What is happening in our economy?
A discussion on economic trends

Minister of Finance
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Address to Fedusa

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Good afternoon ladies and gentlemen. Thank you for inviting me to address your gathering today. I have not prepared a detailed speech. Instead, I wish to have a discussion on what is happening in our economy at the moment, to share some perspectives on some of the current economic trends but also to hear from you what your analysis is on the state of the economy.

In the decade 1983 to 1993, the economy grew by an average of 1.1 per cent a year, far below the rate of population growth. Between 1994 and 2000, the economy grew by 2.9 per cent a year. Since 2001, the economy has grown by an average of 3.8 per cent a year. If I take just the past 4 years, then the average is above 4 per cent. It is clear that since, 2001, we've seen a step change in the pace of economic growth. Economists are revising upwards their view on potential GDP growth up almost every quarter.

In our opinion, there are two main reasons for this faster growth. The first is, we believe, the management of the economy since 1994. The economy has experience structural change on a massive scale and we are now seeing the benefits of those reforms. Secondly, the international economic environment has been supportive of growth through high commodity prices and substantial inflows of foreign capital.

The second feature of the present economic environment is that the pace of job creation has accelerated to the point where we are creating jobs faster than new entrants are joining the labour market. Our unemployment rate is still far too high for us to be satisfied, but the present pace of job creation is making inroads into the unemployed. This is positive, but much more work is still needed to sustain this.

The jobs that are being created are across the spectrum, not just the higher ends of the market. In terms of a table published in the People's Budget 2006-2007, the number of people employed increased in 2005, and the proportion of people earning below R1000 a month (after adjusting for inflation) decreased, suggesting that many of these jobs are of a decent quality. According to a study published last week by the DTI, the number of small businesses in existence since 1995 has grown by 150 per cent. These figures suggest a fair amount of dynamism in the economy.

Tax revenue has grown by almost 15 per cent a year in nominal terms for four years even though the economy has only grown by about 10 per cent a year (in nominal terms). There are three reasons for this. The first is that tax reforms that we put in place have closed loopholes, broadened the tax base and made compliance easier. The second reason is improved efficiency by SARS. The third reason is faster economic growth and employment creation. But even when we analyze the data in detail, tax revenue is growing faster than we can account from all of these factors. One possible explanation is that economy is growing much faster than we are presently measuring. I'll return to this later.

On the back of historically low interest rates (at least until this year), significant tax relief and accelerating employment growth, consumption has been extremely, strong growing at 7 per cent a year for the past six quarters. In fact consumption of durable and semi-durable goods has been growing at 16.4 per cent a year for the past two years.

The number of cars purchased now stands at 43 000 a month, even though the population is growing at about 41 000 a month, and the number of adults is only increasing by about 27 000 a month. According the Mike Schussler, 78 per cent of all formal sector workers now own a vehicle, yet we see no sign of a slowdown in vehicle sales.

Investment as a share of GDP peaked at about 25 per cent in the early 1980s as the state invested in both housing and infrastructure and in state enterprises such as Sasol, Mossgas etc. This level then dropped to as low as 14 per cent a few years ago. Since 2003, investment too has been accelerating. Both private investment in housing and corporate investment in equipment and machinery shows very strong growth. In the first half of this year, gross fixed capital formation reached 17.4 per cent of GDP. Over the next three years, the public sector is budgeting to spend R409 billion on infrastructure, providing further impetus on the investment side.

The story of South Africa's property boom over the past five years is a familiar one. Property prices of medium sized houses[1] have doubled since 2001. However, in the past two years, we have seen a boom in an area most housing analysts didn't know existed. The residential property market in the country's townships continues to show a higher level of activity than the traditional metropolitan areas, according to the latest First National Bank Residential Property Barometer. This barometer measures activity in the housing market, with one to three being very poor and ten being very active. The index is presently at 7.5 suggesting somewhat surprising buoyancy in the township housing market. Investment in new township housing development is also robust.

There are two areas that give rise to concern. The first is that despite rising earnings, household savings continues to lag. National savings has fallen to as low as 13 per cent of GDP. This has two effects. The first is that we have to finance some of our investments through foreign capital inflows. So far, capital has flown in at a rapid pace, allowing us to finance our current account deficit and build up reserves. Will the international environment be as supportive forever?

[1] Medium sized houses are between 80 and 120 m^2

The second blotch on the horizon is that a significant portion of our imports comprise of consumer goods. Going forward, we must improve the quality of this current account deficit towards investment goods. Higher interest rates, faster public sector infrastructure spending, the moderately weaker currency and improved performance of our exporters should allow for a slight easing of the current account deficit. However, if we do not improve our export performance, our economic performance would not be sustainable, requiring a forced slowdown in growth to rebalance the economy. No one wants this.

The international picture is, as pointed out earlier, supportive of faster growth in South Africa. However, there are a few more flashing amber lights than a year ago. Global financial imbalances in the form of high current account deficits in the US, large trade surpluses in China and in oil exporting countries and rising inflation globally all pose a threat to the present pace of global growth.

In 2005, the US current account deficit, the difference between its imports and exports of goods and services was a staggering US$791.5 billion or 6.4 per cent of GDP. In the 2nd quarter of 2006, the deficit, just for that one quarter, reached US$218 billion or 6.6 per cent of GDP. This represents a country living beyond its means at a rate never witnessed before in economic history. At the same time, many developing countries are running massive current account surpluses. China's current account surplus in 2005 was US$161 billion and US$91 billion in the first half of 2006.

Oil exporting countries are also running huge current account surpluses, with much of this money flowing into the US and Europe. In 2005, Saudi Arabia ran a current account surplus of 28 per cent of GDP and Norway ran a surplus of 17 per cent of GDP. This year, the IMF estimates that from the US$700 billion that oil producers would receive, about US$400 billion will be 'parked' offshore, further exacerbating these financial imbalances.

Economic theory suggests that capital should flow from developed countries, traditionally offering lower returns, to developing countries offering higher returns due to more rapid growth. In the past eight years, water has flowed uphill. Capital has flowed in massive quantities from developing countries to developed countries. China now has over one trillion dollars of foreign exchange reserves. China has overtaken Japan and is now the single biggest purchaser of US Treasury bonds. India too has accumulated foreign exchange reserves at a phenomenal pace.

What does all of this mean? To put it crudely, China buys US dollars to keep its currency weak. US citizens take this money and buy iPods made in China, creating jobs in China. As the level of US debt rises, the global economy becomes ever more unstable, increasing the chances of a crash.

There is no apparent solution to this set of problems. From the US perspective, they cannot afford to suddenly stop borrowing. Their budget deficit is now below 4 percent of GDP, but is still about US$400 billion. If the US raises interest rates to slow the economy down, it could attract even more capital further strengthening the currency. If they lower rates to weaken the dollar to make imports more expensive, inflation could rise offsetting any real depreciation. From a Chinese perspective, they need to stimulate domestic consumption, but this may lead to lower savings and higher interest rates. Higher rates or buying fewer dollars could lead to an appreciation of their currency, reducing their competitiveness. It is a complex web of risks that need to be managed jointly, through global action, preferable managed through multilateral institutions.

As India and China industrialises, their hunger for resources and oil in particular increases. In the US, there is a reluctance to reduce the energy intensity of their economy and their dependence on fossil fuels. Rising demand for a diminishing resource is likely to further raise geopolitical tension in the next two decades, putting the lives of many more at risk.

Let me turn to growth on the African continent. Africa today is experiencing a sustained period of rapid economic growth. In the last twenty years of the previous century, GDP per capita on the African continent remained remarkably flat while most other emerging regions enjoyed substantial increases in prosperity and welfare. For the past four years, economic growth on the African continent has averaged 4.5 per cent, with growth reaching 5.1 per cent in 2005. Some of this is driven by historically high commodity prices and in particular oil. However, even net oil importers grew by 4,5 per cent last year. Rising commodity prices combined with sound macroeconomic performance has provided a framework for strong growth in most African countries.

Macroeconomic stability is a feature of the economic environment in most African countries today. Low inflation, manageable debt levels, partly as a consequence of debt reduction, sound fiscal policies and improved public financial management all provide a firm foundation for rising economic growth. In 2005, oil exporting countries ran a budget surplus of 7.6 per cent of GDP and oil importing countries ran a deficit of just 1.6 per cent.

One sparrow does not a summer make. Four yours of economic growth, while encouraging, does not yet provide a sustainable platform for the reduction of poverty and inequality. Africa needs two to three decades of rapid growth to make a substantial dent on the level of poverty. Half of Africa is today regarded as poor, while in regions such as Asia, the number of people living in poverty has halved in the past three decades. Just as in South Africa, the challenge on the continent is to sustain this rapid economic growth through further acceleration of investment in physical and human capital.

In addition, the state must be able to extract a fair share of the rising profits from the resources sectors. The ability of governments to use these resources wisely will determine how sustainable this economic boom is and how widespread the benefits are shared.

In conclusion, the present economic environment is extremely buoyant. What started off as a consumer boom has been translated into rising investment. Rising investment has led to employment growth, further contributing to rising consumption. We are capable of accelerating growth even further. Our key economic policy objective is to sustain the present pace of growth but also to broaden the scope of beneficiaries. However, even as we grow, new challenges emerge. We must do more to understand these challenges and work together to address them.

Last but not least, a few hours ago, Statistics South Africa revised upwards their estimate of GDP growth, going back ten quarters. Growth in 2005 has been revised upwards from 4.9 per cent to 5.1 per cent, making last year the fastest growing year in about 25 years. The growth rate for 2004 was also revised up to 4.8 per cent from 4.5 per cent. The data also suggests that despite a moderate slowdown this year, the economy is still extremely strong. We are on track to meet our growth forecast of 4.4 per cent, set out in the *Medium Term Budget Policy Statement* a few weeks ago.

On that good news, let me step back and hear from you, what your thoughts on the economy are.

Thank you.