An address by Lesetja Kganyago,
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Good morning, ladies and gentlemen.

Thank you for the opportunity to address this important conference today.

As many of you will know, the South African economy faces some major challenges. Economic growth is weak and unemployment remains high despite favourable terms of trade and a robust global recovery. We have good ideas for addressing these problems, but regulatory and policy uncertainty as well as corruption and a lack of direction in some areas have all sapped consumer and investor confidence and weakened private-sector investment. It should not be a difficult task to turn things around. Setting out some investment-friendly ambitions for the economy and reducing political uncertainty would go a long way towards boosting confidence. As is often said, raising confidence is the cheapest form of stimulus.

Given the economy's poor performance, there is an understandable focus on the negatives – but we should not forget that there are also positives. I will touch on these during my address today, particularly on those that impact directly on the work of the South African Reserve Bank (or SARB). These include a much smaller current account deficit, which has made the rand more resilient to risks. There has also been some moderation in inflation, which has eased the near-term pressure on monetary policy. Given our enhanced focus on keeping inflation expectations low, this could extend well into the future.

Current account rebalancing

Four years ago, South Africa was counted as one of the Fragile Five, along with Brazil, India, Indonesia, and Turkey. These were all countries with weak external positions, which seemed vulnerable to shifting capital flows. In particular, all five experienced sharp currency depreciations after the Fed[1] signalled that it could tighten policy faster than the market then expected – provoking the so-called 'taper tantrum'.

The impact of this shock was that South Africa focused on the need for rebalancing. At the time, the fiscal deficit (for 2012/13) was 4.3% of GDP[2] while the current account deficit was unsustainable at nearly 6% of GDP (-5.88% in 2013). The combined twin deficits were just over 10%. Monetary policy was fairly loose: with a repo rate[3] of 5% and an inflation rate close to 6%, our real interest rate was negative and also lower than real interest rates in the major advanced economies. This couldn't go on, and thankfully it didn't.

By 2014, most of the high-deficit countries had begun to adjust their imbalances, even though the capital-flow reversal was more modest than expected. The start of normalization in the advanced economies kept on being delayed, and when it did begin in the US[4], the pace was much slower than initially expected. Today, these 'fragile' countries have adjusted significantly, in response to increased macroeconomic policy discipline. They are now in a better position to deal with the possible consequences of higher interest rates in the advanced economies.

Although the speed of South Africa's current account adjustment was slow, the extent of the adjustment was significant. Over a three-year period, the deficit went from a quarterly trough of 6.8% of GDP to just 1.7% of GDP in the fourth quarter of 2016, and then to 2.0% and 2.4% in the first two quarters of 2017. This correction was facilitated by a more depreciated exchange rate, the tighter monetary policy stance from January 2014, as well as a degree of fiscal consolidation.

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[1] Federal Reserve System (United States)
[2] gross domestic product
[3] repurchase rate
[4] United States

The adjustment has come mainly through the trade account, which turned positive in the second quarter of 2016 and has since been roughly balanced. This reflects better net exports, partly through more favourable terms of trade but also because weak investment expenditure has led to lower imports. The overall current account remains in deficit, however, due to services, transfers, and income payments to foreign investors – which are the inevitable consequence of attracting large quantities of foreign savings on a sustained basis.

Before the global financial crisis, the current account was financed predominantly through equity purchases by non-residents while bond flows were comparatively small on a net basis. Since the crisis, with interest rates in the advanced economies close to 0%, the search for yield has resulted in large-scale net purchases of rand-denominated government bonds by non-residents. This trend intensified following the inclusion of South Africa in the Citibank World Government Bond Index. Whereas before the crisis non-residents held about 7% of domestic currency government debt, this ratio increased to current levels of around 40%. This is a positive development; it reflects South Africa's deep and liquid domestic bond market and an absence of 'original sin'. There are, however, concerns that the increased holdings may make us more vulnerable to changes in non-resident sentiment.

In the context of concerns about the impact of possible sovereign ratings downgrades, the narrower current account deficit implies a lower financing requirement. It puts us in a better position to cope with a possible portfolio capital outflow or reduced inflows. Furthermore, the fact that South Africa has a positive international investment position also means that we do not have a 'fear of floating' as is the case in a number of other emerging markets, where foreign-currency liabilities are relatively high. Under those circumstances, currency depreciations have significant negative balance-sheet effects. The floating rand remains a key shock absorber for the economy, assisting in the correct direction of economic adjustment and making a market in rand assets.

That is not to say that we will emerge unscathed should our local-currency debt be downgraded to sub-investment grade. There is little doubt that such a move would impact negatively on the rand, government bond yields, and confidence. Short-term

overshooting of the currency is likely, with some longer-term level change and pass-through into inflation expectations. But the exact long-term impact is uncertain. Estimates of the possible extent of selling by index-tracker funds range between R100 billion and R180 billion. The short-term impact will also depend on how much is already priced into the markets, the extent to which exposures have already been reduced, and whether the buyers of these bonds are residents or non-residents. While South Africa's risk premiums have increased in line with those of countries that are sub-investment grade, the possibility of an additional deterioration is high as the broader downgrade shock is felt in medium-term decisions of households and firms.

From a monetary policy perspective, a central objective is to reduce the impact that currency volatility and level shifts have on the inflation trajectory. And while pass-through, as in other economies, has been weaker in the post-crisis period, we saw greater price responsiveness to rand strength early this year. We should be cautious in inferring too much from this for our pass-through estimates, but with renewed currency weakness in recent months it does warn us against complacency. Various factors beyond a credit rating review present themselves as risks to the currency, and there are even some, like slower normalization in the advanced economies, that push risk towards a stronger currency. Indeed, conditions in the global economy have generally played a strong role in reducing downside risk to the rand in recent years.

The inflation outlook and monetary policy

The outlook for the exchange rate is an important, although not the only, consideration when making monetary policy decisions. The current environment has created challenges for monetary policy, but the positive news is that inflation has moderated and has been sitting fairly comfortably within the target range for the past few months. However, the expected inflation trajectory is still higher than we would prefer, with the risks tilted to the upside. At the same time, we have to take cognisance of the growth outlook and provide whatever support we can. This is exactly what we did at the Monetary Policy Committee (MPC) meeting in July. However, we must be clear about the limits of monetary policy, and what it can and cannot do. We cannot expect monetary policy to solve what are essentially structural problems in the economy.

Year-on-year headline CPI[5] inflation returned to within the inflation target range in April this year, having declined steadily from 6.6% in January. It reached a low of 4.6% in July before rising to 4.8% in August and to 5.1% in September, in line with our forecasts. At the September MPC meeting, the headline CPI inflation forecast was 5.3% for 2017 and 5.0% and 5.3% for 2018 and 2019 respectively. A lower turning point of 4.6% was still expected in the first quarter of 2018. The forecast for core inflation – which strips out the volatile components of food, petrol, and electricity – and which is a reflection of underlying price pressures, was 4.8% for 2017, rising marginally to 4.9% and 5.0% in the next two years.

These forecasts are markedly lower than those from earlier in the year. We remain concerned, however, that inflation expectations, as reflected in the survey conducted by the Bureau for Economic Research, remain anchored at the upper end of the target range. This is particularly the case for the price-setters in the economy, i.e. business and labour respondents. We would prefer to see these expectations anchored at the midpoint of the target band. Inflation at this level would bring our inflation rate closer to, though still remaining somewhat above, those of our peer emerging-market economies. It would also give us more headroom within the target range to absorb adverse supply-side shocks without breaching the upper end of the range.

Getting inflation expectations to converge on the midpoint of the target band would help to ensure that inflation actually gravitates towards that level. Yet inflation expectations are unlikely to moderate much, unless price-setters believe that lower inflation can be sustained. This requires improving monetary policy credibility by bringing inflation closer to the 4.5% midpoint of the inflation target range.

Bringing inflation to the midpoint and ultimately anchoring expectations there, instead of at 6%, is one of the SARB's most important medium-term strategic goals. Yet we are well aware that the economy is undergoing one of its worst growth phases in several decades, and although most of the growth problem is structural, there is some scope to provide countercyclical stimulus. We therefore aim for a policy stance that

[5] consumer price index

balances short-term growth support with long-term disinflation, and all its accompanying benefits.

It is difficult to calibrate the exact repo rate this requires. In July, the combination of better-than-expected inflation outcomes and worse-than-expected-growth prompted us to reduce the repo rate by 25 basis points to 6.75%. This adjustment also flattened out a spike in the real interest rate, keeping the policy stance fairly expansionary. At that stage, we assessed the risks to the inflation forecast to be broadly balanced. There was a widely held view in the markets that a further cut would transpire in September. In the event, the MPC decided to keep the monetary policy stance unchanged as the inflation forecast shifted marginally while our assessment of the risks to the inflation outlook deteriorated significantly. Events have since vindicated that September decision; in particular, the rand has depreciated quite sharply recently, demonstrating that some of the risks we had in mind were *not* already priced in by asset markets.

It is, perhaps, unfortunate that some market players were surprised by our decisions. Nonetheless, at times of heightened uncertainty, monetary policy becomes highly data-dependent and also more sensitive to our assessment of the risks to the forecast. We have tried to communicate this data dependence and its implications. We also include, in our MPC statements, the preferences of the different MPC members, which should help analysts to understand which decisions are finely poised and which are more straightforward. With a four-two spilt in July and a three-three divide in September, it should have been reasonably clear to observers that monetary policy was not on a predetermined course.

Although it may be comfortable for markets to have certainty around the short-term repo rate path, the real priority for the larger economy is fostering confidence that inflation will be well behaved over the medium and long terms. To this end, we implement monetary policy through flexible inflation targeting. This provides a framework both for interpreting economic news and for communicating our policy stance to our stakeholders so that it is more predictable over time. How, then, does the outlook appear through this lens?

As outlined earlier, the exchange rate and its long-term impact on price and wage determination remains the single biggest risk to inflation. In analysing these risks, we would want to look through short-term volatility and focus on the longer-term trend. This is often easier said than done, given the tendency of the rand to overshoot (in both directions) and the conflicting factors weighing on it.

Apart from the exchange rate, the main risks to the inflation outlook emanate from the supply side. The application by Eskom for a 20% tariff increase from mid-2018 poses a significant risk. An increase of this magnitude could increase the inflation trajectory by 0.2-0.3 percentage points, relative to the current assumption of an 8% tariff increase. The National Energy Regulator of South Africa is currently conducting public hearings into Eskom's request, but at this stage we have not adjusted our assumption and will await the outcome of that determination. However, to the extent that there is an upside surprise, our reaction will be guided by the extent to which we assess the second-round effects. In general, we would not automatically react to the first-round effects of a supply-side shock.

International oil prices have increased significantly since their lows of below US$45 per barrel in June. They are currently trading at over US$60 per barrel, above our current assumptions of US$55 and US$56 in the next two years. Increased global demand, coupled with output restrictions by some producers, has contributed to the higher trend. The prices may, however, be ultimately capped by increased output by US shale producers, who have now become the main swing supplier in the international oil market. While we still expect a moderate increase over the forecast period, there may be some upside risk to this. At this stage, we see the main risk to the domestic petrol price coming from the exchange rate and higher fuel levies.

Demand pressures are expected to remain relatively muted. They may have contributed to the more moderate trend of core inflation in 2017. This is also reflected in the persistence of a negative output gap despite potential output growth of only 1.1% for this year rising to only 1.3% by 2019. We do not see inflation pressures coming from the demand side for some time, although global growth is expected to close the global output gap in 2018 – and this will also further narrow our own gap. Household consumption expenditure growth is expected to remain relatively muted, at

around 1% per annum, over the forecast period. This is against a backdrop of weak growth in credit extension to households, low levels of consumer confidence, higher tax burdens, and the absence of significant wealth effects.

By contrast, some support to consumption expenditure is expected to come from lower inflation and real, albeit modest, wage growth. Wage pressures remain a concern, as nominal wage settlements continue to contribute to the persistence of inflation at higher levels.

Overall, we remain concerned about the weak economic growth outlook. The SARB's forecast for GDP growth for 2017 has been revised upwards, albeit marginally, from 0.5% to 0.6% in September, while the forecasts for 2018 and 2019 have remained unchanged at 1.2% and 1.5% respectively. The risks were assessed to be slightly on the downside. Of major concern is the negative growth in gross fixed capital formation, particularly by the private sector. Growth in private-sector fixed capital formation has been negative for six consecutive quarters. As I mentioned earlier, restoring confidence will go a long way in getting us on a recovery path. Without growth, we will not be able to make any inroads into our most pressing problem of high unemployment, currently at over 27%.

So, what *can* monetary policy do to help in this situation? It is clear that the problems the economy faces are mostly of a structural nature – not something that can be solved by monetary policy alone. In addition, recent surveys conducted by the Bureau for Economic Research also indicate that the uncertain political environment is the single biggest factor weighing on business confidence, and therefore on investment. Research conducted at the SARB indicates that the confidence factor shaved off at least one percentage point from growth in 2016.

Nonetheless, we do not believe that low growth is a non-issue for monetary policy. The moderate nature of the tightening cycle in 2014-16, when we raised interest rates by a cumulative 200 basis points, attests to our sensitivity to growth and the output gap. Furthermore, as we noted in the July MPC statement, we saw the reduction of the repo rate as having a positive impact on growth at the margin, providing a measure of support to the economy.

Conclusion

The SARB will continue to focus on its constitutional mandate to pursue price stability. This is the best contribution we can make to the economy because it creates the conditions for long-term investment decisions that generate jobs. However, this will be done within a flexible inflation-targeting framework, always mindful of the trade-offs and the impact we may have on growth in the short run. This balancing is important. It implies that, while our bi-monthly monetary policy deliberations have become intensely data-dependent and are likely to remain so with uncertainty and risk high, we will continue to see through the noise and focus on long-run outcomes.

This stability in our approach to monetary policy can contribute to better long-term inflation outcomes and therefore a more favourable environment for investment. In conjunction with appropriate structural and confidence-boosting policies, there is no reason why we cannot get investment and growth going again and make South Africa an investment destination of choice once more.

Thank you.