South African Reserve Bank

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The Monetary Policy Outlook for South Africa

Good morning, ladies and gentlemen.

Let me start by thanking J P Morgan for the opportunity to share some thoughts on South Africa's monetary policy outlook.

As you are aware, heightened uncertainty is one of the defining characteristics of the monetary policy environment in many emerging-market economies (EMEs). However, while uncertainty is at the heart of monetary policy formulation, it is the escalation in the level of uncertainty that presents the major challenge for monetary policy formulation in many countries in the current environment.

Recent global economic developments have put a spotlight on the extent of these uncertainties. Take, for example, the developments in oil prices – are they transitory or permanent? How about the path of US interest rate normalisation? Will it happen in June or in September? Will it happen at all this year? These uncertainties have rendered the conduct of monetary policy increasingly complex, given that economic forecasts could vary significantly depending on which assumptions are used.

Let me begin by briefly outlining the recent economic developments in South Africa. This will provide the context to discuss the monetary policy outlook and challenges facing South African policy makers in the short to medium term. Much as they have a significant bearing on developments in South Africa, I will not dwell too much on global economic developments, since these have received much attention here in Washington D.C. following the publication of the IMF's *April 2015 World Economic Outlook* and *Global Financial Stability Report* last Tuesday.

Recent economic developments in South Africa

In line with developments in many other EMEs, policy formulation remains challenging in South Africa. The key the challenge is the difficulty in lifting economic growth. Electricity constraints – which are expected to persist for some time – have compounded other structural bottlenecks (such as inadequate education and skills, low level of investment, competitiveness and productivity challenges) and these remain the most critical impediments to the growth outlook. As a result, there has been a downward revision of short-term potential output to between 2,0 and 2,5 per cent from the pre-crisis levels of 3,5 to 4,0 per cent. The growth rate for 2014 was 1,5 per cent and, based on the most recent South African Reserve Bank forecast, which has downside risks attached to it, an increase to 2,2 per cent is projected for 2015. This is far from the levels of around 4,0 to 5,0 per cent needed to arrest the large unemployment problem in South Africa.

The year-on-year inflation rate, as measured by the consumer price index (or CPI) for all urban areas, registered 4,4 and 3,9 per cent in January and February 2015 respectively, which is well within the inflation target range of 3 to 6 per cent. This improved trend in inflation was, however, mainly due to lower petrol prices.

Recent oil price and exchange rate developments have dampened the inflation outlook. Moreover, core inflation, which excludes food, electricity and petrol prices, remained near the upper end of the inflation target range, measuring 5,8 per cent in both January and February 2015. This is an indication that underlying inflationary pressures persist.

The Bank's inflation forecast released at the time of the most recent Monetary Policy Committee (MPC) meeting last month, indicated that inflation was projected to average 4,8 per cent in 2015, an upward revision from the forecast of 3,8 per cent in

January 2015. Additionally, inflation expectations, as reflected in the Bureau for Economic Research survey conducted during the first quarter of 2015, showed that all respondents expect inflation to return to levels around the upper end of the target range in the next two years.

The rand/dollar exchange rate has exhibited significant volatility lately, which was in line with developments in some of the other emerging-market currencies. Since the beginning of this year to the end of March, the Rand depreciated by about 5,0 per cent against the US dollar, and traded in a wide band between R11,54 and R12,52. This weakening of the rand against the US dollar has, however, not resulted in depreciation on a trade-weighted basis as a result of it having appreciated against the euro by 7,3 per cent since January 2015. Given the Euro's larger weight of around 30 per cent when compared with 13,7 per cent for the US$, the nominal effective exchange rate has been relatively stable since the beginning of 2014.

The current-account deficit registered 5,4 per cent of gross domestic product on an annual basis in 2014 compared to 5,8 per cent for 2013. More recently, the current-account deficit shrank from 5,8 per cent of GDP in the third quarter of 2014 to 5,1 per cent in the fourth quarter. It remains uncertain whether this improvement represented normalisation from earlier strikes affecting exports, and thus would be temporary, or whether this will be the start of a more sustained compression. While the current-account deficit has been comfortably financed so far, the global capital flow environment remains challenging, particularly against the backdrop of uncertainties surrounding the tightening of US monetary policy. The flexible exchange-rate system has so far been able to cushion some of the adverse effects and should continue to do so, assuming an orderly and continued well-communicated normalisation of US monetary policy.

The domestic monetary policy outlook for 2015

Notwithstanding monetary policy tightening in 2014 which saw the repo rate increasing by a cumulative 75 basis points, monetary policy remains relatively accommodative and appropriately takes into account the weak state of the domestic economy. At our most recent meeting of the MPC in March interest rates were kept unchanged, with the committee, however, noting that the near-term inflation outlook had deteriorated, as it is subjected to upward pressure from the partial reversal of the recent petrol price declines, emerging upside pressures on food prices because of drought conditions, and the high risk of further electricity tariff increases. This underscores that the timing of future interest rate increases would depend on the evolution of domestic and external factors and our understanding thereof.

Let me now discuss some of the domestic and global factors that will have a bearing on the domestic outlook and policy response going forward. On the international front, I will concentrate on the three developments that have been receiving increasing attention in policy circles, namely developments in the price of oil, divergent monetary policy in advanced economies, and the impact of a stronger US dollar.

Oil price developments

As you are aware, there has been a significant decline in the price of Brent crude oil, reaching a low of around US$45 per barrel in January 2015. While this oil price decline was expected, the extent and speed of the decline caught many market analysts and policymakers by surprise. As the IMF has pointed out, both demand and supply factors are responsible for the decline. While the role that speculation played in driving down prices is uncertain, the appreciation of the US dollar has also contributed to lower commodity prices in general.

Lower oil prices have had some direct positive impacts on the South African economy through reductions in the oil import bill. While overall net positive, there are also negatives to the decline in the oil price. A number of our export partners in Africa, such as Angola and Nigeria (which are oil-exporting countries), have been severely affected by the decline in oil prices. Reduced export revenues and growth in these economies will adversely affect their trade with South Africa.

Added to this has been the generally weak global growth outlook, particularly in some of South Africa’s major trading partners, including the eurozone and China, which also offsets the positive impact arising from the decline in oil prices.

Furthermore, a lower oil price may strengthen disinflationary pressures in places like the eurozone and Japan, further weakening their growth prospects[1] with adverse implications for countries like South Africa which are reliant on these export markets, although we are encouraged by the most recent assessment of the outlook for the eurozone and Japan as contained in the April 2015 WEO.

On balance, for an oil-importing country like South Africa, the positives of an oil price decline outweigh the negatives. However, we cannot afford to be complacent. In South Africa, the risk to the inflation outlook is tilted to the upside for a variety of reasons. Firstly, oil price developments are uncertain. Secondly, while expectations of US monetary policy normalisation appear to have been moved out, any surprises to the contrary could increase the already high volatility in financial markets, and particularly in foreign-exchange markets. Finally, the current decline in inflation rates as a result of the recent oil price movements, in effect, means that inflation outcomes in a year's time will be subject to strong adverse base effects.

The policy challenge is to ascertain the future path of oil price developments – this is a formidable task! It is uncertain whether the lower price levels that we are currently experiencing are transitory or permanent. Put differently, could oil prices increase again as quickly as they went down? While there seems to be consensus that we would not return to the most recent peaks, unfortunately, these questions do not lend themselves to easy and clear answers.

According to IMF's *World Economic Outlook Update*, January 2015, despite substantial uncertainty about the evolution of supply and demand factors, futures markets suggest that oil prices will rebound but remain below the level of recent years. Experience to date does, however, show that futures prices have been poor predictors of spot prices on the oil market. It is clear that although policymakers have been given some reprieve as a result of the decline in oil prices, we know very little about their drivers and their sustainability, and we therefore remain vulnerable to a disorderly correction or reversal in these prices.

[1] World Bank, *Global Economic Prospects*, January 2015

In the South African context, the exchange rate is also an important factor influencing the net impact of oil prices on its economy. Rand depreciation has offset some of the benefits of the decline in international oil prices. Thus, oil price developments and uncertainty regarding their future path will continue to pose a major challenge to monetary policy formulation in South Africa.

Monetary policy divergence in major advanced economies

Asynchronous monetary policy developments in the major advanced and emerging markets will characterise the monetary policy landscape in 2015. The Federal Reserve is expected to gradually start hiking rates in the near term given the robust recovery in the US, and the Bank of England is also expected to start tightening policy. In both cases there is increased uncertainty as to when the hiking would start.

The implication for South Africa is that rising global interest rates are among the factors that increase interest rate differentials, potentially leading to capital outflows which would put downward pressure on the value of the currency, at least in the short term; this would most likely generate some inflationary pressures.

On the other hand, the €1,1 trillion stimulus package currently being implemented by the European Central Bank and further large-scale asset purchases announced by the Bank of Japan in November 2014 suggest that the euro area and Japan are likely to maintain highly accommodative policies given their generally weak growth performance. To the extent that the ECB's quantitative easing is successful in stimulating growth, this will affect South Africa's exports positively. However, as Europe and Japan start to grow, we will face another bout of spill over from their normalisation, although for South Africa the extent of the impact is likely to be less pronounced than that brought about by US policy normalisation.

Policy divergence in major economies creates uncertainty for us as we attempt to understand the spill over effects and how best to respond to these new developments. At a global level, there is broad consensus on the need for some level of policy coordination to mitigate these uncertainties. However, the evidence to date shows that this is in many respects 'easier said than done'. Containing adverse spill over effects of domestic policy actions remains a major challenge at the global level.

US dollar appreciation

Since October 2014, the dollar has appreciated by more than 5 per cent in effective terms. While this appreciation remains modest from a historical perspective, signs point to the possibility of further appreciation in the future for a variety of reasons.

Firstly, history suggests that a drop in oil prices is often accompanied by a rise in the US dollar. Secondly, the stronger dollar could reflect the relative strength of the US economy and the expected rate hikes. Thirdly, geopolitical risks have promoted a return to ‘safe haven assets’ and US Treasury bonds in particular. Lastly, the expansion of dollar credit outside the US since the crisis could add to the appreciating pressures in the future.

The impact of a stronger dollar on emerging economies is not as clear-cut as one may expect. Other factors being constant, a stronger dollar implies the depreciation of other currencies. To the extent that the dollar strength is a result of stronger US growth, other countries’ exports – and thus growth – would benefit from increased demand from the US and from a more competitive domestic currency. South Africa’s benefit from this channel is, however, likely to be somewhat limited given the US share of our exports: 8,2 per cent in 2013 compared to 20,5 per cent for the euro area.

Then there is the issue of the impact of rand depreciation on inflation outcomes. There is evidence that the pass-through of exchange-rate depreciation to inflation may have declined in recent times, but the adverse impact of currency depreciation on inflation outcomes cannot be ignored, especially if the depreciation occurs over an extended period. Additionally, over the past year, South African long-term bond yields have been declining, even as the rand continued to weaken against the US dollar. For example, while off its late-January lows, the yield on the R186 bond is still about 130 basis points below early-2014 levels. The current yields are nevertheless still substantially higher than the levels that prevailed prior to the ‘taper tantrum’.

In addition, it is important to note that while the rand has depreciated against the dollar, it has appreciated against the yen and the euro. The South African economy would face new challenges should a strong dollar persist and a tightening of monetary policy in the US materialise while growth in the euro area remained weak. Rising interest rates in the US would have an adverse impact on borrowing costs, while a weaker euro would limit external demand for South African exports, Europe being a major trading partner for the country.

Other domestic concerns

Monetary policy will also be influenced by various domestic factors in South Africa going forward. I will focus my attention on two of these challenges, namely the current-account and fiscal deficits.

South Africa's 'twin deficit'

South Africa's 'twin deficit' remains a source of vulnerability. The persistence of these deficits – in the face of global monetary normalisation and weak domestic growth prospects – poses a serious challenge to both monetary and fiscal policies.

In addressing the fiscal deficit, the 2015 Budget announced in February entails a fiscal package which reduces the expenditure ceiling and raises tax revenue over the next two years. Policymakers are aware that stabilising debt at a sustainable level, while necessary and inevitable, will be challenging in the face of subdued economic growth outcomes.

The high current-account deficit is another source of vulnerability. Since the global crisis, weak domestic growth and the sustained depreciation of the rand have failed to significantly narrow the deficit. In addition to better external demand, reducing the level of this deficit by, among others, addressing export competitiveness is a challenge that South Africa needs to address. As pointed out earlier, the fall in oil prices has and will provide some benefits to the trade and current account, but this will be partly offset by lower commodity prices which have accompanied the decline in oil prices.

In the context of the large external financing requirement serving as a ‘pull’ and extraordinarily loose monetary policy in many advanced economies serving as a ‘push’, non-resident demand for bonds and equities has been financing most of the current-account deficit. However, as evidenced by the ‘taper tantrum’ in May 2013, our large financing need as well as reliance on portfolio flows make South Africa vulnerable to changing risk sentiments in the market at a time when the weak growth outlook, geopolitical risk factors, and a stronger dollar may negatively affect capital flows to EMEs. So far in 2015, non-residents have remained net sellers of bonds, but net buyers of local equities. This is broadly in line with the trend in other emerging markets.

Mitigating these risks is South Africa’s limited exposure to foreign-denominated debts and our free-floating exchange-rate regime. Moreover, to the extent that a portion of the current-account deficit is attributable to infrastructure and investment programmes, these are likely to generate a positive rate of return for the South African economy in the medium to long term.

Conclusion

The list of challenges I have focused on is not exhaustive. Nonetheless, from this brief and selective review, it is apparent that South Africa’s economic policy environment, like that of many other emerging markets, will be challenging. Clearly, South Africa’s immediate priority is to strengthen the growth momentum. Unfortunately, the role of monetary policy is limited in this regard as monetary policy cannot address structural deficiencies in the economy and influence long-term growth. While monetary policy should and will play its role within the confines of its mandate, a concerted effort is needed by all role players in agreeing and then effectively coordinating and implementing the necessary structural reforms, including addressing the electricity challenges facing the country. This requires a strong, constructive, and thus effective partnership between Government, business, labour and civil society organisations.

The MPC is of the view that inflation risks are skewed to the upside. Having indicated previously that, while not on a pre-set course and being data-dependent, interest rates will have to normalise over time, earlier this year we felt that short-term dynamics allowed for a pause on the interest rate normalisation path. There is now reduced flexibility in this regard and the recent deterioration in the inflation outlook will require the MPC to carefully assess when it will be appropriate to adjust the policy rate further.

The forecast horizon is fraught with uncertainties, which calls for heightened vigilance, decisive policy action, and clear communication. It requires us to sharpen our analytical tools to better understand, and strengthen our capacity for forecasting, policy analysis and implementation.

Thank you.