South African Reserve Bank

African central banks and monetary policy challenges

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Credit Suisse Africa Conference
Cape Town
6 November 2015

Introduction

Good morning, ladies and gentlemen.

Allow me to express my pleasure at being invited to deliver the opening address at this year's Credit Suisse Africa Conference.

The theme chosen for this address – 'African central banks and monetary policy challenges' – is particularly relevant today, seeing as financial market participants grapple with volatile markets informed by a fluid economic and monetary policy environment. The context is a highly interconnected world where spillover and spill-back risks are evident, and which brings about new challenges.

In my speech, I will look at some of these global challenges and how they have shifted over the past few years, then focusing on their particular relevance for African nations and, in turn, looking at the ways in which African central banks can deal with their policy implications. I will briefly highlight the experience of the South African Reserve Bank in that respect, and discuss how increased cooperation between regional central banks can help to strengthen the way in which we navigate these challenging times.

A more challenging world environment

Despite the elapse of nearly seven years since the height of the global financial crisis, a fully-fledged global economic recovery remains elusive, and new challenges continue to appear. The recovery process that began in some segments of the world economy has started to tentatively bear fruit. Banks in the United States and, increasingly, in the eurozone have seen sufficient improvements in their balance sheets to allow for the resumption of positive credit growth. At the same time, financial conditions have improved sufficiently for corporate entities in these regions to resume hiring, a necessary condition for a consumer recovery. Furthermore, in Europe, a mix of central bank initiatives and political will to hold the European construct together has handed most peripheral countries markedly lower borrowing costs and has created room for them to escape from their double-dip recession.

The global growth outlook, however, continues to vacillate and has once again deteriorated somewhat recently. In its October 2015 *World Economic Outlook*, the International Monetary Fund downgraded its global GDP growth forecasts by 0,2 per cent to 3,1 per cent and 3,6 per cent in 2015 and 2016 respectively. The 3,1 per cent global growth forecasted for 2015 is materially lower than the 3,8 per cent forecasted a year ago. This downward revision is mainly as a result of the downscaling of the growth projections for the emerging economies.

The downwardly revised growth outlook for emerging-market economies is mainly attributable to the relative slowdown in China which faces overcapacity in its traditional industries, a property oversupply, an erosion of its competitive advantages, and elevated levels of debt. Other large emerging-market economies are, however, also feeling the strain, in particular those which have a high degree of dependence on commodity exports. Furthermore, investor risk aversion towards emerging-market assets has been rising against a backdrop of market uncertainties about the timing and impact of US policy rate normalisation coupled with concerns about the economic slowdown in Asia and the impact of lower commodity prices. This has contributed to significant capital flow reversals from emerging-market economies, and the Institute of International Finance has recently projected that emerging markets will see net capital outflows this year for the first time since 1988.[1]

Why these developments matter to Africa

These international developments are highly relevant for sub-Saharan Africa. At the time of the global financial crisis, regional growth was relatively sheltered from adverse developments in the major economies. Regional GDP, for instance, continued to grow by 4,1 per cent in 2009, whereas most of the advanced economies and some emerging-market economies were in recession. The lack of depth in most African financial markets as well as the limited linkages between their banking systems and those of the advanced economies had in part explained Africa's relative resilience. However, Africa appears to have become more vulnerable to global developments since then.

The exposure of sub-Saharan economies, particularly to China – which is now a key contributor to the global slowdown – has continued to increase over recent years.[2] The region's exports to China have grown, on average, by around 25 per cent per year between 2000 and 2014, far outpacing the growth rates of less than 10 per cent for exports to the US and the EU. According to the IMF, China in 2014 accounted for more than 20 per cent of exports in about 15 sub-Saharan countries, including Angola, the DRC, South Africa and Zambia. Interestingly, exports to the other BRICS economies also increased over the past decade, by close to 20 per cent on an annual basis.

But China's relevance for African economies is not limited to trade links. According to the United Nations Conference on Trade and Development (UNCTAD), China is now the largest developing foreign investor in Africa, and official Chinese data indicate a doubling in the stock of foreign direct investment to Africa between 2009 and 2012, to US$21 billion.

1 See 'Capital flight darkens economic prospects for emerging markets', *Financial Times*, 1 October 2015.

2 See 'Linkages between China and sub-Saharan Africa', *Global Economic Prospects*, World Bank, June 2015.

The sharply lower commodity prices equally hold significant implications for Africa. Despite some diversification of their economies over the past decade or so – in particular into the services sectors such as retail, finance and mobile telephony – the export base of countries in sub-Saharan Africa remains highly dependent on commodities. The IMF has identified 15 countries in the region, beyond its eight oil-exporting countries, where non-renewable resources represent more than 25 per cent of exports. In nine of those, the share exceeds 50 per cent – and these calculations exclude agricultural commodities, on which many poorer African nations remain heavily dependent.[3] The negative impact of the lower commodity prices is not limited to lower domestic income, tax revenues and employment in the mining sector, but is equally likely to result in the curtailment of drilling and extraction investment projects.

The region, however, is likely to continue growing above trend in the near future. The IMF forecasts sub-Saharan GDP growth of 4,3 per cent in 2016, up from the estimated 3,8 per cent in the current year but still below the 5,25 per cent average growth rate of the past five years. The most recent projections of the World Bank similarly show a moderate recovery in 2016 and 2017. There are, however, some downside risks to these forecasts, such as the impact of adverse weather conditions on the agricultural sector and the possibility that ongoing public spending on infrastructure may be curtailed due to deteriorating public finance metrics in several countries.

Indeed, the more challenging external environment for African countries occurs at a time when these countries' external and budget balances have been deteriorating. The IMF forecasts that, in 2016, 30 of the 45 sub-Saharan countries will have a current-account deficit in excess of 5,0 per cent of GDP. The region's external shortfall is expected to be as high as 5,5 per cent of GDP, compared with the low of 0,7 per cent in 2011 and net surpluses in the years before the global financial crisis. Equally, the average budget deficit for the region is estimated to have risen to 4,2 per cent of GDP this year, up from 1,8 per cent three years ago; as a result, the public-debt-to-GDP ratio is likely to have reached its highest level

[3] See 'Dealing with the gathering clouds', *Regional Economic Outlook for sub-Saharan Africa*, International Monetary Fund, October 2015.

since 2005. The re-emergence of the 'twin deficit' phenomenon in many African countries may prove of particular concern at a time when global financing conditions have deteriorated and the credit spreads of most emerging sovereigns widen this year, in particular among sub-Saharan issuers.

Many African countries have taken advantage of the low yields in developed countries to increase their issuance of foreign currency-denominated Eurobonds in recent years. Such issuance has helped these sovereigns to tap into international investor demand for yield and reap the rewards of earlier efforts to improve their creditworthiness. However, it has also increased their external debt burden as most of the region's currencies have come under pressure. The trend towards currency depreciation that was witnessed throughout most of the emerging world has not spared sub-Saharan Africa. Since the start of the year, for example, the currencies of countries such as Angola, Ghana, Kenya and South Africa depreciated by between 10 and 25 per cent against the US dollar. In the case of others, like Zambia, the currency-value loss has been close to 50 per cent.

These currency developments have complicated the servicing and refinancing of external debt, and have also contributed to a rise in inflationary pressures in some countries, offsetting the positive effect of lower oil prices in this context. For the sub-Saharan Africa region as a whole, the IMF now forecasts average inflation to accelerate to 6,9 per cent this year and to 7,3 per cent in 2016 compared to 6,4 per cent in 2014.

How central banks can respond to the challenges

A situation where real economic growth slows but inflation accelerates is not one that central banks particularly relish in having to contend with. Central banks' mandate of inflation targeting, be it direct or indirect, requires them to be responsive to any build-up of price pressures, especially if it could result in the un-anchoring of inflation expectations. This is particularly relevant where inflation remains sticky at the upper end of the inflation target range. Yet at the same time, a slowdown in economic growth – at least in the event that it is demand-driven and results in a negative output gap – means that the central bank has to be mindful not to exacerbate the cyclical moderation by unduly tightening monetary policy. Pro-cyclical monetary tightening can negatively impact on economic growth and employment, and over time could contribute to financial instability.

It is worth noting that the nature of the inflation pressures faced by African central banks may itself be changing. A recent IMF study showed that while, in the past, inflation cycles tended to be heavily influenced by domestic supply shocks, the role of foreign exchange, money supply and domestic demand shifts has gradually increased over time.[4] It is therefore likely that demand shocks (global, regional and local) matter increasingly more for inflation rather than supply-related ones. Ever-increasing trade and financial integration has been beneficial to growth and development in sub-Saharan Africa over the past decade or two; it has also brought greater dependency on and responsiveness to international economic and financial trends, and with it also the need for greater cooperation and exchange of information among African countries, including their central banks.

So how should central banks in Africa respond to these new challenges? First of all, there is no 'one size fits all' policy response. Because of the structural differences between African countries – such as their oil exporter/importer status, the diversification of their production, the degree of development of their respective financial sectors, and the health of their public finances – they are not equally vulnerable to the current global challenges. As mentioned earlier, the outlook for both growth and inflation in the region's member states shows significant divergences. The IMF, for example, forecasts that inflation in several countries – mostly members of the CFA zones but also some oil importers, like Kenya – is expected to remain muted, or even to decline, in 2016. Several other countries, however, including many of the largest economies of the continent, are likely to see inflation drifting higher or remaining around uncomfortably elevated levels.

4 See 'On the drivers of inflation in sub-Saharan Africa' by Anh D.M. Nguyen, Jemma Dridi, Filiz D. Unsal and Oral H. Williams, M*onetary Fund Working Paper Series WP/15/189*, August 2015.

Nonetheless, common themes may be emerging. In an environment of weakening growth in key trading partners such as China, of lower commodity prices and of potentially challenging global liquidity conditions, exchange rates are likely to remain under some kind of pressure. But this need not be a negative development. In many ways, provided that a country's external debt remains moderate, depreciated exchange rates act as an automatic stabiliser against an external demand and/or terms-of-trade shock.

It is nevertheless the responsibility of central banks to ensure that such depreciation does not result in a lasting price spike or in an un-anchoring of inflation expectations. This can be a particular risk in Africa, where a large share of consumer goods is imported, and at a time when food prices – a large portion of the CPI basket in many regional economies – are increasingly sensitive to global, rather than domestic, developments. According to the IMF's latest *Regional Economic Outlook for sub-Saharan Africa*, a key factor behind the improved growth performance of sub-Saharan Africa in recent years has been an improved policy environment. Gains in the quality of policymaking and sounder macroeconomic management can ill-afford to be reversed.

In some countries, the challenge for policymakers has been compounded by the relaxation in public spending policy – in particular civil service wage settlements – in recent years. This is certainly not an unusual or a surprising development as it is reasonable to affect some degree of redistribution when economic growth and improved fiscal revenue allows for it given the skewness of income and wealth distribution in many of these countries. It is, however, of great importance that such efforts be undertaken in a sustainable manner and not at the cost of discarding fiscal discipline, as a lack thereof could exacerbate inflation pressures and weigh on investor sentiment, thus complicating the task of monetary policymakers.

Admittedly, this possibly points to the limitations of the role that central banks can play in dealing with the current global and regional challenges. Other economic agents, in particular fiscal policymakers, have a key role to fulfil alongside monetary authorities in ensuring that the path to sustained growth and development in Africa is not derailed. Appropriate countercyclical fiscal policies, which prioritise investment in infrastructure and human capital over current spending, would go some way in assisting central banks in executing their mandates.

It is worth noting that many central banks' mandates have been expanded to now explicitly include financial stability. This may not have been a major focus area in the past for most African central banks due to the region's relatively low credit depth and its lack of large, sophisticated financial markets. But the rapid development of the financial sector, the growing interconnectedness of the countries' banking systems, and the gradual opening of their capital markets has necessitated an increased focus on financial stability. The IMF recently found evidence of linkages – in particular in the case of sub-Saharan Africa countries – between lower commodity prices and financial stability metrics, such as non-performing bank loans, returns on equity, and ratios of liquid assets to deposits. Despite these linkages, it is evident that a growing financial system which is well regulated and supervised is likely to result in better allocation of capital to different economic sectors, the facilitation of entrepreneurship, stronger job creation and, overall, the promotion of sustainable economic development.

Dealing with challenges – the experience of the South African Reserve Bank

The global challenges described above, and the questions of how to deal with them, have not spared the South African Reserve Bank. South African growth has slowed due to various external factors, not least due to the worsening terms of trade on the back of softer commodity prices. It is worth noting that commodity exports continue to represent about 60 per cent of South Africa's external trade but trade is increasingly shifting to other emerging-market economies, for example export shipments to China and the other BRICS countries have risen from 2,6 and 3,0 per cent in 2005 to 9,6 and 5,2 per cent in 2014 respectively.

These external factors have been compounded by domestic supply issues, prominent among which were electricity constraints, prolonged strikes in the mining and manufacturing sectors as well as skills shortages and uncertainties in certain fields of policy, such as the mining and agricultural sectors. The South African Reserve Bank forecasts GDP growth of 1,5 per cent this year and 1,6 per cent next year, which is substantially lower than the post-recession high of 3,2 per cent in 2011. The Bank further estimates that a part of this deterioration may be structural and that potential economic growth has slowed from around 3 to 3,5 per cent in 2010[5] to about 1,8 per cent this year.

Inflation continues to remain of some concern, even as growth slowed and the persistence of a negative output gap seemingly dampened the pass-through effects of currency depreciation to headline CPI inflation. Core consumer price increases have remained relatively elevated against a background of prolonged currency depreciation, above-inflation wage settlements and administrative price increases. Furthermore, the Bank projects that headline inflation will exceed its target range for two quarters in 2016 before declining to 5,7 by the fourth quarter of 2017.

The South African Reserve Bank has also been closely monitoring the broad-based measures of inflation expectations, in particular the Bureau for Economic Research's surveys of analysts, businesspeople and trade unions, which have shown greater stability over the past three to four years yet have remained anchored around the upper limit of the Bank's inflation target range. With inflation expected to overshoot its target range for two quarters in 2016, the Bank has been wary of any possible un-anchoring and/or an upward drift in these expectations. As a result, it stands ready to tighten policy further should such adverse developments occur. The Bank's Monetary Policy Committee has repeatedly indicated that it sees itself in a gradual tightening cycle. So far, interest rates have increased by 100 basis points, to 6,0 per cent, since January 2014. The sluggishness of economic growth and the persistence of a negative output gap inform our view of the gradualism of the current normalisation cycle. Nevertheless, the core mandate of the Bank is price stability, which means that the Bank remains vigilant and stands ready to act against any build-up of inflation

[5] See 'A semi-structural approach to estimate South Africa's potential output' by V Anvari, N Ehlers and R Steinbach, *South African Reserve Bank Working Paper Series WP/14/08*, November 2014.

pressures which may result in a persistent deviation from the inflation target range.

Cooperation and the role of the Association of African Central Banks

Before concluding, let me return to the importance of cooperation between the respective central banks on the continent, and in particular allude to the work undertaken through the Association of African Central Banks, the AACB.

As the economic, banking and financial inter-linkages between African countries multiply, the mutual understanding of our financial systems and the exchange of information on risks associated with, among others, cross-border bank lending can be of paramount importance to limit the risks of contagion through the continent of any future shock. In this respect, the role of the AACB, which has provided African central banks with a mechanism for cooperation and a forum for discussion since 1965, is likely to continue to grow in the coming years.

I would like to highlight the role which the South African Reserve Bank in particular is playing in leading the recently established working group on cross-border banking supervision. Our initial interaction with colleagues from other African central banks makes us confident that the working group will be able to formulate sufficient methods to improve cross-border supervision. Indeed, we anticipate that, over time, this working group will become the preferred platform where experiences are shared, ideas are discussed, and, ultimately, the effective supervision of cross-border banking operations is strengthened. The sharing of knowledge and the more effective use of skills and resources will no doubt be key, in the longer run, to improving the supervision of continental banking groups.

Conclusion

In conclusion, I would like to emphasise that sub-Saharan Africa has shown promising gains in economic growth and diversification, human development and policy governance over the past decade. It will be the task of all stakeholders, central banks included, to ensure that these gains are built upon in coming years, even as the global environment becomes more challenging. Allowing for the necessary adjustments of financial variables, like exchange rates, without endangering financial stability; keeping inflation stable without putting undue strain on fragile economic growth; and ensuring cooperation between the continent's regulatory institutions to allow for the development of cross-border financing while keeping risks in check are among the major challenges of the coming years. I have no doubt that, despite these challenges, the African Renaissance will continue to gain traction and that the next decade or two will see significant overall improvements in all developmental and economic metrics.

Thank you.