"South African monetary policy in the context of central banking developments abroad", Address by Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Tradition dinner, Johannesburg, 28 November 2012

1 Introduction

Good evening and thank you to Tradition South Africa for the kind invitation to speak to you this evening. I have been asked to talk about South African monetary policy in the context of the influences from monetary policy globally.

Monetary policy has evolved in leaps and bounds over the past few years and unconventional measures, in particular, quantitative easing (QE), has become a fundamental part of monetary policy around the world. Japan, known as the pioneer of QE, unfortunately has not had much success with this policy, failing to boost either growth or inflation despite very accommodative monetary policy. There are many views about Japan's so-called lost decades and why it is different for the US and others, and how the speed, vigour and manner in which QE applied can make a difference. Japan's experience is translated into what is happening in the US and elsewhere, and doubts are raised about the appropriateness and success of such unconventional measures. It is too early to draw any definitive conclusions, but no doubt in time economic textbooks will be full of evidence of the success or otherwise of QE.

I will start my remarks off by firstly looking at countercyclical monetary policy, in particular as it pertains to emerging market economies, and the spill-over effects of monetary policies abroad. I will end my remarks by talking about the more recent developments pertaining to South Africa, with reference to the Monetary Policy Committee meeting held last week.

2 Counter-cyclical Monetary Policy and Spillovers

Monetary policy in advanced economies has undergone a drastic makeover since the 2008-2009 crisis, from the implementation of unconventional policies, to forward guidance being provided, and increasingly talk of moving towards specific numerical measures to which monetary policy tightening should be tied. The so called "7/3 threshold rule"[1] has often been bandied about as an alternative to the explicit forward guidance provided thus far by the Federal Reserve Bank. Under such a rule, the Federal Open Market Committee (FOMC) may indicate that it will maintain the fed funds rate at current levels until such time as unemployment moves below 7 per cent or inflation above 3 per cent, at which point, the federal funds rate may be raised.

Alongside such unconventional policies in advanced economies, emerging market economies have witnessed a break from past behaviour, where central banks have graduated from conducting pro-cyclical monetary policy to counter-cyclical monetary policy. This is significant because counter-cyclical policy was seen to be largely the domain of advanced economies, and in crisis situations, emerging markets instead opted to tighten monetary policy as they sought to defend the value of their currencies, contain capital flight and reinforce policy credibility.

In February 2012, the Board of Governors of the Federal Reserve System published a discussion paper entitled "Monetary policy in Emerging Market Economies: What Lessons from the Global Financial Crisis?"[2] The paper looked specifically at the counter-cyclicality of emerging market central banks' monetary policies during the 2008-2009 crisis, and found that at the height of the crisis, over 80 per cent of emerging market economies loosened monetary policy. Similarly, a study[3] conducted in 2012 found that between 1960 - 1999, 51 per cent of developing countries were pro-cyclical with an average correlation between GDP and interest rates of -0.02 per cent. This compared to 0.38 per cent for industrial countries. In contrast, for the period 2000 - 2009, around 77 per cent of developing countries

[1] Proposed by Charles Evans of the Federal Reserve Bank of Chicago
[2] Brahima Coulibaly, International Finance Discussion Papers, Number 1042
[3] "Graduation from monetary policy procyclicality", Vegh,c and Vuletin,G, 22 August 2012

showed counter-cyclical monetary policy. In both periods, South Africa was found to be counter-cyclical, with the correlation increasing from around 0.25 to 0.75 per cent.

The Bank for International Settlements (BIS) in its June 2012 Quarterly Review made reference to this shift among emerging market central banks, and pointed out the benefits of counter-cyclical policy, in particular, the associated reduction in output volatility, which also helped to stabilise the global economy. It is important to realise, however, that not all countries can benefit from counter-cyclical monetary policy. In particular, a country with large short-term foreign currency borrowings could suffer massive exchange rate depreciation, the costs of which could offset any potential costs of a pro-cyclical policy.

The discussion paper I referred to earlier investigates the factors that allowed for this shift to happen, and poses the question whether this marks the beginning of a new era in which emerging markets can now conduct counter-cyclical policy in a sustainable manner. The study finds that robust institutions, stronger macroeconomic fundamentals, reduced vulnerabilities, greater openness to trade and international capital flows and more importantly, financial reforms and adoption of inflation targeting, helped to facilitate this shift. By adopting inflation targeting and implementing financial reforms, greater policy credibility was achieved. Not only does the development of local financial markets enable a more efficient transmission of monetary policy, but the promotion of local financial markets has also encouraged greater borrowing in local currencies in domestic markets, which has helped to reduce the risk of capital flight, as well as currency and maturity mismatches. As such, the development of domestic financial markets has helped to facilitate the conduct of counter-cyclical monetary policy. Central banks that have adopted inflation targeting and moved to a low inflation environment were also seen to be more independent and credible, which also helped to facilitate the loosening of monetary policy.

The BIS notes a few caveats:

- Firstly, that low interest rates in advanced economies may have allowed emerging market central banks to cut policy rates more sharply than they could

have done otherwise, which would then overstate the degree of counter-cyclicality.

- Secondly, that the prolongation of low interest rates in advanced economies could complicate counter-cyclical monetary tightening in the future.
- Finally, the BIS also provides the example of some euro area countries which despite following counter-cyclical policies are facing a crisis today – underlining the importance of continuously monitoring financial imbalances and sustainability of policies.

These caveats brings me to the subject of spill-overs, an issue the G20 spends much of its time discussing, and requested of the IMF to produce spill-over reports for the five most systemically important economies[4]. These reports quantify, inform and educate about the spill-over effects of the policies of these five economies.

The arrival of QE brought much scepticism and unease, with talk of currency wars gaining momentum owing to the spill-over effects of such easy monetary policy on emerging markets. In particular, QE led to increased liquidity globally; amplified carry trade activity owing to favourable spreads; the financialisation and resultant boom in commodity prices; volatility in financial markets, in particular exchange rates; and robust capital inflows into bond and equity markets.

The IMF 2011 Spill-over report for the US[5] provides an analysis of QE spill-overs and finds that from both conventional and unconventional US monetary stimulus, there were in fact substantial output gains, occurring predominantly via significant reductions in nominal bond yields and increases in equity prices, with exchange rates also appreciating both in advanced and emerging market economies. Under conventional policy, for example, the IMF estimates peak output gains of 0.3 per cent in the US; 0.1 – 0.3 per cent for other advanced economies; and 0.0 – 0.2 per cent for emerging markets. Under QE1, the IMF estimates peak output gains of 0.4 per cent in the US; 0.1 – 0.3 per cent for other advanced economies; and 0.0 – 0.4 per cent for emerging markets. The study also finds, however, that the effect of QE2 was somewhat smaller than QE1. In September 2012, the Fed announced a third

[4] US, euro area, Japan, China, UK,

[5] IMF, The United States: Spillover Report, 2011 Article IV consultation, IMF Country Report no 11/203

round of QE, the impact of which is yet to be seen. Nonetheless, the results of these studies are not surprising, given that the US is the benchmark for pricing of other global assets, and was long hailed as the engine of global growth.

Unconventional monetary policies may very well complicate policymaking for emerging market central banks and create significant challenges going forward, not least of which relate to the unwinding of loose monetary policy in the advanced economies and the implications for capital flows. This could have significant repercussions for emerging markets, and the rest of the world, given the increased weight of emerging market economies in global output. Strong capital inflows to emerging markets over the past few years also means that emerging market assets have taken up an increasing share of investor portfolios. In its 82nd Annual Report published in June 2012, the BIS notes a number of longer-term risks for central banks related to prolonged monetary accommodation. These include a threat to advanced economies central bank credibility should they feel pressured to do more and therefore complicate even further the eventual exit from monetary accommodation; a gradual dislodging of inflation expectations in emerging markets should there be doubts about the determination to pursue price stability and exit large scale foreign exchange interventions; and undermining of operational autonomy and financial independence.

Having said this, and understanding the significant risks introduced to emerging markets as a result of QE, there is no denying that in the earlier phases of the crisis, QE policies did help to stabilise markets, support trade and help to prevent a breakdown in demand and economic activity.

3 Recent monetary policy developments in South Africa

We are often asked how much influence global monetary policy has on domestic rate setting. Of course, the Monetary Policy Committee does take into consideration in its deliberations, the decisions of policymakers elsewhere. These are important inputs into the decision-making process, given the large spill-overs associated with global policymaking on economic and financial market variables.

Like other emerging market countries, South Africa has witnessed significant portfolio inflows. In 2008, net outflows of R78 billion were recorded, and since 2009 until 26 November 2012, non-residents have bought a cumulative R280 billion worth of bonds and equities. The nature of these flows has changed, from being primarily equity inflows (turning from net inflows of R75 billion in 2009 to net outflows of R17 billion in 2011 and outflows of R8.3 billion year-to-date) to being predominantly bond inflows (from net inflows of R15.5 billion in 2009, to R85 billion year-to-date). Factors such as South Africa's inclusion into the World Government Bond Index have supported this trend, as well as the appreciation of the rand for much of the past three years, and are a clear reflection of the interest rate sensitivity of capital flows. Having twin deficits (fiscal and current account) and a low domestic savings rate, these inflows were not unwelcome, also to the extent that they helped to lower long-term borrowing costs. One can also argue that rather than inflows being diverted to South Africa because of expectations of rand appreciation, it was the inflows that in fact caused to the rand to appreciate. Whichever view is taken, the exchange rate of the rand did nonetheless appreciate from almost R12 against the USD in 2008 to under R6.60 in 2011.

Other emerging markets lowered policy rates to support growth; they also intervened in the exchange rate markets to try and stem appreciation pressure, or imposed capital controls. South Africa's policy rate was also lowered, although we were less aggressive than other emerging markets in dealing with these inflows as we did not at any time feel it necessary to intervene in the exchange rate market nor were any capital controls imposed. We did, however, with a surplus position on our Balance of Payments, mop up extra liquidity from both portfolio and direct investment flows, and consequently managed to grow the official foreign exchange reserves. We have been consistent in our approach, and have maintained an easy stance throughout the crisis, given that inflation largely remained under control and growth was moderate.

Exchange rate appreciation has been both a positive and a negative, on the one hand lowering South Africa's trade competitiveness, but also helping to dampen inflationary pressures given the influence of the exchange rate on consumer prices. CPI receded from 13.7 per cent in August 2008 to 3.2 per cent in September 2010,

at the same time growth slowed somewhat, never quite recovering from the recession, while unemployment increased to over 25 per cent. It is the combination of these factors, a large output gap, the absence of any significant underlying price pressures and a still dismal outlook for the global economy, that has given the Bank room to manoeuvre and reduce the repo rate from 12.0 per cent in 2008 to 5.0 per cent in July 2012.

However, since July domestic developments in the form of labour unrest, credit rating downgrades, and a widening in the current account deficit, have taken centre stage and been the prime determinant of exchange rate movements, which previously was primarily determined by movements in the USD/EUR exchange rate and other global developments. The exchange rate of the rand has weakened considerably from just above R8.00 against the USD at the beginning of August to levels close to R9.00 against the USD in November. Such developments, together with the lagged effect of higher food prices and higher wage settlements as seen in certain sectors of the economy, do not bode well for inflation going forward. A wide range of estimates have been released from various analysts trying to ascertain the potential impact of the rebasing and reweighting of the CPI basket in 2013. Our own estimates indicate some upward pressure on both headline and core prices, as noted in the MPC statement, to the magnitude of around 0.2 per cent on headline CPI. However, I should caution that these estimates are subject to the final set of price-updated weights which will only be published in January 2013, and as such, are subject to change.

Alongside a less favourable outlook for inflation, the domestic growth outlook has deteriorated, not only due to developments in the euro zone and US, but intensified further by labour market instability. Such actions as we have seen in the mining and agricultural sectors in particular, not only amplify wage pressures, but hurt output growth and export volumes, raise the prospects for even higher unemployment and aggravate the widening in the current account deficit. The third quarter GDP figures provided the first glimpse of the negative impact from the strike action, as growth slowed from 3.4 per cent in the second quarter to 1.2 per cent quarter-on-quarter. Mining reflected a contraction of 12.7 per cent, while manufacturing grew a paltry 1.2 per cent. The negative impacts of the strike action on growth have not fully fed

through and we are likely to see further weakness in the quarter ahead. Both business and consumer confidence are far from robust and it is unlikely that the demand side of the economy will provide much support. The Bank has lowered its growth forecast to 2.5 per cent for 2012, improving to 3.6 per cent in 2014 – with risks tilted to the downside. Inflation forecasts on the other hand, have been adjusted higher and the risks are tilted to the upside. The forecast do not take into consideration the new CPI weights or the rebasing that will take place in January 2013, nonetheless, the CPI forecast was revised higher to 5.5 per cent for 2013 (previously 5.2 per cent), and the forecast for 2014 kept unchanged at 5.0 per cent. The outlook for core inflation remains relatively benign, with a peak of 5.0 per cent in the first quarter of next year and an average of 4.8 per cent in 2013, dropping to an average of 4.5 per cent in 2014.

The combination of low global growth, domestic challenges further hampering the growth outlook, rising wage settlements, a weaker rand and higher current account deficit – makes for a very difficult combination of factors to consider when making policy decisions.

Olivier Blanchard in 2006 presented a paper entitled “Monetary Policy; Science or Art”. He said that monetary policy can pretend to be close to science if it can be conducted using simple and robust rules, however, monetary policy must be closer to art if it is frequently confronted to new, poorly anticipated and poorly understood, contingencies. In that case, each of these contingencies requires fast thinking and having to make decisions, not fully based on existing research but rather on well trained intuition. There is little doubt that monetary policy has gravitated towards being more of an art than a science.

Thank you