South African Reserve Bank

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## South Africa's crisis of confidence and the policy response

Good evening, ladies and gentlemen.

Thank you for inviting me to address you today.

The global economy has been as favourable recently as it has been for some time. We are experiencing a synchronised cyclical upturn across major economies. South Africa's terms of trade are near all-time highs. Meanwhile, global financial markets have resumed a search for yield, causing stronger capital inflows to emerging markets, including South Africa.

By contrast, the domestic economy has fallen into recession, with output contracting in both the last quarter of 2016 and the first quarter of 2017. Although this is the first technical recession since 2009, it continues a trend of exceptionally poor economic performance. We have warned about poor economic performance for several years, and although we did not expect the first-quarter GDP[1] figure to be quite so weak in quarter-on-quarter terms, our assessment in the May MPC[2] meeting was that the risks to the growth forecast were on the downside.

[1] gross domestic product
[2] Monetary Policy Committee

Meanwhile, inflation has returned to within the target range, as expected. Some recent numbers have come in a bit lower than anticipated, but our forecast still indicates inflation in the upper half of the target range across the forecast horizon, which stretches to the end of 2019.

The combination of lower inflation and lower growth suggests, at least to some, that the time has come for rate cuts. The MPC will meet in late July to consider how the outlook has changed, and we will make the appropriate decision at that time. We are not here for me to give interesting hints about the next repo rate decision. The best source on MPC decisions is the MPC statement, not speeches a month prior.

Instead, this speech is about our broader policy constraints and the medium-term outlook for the South African economy. We confront major challenges – challenges which cannot be resolved in any meaningful sense by fine-tuning the repo rate – and we need to grapple with those problems. Monetary policy does have a role to play, but it is crucial to acknowledge the limits to monetary policy and to focus on its optimal contribution over a medium-term horizon.

Today, I will start by discussing South Africa's macroeconomic strategy since 2009 before turning to the outlook.

**The world economy and South Africa's macroeconomic strategy**

The most recent Global Financial Crisis was a huge economic earthquake, one which threw South Africa and most other countries into recession. Like many big earthquakes, it was followed by a series of aftershocks. One was the euro area crisis of 2011-12, which produced two years of negative growth in one of our most important trading partners. More recently, the global economy has suffered a second aftershock in the form of an emerging market slowdown, linked to weaker commodity prices, overstretched policy frameworks, and risk-off sentiment in global financial markets. Because of these shocks, world economic growth has repeatedly fallen short of forecasts.

The South African policy response to these conditions can be summarised as 'support and wait'. Macroeconomic policy provided support in the form of low interest rates and large budget deficits. At the same time, we waited for the global economy to recover. But this strategy has yielded disappointing results. In part, this is because we ended up waiting much longer than expected. Furthermore, as the waiting went on and domestic growth kept slowing, loose policy settings became not simply a response to slow growth but also one of its causes.

As the post-Crisis period dragged on without a robust global recovery, persistently large fiscal deficits caused our debt-to-GDP ratio to almost double.[3] By importing large quantities of savings from the rest of the world and then exporting revenue to pay the interest, our current account widened to become very large, exceeding 6% of GDP in some quarters. Investor doubt about the strength of our macroeconomic framework contributed to higher borrowing costs as well as exchange rate weakness, with the rand becoming one of the world's worst-performing currencies. The depreciated currency was, of course, a major reason why inflation forecasts began indicating prolonged breaches of the top end of our inflation target range. By 2014, it was clear that this broad macroeconomic trajectory was unsustainable; something had to change. Accordingly, monetary policy embarked on a gradual tightening cycle, with the repo rate rising from 5% to 7% over the course of two years. Similarly, fiscal policymakers set out a consolidation agenda to stabilise debt and contain spending growth.

It would be wrong to say that policymakers slammed on the brakes. Rather, we eased off the accelerator. The monetary policy adjustment was the most limited and gradual in recent history, with the repo rate rising by just 2 percentage points over 27 months. At 7%, which is where we are now, the policy rate remains quite low from a historical perspective.

Meanwhile, although fiscal policy has become less expansionary, deficits have remained larger than 3.5% of GDP over the past three years. These deficits have been

[3] In gross debt terms, as a share of GDP, government's debt stock was 26.5% of GDP in 2008. In 2016, it was 50.5% of GDP, and IMF forecasts indicate that it will reach 52.5% of GDP in 2017.

more than simply the unfortunate consequence of low tax revenues caused by slowing growth. In structural terms – that is, correcting for the economic cycle – South Africa's fiscal deficit has still averaged about 3% over the past three years, according to IMF[4] estimates.[5] As an illustration, 3% is greater than the output of the entire agriculture, forestry and fishing sector; it is a large amount to borrow every year and it injects substantial spending into the economy.

South Africa's macroeconomic settings also look accommodative in comparison with those of other countries. In fiscal terms, most of our peer countries have borrowed less heavily. Amongst the major non-oil commodity exporters, South Africa's average post-Crisis deficit is larger than any country's except Brazil's.[6] Indeed, not only have many of our peers achieved smaller deficits than we have; sometimes they have even managed budget surpluses. For example, Chile, Colombia and Peru all exploited the post-Crisis rebound in commodity prices to balance their budgets.[7] If anything, South Africa stands out for running consistently large budget deficits despite historically high commodity prices. The result has been higher debt service costs and reduced fiscal space.

In monetary policy terms, South Africa more closely resembles its emerging market peers. Most of these countries began tightening policy around 2013 or 2014. Some of these countries faced inflation well above their targets and therefore raised rates sharply. The most prominent cases were Brazil and Russia, where policy rates went up by 700 and 1 150 basis points respectively. Where the inflation challenge was less extreme, smaller adjustments were possible. Colombia, for instance, tightened by 450 basis points, Indonesia by 200 basis points, and Chile by just 50 basis points.

[4] International Monetary Fund

[5] The April 2017 *Fiscal Monitor* estimates South Africa's structural budget balance at -3.4% for 2014, -2.8% for 2015 and -2.8% for 2016. Since 2009, the structural budget balance has averaged -3.5% of GDP. Internal SARB estimates are very similar.

[6] This comparison refers to the following countries (with the average 2010-2016 fiscal balances in brackets): Brazil (-5.1%), South Africa (-3.9%), Argentina (-3.6%), Australia (-3.4%), Canada (-2.2%), Colombia (-2.1%), New Zealand (-1.9%), Indonesia (-1.8%), Chile (-0.7%) and Peru (0%).

[7] Specifically, Chile recorded budget surpluses in 2011 and 2012, Colombia in 2012, and Peru in each year from 2010-2013.

More recently, some emerging markets have had space to cut rates. The prevailing pattern has been that the countries that are closer to their inflation targets, and which previously increased rates more, now have greater scope to cut. For instance, inflation in Chile has fallen from 5.7% at its peak to just 2.6%, below the 3% inflation target, permitting the central bank to reduce rates by 100 basis points. In Brazil, inflation has declined from a high of 10.6% at the start of 2016 to 4.1% in May, and the policy rate has come down from 14.25% to 10.25%. Brazil's inflation target, for your information, is a point of 4.5% within a range of 3-6%.

In sum, we have run accommodative macroeconomic policies throughout the post-Crisis period. Since 2014, the degree of stimulus provided by policy has been reduced to contain inflation and slow the pace of debt accumulation. Policy nonetheless remains broadly supportive of economic activity. Despite this fact, growth has slowed steadily throughout the post-Crisis period. To some extent, we have been able to blame this on an unfavourable global economic environment. Yet, now the global economy looks as healthy as it has in years – but the South African economy is still struggling. So why are we doing so badly? And what can be done about it?

**South Africa's crisis of confidence**

At the present juncture, our fundamental problem is confidence. In economic discussions, 'confidence' is sometimes an opaque and disreputable concept. Paul Krugman in 2010 coined the term 'confidence fairy' for when pundits rely on magical thinking to explain how their favourite policies can have only good effects.[8] But I'm afraid that, in South Africa at the moment, we can't comfort ourselves that confidence is a mythical creature. It would be more accurate to say that it is very real – but badly endangered.

We have reliable measures of business and consumer confidence. The BER's[9] surveys show that the confidence levels of both these sectors are at their lowest since

[8] See the article by Paul Krugman, 'Myths of austerity, published on 1 July 2010, available at http://www.nytimes.com/2010/07/02/opinion/02krugman.html.
[9] Bureau for Economic Research (Stellenbosch University)

the Global Financial Crisis. These two indicators slipped below their long-term averages in late 2015 and have stayed there ever since. Just last week, for example, new data for business confidence in the second quarter came out at a fresh post-Crisis low, with 70% of the respondents pessimistic about local business conditions.

Weak confidence has profound economic consequences. When people are this worried about the economy, theory tells us, they don't make large purchases. Businesses defer investments. All of this weakens economic growth. These theoretical predictions are completely consistent with what we see in the data.

Why is confidence so subdued? The answer is simple. Everyone in South Africa is worried about their country. Twice a year, South African Reserve Bank (SARB) hosts monetary policy forums in 10 major and secondary cities. During these forums we find that people want to talk about governance, about the exchange rate, about credit rating downgrades. They're worried about policy; they're worried about living in a junk status country. It is a depressing discussion, but in a way it is impressive: economic issues often seem obscure, yet people quickly become informed and passionate when the situation is serious.

The message we get from regular South African citizens is fundamentally very similar to the one we hear from the ratings agencies. We have deep-rooted problems of unemployment, poverty and inequality. Our economy is not growing as fast as it needs to, and this problem has been getting worse.

Nonetheless, South Africa still has strengths. In particular, we have functioning institutions that deliver on their mandates. We also have sophisticated firms and markets, even if there is always room for improvement. Nonetheless, these general positives help to maintain South Africa's status as an upper-middle-income country, a member of the G20[10], and a member of the BRICS[11] grouping. Many other countries do worse. But if South Africa doesn't start doing better, it won't be able to meet its

[10] Group of Twenty
[11] Brazil, Russia, India, China, South Africa

challenges – and it will be overtaken by other countries. So what do we do about our growth trap, our downgrade challenges, and our crisis of confidence?

There are roughly two narratives forming around the subject. One of them holds that if the ratings agencies don't like us, that's their problem – and their judgement is unreliable and biased anyhow. Policy settings are much too tight; fiscal and monetary discipline really means asphyxiation. If private confidence is so elusive, it might as well be ignored. This view is wrong-headed and dangerous. In my view, it amounts to shooting yourself in the foot, finding it hurts, then shooting yourself in the other foot to get even.

The alternative view is that South Africa needs to re-establish its strengths and recover from there. Back before the Global Financial Crisis, some observers used to look at growth rates of 3% or even 4% and complain that they weren't high enough, that we had implemented such excellent macroeconomic policies and worked so hard to make the country attractive to investors, yet the rewards were meagre. We are now seeing what it looks like when we are not so virtuous. We don't grow at 3% anymore; we don't even grow fast enough to keep up with the growth rate of the population. There was a lot to be said for an economy with rock-solid finances, confident investors and 3% growth. I think we can do even better than 3% growth, but we certainly need not do worse.

**The contribution of the South African Reserve Bank**

So what is the contribution from the SARB?  Our fundamental, constitutional mandate is to protect the value of the currency in the interests of balanced and sustainable growth. Balanced growth is about seeing to it that the value of the currency allows both exporters and importers to engage productively in the economy. It also means that the economy's growth is sustainable, that imbalances are neither generated that cause crises through over-heating nor throw the economy into severe downturns.  All of this is clearly in the interest of all South Africans.

We implement this mandate through a flexible inflation targeting framework. We sometimes hear the objection that targeting inflation is bad for growth – that is, one part of our constitutional mandate conflicts with the other, and protecting the buying power of the rand is anti-development. However, low inflation is actually the ally of development. There are several reasons for this. Low inflation helps maintain the value of the money in your pocket. This is good for all South Africans, but especially the marginalised and poor – those without the information or power to protect themselves from inflation. Low inflation also helps maintain the competitiveness of South African goods and services in foreign and domestic markets, by moderating real exchange rate appreciation. Furthermore, low inflation produces lower interest rates. In summary, there is no long-term trade-off between growth or inflation. Keeping inflation low, protecting the value of the currency, is supportive of growth.

Through history, some countries have tried to deny these truths, pretending that high inflation somehow begets sustainable growth. This kind of macroeconomic populism is usually a precursor to misery, not least because it impoverishes nearly everyone in society. The few who benefit are those that somehow are able to capture a dwindling supply of the necessities of life or gain privileged access to foreign currency (for a short time). Neither the middle classes nor the poor of high inflation countries are likely today to be partisans of such an approach to policy.

The impact of inflation on interest rates is often misunderstood. This is probably because the interest rate is our main tool for controlling inflation, so when interest rates rise the reason for this is typically higher inflation. Sometimes people suggest that if we would just ignore the inflation, then interest rates wouldn't have to move and we could have more growth. But as I explained in my speech at the University of Kwazulu-Natal earlier in the year, interest rates incorporate compensation for expected inflation. For this reason, as the Fisher equation states, the rate of interest is equal to expected inflation plus a real premium. If you have two identical countries, and one has a three percent inflation target and the other has a six percent target, then interest rates will be exactly three per cent *higher* in the country with the higher target. If that country raises its target to nine per cent, then interest rates will end up rising another three percent. And if that country simply stops trying to control inflation at all, then it will become harder to borrow in its currency, with lenders switching to some other currency with more predictable inflation. In the short run, you can get lower interest rates by surprising people with higher inflation. But once they wake up – and investors aren't slow to see higher inflation – interest rates have to rise.

For this reason, one of the most effective ways for lowering interest rates is to keep inflation low and predictable. Looking around the world, the evidence is very clear that low inflation countries have low interest rates and high inflation countries have high interest rates. In the extreme cases, such as Sweden, inflation is so low they even have negative interest rates. Sweden's repo rate, for example, is currently at -0.5 per cent. By contrast, in countries with much higher inflation, like Argentina or Nigeria, policy rates are much higher. Nigeria's is currently 14 per cent. Argentina's is 26.25 per cent.[12] So although it is the case that interest rates typically rise in response to higher inflation, on average interest rates are *lower* because of lower inflation. This is why inflation targeting is a way to get lower rates over time.

This sets the context for our current policy settings. Inflation in South Africa has moderated in recent months. We now have a good chance of getting inflation down well within the middle part of the target. Inflation is likely to move in this direction because of declining food inflation, our policy communications, the stronger exchange rate, and the sensitivity of price and wage setters to weak economic conditions. If we can keep inflation lower, anchoring inflation expectations, that should in turn generate a lower rate of interest to support the economy.

Unfortunately, we also have to worry about higher inflation if things go wrong – that is, if the exchange rate begins depreciating again, if wage settlements are excessive, or if our monetary policy communication isn't heard, loud and clear. These factors limit our policy space.[13]

The ratings agencies have been clear that the effectiveness of the central bank is one of the strongest pillars supporting this economy – a claim that speaks to both our price and financial stability mandates. We will continue to honour our constitutional mandate and the trust placed in us by the South African society.

[12] Argentina's May 2017 inflation rate was 24%. Nigeria's was 16.25%. (Data from Haver.)

Thank you.