South African Reserve Bank

Address by Daniel Mminele, Deputy Governor, South African Reserve Bank, at the 2013 Pictet annual global outlook, Summer Place, Johannesburg, 12 August 2013

"Global liquidity, monetary policy and communication"

1. Introduction

Good evening ladies and gentlemen. Thank you to Pictet for inviting me to speak at this year's annual global outlook, which is taking place against the background of an environment that continues to be uncertain.

I was requested to speak about the "Outlook for the SA economy" as your programme suggests. I have taken a bit of liberty, and hope I will be forgiven, as a lot has already been said on this matter in the last couple of weeks by my colleagues in various speeches, and the Monetary Policy Committee (MPC) meeting took place less than a month ago - so I shall only briefly touch on this towards the end of my remarks. I thought that I should discuss some topical issues relating to global liquidity, monetary policy and communication.

The title of the speech we just heard - "The end of cheap dollars" - is certainly a very apt description of what the financial markets across the globe have been seized with over the past few months. "Cheap dollars" have become a feature of financial markets since the onset of the global financial crisis. Although the "Greenspan put" initially became the "Bernanke call" at the start of the global crisis, this was quickly transformed into a "Bernanke put" as quantitative easing gained traction. In addition to quantitative easing, the concept of forward guidance, whilst not completely new, gained increasing traction albeit in different forms. Across the developed world, forward guidance was used by policymakers to inject additional stimulus as interest rates reached the lower bound. Such actions signalled a change in the reaction function of central banks – that is, to keep rates low for longer. Last year, the Fed for the first time employed the practice of numerical thresholds as guidance to markets about the possible future path of monetary policy, the issue having featured prominently in deliberations at the annual Jackson Hole conference a month earlier. BoE Governor Mark Carney just last week for the first time linked the monetary policy outlook in the UK to an unemployment threshold and pledged to expand stimulus if needed. ECB President Draghi's pledge to "do whatever it takes" within the mandate of the ECB was yet another form of forward guidance. In Japan, Prime Minister Shinzo Abe introduced an ambitious programme to deal with Japans deep-seated macroeconomic problems, which similarly has an element of forward guidance and quantative easing. Although we may now be close to the period when the Fed starts to taper its asset purchases, in the rest of the advanced world, it seems that such accommodative monetary policy is likely to stay for a while still.

2. Global economic and liquidity developments

The question is whether the markets and the global economy can survive without Bernanke's put? Or have markets become hooked on central bank money? Despite the substantial stimulus provided by central banks and fiscal authorities, the global outlook has improved only marginally and there are questions as to its sustainability. The euro zone remains in recession, and emerging market economies, which were the engines of growth through the crisis, are slowing, particularly China and economies in Latin America. On the upside, there are signs of stronger growth in both Japan and the US, although fiscal issues in the US continue to cast a shadow over and could potentially derail the recovery.

It is therefore disappointing that 6 years since the start of the crisis, economic growth prospects remain relatively bleak and employment creation has disappointed.

Raghuram Rajan[1], Professor of Finance at the University of Chicago and soon to be Governor of the Reserve Bank of India, posed the question, what if the problem is the assumption that all demand is created equal? We know that prior to the crisis, demand was boosted by massive amounts of borrowing, and that the increase in spending came from poorer and younger families whose needs are greater than their incomes and are different from those of the rich. As lending dried up, so did borrowing, and demand for particular goods changed disproportionately. For this reason, Rajan argues that the general stimulus to demand that has been provided may not have been the most effective means to restore the economy to full employment, and instead, unlike the neo-Keynesian view, sees the only sustainable solution being to allow the supply side to adjust to more normal and sustainable sources of demand.

Although the growth performance has been disappointing, one cannot say that the fiscal and monetary policies employed were fruitless, because it is impossible to know the economic situation in the absence of such policies. It seems reasonable, though, to assume, that the Great Recession may have been a little or a lot worse than a recession, and that the period of recovery may have been even longer than what is currently being experienced. There is no doubt that there was a need for the policies employed, and that authorities had to make use of all instruments at their disposal to prevent an even more severe downturn in the global economy and to prevent a collapse of the world financial system. There is also no doubt that implementing some of these policies was an experiment of sorts, and central banks have always been ready to admit that this is new territory and exits from these non-conventional and non-standard measures could be complicated, because there is no blueprint to work from when it comes to the extent to which central bank balance sheets were put to use.

Whether or not policies employed thus far are the correct ones and will have any significant impact on growth going forward is a debate for another day. But it does seem clear that we have entered a period of structurally lower and more moderate

[1] "Why Stimulus has Failed", January 2013

growth and that it will be a long time yet before the world can enjoy the kind of growth and demand as seen before the crisis.

In recent weeks we have witnessed significant volatility in financial markets. Emerging market economies in particular have been rendered somewhat more vulnerable owing to the strength of capital inflows over the past few years. Steepening yield curves, sharper than expected tightening of financing conditions and subsequent sell-off in risky assets and reversals in capital flows are risks that we probably have to contend with in the foreseeable future.

This volatility reflects markets that have become reliant on cheap dollars, unnervingly so, because as we witnessed during May and June this year, the very idea or utterance from the Fed that asset purchases may soon be tapered, has seen emerging market currencies, debt prices and equities tumble. Currencies in Brazil, South Africa, Russia and India depreciated by between 7 per cent (in Russia) and 15 per cent since the beginning of May to July. On a year-to-date basis, local currency bond yields of Brazil and Turkey are over 220 basis points higher, while stock markets are lower.

Jaime Caruana[2] explains that the market sensitivity emanates from concerns that existing imbalances and distortions, particularly persistently high debt levels, could produce large losses once monetary accommodation comes to an end. He notes that indebtedness in G-20 economies has increased by more than 30 per cent since the beginning of the crisis, reflecting a large increase in public indebtedness, particularly in advanced economies, that has not been offset by a decline in aggregate private indebtedness.

A withdrawal of global liquidity would equate to a withdrawal in capital inflows to emerging markets, which would remove a source of financing for emerging markets and potentially lead to a sharp rise in term premia. The Institute of International

[2] Bank for international Settlements, Debt, global liquidity and the challenges of exit, 8 July 2013

Finance (IIF)[3], however, projects that while capital flows to emerging market economies may decline, this should not be too severe. Capital flows to emerging market economies during 2013 and 2014 are projected to slow to US$1.145 billion and US$1.112 billion respectively. Such projections may indicate less appetite for emerging market assets, but certainly do not reflect any severe aversion either. The IIF notes that south-south flows could potentially offset declining flows from mature economies. But, one can only speculate about the impact of the eventual exit from unconventional monetary policy, the conflicting forces and which will be stronger. There may also be a fair amount of differentiation among emerging economies and some may be affected somewhat more than others depending on risk perceptions.

Global liquidity, its measurement and its impact, under direction from the G20, is receiving greater attention from international financial institutions, precisely because of the recognition of the role that liquidity played in the global financial crisis, as a potential factor behind the pre-crisis accumulation of financial vulnerabilities. Similarly, during the crisis, spillovers from the general monetary easing in advanced economies have also created vulnerabilities, while there are also global financial-stability implications of prolonged accommodation. The Bank for International Settlements and the International Monetary Fund are studying this topic under the guidance of the G20, looking at both price and quantity based indicators, core and non-core indicators, with the objective of developing a suite of indicators that can be monitored and considered for inclusion in surveillance exercises of the IMF.

3. Importance of Communication

In 1981, Karl Brunner wrote, with evident sarcasm:

"Central Banking… thrives on a pervasive impression that [it]… is an esoteric art. Access to this art and its proper execution is confined to the initiated elite. The esoteric nature of the art is moreover revealed by an inherent impossibility to articulate its insights in explicit and intelligible words and sentences."

[3] Capital Flows to Emerging Market Economies, June 26, 2013

I can assure you that we have moved on a bit from those days.

With this uncertain outlook and a volatile environment, communication becomes essential, and much has been said recently about central bank communications. The National Bureau of Economic Research[4] highlighted the increasing importance of communication as a powerful tool that has the ability to move financial markets, enhance the predictability of monetary policy decisions and help achieve central banks macroeconomic objectives. This is because central bank communications influence short-term interest rates which in turn influence long-term interest rates and other asset prices which affect macroeconomic variables such as inflation and output. Having said that, it is also true that poorly executed communications can do more harm than good and in these instances sometimes "less is more".

Janet Yellen[5] made reference to a growing body of research and experience around the topic of communication which demonstrates that clear communication is itself a vital tool for increasing the efficacy and reliability of monetary policy. She pointed out that the challenges facing the US economy in the wake of the financial crisis have made clear communication more important than ever before.

Often, comparisons are made between the 1994 Fed rate hiking cycle and that of 2004 and many have contemplated whether we could be headed for a repeat of 1994. In 1994 the Fed hiked interest rates from 3 per cent to 6 per cent in the space of 12 months. There was significant spillover effects on global financial markets in particular as they related to a sharp decline in portfolio inflows into Latin America and the Mexican crisis ensued. In contrast, the Fed's exit in 2004 had a much more muted impact on global markets. Nonetheless, markets reacted quite differently in the two episodes….what was the difference? The 1994 exit was unanticipated while the 2004 exit was anticipated. Expectations created and communication provided played a big role in how markets reacted. Suffice to say, of course, preparing the market and clear communication does not in and of its own ensure a smooth

[4] Central Bank Communication and Monetary Policy: A survey of theory and evidence, April 2008

[5] Communication in Monetary Policy, April 4, 2013

transition, but it can certainly help limit volatility and uncertainty. This time around, the task at hand is made even more complicated by the fact that monetary accommodation provided is much more than was provided in the past and much more creative than in previous episodes. It is clear that consistent and clear communication will be vital going forward in directing markets and ensuring that withdrawal symptoms are kept to a minimum. However, the very volatile and uncertain environment itself does present communication challenges.

The South African Reserve Bank is committed to transparent monetary policy communication. At the conclusion of every MPC meeting, a statement is issued through a press conference chaired by the Governor, with all MPC members in attendance, to explain the monetary policy stance.

The monetary policy statements, speeches by the Governors and senior officials as well as publications such as the Monetary Policy Review identify and discuss the balance of risks around our central forecasts in such a way that market participants and other stakeholders are in a reasonable position to form a view about our possible reaction to changing circumstances.

4. Economic outlook

As I draw to a conclusion, let me now very briefly turn to the economic outlook for South Africa.

South Africa's growth outlook is inextricably linked to the global outlook. Although the recovery is somewhat stronger in certain regions, overall global growth prospects remain broadly on the downside. The extraordinary challenge facing policy makers globally is how to roll-out an ambitious programme of ensuring that the global recovery is sustainable and can gain momentum, by simultaneously implementing various initiatives while ensuring that they don't conflict with each other. There is a need to support growth in the near-term, while also implementing credible medium-term fiscal policies, there is a need to continue the repair work to banking systems by pressing ahead with regulatory reform, which in some instances requires further deleveraging, but at the same time credit needs to flow to ensure that the abundant liquidity made available by central banks actually gets transmitted into the real economy. Alongside all these, structural reform needs to be progressed in a growth-friendly way to give us a better foundation for the future.

Against the backdrop of a still difficult international environment affecting our major trading partners, as well as domestic challenges, at the time of the last MPC meeting the Bank revised lower its forecast for 2013 growth from 2.4 per cent to 2.0 per cent, while that for 2014 was revised from 3.5 per cent to 3.3 per cent. At the same time the Bank announced an adjusted CPI forecast, and expected inflation to average slightly higher at 5.9 per cent for 2013 and 5.5 per cent for 2014, with a temporary breach of the inflation target range during this quarter (Q3/2013). As we have indicated before, the challenge remains how best to manage upside inflation risks and downside growth risks.

Apart from international factors, growth risks stem from relatively weak business and consumer confidence, which have impacted on private sector real gross fixed capital formation, and have also moderated household consumption expenditure, the latter also being constrained by subdued employment growth, and higher costs for electricity and fuel, and relatively high debt levels. An additional risk would be possible disruptions from strike action as part of the current wage negotiations in various sectors. Recent data releases and base effects suggest a better performance in the second quarter of 2013 when compared to the growth rate of 0.9% in first quarter, but much will depend on the performance in the subsequent quarters to improve an outlook that currently exhibits downside risks.

Risks to the inflation outlook present themselves mainly through a more depreciated exchange rate of the rand, especially if such depreciation occurs very rapidly and is sustained, and possible inflationary pressures arising from excessively high wage settlements, and from higher food prices. Demand driven pressures continue to be relatively low, and the pass through from the exchange rate depreciation at this stage appears somewhat weaker than observed previously during periods of exchange rate depreciation. As regards the exchange rate, the fact that South Africa has a current account deficit and is reliant on portfolio flows has meant that the impact of global risk aversion has been somewhat more severe on South Africa than other emerging market countries, coupled with the fact that our markets tend to be more liquid and deeper than other emerging markets. However, while depreciation in the rand exchange rate poses inflationary threats, it could also improve South Africa's outlook if it results in greater competitiveness of South Africa's exports and an improvement in the terms of trade and current account deficit. This presupposes that the benefits arising from and exchange depreciation can be locked-in and such weakness does not translate into higher wages not matched by productivity gains, and thus higher inflation.

For now, the Bank deemed it prudent to keep policy unchanged, but depending on unfolding events in the global and domestic environment, the Bank stands ready, as always, to act in whichever manner is deemed prudent, in line with its mandate, to ensure that inflation does not breach the upper end of the inflation band on a sustained basis, and results in a deterioration of inflation expectations.

Let me finish by wishing you all the very best as you try to navigate these very difficult times. These are difficult times not only for you as investors, but also for us as central banks.

Thank you.