South African Reserve Bank

Monetary Policy and Inflationary Challenges in the Face of the Global Economic Crisis

Address by Gill Marcus, Governor of the South African Reserve Bank

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Thank you for the invitation to address you this evening. Your conference is generating a great deal of interest, and is taking place at a time when the global economy is in an increasingly precarious position. The unfolding developments in Europe in particular are likely to have a significant impact on the global outlook, emerging markets and the domestic economy. As a large and influential trade union, you have voice and influence, and you have responsibilities not only to your members, but to the country as a whole. In these extremely difficult times there needs to be coordination of effort and a common purpose. It seems that Europe is heading into a "perfect storm", and it is in such times that leadership needs to exercise both reason and choice.

This evening I will give a perspective on aspects of the global and domestic economic backdrop against which your deliberations are taking place. I will spend some time on the global situation, as the context within which we operate, formulate policy, and adopt strategies is critical to enable all of us to ensure that South Africa is able to take advantage of what opportunities do exist, and take appropriate measures to try to protect us from the ravages of the worsening global crisis.

The global environment has become increasingly uncertain in the past few weeks. The danger signs have been there for some time, notwithstanding initiatives undertaken by the leaders in Europe, including the ECB, which have had the short term effect of pacifying the market. However, such initiatives were attempts to provide much-needed liquidity to a banking a system in which interbank trust had collapsed, as well as buying time for longer term solutions to be found. Unfortunately, this time has not been well used, and the crisis is intensifying as we speak, with the recession likely to worsen in the weeks ahead.

The problems in Europe have taken on a number of dimensions. What was initially a systemic banking crisis with the problem of excessive household borrowing became one of excessive sovereign debt, with the escalation of sovereign debt ratios to what are, in many instances, regarded to be at unsustainable levels. The banks hold this government debt and the associated risks of default, and at the same time they are required to adjust to regulatory reforms envisaged in Basel III and additional capital requirements. In order to meet these new capital adequacy ratios, banks have been deleveraging, partly by selling assets, and in part by reducing lending. Raising capital is difficult and expensive in such circumstances. The result is that governments are not spending, as excessive fiscal austerity has become the order of the day; households are not spending as they are repairing their balance sheets; and banks are not lending. This toxic combination has contributed to the low or negative growth environment which, in turn, has resulted in two new dimensions in Europe, that is, high unemployment and the associated breakdown of social cohesion; and a fractured political environment with weak coalition governments that are incapable of taking hard decisions.

The Eurozone escaped a technical recession only due to unexpectedly high growth in Germany in the first quarter of this year. But almost half of the eurozone members are in recession, and if we look at the broader EU, we see an even more depressed picture. So, in the unlikely event of a quick resolution to the sovereign debt crisis, the growth outlook remains grim. Eurozone unemployment reached 11,0 per cent in April, but within that there is a wide dispersion, with Spain and Greece recording rates of 24,3 per cent and 21,7 per cent, respectively. More disturbing, and more dangerous from a social perspective, is the rising youth unemployment, which averaged 22,4 per cent in the Eurozone, and 51,5 per cent and 52,7 per cent in Spain and Greece, respectively.

It is also important to understand that this crisis is not simply about Greece, notwithstanding the likelihood that Greece both defaults on its official debt and exits the Euro,and indications that Greece's economy is literally collapsing. Greece in itself is a very small part of the region. It is more about the contagion effects to other parts of the Eurozone. Spain and Italy are not peripheral, and if the markets believe that their positions are not sustainable and the firewalls that are erected to protect them are not credible, then they won't be, as these fears become self-fulfilling.

Recently it has become increasingly clear that the crisis in Europe is having an impact on other regions as well, which brings into question the notion of decoupling. While there are definite signs that the centre of gravity of the global economy is shifting eastwards, the interdependencies are still very much there. For some time the hopes of the global economy had been pinned on the United States, where growth was surprising on the upside. However, first quarter growth has now been revised down from an annualised rate of 2,2 per cent to 1,9 per cent. The latest unemployment data also show a reversal of the recent downward trend, with the rate increasing to 8,2 per cent. The short-term outlook has deteriorated, but there are concerns about a possible sharp fiscal retrenchment in early 2013 – now widely referred to as the "fiscal cliff" – when a range of tax exemptions expire, and could result in a fiscal contraction in the order of around 4 per cent of GDP. The impact on growth could be severe. How this will evolve is largely dependent on the outcome of the US elections. Until then risk, uncertainty and market turbulence are likely to intensify.

The outlook for China has also deteriorated recently. The slowdown was partly policy-induced initially, as the authorities attempted to slow down an overheating housing market. Recent data also show that Chinese manufacturing production growth has been slowing and there is some debate about how hard or soft the landing will be. Today the People's Bank of China, reflecting their concerns at the deteriorating growth outlook, announced a symmetric cut of both benchmark lending and deposit rates of 25 basis points.

The Indian economy is also slowing markedly and, although the growth rates of both China and India are still high by the standards of most countries, a slowdown will have an impact on global demand and commodity prices. The Brazilian economy contracted by 0,2 per cent in the third quarter of 2011 and growth in the subsequent two quarters has averaged around 0,7 per cent.

How is the European situation likely to impact on South Africa? The main channel is through trade. Europe accounts for a declining share of total South African manufactured exports but, at around 29 per cent, it is still an extremely important trading partner. This is down from 36 per cent in 2007. A mitigating factor is the increasing proportion of our exports going to other parts of Africa. Between 2007 and 2012, the proportion of manufactured exports to Africa increased from 25 per cent to 34 per cent. More emphasis should, therefore, be placed on expanding South Africa's trade links with the rest of the continent.

A further channel of contagion could be on the impact of commodity prices and, therefore, on South Africa's terms of trade. While lower oil prices are welcome, other commodity price declines are likely to affect adversely the mining sector, and further undermine its weak prospects. For example, platinum prices reached a historic peak of around US$2,200 per oz in 2008 before collapsing during the crisis. After recovering to a recent peak of around US$1,800 per oz, they have since fallen to around US$1450 per oz. With the exception of gold which has a safe haven status, similar patterns can be seen in the prices of other commodities.

South Africa's financial markets are also likely to be affected by contagion effects. The banking sector has minimal direct exposure to the Eurozone and, to the extent that this sector is affected by the global slowdown, the effect is likely to be indirect through slower domestic growth. We are one of only a handful of countries that has not had a banking crisis during this financial turmoil: without being complacent at all, it is important to recognise that our banks are sound and well capitalised. I wish to stress that, in such turbulent times, a sound banking system is a huge national asset.

However, other parts of the financial markets are already reflecting the high current levels of risk aversion. The direct impact is on the foreign exchange market where a high degree of volatility has been experienced, despite the higher level of foreign exchange reserves that have been accumulated. This is not South Africa-specific, but a general emerging market phenomenon where funds move to so-called safe havens at times of risk aversion in the financial markets, even though the cause of the risk aversion has nothing to do with emerging markets. Outflows from the domestic bond market could have implications for long term interest rates and the cost of financing government debt. However, year to date we have seen net non-resident purchases of bonds to the value of around R33bn.

The increased volatility observed in the rand foreign exchange market is similar to that experienced in some of South Africa's peer emerging market economies, including Mexico and Brazil, despite significant direct intervention by the latter to try and iron out this volatility. The weaker exchange rate does help cushion export sectors, particularly the mining sector, that is facing falling commodity prices. To this extent it is acting as a shock absorber for the economy. We should also be aware that the weaker exchange rate is not a panacea for the decline in manufacturing sector exports. The exchange rate, while important, is only one element of a country's international competitiveness. Other critical elements include relative unit labour costs, input costs such as electricity costs, transport logistics including costs, quality and efficiency of roads, railways and ports. But also of overriding importance is the state of global demand. The income elasticities are generally much higher than the relative price elasticities, meaning that the price advantage from a weaker exchange rate may be insufficient to compensate for the decline in demand.

Recent economic data illustrate how fragile the domestic economy is. Although GDP growth in the first quarter surprised many analysts on the upside, it was in line with the Bank's forecasts. Domestic economic growth has remained relatively subdued and measured 2,7 per cent in the first quarter of 2012, after growing at 3,2 per cent in the final quarter of 2011, and 3,1 per cent for the year as a whole. The Bank's forecast is for growth to average 2,9 per cent in 2012, and 3,9 in 2013. But, as was noted in the MPC statement, the risks to this forecast are to the downside, primarily a result of the risks posed by global developments. The fragile nature of the domestic outlook is confirmed in today's release of the RMB/BER Business Confidence Index for the second quarter of 2012 which declined from 52 to 41 index points.

A significant part of the domestic slowdown can be attributed to the dismal performance of the mining sector which contracted at an annualised rate of 16,8 per cent in the first quarter of this year and shaved about 1 per cent off overall growth. This is a continuation of the negative trend that has characterised the sector in recent years, at a time when commodity prices have been in something of a supercycle. Therefore, what has proven to be a significant strength in a country like Australia, where mining has performed so well that a recession has been avoided, in South Africa it has been a drag on growth with minimal contribution to employment creation. Going forward, the sector is likely to face renewed pressure from weak commodity prices resulting from the global slowdown.

The manufacturing sector, which is the engine of employment creation in the economy, showed a marked improvement in the first quarter, having grown at an annualised rate of 7,7 per cent. However, this was off a low base and some very poor outcomes in previous quarters. Also of concern is the fact that manufacturing output in fact contracted in March 2012 as exports came increasingly under pressure due to weaker global demand, though there was a modest recovery in April. For example, exports of motor vehicles declined by 18,9 per cent in April, compared with March, and by 11 per cent on a year-on-year basis. There was a modest improvement in April when an increase of 2,5 per cent was recorded. Although the PMI is still above the 50 level, the upward trend seen in the early part of the year has been reversed. There is no doubt that the manufacturing sector outlook is, to a significant degree, dependent on global demand.

Employment creation has suffered since the crisis. The unemployment rate has fluctuated around the 25 per cent level, and employment is still below pre-crisis levels. This indicates that the 3 per cent average annual growth recorded since coming out of recession has not been sufficient to make an appreciable dent in the unemployment numbers. When growth was averaging in excess of 5 per cent the unemployment rate declined to around 21 per cent. This suggests that higher rates of growth do generate employment opportunities, but the persistently high rate of unemployment illustrates the structural nature of the unemployment problem.

The Bank estimates potential output growth to be around 3,5 per cent, but such a level is not good enough. Raising it will require structural policies that increase productivity and efficiency in the economy. In the short run, this growth potential is constrained by the unavailability of a reliable and adequate electricity supply. Structural constraints in the longer term include transport infrastructure, including rail, roads and ports. The planned expenditure on infrastructure over the next three years exceeds R800 billion and, if implemented as planned, will make a significant impact on jobs, economic efficiencies and growth potential.

It is not only the government and state-owned enterprises that need to invest, though this is crucial. The private sector accounts for about two-thirds of total investment, but the recovery of private sector investment has been slow. In 2011, growth in private sector fixed capital formation was 5,3 per cent, following contractions in the previous two years. The ratio of total investment to GDP has declined from a peak of 23 per cent in 2008 to 18,9 per cent in 2011. This is well below the 25 per cent level usually regarded as the minimum benchmark for sustained higher growth. Part of the reason for the lacklustre investment performance is the existence of excess capacity in the economy, particularly in manufacturing, and low levels of business confidence. Our growth must be investment driven. By definition this requires a postponement of current consumption to help generate the required savings for this investment.

Human capital investment is also of the essence. Whereas we know that education is a long term generational issue, we have already lost a generation. We cannot afford to waste more time in reforming the dysfunctional parts of our education system. Education is not only about formal schooling, but involves technical training as well. Artisan training is relatively quick and its benefits can be readily felt. We should not have to import skills that should be easy to supply locally.

Getting growth going does not always require grand schemes. A lot can be done that can achieve high returns with very little outlay. We need to know what the state should do, what the state should not do, and what the state has the capacity to do. All three spheres of governement need to function efficiently and effectively.

There needs to be a concerted effort to increase the potential growth rate of the economy. An annual growth rate of 7 per cent – twice what we have now - allows for a doubling of incomes every 10 years. The structural changes required to achieve this growth rate are of a longer term nature, and we cannot achieve these levels on a sustainable basis in the short term, particularly given the global environment. But these are not reasons for delaying the necessary reforms, and the weak global situation provides the ideal backdrop against which to implement such initiatives as they add to the countercyclical nature of the policy response. This is not just the responsibility of government. It is a shared responsibility.

Many of our challenges are longer term structural issues. But what about short term interventions? Unfortunately, the world is in a worse position now than at the start of the crisis. At that time most countries had both fiscal and monetary policy space to try and alleviate the worst of the crisis. However, as noted earlier, most countries in the advanced economies no longer have the fiscal space to deal with this new phase. In South Africa, the fiscal surplus at the beginning of the crisis allowed for contracyclical fiscal policy, but also saw the debt ratios deteriorating as a result, although still at manageable levels. However, one of the lessons of the crisis was the demonstration of just how quickly debt ratios can deteriorate, and with this the escalating costs of servicing that debt, so the amount of space the fiscal authorities have is limited.

The lack of fiscal space in many countries has also increased the burden on, and expectations of, monetary policy. However, monetary policy is limited in what it can do. Abnormally low interest rates in the advanced economies, quantitative easing and provision of liquidity to financial markets that have seized up have no doubt prevented a greater deterioration of the global crisis. On their own these interventions have been unable to give the required impetus to growth. If households and firms are not investing or spending, whether a result of lack of confidence, lack of access to finance or deleveraging, low interest rates on their own will not necessarily provide a growth stimulus. There needs to be realistic expectations as to what monetary policy can achieve.

What can monetary policy do? The primary mandate of central banks is the control of inflation. We have yet to hear a good argument for high inflation, and even moderate inflation, which often leads to high inflation, erodes the purchasing power of wage earners, and reduces the value of wealth and assets of those unable to protect themselves. High and variable inflation also increases uncertainty about future relative prices and, therefore, is a disincentive to investment. It goes without saying that high domestic inflation reduces the competitiveness of a country's exports, unless there are offsetting exchange rate movements, but this generally sets off an inflation-exchange rate spiral, with higher inflation requiring a depreciation which, in turn, results in higher inflation. The social problems caused by high inflation are well known.

However, it is also true that, in trying to bring inflation under control, there could be adverse short run effects on output and employment. Recognition of this fact is the essence of a flexible inflation targeting framework. In pursuing our mandate of price stability, we are mindful of the possible implications of our actions on growth and employment. Given the persistent negative output gap since the crisis, the Bank has adopted an accommodative monetary policy stance. Inflation has been outside the target range, and the challenge has been to deal with high inflation and low growth – a nightmare scenario for any central banker. We have had to steer a course through this. Fortunately, inflation appears to be on a downward trend and interest rates are at their lowest nominal rates in more than 30 years. The policy rate is negative in real terms. In other words, our mandate is being pursued in a flexible rather than rigid manner. And as I outlined in an address last week, central banks are being given additional mandates, and this brings new challenges when conflicts arise between different objectives.

The main risk to the inflation outlook posed by the crisis arises from the depreciation of the rand exchange rate. However, there is not an automatic response of monetary policy to the depreciation, as the focus of monetary policy is not on the exchange rate per se, but rather on the overall inflation rate over an appropriate time horizon. Under current global circumstances, while the exchange rate does pose an upside risk, the current environment also generates offsetting, albeit often partial, effects. For example, international oil prices have declined quite markedly, from a recent peak of US$126 per barrel to current levels of around US$100 per barrel. Prior to the current bout of risk aversion, the oil price had been identified as the main upside risk to inflation.

Monetary policy will face a challenging period ahead, in trying to deal with these risks to inflation against the backdrop of a volatile and uncertain global environment and the implications for the domestic economy. At the same time, in line with our expanded mandate, we also have to be mindful of possible risks to financial stability. As was noted in the recent monetary policy statement, monetary policy remains ready to respond to these challenges. But these challenges will be made more daunting if domestic price pressures intensify at a time of economic weakness. These pressures include excessively high administered prices, and real remuneration increases (at all levels) in excess of average productivity increases.

Numsa's views on the economy have been in the press recently, and there are two issues I feel it is appropriate to address: that of the call to nationalise the Bank, and the proposal of an employment target for monetary policy.

With respect to nationalisation, it is incorrect that the Bank is technically owned by private shareholders. The Bank is a legal entity established through an Act of Parliament. It does have shareholders, but they do not have the same rights as shareholders in private companies. When buying shares, shareholders in the Bank know they are limited to 10,000 shares, and that the dividend is prescribed by law at 10 cents per share. Given that shares currently trade for around R11 per share, this is not a high return on investment. Of the profits the Bank makes, 10 per cent is put in its reserves, and the 90 per cent is transferred to government, not to shareholders. Shareholders vote for seven representatives on the board of the Bank, but government appoints 8 board members (including the Governors). So, in effect, government has a majority on the board. Finally, the board is a governance board only. It has no say over monetary policy decisions or other policy areas that the Bank may be involved in. In the current framework, the government sets the inflation target, and the Bank has the constitutionally guaranteed independence to implement monetary policy to achieve its set mandate.

With respect to an employment target for monetary policy, while we would all like to see maximum employment creation, we do not believe that monetary policy is the appropriate tool to solve what is essentially a structural problem. Monetary policy can influence growth, and by extension employment, over the cycle, but does not impact directly on long run potential growth. But even abstracting from this and from the difficulties relating to the practical implementation of an employment target, there is the more fundamental question of the control of inflation. If monetary policy is no longer focused on price stability, what is the anchor for inflation? The Numsa media release of 1 November 2010 relied selectively on the 2010 UNCTAD Trade and Development Report as intellectual support for its proposal for an employment target for monetary policy. However, the UNCTAD Report recognises the inflationary dangers of a "growth-oriented" monetary policy, and explicitly notes that an additional instrument will be necessary to control inflation. For UNCTAD the solution is very clear: to offset the inevitable inflationary pressures, an incomes policy is needed, because of the centrality of wages in the inflation process. To quote the Report: "as labour costs are the most important determinant of the overall cost level… their importance in helping stabilize the inflation rate cannot be overemphasized" (pXI). The Report suggests that wage growth should be aligned with average productivity growth and targeted inflation. For this reason, according to UNCTAD, a social compact is required, in line with what was proposed in the New Growth Path document.

Unfortunately there are no easy ways or free lunches when it comes to preventing or controlling inflation. The current policy is to control inflation primarily through the interest rate mechanism. When inflation is under control, and when inflation expectations are relatively anchored, monetary policy has greater flexibility. A more flexible monetary policy can be attained through a tighter fiscal policy stance, or through providing space through an incomes policy as suggested by UNCTAD. However, if wage settlements are well above inflation and productivity increases, and if fiscal policy is highly expansionary, the burden of controlling inflation falls solely on monetary policy.

There are ever-increasing demands and expectations of what monetary policy and central banks should do. Hervé Hannoun, Deputy General Manager of the BIS, has recently argued that central banks are increasingly seen as being able to do everything, including ensuring price stability, resolving balance sheet problems, shaping the yield curve, delivering low unemployment, relieving sovereign debt problems and bringing about predetermined exchange rate outcomes. While arguing that central banks were critical in preventing "unfettered financial instability and a potential deflationary spiral," he warns that "we should not lose sight of the limits of monetary policy. By trying to do everything, central banks may end up putting at risk their main achievement: the credible establishment of price stability".

Apart from these monetary policy related expectations, central banks are increasingly required to take on an explicit financial stability or macroprudential oversight function. This is apart from other traditional roles of the central bank, including regulation and supervision of the banking system (in some countries), the oversight and maintenance of the national payments system infrastructure, the management of foreign exchange reserves and the printing and distribution of currency.

South Africa has the potential to be a sought-after investment destination. Together, we should focus on the key components of successful countries, which invariably have developed a common purpose, alignment of interests and cohesive action between the leadership of the country, business, trade unions and society. In today's unprecedented global fragility this is not a nice to have but a way in which we can protect our gains and build our future, a future that values all our people.

In conclusion, I reiterate my offer to the leadership of Numsa, a union with a proud history and tradition, a union that represents the views and aspirations of tens of thousands of workers, to meet with us so that we can exchange views, share information and work together to better the lives of all South Africans. The South African Reserve Bank will vigorously defend our independence, our ability to act without fear or favour, and to take decisions that are in the interests of all South Africans. But this independence does not set the Bank apart from our society, and we see ourselves as an integral part of the institutions that we are here to serve.

Thank you.