South African Reserve Bank

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The role of monetary policy settings in the current conjuncture

Introduction

Good afternoon, ladies and gentlemen.

It is my pleasure to be addressing you today.

Since 2008, central banks have occupied a significant place in the global discourse about economic growth. This is largely because, in the aftermath of the global financial crisis, central banks acted decisively and in a coordinated manner to shore up liquidity in financial markets, which provided space for countries to make appropriate policy adjustments to boost actual and potential growth. It is therefore not surprising that, as the global growth momentum is weakening, the debate about the role played by central banks is gaining prominence. While the global discourse has straddled both financial and price stability, in South Africa the focus has largely been on the role of monetary policy in supporting growth.

My remarks this afternoon will be on South Africa's monetary policy settings in the current economic environment.

My message will be presented in three parts. First, I will briefly outline the delicate economic conditions prevailing - both global and domestic. Second, I will highlight how the South African Reserve Bank (SARB) is playing its part in supporting balanced and sustainable growth. Third, I will demonstrate why structural reforms and policy certainty are essential to building the confidence required to increase investment and enhance the resilience of the South African economy.

The conjuncture

Let me begin with a brief reflection on the conjuncture.

While the level of global growth is around the long-term average and global financial conditions remain supportive, the momentum for global growth has slowed and commodity prices are struggling to reach the levels recorded at the peak of the commodity cycle. There are significant downside risks, the most prominent being the escalation in trade tensions, which could undermine both global trade and investment, with potential negative spillovers into market sentiment. Therefore, the risk of a renewed tightening of financial conditions should not be underestimated. In this regard, global conditions are likely to be less supportive of South Africa’s growth over the medium term.

Domestic growth is showing signs of continuing sluggishness, as reflected in the most recent gross domestic product (GDP) data and weak confidence indicators. The SARB’s composite leading business cycle indicator has also trended downwards from March 2018 up to March 2019, pointing to a renewed slowdown in output growth.

The contraction of 3.2% in the first quarter of 2019 is the lowest GDP outcome since the global financial crisis. Even more concerning is the fact that the contraction was broad-based.

In May, the SARB’s forecast was for growth to average 1% in 2019. This was based on expectations of a smaller contraction in the first quarter. Given the actual outcome, growth above 3% is now required in each of the remaining quarters of 2019 to achieve the projected growth of 1%.

Overall, there remain significant downside risks to domestic growth. Weak business confidence, possible electricity supply constraints and high debt levels in certain state-owned enterprises (SOEs) will continue to limit investment prospects.

Inflation outcomes and the role of monetary policy

Let me now turn to inflation outcomes and the role of monetary policy.

Since 2008, monetary policy has endeavoured to smooth output around potential, by providing accommodation to a weak economy. This was achieved up to 2014, with a repurchase rate at historically low levels. But as inflation gradually increased from 2011 to 2014 to about 6%, policy shifted somewhat to reduce accommodation, in an effort to lessen the upward pressure of rising inflation on long-term interest rates, but also to remain supportive of growth.

On balance, monetary policy has been accommodative, although the degree of accommodation has declined over the past 10 months in particular. This decline in accommodation, based on short-term real interest rates, has been caused by an unexpected fall in consumer prices, mostly caused by two factors: a sharp decline in the prices of imported goods due to rand appreciation early in 2018, and much lower food prices than expected.

Imported goods prices were much lower than expected, and domestic meat prices have fallen sharply. More recently, nominal compensation growth has also eased alongside moderating rental prices. And as inflation has eased, the real interest rate has risen, reducing notional accommodation. However, over the next three years, real interest rates are expected to moderate.

Alongside less global inflationary pressure, these factors have fed into the SARB's forecasting of future inflation and, in the absence of any large shocks to inflation or a sharp increase in risk, they have started to create more space for policy. Inflation itself is rising moderately, but it is lower than had been forecast last year.

The SARB expects headline inflation to average 4.5% in 2019, increasing to 5.1% in 2020 and moderating to 4.6% in 2021. When we met in May, the Monetary Policy Committee (MPC) found the risks to the inflation outlook to be more or less evenly balanced. The MPC is encouraged by the moderation in inflation expectations. Over the next three years, the SARB's model shows convergence towards the midpoint of the inflation target range.

The South African Reserve Bank's response to the current conjuncture

So how, then, should the SARB respond to the conjuncture?

Economic growth is in fact an explicit part of the policy equation in the SARB's quarterly projection model. It is a central feature of all policy discussions. I have come across arguments that the SARB does not care about growth. I must say, I do not recognise this image of the SARB in the policy processes that I see and participate in, day to day.

The flexible inflation-targeting framework takes account of the outlook for the real economy and how it will likely affect inflation over the three-year forecasting period. For instance, when demand is weak and exerts downward pressure on prices, the SARB has more latitude to look through supply shocks than in an environment of rapid demand growth.

While the SARB recognises the role that monetary policy has to play in the economy, this is in the context of smoothing output fluctuations over the business cycle. The current challenges constraining South Africa's economic growth are primarily structural in nature. In this regard, to ensure that monetary policy settings have a sustained positive impact on growth, monetary policy should be appropriately supported by other macroeconomic policies. The longer-term costs of higher inflation and a deterioration in inflation expectations have potentially adverse impacts on policy credibility, consumer purchasing power, borrowing costs, and the global competitiveness of South African firms.

Indeed, there is a conversation to be had about why South African prices and inflation remain elevated relative to our trading partners. The SARB's assessment is that this is due to pricing practices, market structure, and other supply-side rigidities. Reducing the cost structure of the economy requires the implementation of credible structural policy initiatives.

The role of structural reforms

Allow me to reflect on why structural reforms matter more now than they perhaps did before.

The key constraint for macroeconomic policymakers has been, and remains, a very low potential growth rate. Estimates of potential growth have decreased from over 4% prior to the global financial crisis to just over 1% today.

This low growth potential has been caused by a series of shocks, including an insufficient electricity supply and rising electricity costs, protracted strikes and weak investment in the mining and manufacturing sectors, severe drought, and very low business confidence as a result of policy uncertainty. This, in turn, has translated into lower levels of private investment generally, while public investment has slowed due to the crowding out of capital budgets by strong growth in public employment costs, wasteful procurement practices, and management failures at SOEs.

Low growth potential is a serious problem for policy. It means that, in a vicious cycle, macroeconomic stimulus will inevitably cause higher inflation, more currency depreciation and higher interest rates rather than growth in investment, employment and output. In this regard, monetary policy space needs to be created by reforms that raise potential growth through the improved use of capital, labour and higher productivity. The same goes for fiscal policy. This is important for efforts to initiate stronger growth, and implies that microeconomic reforms need to be staged first.

Getting the sequencing right will ease the constraint on the macroeconomic policy levers and will enable them to be used judiciously to support economic growth when the business cycle weakens.

Investment by firms, households and government may not be the largest component of demand, but it is the most important factor for GDP growth. In the short run, investment creates demand for goods and services as firms buy materials and services to create new productive capacity. In the medium term, the new capacity is used to produce more goods and services.

Investment appetites are strongly influenced by what government chooses and how fast the choices are implemented. The willingness of firms to invest also depends on their expectations of future economic activity, the opportunities available, the cost of investing, as well as whether they believe that their property rights are protected. These also contribute to firms' hiring decisions.

It should also be recognised that investment will not be sustainable if more South Africans do not benefit from stronger economic growth. To get this right, investment needs to generate many more jobs, even as others are lost due to productivity gains and more competition.

Structural reforms are critical to that effort, because they increase competition to incumbent firms, providing new opportunities, and remove impediments to South Africans of all skill levels to take advantage of opportunities to work. We need to develop mechanisms to retrain, develop skills, and facilitate the rapid re-entry of workers at all skill levels back into the growing sectors.

While various commitments of investment have been made over the last year, poor GDP outcomes and weak confidence point to a trust deficit that continues to hinder growth.[1] Rebuilding trust in all the aspects of economic policy requires rapid delivery on a well-designed policy agenda.

There is no shortage of reform ideas, although understanding and assessing their effects on the economy is a complicated task. And so while we do not need to reinvent the wheel, we do still need to prioritise where to apply effort, on what timescale, and in what order or sequence.

Conclusion

To conclude, let me reiterate that the current global economic conditions are clouded with risks and that the current domestic economic conditions are delicate. We need to get domestic growth going again.

[1] Algan and Cahuc (2010) establish a positive relationship between the level of economic activity and trust. Higher trust levels are associated with stronger and more sustainable growth.

To ensure that this growth is sustainable, balanced and shared, policy choices must carefully balance short-term gains and costs against long-term gains and costs.

In an environment of limited resources and constrained policy space, I would advocate that policy certainty is the cheapest form of stimulus for this economy. In this context, understanding and clearly communicating the role of various institutions and policy instruments is important.

As mentioned earlier, the primary contribution of monetary policy to growth is its ability to smooth output fluctuations over the business cycle. However, where structural constraints are prominent, monetary policy effectiveness is impeded. In the interest of contributing to policy certainty, the SARB has strengthened its monetary policy communication and transparency. Indeed, the views I am conveying to you today are captured in various MPC statements.

The SARB discharges its duties in the public interest. This is a fine balancing act. It is the SARB's assessment that macroeconomic stability is that which gives comfort to investors to make investments that enable growth and employment in our economy. Equally, preserving the purchasing power of households, and having stable costs of borrowing, is important to achieving real income growth for households. These factors are essential for economic development, but not possible in an environment of high inflation.

The conjuncture calls for decisive and appropriate policy action. The SARB remains committed to playing its part in building confidence and enhancing the resilience of the economy.

Thank you.