The Outlook for Monetary Policy

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Introduction

The global economy appears to be emerging from one of its most turbulent periods in living memory. Due in part to the unprecedented and largely coordinated policy responses that were undertaken by monetary and fiscal authorities around the world, we seem to have weathered the storm. However, while there are many positive developments, we cannot be blind to the risks and uncertainties that persist which could have systemic implications globally.

It is against this uncertain global backdrop that we have to implement monetary policy domestically. Because monetary policy has to be forward looking, it is a truism then that monetary policy is always conducted in an uncertain environment.

However it is probably true to say that the current environment is still characterised by heightened uncertainty. We therefore face difficult challenges in ensuring that inflation remains under control while allowing for the continued recovery of the domestic economy, which remains fragile.

In my address today I will make a few comments on the lessons of the crisis for the monetary policy framework. I will then give a brief overview of the current domestic and global situation and end with some remarks on the outlook for monetary policy.

The global crisis and monetary policy

In South Africa, there has been considerable focus on inflation targeting. The debate has generally revolved around the impact of monetary policy on domestic growth. Globally, there has also been a renewed focus on inflation targeting, but for very different reasons.

The argument put forward by, amongst others, Bill White, formerly of the BIS, argues that inflation targeting contributed to the global crisis precisely because it was too successful. The period of the 2000s was one where global inflation was low and, in terms of the narrow focus on inflation, it meant that central banks could keep interest rates at very low levels.

These low interest rates, the argument goes, led to excessive credit extension and asset bubbles in the housing and equity markets, and to the lending excesses that ultimately caused or exacerbated the crisis. In other words, by focusing too narrowly on inflation, monetary policy ignored the financial stability implications of low interest rates.

This throws the issue of financial stability squarely into the monetary policy arena. What should the appropriate policy have been under these circumstances? Bill White argues that it means that interest rates should have been higher than they were, and this would have prevented the need for such low interest rates later on.

In other words, monetary policy should have a clear financial stability mandate, which is part of the objective function of the Bank.

Others, however, have a different take on this. Firstly it is argued that higher interest rates on their own would not have prevented the credit excesses, and they have been prohibitively high.

The alternative then is to assign different instruments to the financial stability objective while maintaining the interest rate for the broader monetary policy objective. But it is not immediately obvious what these tools are and how effective they will be.

In a recent review of macroeconomic policy issues, Olivier Blanchard and others of the IMF argue that previously discarded tools need to be reactivated and used for focused intervention, even though they may be partially circumvented.

Such tools include reserve requirements, contra-cyclical capital requirements on banks, and loan-to-value ratio restrictions.

A related question is: who should be responsible for financial macro-prudential oversight? Should this be a central bank role, a separate entity or a joint role? If it is a central bank role, does it form part of the mandate of the Monetary Policy Committee (MPC), and how does it relate to the Bank's supervisory role over the banking system?

These are important questions currently being explored by central banks, and there is no simple or correct answer. Our own view is that the central bank already has an implicit financial stability mandate, and there is widespread expectation that, should a systemic financial or banking crisis occur, the central bank has, and would be expected to have, a key role to play.

Secondly, central banks already compile and analyse much of the macroeconomic data of a country. However, should a financial stability mandate be made explicit, a way needs to be found for co-ordination with government. Our suggestion, at this stage, is that while the compilation of data and analysis would primarily be the responsibility of the central bank, a financial stability committee co-chaired by the Governor and the Minister of Finance could be considered.

These issues have been the focus of much discussion at the bi-monthly BIS meetings. While there is broad agreement that monetary policy should have some focus on macro-prudential issues, there is far less agreement on the application and efficacy of these proposed policy tools. In fact, there is surprisingly little knowledge or agreement.

Much of this is unchartered territory, and we do not really know what instruments to use, how to separate micro- and macro-prudential instruments and banking oversight.

It is also clear that in future the conduct of monetary policy, even within inflation targeting mandates, will need to have a more pro-active financial stability focus.

The idea that central banks cannot recognise or pop asset price bubbles, and that they should only take them into consideration to the extent that these bubbles impact on the inflation outlook, is overly simplistic. Until now the conventional wisdom has been that the best that monetary policy can do is to clean up the mess after the bubble has popped.

The recent cleaning up that central banks and governments have had to undertake in the aftermath of the crisis points to a need for a reconsideration of this issue.

Although there will be more focus on financial stability issues in future, it will not be at the exclusion of other objectives, and we will continue to implement inflation targeting in a flexible manner. This means that while our primary objective remains the containment of inflation, it is not to the exclusion of factors such as growth and employment.

In our analysis and policy implementation we take account of these factors, not only through their impact on the inflation outlook, but also in terms of how our policies impact on these variables.

Our objective in this respect will always be to minimise the shocks to the system, and to avoid unnecessary volatility in output and interest rates.

Furthermore, if inflation is expected to remain within the target, monetary policy will have greater flexibility to focus on growth issues, particularly when the growth rate is below potential. This is entirely consistent with a flexible inflation targeting environment.

But we also have to recognise the limits to our impact on growth. Monetary policy can and does affect cyclical growth around long run potential output growth. In other words, we can affect the size of the output gap by impacting on cyclical growth. However, our impact on potential output itself is limited - this is really the job of micro-economic policies.

These include industrial and trade policies, investment in infrastructure and physical capital, technological innovation and productivity, and the quantity and quality of labour.

Low inflation or price stability can contribute to long-term growth by providing greater stability and reducing uncertainty, which will be positive for longer term investment. However we cannot buy more growth with high inflation, and we cannot expect monetary policy to solve what is essentially a structural unemployment problem in the economy.

The review by Blanchard *et al* identified the need for a reassessment of exchange rate policies, particularly in emerging market economies.

The authors challenged the conventional wisdom that inflation targeting emerging market economies should adopt a policy of benign neglect with respect to the exchange rate, given the significant resource misallocation that could result from extended periods of exchange rate misalignment.

There is increasing recognition that emerging market economies are, in effect, being forced to adjust to disequilibrium positions in the advanced economies where abnormally low interest rates are still prevalent.

There is also an expectation that these low rates are likely to persist for some time. The resultant search for yield, particularly when risk aversion is low, has seen a wall of money moving into emerging markets, with consequences for their exchange rates.

Year to date has seen non-resident purchases of South African bonds and equities totalling around R35bn, and the consequent impact on the exchange rate. This can be compared with net sales of R76 billion in the second half of 2008 and net purchases of R90bn for 2009.

The fortunes of the rand exchange rate followed these trends.

There is little doubt that the rand exchange rate is one of the most volatile currencies, and is also currently assessed to be overvalued by many market participants and analysts, including the IMF. However, estimates of the degree of overvaluation differ markedly.

More vexing is the question as to what can be done about it. Direct intervention is constrained by the costs of sterilisation; the jury is still out as to whether taxation of inflows, such as applied by Brazil, are effective; and while economic theory tells us that a narrowing of interest differentials should lead to a decline in inflows, this is not always the case, particularly if lower interest rates encourage growth-sensitive flows.

The Bank has continued to buy foreign exchange as part of its strategy to increase the level of foreign exchange reserves. Despite significant foreign currency purchases at times, the rand has remained at elevated levels on a trade-weighted basis, but the cost of sterilisation has been significant, given the wide interest rate differential.

One of the consequences of these interventions, and building up the gross foreign exchange reserves of the country to US$42 billion, is that the SARB will report an after-tax loss of around R1billion for the financial year 2009/10.

While it may appear that in the past months there has been minimal reserve accumulation, our overall reserves are reported in dollars, and the recent weakening of the euro and sterling have resulted in significant valuation changes which have, at times, dwarfed the net accumulation. The SARB has continued to build reserves as and when this has been appropriate.

The recent reduction of interest rates was seen by some as an attempt to weaken the rand. This was not a factor in our decision.

Past experience has shown that the response of the rand to lowering or raising interest rates is unpredictable, and it has previously responded by both appreciating and depreciating for varying periods of time.

However, the recent rand strength has resulted in an improved inflation outlook, which in turn gave room for a further rate reduction. While we do not target the exchange rate, we would want to see the rand at a stable and competitive level.

Unfortunately, we have seen that achieving this is not straightforward.

The global outlook

In assessing the future direction of monetary policy, it is important to have a view of the global and domestic outlook. Previous speakers will have dealt with these issues at greater length.

Overall the global outlook is a lot more positive than it has been for some time. Many growth forecasts have been revised up progressively over the past months as the fear of a ‘double dip’ or W shaped recovery has receded.

The latest World Economic Outlook expects global growth to average 4,2 per cent in 2010 and 4,3 per cent in 2012. In September 2009 their forecast for 2010 was 3,1 per cent.

Emerging markets in general, and China in particular, which is forecast by the IMF to grow by 9,6 per cent this year, have been growing strongly, and there are now fears of evolving asset price bubbles in China.

Growth prospects in the advanced economies have also improved: the WEO forecasts US growth to measure 3,1 per cent in 2010, and 2,6 per cent in 2011. In September 2009 the forecast for 2010 was 1,5 per cent. Growth prospects in the euro area have also improved, but remain subdued at 1,0 per cent for this year.

Despite the good news and increasingly positive outlook, we cannot ignore the significant risks and uncertainties that still abound. The responses by governments and central banks around the world were necessary to prevent a full-blown depression. However the reversal of these positions is not trivial. In particular, we have seen unsustainable increases in fiscal deficits and debt ratios in a number of advanced economies.

For example, fiscal deficits in the United Kingdom, Greece, Ireland and the United States are expected to exceed 10 per cent of GDP in 2010, What happens when these fiscal stimuli are withdrawn is critical. Much depends on whether the consumers in these countries are in a position to take up the slack. The answer is not clear cut, and will differ in various countries.

In the US, the latest indications are that retail sales are rebounding and the consumer appears to be recovering. However, the housing market is still under pressure and unemployment remains high

at around 10 per cent on a narrow definition, and around 18 per cent on a broader definition. The employment response to the downturn was far greater than in previous downturns, and the question remains as to whether this decline is merely cyclical or structural. If it is structural, the US consumer may be constrained for longer.

There are similar concerns about the health of the consumer in several European economies, particularly Greece, the UK and Spain, where unemployment has risen to in excess of 20 per cent.

While the immediate threat from Greece appears to have passed, the issue has not been fully resolved and significant risks remain.

It is clear that there are limits to further government expenditure stimuli, and at the same time a number of European economies will find the adjustment process painful because of the lack of an exchange rate safety valve.

The IMF also expects global inflation to remain low, at 1,5 per cent in the advanced economies, and just under 3 per cent globally, in both 2010 and 2011. This, coupled with the relatively fragile economic recovery in some countries, is likely to result in monetary policy in some advanced economies being accommodative for some time.

This is turn means that emerging markets, including South Africa can, in the absence of general risk aversion, continue to expect capital inflows.

A further potential constraint on the growth outlook relates to the recovery of the global banking sector.

According to the latest IMF Global Financial Stability Report, current estimates are that global bank write-downs through to end of 2010 will amount to US$2,3 trillion. As at the end of 2009, US$1,5 trillion of the $2,3 trillion had already been realised. These pressures mean that, in some countries, banks are still reluctant to lend.

Hanging over the banks are the impending changes in global bank regulations. The nature of the changes and the implementation date are still to be decided by the Basel Committee on Banking Supervision. These proposed changes are aimed at building up stronger buffers to counteract the build-up of excessive procyclical leverage. Changes in the regulatory framework are necessary to prevent a recurrence of the recent crisis. However, we do need banks to be in a position to lend, and to be engaged in maturity transformation.

A fine line has to be drawn: we cannot admonish the banks for not lending, but at the same time introduce regulations that make it difficult for them to lend.

Decisions on the final proposals and their calibration will be made only after an analysis of the impact assessments that are currently underway, and comments received on the consultative documents.

The domestic outlook

The domestic outlook also looks increasingly more promising, but risks remain. Our current forecast is for growth to average around 2,6 per cent in 2010 and around 3,5 per cent in 2011.

Growth is expected to be driven in part by the external sector, and is therefore dependent on the global growth outlook. If global growth is sustained, we can expect commodity prices to be well supported, but our manufacturing export performance may be affected by continued low growth in some of our traditional export markets.

The manufacturing sector is experiencing positive growth again, driven primarily by external rather than internal demand.

Domestic demand is still relatively weak but is showing signs of recovery. We believe it will remain relatively constrained for some time by elevated household debt levels, high levels of unemployment and the fact that credit extension by banks remains very subdued.

Overall we would expect the deficit on the current account of the balance of payments to widen somewhat as imports respond to the higher infrastructural expenditure.

Private sector investment expenditure is expected to lag that of the public sector, particularly if domestic consumption expenditure remains under pressure. Despite the more positive growth outlook, employment is expected to lag somewhat.

The inflation outlook has improved despite significant risks posed by administered price developments. Our forecasts indicate that inflation is expected to remain within the target range for the remainder of the forecast period.

The combination of an improved inflation outlook, and a decline in the risks to the inflation outlook, allowed us to reduce the repurchase rate by a further 50 basis points at the most recent meeting of the MPC.

The factors that contributed to a decline in the risk to the inflation outlook included the persistent strength of the rand exchange rate and increased certainty with regard to the electricity price increases granted to Eskom.

The view was that despite the indications that the economy was turning around, this recovery was expected to be relatively slow, particularly with respect to household consumption expenditure.

Since that meeting, there have been a number of data releases that have heightened speculation about further reductions in the repo rate. In particular, the February retail sales came in well below consensus, and some of the manufacturing sector releases also disappointed.

I should, however, warn against jumping to conclusions, particularly on the basis of one month's data that is open to various interpretations. It is important to look at the reasons for the latest repurchase rate reduction.

Our statement emphasised that despite clear signs that the economy had emerged from the recession, the pace of recovery was still below potential. We saw the improvement in consumption expenditure in particular as being tenuous.

It does not however follow that one bad retail sales number automatically leads to a need for further easing. The latest data were a confirmation of the fragile nature of consumption expenditure growth, rather than necessarily being a downside surprise requiring further stimulus.

I am sure that the general view of the MPC which prevailed at the time would therefore be unchanged in the light of recent data: that is, that the relatively low growth in consumption expenditure, together with other factors, provided a window of opportunity to reduce rates without jeopardising the inflation target.

However, the scope for further easing is limited, and the repurchase rate is likely to remain stable for some time.

I must emphasise that this is not an unconditional commitment. It is dependent on no major developments that change the inflation outlook, or significant changes in the risks to the outlook. Such occurrences would include markedly lower than expected output or expenditure trends, or a sustained further appreciation of the rand exchange rate, which overall would lead to a significant decline in the long term inflation forecast.

Conclusion

Monetary policy always has to be implemented in a forward-looking manner, given the lags between a policy change and its full impact on the economy. We will continue to examine the data in a forward-looking manner and, taking all factors into account, will decide accordingly.

At this stage inflation appears to be consistently within the inflation target range and the domestic economy appears to be on a recovery path. However risks to the domestic and global outlook remain and we will maintain our vigilance.

We will continue to try to contribute to long-term economic growth through our endeavours to achieve our mandate and through our commitment to price stability.