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International, domestic, regional – comments on the South African economy

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Thank you for inviting me to address you today.

We find ourselves at a particular juncture of longer-term economic trends specific to the South African economy and some shorter and longer-term dynamics arising from the global economic environment. I want to speak today about some of those trends and how they interact with the South African economy. I also want to explore how the further development of Sub-Saharan Africa as an economic region helps the South African economy to weather the storms of the global environment and expand our markets.

Prudent fiscal and monetary policies have contributed to a vastly improved economic climate, while government's expenditure programmes have lowered the costs of economic activity and broadened access to the economy for the disadvantaged. Over the past two years, stronger growth in the world economy and rapidly rising commodity prices have contributed to South Africa's improved growth performance. Low yields on developed country assets have further strengthened capital inflows to South Africa and the developing world more broadly, and enabled us to borrow from the rest of the world to finance consumption and investment.

Over the very long-term, the growth rate of the economy slowed from about 1975 through to 1993, and has accelerated since. From 1994 to 2000, growth averaged 2,9 per cent per year, and has accelerated to 3,8 per cent from 2001 to 2006.

The MTBPS forecast, which will be published on 25 October, will take into account short-term effects on the economy, such as interest rate changes (repo now at 8%) and money supply growth (+24% in August), and longer-term effects, such as the impact of real depreciation on net exports.[1]

Looking at growth by sector, the most rapid advances have been in construction, wholesale and retail trade, and financial services. Manufacturing growth has been more variable, with recent good rates (4,1 per cent for 2005 and 4,5 per cent for the first half of 2006).[2]

The economy's robust growth has been propelled by private and public investment, which grew by 9,2 per cent in 2005 and by 10,3 per cent in the first half of 2006. Investment has averaged growth of nearly 10% from 2003.

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[1] Real depreciation (nominal adjusted for inflation) has a negative effect on consumption in the short-term as it represents a real loss of income in ppp terms and increases the cost of imported goods. Over time, imports fall (or grow more slowly) because the cost has risen and exports rise because they are more competitive. This is reflected in the 'j-curve' effect, which shows a worsening the trade and current account deficit before it begins to improve. The depreciation has to be real for it to have real economic effects… so if inflation rises in the wake of the depreciation, then it is only a nominal depreciation. There are no long-term economic effects of this except higher inflation and a raised price level.

[2] Growth in manufacturing in 2003 and 2004 was -1,4 and 4,6 per cent.

As a percentage of GDP, gross fixed capital formation rose from 17.3 to near 18 % over the same period.[3]

Robust growth in investment has been matched by household spending that has been propelled by historically low inflation and interest rates and greater access to finance. Household consumption spending averaged 3,5 per cent from 1995 to 2000 to 4,7 per cent from 2001 and reaching 7,3 per cent in the first half of 2006. Some commentators have pointed to a rise in a new black middle class to explain part of this rise. Our official employment statistics, which we all recognize need work, seem to bear out an increase in employment in the economy. Real wage growth, averaging 1,0 per cent a year since 2001, is also supportive.

We need to remain mindful of the limits of our labour market statistics, however, in part by noting that the ratio of household debt to personal disposable income has climbed sharply in the last two years – from 52,8 per cent in March 2001 to about 70 per cent today.[4]

Climbing household debt reflects a broader trend of persistently weak saving across the economy. Household saving as per cent of GDP has fallen to 1,5 per cent this year.

Our overall saving and investment performance is reflected in the current account deficit, which averaged 6.1% of GDP in the first half of 2006. In itself the deficit does not present financing difficulties. Our foreign exchange reserves have increased to over US$24 billion and our fiscal deficit is low. Net inflows of

[3] Investment grew most rapidly in sectors needing to upgrade building stock, with the bulk of investment in machinery coming through the manufacturing sector. Growth in residential buildings has been exceedingly strong in 2006 at 21,8% per cent followed by non-residential building and construction at 10,8 and 6,6 per cent, respectively. In 2005, investment expenditure in residential buildings was 16,6%. Investment in transport equipment has also been robust – at 19 per cent in 2005. And while growth in machinery was quite moderate (at about 5.5% in the first half of 2006), it constitutes a large percentage of overall GFCF (about 45%).

[4] Despite considerable improvement in growth, recent improvements in employment, have been limited to non-traded goods, services sectors (like construction), and the informal sector. Employment in export sectors and import-competing sectors remains a challenge, as reflected in relatively low increase in formal sector employment.

capital have remained strong, with about R54 billion into equities and R19 billion into bonds in the year to date.

Current account balance

Year	Balance
2003	-1.3
2004	-3.4
2005	-4.2
2006 (H1)	-6.1

Unfortunately, the current account deficit also reflects a weaker trade balance, with imports of consumer goods, petroleum, motor vehicles and some capital goods especially high.

Much of this import content contributes to improvements to productivity over the long-run, and reflects stronger growth in investment by public and private corporations – but there is a clear need to consider how to boost South Africa's export performance and develop stronger and more permanent exporting relationships.

The import content of investment is also high, with a minimum of about 40%. The Gautrain and World Cup infrastructure projects, plus the many other capital spending programmes underway throughout national, provincial and local spheres of government, will put pressure on imports and also contribute to economic growth.

Stronger investment will result in future improvements in saving, better growth rates, and will strengthen capital inflows and dampen movements in the exchange rate. Nonetheless, overshooting of the exchange rate by financial markets will continue to be a common feature of commodity exporting countries.

Uncertainty about the trajectories of major world economies will continue to add volatility to the international environment and flows of capital between developed and developing countries. At root is a pattern of large current account deficits and surpluses in major economies, caused by…

- negative shifts in saving, positive but mild shifts in investment, in the United States.
- positive shifts in saving, and negative shifts in investment, in the rest of the world.
- portfolio shifts towards US assets, by both private and public (accumulation of dollar reserves by central banks) investors.

The path of adjustment needs to be a gradual depreciation of the US dollar to avoid international financial contagion.

The South African economy can support a larger current account deficit, in part because of its improved growth performance itself and in part because of the policy underpinnings we have put in place over the last ten years.

Fiscal policy is supported by a transparent and robust budget process. Increased expenditure is further helping to sustain economic growth by broadening its base and drawing people into the formal economy.

Nonetheless, more work needs to be done to improve expenditure performance. As real budgeted allocations have increased strongly since 2001, limits to ability of departments, provinces and municipalities to spend have become apparent.[5]

Shift in deficit targets in 2006 MTEF from around 3% to below 1.5% signals policy stance towards reducing government dissaving, decreasing pressure on the real exchange rate, and lowering the current account deficit.

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[5] FY 2005/06 under spending of R5.6 billion of available funds (2.4 percent).

Monetary policy anchored by inflation targeting framework, which allows an exchange rate cushion for the economy, enables increasing reserves, and has contributed to historically low interest rates.

The recent upturn in inflation primarily reflects a state of nature…South Africa is a small open economy, meaning that those producer prices affected by external price developments and from changes in the exchange rate will tend to be more volatile than others.

An indication of the strength of the inflation targeting framework in anchoring medium and long-run expectations, changes to inflation expectations have remained muted – despite the fairly sharp increases in the prices of imported fresh meat and grains, and of petroleum products in recent months. Price volatility in commodities generally and non-ferrous basic metals and wire and cable in particular, have driven up the domestic component of PPI.

Similar factors, particularly food and transport prices, have pushed up consumer prices.

A number of factors suggest that the present deficit on the current account will fall of its own accord, including the rise in interest rates which will slow consumer spending and construction somewhat and a drop in the value of oil imports. The weaker rand will further feed through into stronger exports in due course.

The central question facing government is how it can contribute to growth by boosting investment, saving, productivity and employment – or what is the effect of government policies, broadly defined, on the potential growth rate of the economy?

A range of economic opportunities are available to us over the next few years, including the development of major transport infrastructure and efficiency improvements, the upgrading of our energy production industries, and major infrastructure and tourism growth related to the World Cup in 2010.

There are also some areas where government needs to improve the regulatory framework and needs to think more clearly about how to develop the country to be a major exporter. Trade reform and industrial policy needs work – as do our systems for assisting firms and workers to adjust to economic change. As government, it is critical to keep our short and medium run policy adjustments focused on the longer term gains to economic growth and employment. Coordination within government is facilitated by the ASGISA project.

It also seems important in a more unstable international environment to strengthen regional economic development to help realize the ambition of rapidly growing Sub-Saharan economies. Our region is a vitally important aspect of our growth path. We need economically vibrant neighbours that enable all of us to diversify our economies and create far greater gains from regional trade than we have experienced so far. Africa's population presents, next to China and India, one of the largest potential commercial markets in the world.

While poor, Africa's population presents, next to China and India, one of the largest potential commercial markets in the world. Because of the catch-up needed to meet best practice in economic governance and the current low density of infrastructure, Africa's growth rates have the potential to rise rapidly for many years. Of course, as African governments we need to ensure that the economic gains to be made from policy reform, better governance, expanded infrastructure, and rising incomes of our populations are realised. Historically, that has not been a simple matter, either in Africa in the last few decades, or in other parts of the world over a longer time frame. Timeframes and history are critical elements of vision and leadership.

We speak about 40 years of African history and slow economic growth. We should occasionally remind ourselves of the extreme poverty that existed in most European countries only 100 years ago.

Just as Europe and Asia discovered over time the complex set of political institutions, social balances, and economic policies that enabled rapid economic

growth and rising incomes, so too will Africa. And, indeed, I believe we have made great strides in the last 10 years in that direction.

We have a far better understanding today of the economic and social constraints facing us and how to address them. We understand far better also the international trade and financial environment within which Africa must grow and interact with other economies and regions. We also understand how natural impediments to our growth, from disease to geography, constrain us.

To get some sense of the macroeconomic improvement, the average inflation rate for Sub-Saharan Africa from 1995 to 2005 was 18 percent.[6] By 2005 this had fallen to 11 percent, and is expected to be about 8 percent in 2007. The average budget balance in the region is expected to be a surplus of 2.1 percent in 2006. And average GDP growth for 2005 was 5.5 percent and is expected to be 5.8 in 2006. Sub-Saharan Africa is expected to grow faster in the next year or two than it has in decades.

Trade policy development in the Regional Economic Communities, such as COMESA and SADC, seeks to lower tariff and non-tariff barriers to intra-African trade and spur trade and cross-border investment. South Africa invests about 1 percent of GDP annually in foreign direct investments in the rest of Africa, most of which supports increased trade in goods and services.

Yet Africa needs to sustain progress and avoid costly policy reversals. Given the small sizes of our economies, we need to become more serious about integrating our economies and sorting out the overlapping memberships of regional integration arrangements.

Infrastructure development and deeper trade links between coastal and interior economies are supplemented with the growing size of the African oil industry. Between 2002 and 2008, Africa's oil production is expected to treble.

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[6] Average inflation for the SSA region peaked at 61 percent in 1994. IMF, WEO 2006.

All of these dynamics feed into a larger one, which is the potential for Africa as a continental commercial market. While geography will remain a stumbling block, the incentives for developing the infrastructure to make a single market a reality are growing – particularly for some of our landlocked economies that are growing more rapidly. For them, the incentives to develop infrastructure appropriate to an African market will continue to strengthen.

In sum, Africa's economies are clearly moving in the direction of sustained growth and development. Macroeconomic stability has taken root in almost all countries in the region. Renewed investment by regional governments in appropriate governance structure, initiatives to develop cross-border and local infrastructure, and rising spending on human capital – in part assisted by debt relief –helps to develop the local skills base and create the environment to attract FDI and take advantage of trade opportunities.

Human capital creation, better public services create domestic economic activity, reducing poverty and making more attractive markets for domestic and international investors. Africa has a bright economic future. And it will take time to reach our goals. But the fundamental political will is evident and the resolve of governments and our international development partners to succeed has strengthened greatly in recent years.

For South Africa, our economy's development is inextricably tied to the broader world – our capital flows depend in part on events and policies in major world economies just as they do on the policy decisions made here. We have created policy frameworks to help us navigate an inherently turbulent international environment and maintain a sustainable growth path. Further attention on the region and realizing a vision of a thriving Southern African market is integral to that path.

Thank you