



**“Check in” from the South African Reserve Bank
Address by Brian Kahn, Advisor to the Governor,
to the 6th Annual Nedgroup Investments Treasurer’s Conference,
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Good morning, and thank you to Nedgroup Investments for the invitation to “check in” from the South African Reserve Bank. We are facing a particularly challenging domestic environment. The economy has entered a recession following the surprisingly negative outcome in the first quarter of this year, and at the same time we face the prospect of further sovereign ratings downgrades. Added to that, we are likely to have an increasingly noisy political backdrop for the remainder of the year. Such conditions do not bode well for a near-term improvement in business and consumer confidence. Fortunately, there are some positives as well. The inflation outlook has improved in recent months, and the global growth prognosis is probably the best it has been for some time. In particular, the current sentiment towards emerging markets is favourable, with continued capital flows to these regions. But as we know, risks remain and conditions can change very quickly.

It is against this backdrop that we have to implement monetary policy. Monetary policy acts with a lag, so what we do today will only have its full impact on inflation over the next 18 months or so. Therefore, the inflation forecast is central to our decision-making process. We cannot impact on today’s inflation, that is history. But today’s inflation rate is useful to the extent that it may contain new information about the future inflation outlook, and it may also

impact on the starting point of the forecast. Monetary policy-making is not only about calibrating the interest rate path to achieve an inflation outcome, but it is also about analysing the risks to the forecast. The future is inherently uncertain, and the more uncertain the environment, the more risks there are to any forecast. In my remarks to you today, I will focus on our recent decision and outline how we view the risks to the outlook. In particular, I will focus on how we deal with the exchange rate, as it is currently one of the key risks to the inflation outlook. This will relate directly to how we see the recent ratings downgrades.

But first, allow me to summarise the main points from the most recent MPC statement.

- 1) The latest two inflation numbers surprised significantly on the downside. This was true for both headline inflation and core inflation. CPI inflation measured 6.1% and 5.3% in March and April, while core inflation measured 4.9% and 4.8% in these two months.
- 2) The headline inflation forecast improved over the short to medium term, but remains unchanged for the outer period. We now expect an average of 5.7% and 5.3% for 2017 and 2018 rising to 5.5% in 2019. Although it is within the target range for the entire period, it is still uncomfortably close to the upper end of the target range, at around 5.5% for the last 6 quarters of the forecast period. Our forecast did not incorporate the most recent inflation outcomes, which were published the day before the announcement.
- 3) The risks to the inflation forecast were seen to be more or less balanced. This was a change from the previous meetings when the risks were seen to be moderately on the upside, although we had assessed the degree of upside risk to have moderated over the past few meetings.

- 4) The most important upside risk came from exchange rate uncertainty. However, despite this, there was still some “fat” in the forecast, as the prevailing exchange rate at that time was still a bit stronger than that assumed in the forecast. I will come back to the exchange rate issue a bit later.
- 5) The Bank’s forecast for GDP growth was revised down for the entire forecast period, by 0.2 percentage points for 2017 and 2018, and by 0.3 percentage points in 2019. Annual growth rates of 1.0%, 1.5% and 1.7% for the forecast years were expected in the forecast round. The main reason for the downward revision and continued downside risk was the adverse impact of the sovereign credit ratings downgrade on consumer and investor sentiment in particular. Since then we have seen the GDP outcome for the first quarter, which, at -0.7%, surprised markedly on the downside, reinforcing the downside risk. We are therefore likely to see a further downward revision to our growth forecast in the next forecast round.
- 6) The repo rate was left unchanged. In fact, the last change was in March 2016. In the last two meetings the vote was not unanimous, with one dissenting vote at both meetings.
- 7) The MPC viewed the level of rates to be appropriate, but that we were likely at the end of the tightening cycle. The MPC still felt that the inflation trajectory was uncomfortably close to the upper end of the target range, and with inflation expectations still anchored at the upper end, it means that any adverse shock could take us quite quickly outside the target range. We noted, however, that a reduction in rates would be possible should inflation continue to surprise on the downside and if the forecast is assessed to be sustainably within the target range over the forecast period. However, we cautioned that in the current environment of high levels of

uncertainty, the risks to the outlook could easily deteriorate. The MPC would want to be more convinced that the improved inflation outlook could be sustained. We would not want reduce rates, only to be forced into a premature reversal of policy.

It is not just the forecast itself that is of importance, but also how we perceive the risks to the forecast. Any particular forecast trajectory could have a different policy outcome depending on how we assess the risks. MPC members may have differing views of these risks, which explains to some extent why we do not always have unanimity in the decision-making process.

Most of these risks revolve around the assumptions regarding the exogenous variables in the model. These risks have varied over time and in the past have included international oil prices, food prices, and electricity tariffs. In the previous two meetings we flagged downside risk coming from oil prices and electricity tariffs, particularly over the short to medium term, although there is a higher degree of uncertainty regarding the electricity tariffs applicable from mid-2018. The degree of downside risk was partly reduced by the downward revision of the assumptions of both of these variables at the May meeting, and therefore incorporated into the forecast itself.

The rand exchange rate has been the main upside risk for some time, although the degree of upside risk has varied. A number of the risks that we face, for example higher US interest rates, domestic political uncertainty, changes in global sentiment or the possibility of ratings downgrades, affect the inflation outlook primarily through their impact on the rand. Given

the importance of the exchange rate I will spend some time talking about how we deal with the exchange rate in our decision making.

It is often assumed that monetary policy is mainly about the exchange rate. This is an overstatement. Clearly, not every large exchange rate move requires or elicits a response. If that were the case, the interest rate path would have been highly variable, rather than the very moderate, low volatility path that we have followed in recent years. While the exchange rate is one of the important variables in our inflation forecast, it is not the only one and we have to look at its impact in conjunction with the movement of other variables. And we certainly do not conduct monetary policy with a view to impacting on the rand itself.

From a monetary policy perspective, we are also more concerned about the longer-term trend of the exchange rate, rather than being overly focused on shorter term volatility or noise. We know that the rand often overreacts or overshoots in response to events and then retraces somewhat. Nevertheless, an understanding of the rand's longer term trends is important for our risk assessment.

The rand's impact on inflation is dependent on the degree of pass-through. In our forecasting models we have a pass-through co-efficient of around 0.2 i.e. a 10% depreciation will add 2 percentage points to inflation. In the past few years, however, we have seen a significantly lower pass-through. There are different estimates that have been made by various analysts. Our own estimates suggest a pass-through co-efficient of between 0.1 and 0.15. In effect this means that the impact of an exchange rate change may be overstated to some extent in our models.

The main reason for the decline in pass-through is probably due to the weak demand in the economy, which makes it difficult for firms to pass through increased costs, with resulting margin squeeze somewhere along the value chain. This suggests it may be a cyclical phenomenon. Research at the Bank suggests that there is in fact some asymmetry with respect to the reaction to the cycle: during a cyclical upswing, pass-through is much stronger, whereas in a downswing, it is much weaker.

How do we deal with the exchange rate in our forecast? We make a simplifying assumption of a stable real effective exchange rate over the forecast period. That implies an expectation of a rand depreciation over that period in line with inflation differentials with our major trading partners. We then use our judgement to assign a risk to this assumption, which then feeds in to the overall risk to the inflation forecast.

The critical issue then is the level of the starting point. As a general rule, we set it at the prevailing index level of the real exchange rate. However, if we feel that the exchange rate is clearly over- or undervalued at that point, we may adjust that level. In other words, should we regard the current strengthening or weakening of the rand as being temporary, we may not adjust the assumption fully until we have greater confidence of its persistence at those levels.

The level that we choose has an important implication for the forecast. In 2016, for example, we saw a progressive improvement of the inflation forecast over the year. Most of this was due to revisions to the exchange rate assumption, following a recovery of the rand. For

example, between January and September last year, the average headline inflation forecast for 2016 declined from 6,8% to 6.4%; for 2017, from 7.0% to 5.8%; the peak declined from 7.8% to 6.7%; and the expected return to within the target range moved from 4th quarter of 2017 to the second quarter. During the same period, the starting point of the exchange rate assumption appreciated by 11%. However, I should emphasise that it is not only the exchange rate that impacts the forecast. The deterioration of the forecast in January 2017, for example, was mainly due to an upward revision of the international oil price assumption, following the price response to the OPEC-led supply curtailments, as well as a higher food price forecast.

More recently, the ratings downgrades in the wake of the cabinet reshuffle caused an initial depreciation of the rand to almost R14 against the US dollar, and in our following forecast we adjusted the assumption to a slightly weaker level. The rand subsequently recovered much of its losses, and at the May meeting of the MPC, the rand/dollar exchange rate implicit in the real effective exchange rate (around R13.60 against the US dollar) was in fact weaker than the prevailing spot exchange rate at that time. The rand has remained relatively strong since. So even if we see a moderate weakening of the rand going forward, it does not necessarily follow that the assumption will automatically be changed, as there is some latitude for it to move. But we also know that the rand can move significantly and very quickly in response to shocks.

Not all of the risks to the rand are on the upside (i.e. rand weakening). The rand has been surprisingly resilient in the past 16 months, despite the adverse domestic shocks that it has faced. Part of the underlying support has come from improved terms of trade, driven in part by weak oil prices and positive Chinese growth prospects which has impacted positively on

other commodity prices; a marked narrowing of the current account deficit, which has reduced the perceived fragility of the rand to possible capital flow reversals; and a generally more favourable view of emerging markets which has seen continued capital flows to these markets as the global search for yield continues.

However, as you are all aware, there are various upside risks to the rand. Two of these are the risk of US policy tightening, and the risk of further ratings downgrades. We get recurring questions as to how deal with these issues in our deliberations.

For much of the past two years or so, normalisation of monetary policy in the US has been seen as a risk to the rand. This is in part due to the strong reaction of a number of emerging market currencies to the so-called “taper tantrum” in 2013. Since then, the US Fed has been a lot more careful about its communication, and has emphasised the moderate nature of its tightening cycle. For some time we flagged this as a risk to the exchange rate outlook, given the possible impact on the direction of global capital flows, but the restrained market reaction to the actual tightening suggested that it was mostly priced in.

The impact of Fed tightening on our monetary policy stance would depend on how it affects the inflation forecast through the impact on the currency. We do not react one for one with Fed moves, and we never have. We set interest rates in line with what is appropriate for our economy. In fact, had we reacted preemptively to possible Fed tightening, we would have got it terribly wrong. Since 2014, each year began with expectations of more aggressive tightening than actually transpired. As it turns out, there have been only 3 increases of 25 basis points each in December of both 2015 and 2016 and again in March this year. There is currently an

expectation of two further increases this year priced into the markets. Increases in line with expectations are unlikely to have a major impact on the rand, and for this reason we have not mentioned the possibility of Fed tightening as a risk to the forecast in our recent statements. Surprises in forward guidance provided by the Fed, however, could have an impact.

There is therefore no automatic reaction on our part to global interest rate increases. We also have to take cognisance of what is happening to other interest rates along the yield curve. Capital flows are not only sensitive to short term yield differentials. In fact, the correlation between South African and US long bond yields is much higher than at the shorter end. And we should also bear in mind that the current “global interest rate cycle” is unsynchronised: monetary policies in Japan, the Euro area and UK are still in accommodative mode, and there is a general loosening bias in emerging markets.

With respect to how we position ourselves for a sovereign ratings downgrade, it is difficult to give a simple answer, as there are so many scenarios that we can come up with. A ratings downgrade is not a one-off discrete event, it is a continuing process. Two ratings agencies, S&P Global Ratings and Fitch Ratings reported last week, and we await a report from Moody’s Investors Service very soon. But that will not be the end and more reviews will follow later in the year. The impact of a downgrade also depends on a number of factors: how many agencies have downgraded us and which ones are they? Some are more important than others for investor mandates and for inclusion in the various bond indices. How is domestic currency denominated debt rated? Currently S&P and Moody’s still have domestic currency denominated debt at investment grade.

A further fundamental question is who are the likely buyers of the bonds in the event of a local bond selloff? If it is other non-residents, the impact on the exchange rate in particular could be very different to a situation where the buyers are other non-residents who may be attracted by the consequential high yields. We have seen, for example, that non-residents have remained net buyers of South African government bonds in recent weeks and that bond yields are largely unchanged compared to where they were at the time of the downgrade. And finally, given that ratings announcements are generally not a big surprise, how much is already priced into bond yields and the exchange rate?

Clearly there are quite a number of possible scenarios, with numerous combinations of outcomes and timing which makes it very difficult to assess the ultimate impact. A worst-case scenario would be one where all three agencies rate us as speculative or sub-investment grade, including domestic currency denominated debt, which results in South African government bonds falling out of the global bond indices. Such a scenario could entail large-scale net bond sales by non-residents.

The fact that the response to the downgrade so far has been relatively benign probably has a lot to do with the fact that we are still not in a worst-case scenario, and we still have a window of opportunity to avoid this before the next round. Whether or not we will take that opportunity remains to be seen. But we cannot assume that further downgrades will have the same muted effect. Furthermore, the downgrades coincided with a more positive sentiment towards emerging markets in general, which could have masked some of the adverse impact.

Work done at the Bank suggests that there are three main channels through which the economy and monetary policy could be impacted. First would be the exchange rate channel, and depends on the extent of the increase in the risk premium and the net sales of bonds by non-residents. The second would be the impact on long bond yields in particular, but the effect could be on the short end as well, should the depreciation impact on the inflation outlook sufficiently to require a tightening of monetary policy. Ultimately, we believe the most serious impact of the downgrade would be on private sector investment sentiment and therefore on growth.

A scenario exercise conducted in the Bank assumed that local currency debt was downgraded to sub-investment grade by all agencies, but in a favourable global environment. This is assumed to result in a net bond outflow in excess of R100bn, and a permanent increase in the country risk premium. The impact effect is an 11% depreciation of the rand, but it recovers over time and by the end of 2019 it is 5% weaker than at the starting point. By 2019, compared with the baseline, the GDP level is 1.1% lower (due to cumulative lower growth); potential output is 1% lower; and CPI inflation is 0.6% higher. Private sector investment and household consumption expenditure are 4% and 1% lower respectively. In terms of a monetary policy response, the model suggests an immediate 50 basis point increase, and a cumulative 120 basis point increase compared with the baseline. I should stress this is a model-generated scenario exercise only.

The bottom line, however, is that the uncertainty in this regard does cloud the outlook and contributes to upside risk to the inflation outlook, and downside risk to growth. The outcome is very uncertain, given the range of possible scenarios.

Moving away from the exchange rate, we are often asked why do we not reduce interest rates to stimulate growth, given that the ratings agencies highlight our slow growth as a key risk. We are of view that while monetary policy can impact on short term or cyclical growth, it has limited impact on potential growth or the underlying structural growth in the economy. To achieve a higher potential output would require structural reform initiatives that are beyond the capabilities of the Bank. But we can impact cyclical growth, and we are very aware of this in our policy decisions. This explains in part why the current interest rate cycle has been so moderate compared with previous cycles.

The ratings agencies do not highlight monetary policy as one of the areas of concern. Nor do they see a temporary stimulus as a solution to what they see as a structural growth problem. To quote from the latest S&P release of last week when they maintained the current rating:

We consider South Africa's monetary flexibility, and its track record in achieving price stability, to be important credit strengths. The SARB is operationally independent, in our opinion, with transparent and credible policies.... We expect that inflation will remain below 6% this year and remain in the target range of 3%-6% over our three-year forecast horizon.

In conclusion, we are concerned about the impact of our policies on short term growth, but we see price stability as the main contribution that we can make to longer-term growth. Our assessment is that the current stance of monetary policy is not tight and is not a major constraint to growth. As I mentioned earlier, for interest rates to be cut, we would like to see the inflation forecast more comfortably within the target range over the forecast period. The

recent negative growth outcomes, and in particular the contraction in household consumption expenditure, suggest a continued absence, and possibly weakening of demand pressures, which may contribute to further inflation moderation. Further downside surprises are also possible. But the risks that I have outlined still persist. Our policy reaction will remain guided by how we see the inflation outlook going forward within the economic growth context, but cognisant of the risks to the forecast. Ultimately it is a judgement call and, as always, our decisions remain highly data dependent.

Thank you.