain prices and food production and distribution costs, as well as the depreciation in the value of the Rand since the beginning of the year.

Electricity prices also pose a significant risk to the inflation outlook. The National Energy Regulator of South Africa (NERSA) is due to make a decision on the application by Eskom to raise electricity tariffs by more than the original approved 14,2 per cent on 18 June 2008. In addition, the electricity price levy of 2c per kWh announced in the Budget Policy Statement of February 2008, and the announced increase in property taxes will add further pressure to inflation.

## **Concluding remarks**

Given these broad-based inflationary pressures, CPIX inflation is unlikely to return to within the inflation target range before 2010. And the public, both of the Republic and the Southern African region, expects the value of the Rand currency to be protected, now and beyond 2010.

It is not in the best interest of the Bank to curb activity through painful policy rate adjustments, but to provide a platform, among other agents, for another prolonged and healthy economic cycle. Constraining inflation is what most Central Banks world over, are mandated to do.

At the South African Reserve Bank we conduct Monetary Policy in the interest of broader South African economic objectives – which are employment creating growth and poverty alleviating goals. Upward adjustment of the policy rate does not indicate a deviation by monetary authorities from these goals.

An understanding of the Bank's role in this economy by the South African society and its purpose to achieve what is in the best economic interest of this country should be viewed in a positive light by the Public as a whole. Unbridled price increases, as reflected in the basket of consumer goods and services, go against the interest of economic growth and development and must be resisted by the Bank and by all role-players in society. It must also be remembered that high inflation punishes the poor disproportionately.

The Bank needs the support of your institution, of other formations of similar standing, of the country's political formations, unions and civil society to continue to focus on curbing high rates of inflation, and maintaining the value of the Rand.

I trust that the Bank can, at the least, count on the support of your institution in fighting inflation – and can assure you that the MPC Policy decisions are

decided upon in a professional, non-sectarian, a-political, and more than certain, in an environment that considers the micro and macroeconomic welfare of all South Africans.

Thank you very much for your attention.

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