South African Reserve Bank

South African monetary policy and the path to normalisation

Address by Lesetja Kganyago

Deputy Governor - South African Reserve Bank

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1. Introduction and context

Global economic rhythms remain disturbed and economic policies of major advanced economies are moving in different directions. Much of the emerging market universe is experiencing weak economic growth and higher than comfortable inflation. US policy is slowly normalising, while Europe is taking strong remedial action in an attempt to address extremely low inflation and a protracted recession. These developments, and others, will continue to affect South Africa and test our policies.

This has already been a challenging year for the Reserve Bank. We have seen a sustained breach of the inflation target. We have raised policy rates for the first time since 2008. Output contracted for the first time since the crisis. In August, African Bank was placed under curatorship.

Confidence in the economy is currently weak, and all else equal, will tend to put upward pressure on inflation rates as households and firms seek price increases as a way to improve their finances. Stubborn inflation persists in South Africa in part because of this, and we need to be clear as a society that a spiral of wage-price inflation cannot substitute for productivity growth as a way to improve our incomes. We need low inflation, as a protection of the living standards of the poorest among us, to support access to finance, for financial stability – and as a means of safeguarding our competitiveness and encouraging investment and job creation.

At present it is important to conserve and move to rebuild policy space, and facilitate macroeconomic adjustment away from our persistent and large current account deficit. This should be achieved by increasing exports, investment and saving, and more moderate consumption of imported goods as spending rises. Higher inflation and large twin deficits are undesirable and unsustainable. A moderation in imbalances will support sustainable long-term investment by reducing long-term costs of capital and improving confidence, enabling the economy to grow and create the jobs we need.

Policy normalisation in the US will occur in a global environment that is slowly improving and which will require higher global interest rates. Our monetary policy stance will need to evolve in line with domestic priorities and take into account pressures exerted by international policy normalisation. A normalisation cycle will support the moderation in inflation that we seek to achieve and to assist in correcting macroeconomic imbalances. We can also expect, however, that normalisation will generate volatility in the short-term. Our policy framework allows for most of the volatility to remain in the foreign currency market, thereby enhancing stability in the real economy.

Further dampening of volatility can be achieved by ensuring effective policy communication across monetary and fiscal domains.

We have in place the right kind of macroeconomic policy framework to facilitate the adjustment to external and internal shocks, both those hitting us now and those we will experience in future. This policy framework enables policy makers and investors to see through near term volatility, keeping policy rates and adjustments minimal and efficient, and economic fundamentals more stable. This is critical to enabling public and private sector actors to keep their eyes on the real economy backdrop – the improvement in global conditions – and seek ways to strengthen our ability to take advantage of it through rising investment.

Before I discuss SA policy normalisation, let me first say a few words about the global economy and its effects on South African conditions.

2. US policy normalisation

The US economy has achieved critically important gains over the past year. Unemployment has fallen faster than expected and is now approaching its natural level. The budget deficit has fallen steeply since the crisis and fiscal policy has also become more predictable. New estimates of future health care costs from the CBO (US Congressional Budget Office) suggest long run fiscal prospects are much rosier than previously thought. Technology and resources, particularly the shale boom, have provided new sources of economic growth, perhaps enabling a further permanent improvement in the US trade deficit and balance of payments.

Inflation to accelerate

Certainly, we stand at the beginning of a long path to normalisation of US policy. But the *pace* of normalisation is less certain and will depend on data and how the Federal Reserve interprets inflationary pressures and the economic recovery.

The productivity enhancing effects of shale oil developments will tend to weigh against rising inflation in the US. But this structural downward force on inflation may be offset by the decline in the US labour force participation rate. So far, we have seen unemployment fall sharply without generating sustained inflationary pressures. If the decline in the labour force participation rate is permanent, then, as GDP rises, there will be greater pressure on wages and prices – with falling participation the labour market tightens more quickly. Other longer term factors, like less immigration and the on-going re-pricing of labour costs in China, will also tend to give impetus to global and US inflation.

It is also possible however that substantial slack remains in the US labour market. As GDP rises many discouraged workers will return to work, and part-time workers will get more hours, before we see wages and inflation rise. This is one crucial problem for the US policymakers. Another is how much inflation to accept before feeling secure enough in the recovery to raise rates. Understandably, the Fed will be reluctant to throttle an infant recovery with premature tightening.

The US policy response

We might conclude that it seems unlikely that the US Fed will allow inflation to rise *too* strongly as the real economy recovers. After all, the success of counter-cyclical fiscal and monetary efforts has depended in large part on the willingness of domestic and foreign economic agents to finance the US deficit and rise in public debt. Allowing inflation to erode the value of the debt and the income payments associated with it would undermine the effectiveness of future counter-cyclical policy efforts.

These thoughts suggest that a reasonable baseline view is that as the US recovery continues, on balance inflationary pressures should creep up. Policy will respond, via a commensurate tightening from the zero lower bound over the medium term, and also through sustained fiscal deficit reduction. Smaller fiscal deficits, higher interest rates, and strong economic growth should generate a sustained rise in the US dollar against other currencies – including the rand. All things equal, US normalisation will require corresponding policy shifts in South Africa, including higher local interest rates.

These predictions are reliable, but specifying just when they will be validated is harder. Will the first rate increase in the US come in mid-2015? A few months later? Will policy tighten at every meeting, and in what increments? Will markets understand the signals sent by the Fed? These uncertainties will probably generate bouts of volatility, which in turn might be misread as a trend reversal or strengthening. One possibility is of a further gradual weakening in the rand as clarity about US normalisation emerges incrementally. Another possibility is of step changes, in which markets react most strongly to occasional clear policy signals and adjust expectations of forward values for the rand and interest rates in larger discrete movements.

3. Baseline complexities

This baseline for the US economy, which promises economic recovery and policy normalisation, is clouded by developments in Europe, Japan, China and much of the rest of the emerging market universe.

Japan

In Japan, the sustainability of the effort to push up inflation and re-ignite growth seems to be in question, in large part because of the futility of trying to use macroeconomic policy alone to address structural features of a complicated socio-economy. The three arrows strategy is currently a one arrow strategy, with structural reforms still missing and the second quarter tax hike lowering growth. The pre-tax consumption boom was more than cancelled out by the post-tax slump, leaving the Japanese economy at mid-year smaller than it was at the end of 2013. The world's third largest economy continues to struggle for the kind of sustained growth rates that have eluded it for almost a generation.

Emerging markets

Emerging market economies bounced back quickly from the Great Recession, prompting much talk of decoupling from the advanced economies. Since 2010, however, growth has trended persistently lower, to the point where we now sit with a generalised EM slowdown. Meanwhile, China aside, the average large EM has experienced rising inflation and an expanding current account deficit, with monetary policy moving in the direction of tightening. The lesson is that EMs have not decoupled; instead, many of the biggest emerging markets have been contributing to global demand, using up policy space, and slowing for a lack of world growth. Now they must rebalance and restructure to ensure economic stability.

What role will China play in our fortunes? We know that policymakers are trying to find a path between keeping growth strong and rebalancing away from investments and exports. We really don't know how this process will affect us. South Africa's terms of trade have softened by just over 6% since 2011 as commodity prices have weakened, but they remain at historically elevated levels.[1] How much further could they fall, and what impact will softer prices have on volumes demanded?

Evidence suggests that iron ore, coal and other exporters cannot rely on high prices to keep profits up, but this doesn't mean a collapse in volumes. To take one example, production of iron ore increased 114%, in volume terms, between 2005 to

[1] Terms of trade, including gold, weakened 6.3% from 2011Q1 to 2014Q2. Excluding gold, the decrease is 7%.

2014.[2] It is hard to imagine a scenario in which these volumes collapse, although it is easy to see that firms will need to restructure to remain profitable with lower prices. The price effects of commodity prices falling in USD terms have been offset in rand terms by currency depreciation, but we should be careful about extrapolating further when structural factors supporting high volumes remain intact.

It is also worth noting that South Africa's export markets continue to shift. In particular, the African market is becoming much more important for us, with the African share of SA's trade with the world nearly doubling from about 2007 to 2013.[3]

Europe

The trajectory of Europe remains an important determinant of global macroeconomic conditions and for South African outcomes. In recent years, weakness in the European economy has meant that there have been few real benefits to SA despite major rand depreciation against the Euro.[4] As with the United States, we appear to be witnessing a sea-change in European policy – although this could not possibly be described as normalisation. The question for South African monetary policy is whether these changes will offset US normalisation, fully, partially, or not at all.

From a real economy perspective, a sustainably growing Europe is crucial, but this may take considerable time to materialise. It is very hard to imagine Europe returning to growth with its current institutional configuration and policy settings. The contradictions are too overwhelming.

Household consumption and investment across Euro Area has and will remain weak so long as banks remain in financial distress and property values and the housing markets are depressed. Europe's financial sector needs a clearing out of bad debt.

The emphasis on fiscal austerity – clearly correct for over-indebted sovereigns – would, cumulated across Europe, weigh too heavily on growth in the absence of any other demand stimulus and an exuberantly strong currency.

[2] Physical volume production, iron, 2005Q1 to 2014Q2.
[3] According to DTI data, the African share as a per cent of SA's total trade with the world increased from 11.4% in 2007 to 19.8% in 2013.
[4] Between 2011 and August 2014, the rand depreciated by 29.7% against the Euro (compared to 32.6%% to the USD).

Germany has stood out for its strong growth in the midst of stagnation by its neighbours, but its longer-term interests cannot be served by endless stagnation in the euro area. The country seems too integral to the rest of Europe, via positive and negative spillovers, to continue indefinitely on a real depreciation-based economic strategy. It cannot declare independence from Europe.

Rather, Europeans probably need to think of themselves less like we do these days – less as small open economies subjected to the vagaries of currency fluctuations and capital flows – and more like a continental super-economy if the region as a whole is to prosper.

It is, perhaps, out of recognition that the old ‘normal’ cannot go on that the ECB has moved resolutely in the direction of encouraging more coherence in Euro Area macroeconomic policy. As Europe’s inflation rate has declined, the ECB has begun urging governments to consider some easing of budget consolidation while expanding its own monetary easing programme. And the President of the ECB has emphasised that this must be accompanied by structural reforms, which would pay off now as well as later if they could be locked in alongside policy easing. This may create confidence that European governments understand their challenges and have the will to address them.

The impact of ECB policy easing should be to sustain a depreciation of the Euro against the USD, both nominal and real. Cees Bruggemans has reminded us recently that when the US dollar and Euro change directions, they do so much more than analysts tend to realise and over significant time frames.[5]

As the Fed’s purchases of mortgage backed securities dwindle to nothing, the ECB will buy about 1 trillion Euros, returning its balance sheet to 2012 levels.[6] It will also buy asset backed securities. The impact of this on the rand will be to encourage depreciation against the US dollar and some appreciation against the Euro, but the net effect on the Rand’s nominal effective exchange rate will also be affected by commodity price trends. We don’t expect that the ECB’s easing programme will

[5] Cees Bruggemans, “Dollar & Euro part ways,” Rex Column, 8 September 2014.

[6] The ECB is expected to auction nearly €400 billion in 2014, with €174 billion in September and €167 billion in October. An asset backed securities purchase programme will be articulated in October. With expected repayments, the 1 trillion Euros will end up resulting in roughly a 600 to 650 billion Euro rise in ECB assets. The rules of the purchases suggest that this will help to lock in low rates until some time in 2016.

offset normalisation on a one for one basis. It may delay or slow the process, drawing out the global normalisation process.

4. South African monetary policy

Fortunately, the direct implications of normalisation for South African policy settings at this point in time are reasonably straight-forward. Rising global interest rates will put downward pressure on the value of the currency, at least in the short term, and push up interest rates. The less responsive short term rates are to this upward pressure, and the stronger the build-up of inflationary pressures in the wake of depreciation, the steeper the yield curve is likely to get. Long-term borrowing costs will take the burden of slow policy responses to a widening interest differential and currency weakness.

The real economy effects of being behind the curve with short rates will be relatively small in the near term, but working against the longer term direction I think we want to go. Lower short rates *might* generate somewhat more near term consumption growth for less investment growth in the longer-run. But this is a poor trade-off for us to make and one we cannot exploit. With rising inflation, more policy accommodation would significantly increase the risk of a sell-off of rand assets and pre-emptively push market interest rates across the yield curve higher than they should be given our fundamentals.

Economic growth

Certainly our growth and employment outcomes have been poor. After 3.0% growth in 2011 and 2.5% in 2012, the outcome for 2013 was desultory and 2014 is proving as bad. Protracted strikes have had serious economic consequences; the platinum strike is estimated to have directly and indirectly reduced annualised quarterly GDP growth by 1.6 percentage points.

Up to 2011, South Africa has benefited from a sustained positive demand shock caused by a rising terms of trade. As China's economy has cooled, the deflating commodity price bubble has generated a significant negative *demand* shock as the terms of trade declined by 6.7% since 2011 (and 9.4% since Q4 2010).

But can we say this has much to do with monetary policy settings? Our real interest rates have averaged around -0.5% since 2009, reflecting accommodative monetary conditions. Meanwhile, household spending has slowed amid[7] greater emphasis on working down household debt levels. Lower nominal interest rates have increased cash flow to households and this is going in part to debt service and debt reduction rather than consumption and taking on new debt. This makes sense – future expected real growth in income is low relative to future potential interest payments on new debt. Improving household balance sheets will create space for future consumption growth.[8] But there are limits here too – low rates don't encourage households to reduce debt levels faster neither do they impose a penalty on government borrowing, to speed up the process of shedding excess debt.

More broadly, this debt constraint continues to have implications for economic growth. With the stock of household and public debt remaining high relative to historic norms, there is insufficient domestic investment or productivity growth, or exports, to offset the slower consumption growth attributable to our weaker terms of trade and over indebted households.[9]

Low rates are also not doing much for investment in fixed capital, with gross fixed capital formation growing by just under half the pace of the 2000s and a third of the rate achieved in the six years before the crisis.[10] Of course the stronger rise in loans and advances to firms seen in 2014 so far is welcome. But we have some distance to go before we move beyond the minimal investment in productive capacity we have seen in recent years. This suggests that future growth in the economy will be handicapped unless investment becomes much stronger.

For many years we took the view that the economy's potential growth rate hovered somewhere around 4 percent. This was optimistic. Our current estimates suggest that it could be considerably lower, in part because we overestimated historical growth and in part because of the effects of the economic slowdown.

[7] HCE grew by 4.9% in 2011, down to 2.6% in 2013 and about 1.7% average for Q1 and Q2 2014.
[8] Debt service cost to disposable income: 12.5% in 2008; 7.9% in 2014.
[9] Household debt to disposable income: 82.4% peak in 2008; 75.2% in 2013; 73.5% Q2 2014.
[10] Real growth rates have been just over 4% for 2011-12-13, after negative growth in 2009 and 2010. The average for the whole of the 2000s is 7.9%.

Negative supply shocks explain some good part of our lower potential growth. One recent shock was the strikes I referred to earlier. Another more distant shock was the sharp rise in unit labour costs that occurred in 2008 and 2009 just as the global crisis hit. These factors have also dragged down confidence.

Reversing negative supply shocks will be an important part of achieving better growth rates and reducing macroeconomic imbalances. But the role of monetary policy is limited – for instance, having no impact on building additional electricity production capacity.

However, inflation differentials and cost differentials with the rest of the world continue to weigh heavily on South African competitiveness.[11] The exchange rate has supported domestic producers, with the nominal effective rate falling 36% from the end of 2010 and the real effective rate falling 20%. But if we measure our competitiveness by unit labour costs, say against the US dollar, SA has about 20% more real depreciation to claw back.[12]

Monetary policy can – by being credible and focused on the right target – reduce the extent to which domestic inflation appreciates the real exchange rate and erodes competitiveness. When a domestic real cost shock hits, the currency needs to adjust to offset the real impact, but we don't want the currency reaction to set off an inflation spiral or entrench higher inflation expectations. With this in mind, the Monetary Policy Committee has closely monitored the trend rise in core inflation, unit labour costs, and producer prices and how rand movements interact with them. It is important that real depreciation is not offset by future upward spikes in unit labour costs or a sustained upward trend in core and consumer price inflation.

Currency weakness has contributed to the sustained rise in inflation since mid-2013. Headline consumer price inflation has led this rise, drifting up from 5.0% in 2011 to 6.6% in June this year before moderating to 6.3% for July. Core consumer price inflation, excluding food, NAB, and petrol, has risen from 4.0% in 2011 to 5.3% in 2013 and 5.7% as of July 2014.

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[12] SA unit labour costs have risen by about 57% since 2008, compared to 4% in the US.

Other factors have weighed against the rise in consumer prices and core inflation, in particular the sharp fall in international food prices through the latter half of 2013 and the renewed deceleration in food prices we are seeing at present. But these exogenously-driven movements in food prices are only slowly impacting on core and headline inflation. We expect headline CPI to average 6.2% in the fourth quarter of 2014. The forecast for 2015 is 5.7%; for 2016 it is 5.8%. This is much higher than our main trading partners. China is 3%, the US at 1.4%, the euro area at 0.9%, the UK at 1.9%.[13]

This suggests reasons for the buoyancy of our current account deficit despite what appears to be significant real exchange rate depreciation since 2011. The deficit, in turn, heightens our vulnerability to shocks, as we saw in May 2013 and again this month, when we published the information that the current account deficit for the second quarter was 6.2% of GDP. South Africa needs rebalancing, and this will be aided both by the moderation of policy stimulus, which often generates import-intensive demand, and the weaker currency, which makes foreign goods and services less attractive relative to locally-produced ones.

Financial stability

Finally, we should consider the implications of monetary policy developments for financial stability.

The decision to put African Bank under curatorship was not a signal of concern with a weak banking system. It was a specific intervention targeted at idiosyncratic risks emanating from a small bank (which accounts for about 1.2% of total banking sector assets) emanating from its unique, undiversified and as such unsustainable business model.

Critically, the terms of the curatorship as announced by the Governor on 10 August are designed to ensure that the bank remains open for business, preventing an abrupt halt to credit extension to the important segment of the market (low income earners) which African Bank serves. Such credit extension, however, is now done on

[13] These are 2014 averages from the IMF. 2015 is China 3%, US 1.6%, EA 1.2%, UK 1.9%. 2016 is China 3%, US 1.8%, EA 1.3%, UK 1.9%.

much sustainable terms, given the need to improve asset quality in the banking book of the “good bank”.

Given the isolated nature of the intervention, and the uniqueness of African Bank’s previous business model, the concern that higher rates will impose an unbearable burden on borrowers, with dire consequences for lenders in general is overstated. Most clients of African Bank had fixed rate loans. For the rest of South African borrowers, interest rates are rising slowly from very low levels, giving borrowers and lenders plenty of warning and space, as well as incentives, to improve their balance sheets.

5. Conclusion

In 2003, the Nobel-prize winning economist Robert Lucas published an article in the American Economic Review entitled ‘Macroeconomic Priorities’. It was elegant, compelling, and a terrible prophecy. He argued that further attempts to smooth out the business cycle weren’t much use, because fluctuations in economic activity just didn’t cost much. Instead, the priority should be growth, because over the longer run that meant vastly more wealth.

Naturally, the Great Recession devastated this argument. Lucas was not entirely right: there was still an awful lot to be learnt about depression-fighting and high costs to getting it wrong.

And yet, we may perhaps have learnt the lesson too well, and focussed too much on demand management and smoothing economic fluctuations. Today, there is little policy space left to boost demand, and it is surprisingly hard even to specify where we are in the business cycle. We should take this as an invitation to shift our focus. The greater problem is not getting the output gap to zero, it is raising the economy’s growth rate. We used to think potential growth was close to 4%, and more with brave reforms. The IMF suggests it is about 2 to 2.5% and we fall short of that. We need to reorient households, firms and investors on longer-term targets, and to be clear about the policy settings needed to achieve them. The contribution from monetary policy is threefold:

First, sensible and sustainable monetary policies (as well as fiscal policies) support the availability of capital for growth in South Africa, which is crucial to ameliorate our chronic lack of savings. Global financing conditions have remained benign since 2010, but as part of normalisation we should expect rising global yields ratcheting up our own borrowing costs. It is important that we seek to minimise this where possible. The more money we spend on schools and roads, and the less on paying interest, the better. It is also important that we avoid taking an overly-mechanical or short-term view of the impact of rising rates. Ultra-low world rates were the right policy response to a global economic catastrophe; rising rates are a sign of a healthier world economy, which will help to realign investment decisions around long-term growth prospects.

Second, we need the exchange rate to play its part as a dependable buffer for the real economy in the face of international financial and economic shocks. With our terms of trade easing, a large current account deficit, and the global recovery firming up only incrementally, currency depreciation helps improve the balance of payments in a market-friendly way, sending the right incentives to exporters, importers and import-competing industries. Macroeconomic adjustment should and needs to occur in the direction of more exports, investment and saving, and less consumption. Meanwhile, credible monetary policy – moving back within the inflation target – will help moderate volatility and facilitate SA's adjustment to US policy normalisation.

Third, we need to be competitive, which in part means ensuring inflation does not price South African goods and services out of world markets. Monetary policy must retain and strengthen its focus on inflation. In doing so, we will push the envelope of transparency and clarity wherever possible; to help ensure that inflation expectations do not drift from the target.

My concluding message to you is that we must keep our eyes on our goal: to get South Africa growing again, to create jobs, to restore our macroeconomic balances, and deliver meaningful transformation.

Thank you