South African Reserve Bank

Introductory remarks
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Welcome to the launch of the June 2012 *Quarterly Bulletin* of the South African Reserve Bank, in which the focus is on economic developments in the first quarter of 2012. Allow me to first point out a handful of notable trends and highlights, which will be illustrated in the graphs to be presented shortly.

In a nutshell one can say that the South African economic recovery continues, despite both international and domestic headwinds. Growth decelerated slightly in the first quarter of 2012, and continues to be unevenly dispersed at the sectoral level. Aggregate domestic expenditure again rose more briskly than domestic production over the period.

As far as the international environment is concerned, economic outcomes in the euro area in particular have been disappointing in the first five months of the year. This has contributed to a weakening of most commodity prices and a moderate deterioration in South Africa's terms of trade. Strike activity in the first quarter of 2012 also detracted from mining production and exports, resulting in subdued export volumes while import volumes continued to rise. Under these circumstances the trade deficit with the rest of the world widened in the first quarter of the year. Together with a larger shortfall on the services, income and current transfer account with the rest of the world, this resulted in a further widening of the current-account deficit.

However, one should remember that this current-account deficit was again readily financed from abroad, and more fundamentally that the floating exchange rate dispensation in South Africa provides a mechanism which moderates the magnitude of imbalances arising on the balance of payments. The exchange value of the rand in fact declined in the second quarter of 2012. It may also be noted that company dividend declarations - and therefore dividends accruing to non-residents - rose significantly in the quarter under review, partly to escape a higher effective rate of taxation later on. This may therefore well be temporary in nature.

A most welcome trend is the further strengthening of South Africa's foreign travel receipts from the rest of the world. It should be pointed out that such receipts have risen to the point where they now exceed the travel proceeds recorded at the time of the FIFA World Cup Football Tournament in 2010. Structural changes supporting this trend include higher spending by visitors from African countries such as Angola. The increased travel receipts is also testimony to the efforts of the tourism sector, alongside South Africa's diversity, natural beauty and pleasant climate. While this release of the *Quarterly Bulletin* coincides with the longest night and shortest day in the Southern Hemisphere, even at this point the maximum temperature for the day in sunny Pretoria will be a pleasant 19 degrees centigrade.

Allow me to mention the most recent inflation outcomes. The consumer price inflation rate released on 20 June could not be incorporated in this *Quarterly Bulletin*, which had already been printed at the time. However, the fact that in the early part of 2012 inflation has generally been lower than earlier projections is to be welcomed, as is the reading of 5,7 per cent which was released yesterday by Statistics South Africa. Recent trends in food inflation and in the oil price have been favourable, while the rather tame pace of increase in bank loans and advances to the private sector suggests the absence of credit-driven inflationary pressures.

The modest gain in formal-sector employment in the first quarter of 2012 (released on 19 June) is also to be welcomed, although South Africa clearly needs stronger momentum on this front. The South African Reserve Bank continues to provide a stable platform for enhanced growth and job creation through its policies. At the same time the Bank monitors the range of initiatives, programmes and policies set to structurally raise South Africa's growth and employment potential, and is heartened by the greater urgency attached to them.

These then are a few pointers. The presentation highlighting key graphs from the publication follows immediately.

The **Introduction** to the June 2012 *Quarterly Bulletin* reads as follows:

Concerns about fiscal sustainability in Italy and Spain gave rise to a sharp increase in sovereign yields in the closing months of 2011. These fears and the concomitant loss of confidence were partly arrested by strong policy responses and a simultaneous commitment by European Union (EU) member countries to address the fiscal deficits and outstanding debt obligations of European economies. Furthermore, the provision of additional funding by the European Central Bank (ECB) helped to reduce the risk of a liquidity crisis, thereby raising market sentiment and contributing to the enhanced economic performance of advanced as well as developing countries in the opening months of 2012. The more optimistic outlook, however, deteriorated somewhat in May 2012 on renewed concerns and mounting speculation that Greece may leave the euro area and fading hopes of reaching a resolution on fiscal integration. This negative news unsettled global financial markets, causing stock markets to tumble while simultaneously increasing volatility in foreign-exchange markets. Although the outlook for growth in the United States (US) improved in the first quarter of 2012, activity in China, India and emerging Asia moderated alongside weaker growth prospects for the euro area, South Africa's most important trading partner.

Real economic growth in the domestic economy decelerated to 2,7 per cent in the first quarter of 2012, notwithstanding the sustained accommodative monetary policy stance and an improvement in business confidence levels. Production volumes in the mining sector contracted sharply in the first quarter of 2012 due to domestic supply constraints alongside relatively weaker demand from especially Asia. Growth in the real output in the manufacturing sector, however, accelerated in response to a more vibrant domestic economy; export volumes remained fairly subdued over the period. In addition to relatively weak demand from the euro area, domestic producers also experienced a decline in international price competitiveness due to an increase in the real effective exchange rate of the rand. Real value added by the construction sector rose moderately, largely underpinned by civil construction activity. By contrast, the real output of the trade sector displayed slower growth over the period. The finance sector recorded the strongest growth among the tertiary sectors in the first quarter of 2012.

Consistent with the slower growth in domestic production, real gross domestic expenditure also lost some momentum in the first quarter of 2012. Household consumption expenditure moderated in pace with a slower rate of increase in real disposable income, notwithstanding low interest rates and attractive prices of imported items. Government consumption expenditure increased at a slower pace in the first quarter of 2012, reflecting a decline in the procurement of military equipment and a much slower pace of increase in salaries and wages following the completion of the population census fieldwork conducted in the preceding quarter. Fixed capital formation was supported by the enhanced affordability of imported capital goods, low interest rates and the higher priority assigned to infrastructural development in public-sector investment programmes. Nevertheless, the ratio of fixed investment to gross domestic product in South Africa remained low relative to that of many other developing countries and to investment levels needed to obtain higher growth. Enhanced levels of capital formation, allocated to economically efficient and sustainable projects, would go a long way towards strengthening the job-creating capacity of the economy.

According to the *Quarterly Labour Force Survey (QLFS)* conducted by Statistics South Africa (Stats SA), South Africa’s official unemployment rate rose from 25 per cent in the first quarter of 2011 to 25,2 per cent in the first quarter of 2012. Even though 304 000 job opportunities were created in the year to the first quarter of 2012, the pace of increase was not sufficient to prevent the number of unemployed people increasing by 164 000; the number of discouraged work-seekers also rose by 112 000 over the same period.

Owing to the sustained strong increases in real gross domestic expenditure, the deficit on the trade account of the balance of payments widened significantly in the first quarter of 2012 as import volumes continued to rise alongside declining export volumes. The size of the trade deficit was exacerbated by a further deterioration in South Africa’s terms of trade, as declining commodity prices adversely affected South Africa’s export earnings. Combined with a meaningfully larger shortfall on the services, income and current transfer account with the rest of the world, the current-account deficit widened further to 4,9 per cent of gross domestic product in the first quarter of 2012. This negative imbalance continued to be financed through a combination of net foreign direct investment, portfolio and other investment-related foreign capital inflows. In fact, the substantially larger net inward movement of capital in the first quarter of 2012 gave rise to an improvement in the overall balance-of-payments position. This contributed to an increase in the nominal effective exchange rate of the rand over the period, assisting in the moderation of inflationary pressures.

Global consumer price inflation remained well contained in early 2012, despite intensifying concerns regarding international oil prices resulting from geopolitical tensions over the period. Against the background of slowing global demand, crude oil prices, however, receded notably in May. In South Africa the acceleration in domestic inflation was arrested during the opening months of 2012 as twelve-month headline consumer price inflation moderated from
6,3 per cent in January 2012 to 6,0 per cent in March before picking up marginally to 6,1 per cent in April. This favourable development primarily resulted from a moderation in food price inflation.

Growth in credit extension picked up its pace during the first quarter of 2012, buoyed mainly by renewed appetite for credit by the corporate sector, which probably reflected the sector's continued fixed investment activity and inventory accumulation. Although all credit categories contributed towards the overall increase in total loans and advances, the general loans category remained the dominant form of new credit extension in the opening months of 2012, while the asset-backed categories maintained muted growth rates. General loans to the household sector – also referred to as unsecured lending – rose briskly although at a somewhat slower pace than before.

Short-term money-market rates continued to track the sideways movement in the repurchase rate during the first five months of 2012, while forward rate agreements most recently started discounting the possibility of policy easing towards the end of the year. The South African Reserve Bank's Monetary Policy Committee (MPC) kept the repurchase rate unchanged at its May 2012 meeting. While the inflation forecast appears to be more favourable, the committee emphasised the renewed risks from a possible further weakening of the exchange rate of the rand. However, the MPC noted that countervailing pressures could come from weaker demand and lower commodity prices, particularly those of oil. On balance, the risks to the inflation outlook appear to be somewhat on the upside.

Despite the change of South Africa's sovereign debt outlook to negative by the rating agency Standard & Poor's in March 2012, local bond yields continued to fluctuate downwards. This trend occurred alongside the appreciation in the exchange value of the rand up to March, the release of better-than-expected inflation data, strong demand for domestic bonds by non-residents and the announcement of the likely inclusion of South African government bonds in the Citigroup World Government Bond Index (WGBI) in the near future. Citigroup confirmed such inclusion early in

June, indicating that it would take effect in October. Domestic share prices reached an all-time high in early May 2012.

National government recorded a smaller deficit in fiscal 2011/12 than originally budgeted, mainly on account of stronger revenue collections. Corporate income tax and customs duty collections exceeded the original projections by a considerable margin, more than offsetting weaker-than-budgeted value-added tax collections. The deficit of 4,9 per cent of gross domestic product was predominantly financed in the domestic bond market. Despite more than three years of significant fiscal stimulation, government's gross loan debt, while rising, still remained below 39 per cent of annual gross domestic product.