‘Monetary policy and financial markets in post-COVID-19 South Africa’
Opening remarks by Ms Fundi Tshazibana, Deputy Governor of the South African Reserve Bank, at the JP Morgan Emerging Markets Credit Conference, 22 September 2020

1. Introduction

Ladies and gentlemen, thank you for the opportunity to address this edition of the JP Morgan Emerging Markets Credit Conference – the first to be held online. In many aspects, 2020 has been a year of firsts. In recent years, much of the concern about a halt in global growth has emanated from concerns about the possibility of a recession in the world’s largest economy, concerns that the escalation of trade tensions would result in a large reduction in global trade and investment, as well as concerns about geopolitical developments. But until now, never has there been such widespread concern around a pandemic that would change so many aspects of our daily lives.

The COVID-19 outbreak has had major health, social and economic impacts, which have required sizeable adjustments to policy. Monetary policy, unsurprisingly, has also had to respond to this once-in-a-100-years event. In my comments today, I would like to elucidate how the South African Reserve Bank (SARB) has responded to these exceptional circumstances. Second, I will highlight the policy outlook as we see it. Finally, I will turn to some of the challenges the ‘post-COVID’ world may pose for monetary policymaking, and the role financial markets may play in informing our approach.

2. How the COVID-19 crisis required a strong response

As the COVID-19 pandemic started to spread in Asia, and then Europe, the South African authorities moved quickly to follow international best practice and imposed restrictions on people's movements and economic activities. These measures helped to 'flatten the curve' of infections and allowed the healthcare sector time to make adequate preparations. These measures appear to have paid dividends. While COVID-19 infection rates surged in South Africa in June and July, the rate of new infections appears to be subsiding. The mortality rate remains moderate by global standards, and our healthcare system has been largely responsive to those in need. Experts agree that the human cost would have been higher had the government's response been delayed.

However, as in other parts of the world, these healthcare gains came at significant economic costs. In April 2020, under the strictest lockdown levels, manufacturing production and retail sales fell by 45% and 49% respectively when compared to a month earlier. Vehicle, accommodation and restaurants sales basically ground to a halt. As Statistics South Africa has since reported, gross domestic product (GDP) for the second quarter fell by an unprecedented 51% (annualised). The SARB's latest forecast now shows that annual GDP for 2020 will fall by 8.2%. This is several times worse than the previous deepest annual contraction, which was -2.1% in 1992.[1]

While these numbers and other bad news have dominated headlines, it is also important to understand that GDP data arrives with a lag, and that the economy has since begun to recover. As lockdown restrictions were gradually eased from early May, business activity resumed. By July, more than half of the April plunge in output and sales had been reversed. High-frequency mobility and transaction indicators show that this normalisation continued in August, in some cases returning to pre-crisis levels. Globally, many countries are also seeing stronger-than-expected rebounds. Although the recovery path is likely to be a difficult one, the current data are encouraging.

[1] The comparison stretches back to 1947.

Part of the explanation for this strong rebound is that fiscal and monetary authorities have provided unprecedented stimulus. Conditions have certainly justified it. Let us recall that at the height of risk aversion, in the fourth week of March, financial conditions in the United States (US) were about six standard deviations in restrictive territory; the South African rand had declined by 17% against the US dollar in a space of five weeks, and the yield on the 10-year government bond had risen by about 280 basis points to as high as 11.7%.

Emergency action by fiscal and monetary authorities helped stave off a financial crisis. In South Africa, earlier gains in stabilising inflation well within the target range allowed the SARB to join in this massive stimulus effort. The Monetary Policy Committee lowered the repurchase (repo) rate by a cumulative 275 basis points between March and July – one of the largest moves by any emerging market country.

Our response was not limited to policy rate cuts. To facilitate the flow of credit to cash-constrained businesses and individuals, the SARB injected liquidity into money markets through larger and more frequent repo operations; it also temporarily lowered regulatory requirements for banks. In response to signs of illiquidity in the government bond market, the SARB also embarked on a programme of asset purchases, a point to which I will return later. Finally, the SARB has assisted the National Treasury in setting up and administering the government's Loan Guarantee Scheme, which aims to promote bank lending to qualifying businesses.

3. Normalisation process will take time

As indicated earlier, economic activity indicators have been rebounding in recent months. Encouragingly, monthly monetary data show that credit to the private sector has continued to grow in year-on-year terms, indicating that risks of a 'credit crunch' have abated. Since peaking in late March, yields on short-dated local-currency bonds have declined by as much as 400 basis points, while those at the longer end have declined by less than 200 basis points – consistent with the steeper

shape of the yield curve. Nevertheless, full normalisation of economic activity is likely to be a long-haul effort.

Favourable base effects are likely to result in strong GDP gains in both the third quarter and 2021 as a whole. Thus, the SARB’s Quarterly Projection Model (QPM) forecasts a real GDP gain of 3.9% next year. But in level terms, our model only expects real GDP to gradually converge towards pre-COVID-19 levels. The QPM therefore points to a large output gap (as high as 6.5% of potential GDP on average in 2020) that will only gradually narrow over the remainder of the forecast period and remain negative even in 2022.

Because of both the persistence of such economic slack and the better anchoring of inflation expectations, the SARB expects that consumer price inflation will remain within the lower half of the 3−6% target range over the forecasting period, with the exception of a short-lived spike in the second quarter of next year as a low base distorts energy price inflation. Barring the materialisation of upside risks, this benign inflation outlook should allow the SARB to maintain an accommodative stance for most of the coming two years, and only withdraw stimulus in a gradual fashion, as the output gap slowly closes. In our September forecasting exercise, the QPM’s projections are consistent with a rise in the policy rate from the current rate of 3.5% to 4% by the end of 2021 and 5% a year later. The latter would still be 70 basis points below the CPI average of the past decade.

4 Monetary policy challenges in a post-COVID-19 world

However, as the Monetary Policy Committee has highlighted many times in the past, the QPM policy rate forecast only serves as a guideline, since the economic developments on which it is premised are uncertain. Indeed, this uncertainty may turn out to be higher than usual in a post-COVID-19 world. As we contemplate the global and domestic economy beyond the pandemic, I would like to focus on several issues which may affect the conduct of monetary policy in the coming years.

We do not know how the crisis will affect trend productivity and potential economic growth over the medium term, both globally and at a domestic level.

Are we going to experience a further loss of growth momentum, as occurred after the global financial crisis, due to the slow reaction by businesses to structural changes in demand? Will the rise in public and corporate debt levels crowd out private investment? Or, on the contrary, will the change in the behaviour of economic agents' spur investments in new high-tech industries raise productivity on a sustained basis? Few economists are willing to express strong views on the topic at present.

However, some are taking the view that trend growth is more likely to be weaker than stronger over the next cycle, projecting in particular a weaker contribution from capital accumulation.[2] And this is where the uncertainty I have alluded to can play a negative role. By increasing the likelihood of large losses, uncertainty can discourage businesses from risking capital into supply-enhancing projects; the pandemic's memory could result in 'belief scarring' which could durably undermine confidence in the economy's ability to again grow strongly, as was recently highlighted during the Jackson Hole Symposium.[3]

In turn, lower potential growth – either globally or in South Africa, or both – would have implications for the equilibrium, or neutral real interest rate[4] (NRIR), which is a crucial element of medium-term monetary policy calibration. Traditional economic theory argues that a decline in potential growth implies a decline in the neutral rate.[5] Indeed, research over the past decade suggests that in advanced economies at least, lower potential growth has contributed to the secular decline in neutral rates.[6]

However, the linkages may be more complex for an emerging economy such as South Africa, which has long had a structural current account deficit and hence requires an equilibrium interest rate that attracts foreign as well as domestic savings to finance investment. The SARB's models link the domestic neutral rate to both its

[2] See 'Coronavirus' global effects: growth drivers in a post-virus world', Global Economics View, Citi, 8 July 2020.
[3] See J Kozlowski, L Veldkamp and V Venkateswaran, 'Scarring body and mind: the long-term belief-scarring effects of COVID-19', 2 September 2020.
[4] The neutral real interest rate is the rate at which inflation is stable at the inflation target midpoint and output is operating at its potential. It cannot be observed directly.
[5] The theory was first developed by Knut Wicksell in *Interest and prices* (1898).
[6] See for instance L Rachel and T Smith, 'Secular drivers of the global real interest rate', *Bank of England Working Paper No. 571*, December 2015.

global counterpart and a South African-specific risk premium. The risk, however, is that this risk premium will rise over time as weak growth increases concerns about fiscal sustainability, thus offsetting the benefits from a lower global neutral rate.

Uncertainties over both potential GDP growth and the neutral rate can also affect the speed at which a central bank normalises its policy stance. As indicated earlier, at present the SARB only sees a slow narrowing of the output gap, which should allow for gradual real rate normalisation. But were the output gap to be less negative than we expect in the latter years of the forecast, or the equilibrium real rate higher, risks of higher inflation might end up under-estimated. At the same time, uncertainties remain as to whether the lower pass-through of foreign exchange movements to inflation will persist in coming years, especially if South Africa's loss of its investment-grade status results in structurally higher rand exchange rate volatility.

5. Heeding the messages from financial markets

In trying to ascertain potential structural changes to long-term macroeconomic variables, the SARB will, of course, be watching the signs from financial markets. In that respect, our Financial Markets Department continues to monitor market developments, both to detect threats to smooth market functioning and also to understand market expectations of interest rates, inflation and credit risk premia, among other variables. For instance, the SARB has paid close attention to the steepening of the government bond yield curve, which began before the onset of the COVID-19 crisis, and which has persisted even as the March risk aversion abated. Is the steepness of the yield curve – both in absolute terms and relative to emerging market peers – simply a function of credit risk, or is it telling us something about future inflation risk too? Inflation expectations, from surveys or breakeven rates, are in most cases lower than they were historically and generally well within the target range. But we want to be sure that concerns about South Africa's debt trajectory do not crystallise into higher inflation expectations.

In that respect, I would like to briefly touch on a point that has been strongly debated since the SARB introduced a programme of government bond purchases in March. Should the aim of this programme be limited (as it is now) to ensure proper bond

market liquidity? Or should it extend to influencing the shape of the yield curve in order to limit government funding costs and to ensure that lower policy rates fully transmit to broader borrowing costs in the economy? The answer to this question is not simple, especially as yield curve control policies have become more widespread recently, and therefore less disreputable.

However, there are risks in considering such a strategy in South Africa. First, unlike most advanced economies, South Africa remains far from the effective lower bound on interest rates. Hence, influencing the shape of the yield curve at a time when the SARB can, if needed, cut rates further to achieve its goals could unnecessarily complicate policymaking and policy communication. Second, by interfering with the market's 'price discovery' mechanism, the SARB would reduce its ability to learn from the yield curve's signalling capacity, which provides messages over longer-term inflation expectations. Losing that signal would also make it harder for policymakers elsewhere to assess the fiscal space. Third, keeping longer-term yields lower than their market 'equilibrium' might discourage non-resident investors from resuming purchases of domestic bonds, keeping the rand undervalued and hence adding to future inflation risks.

6. **Conclusion**

In conclusion, let me again highlight that the SARB's response to an unprecedented crisis and contraction in economic activity has been strong and quick, in large part due to our earlier hard-won credibility gains on anchoring inflation expectations. As a result of these gains, the SARB was able to prevent this economic contraction from feeding into a credit crunch and financial market meltdown. The stabilisation in the rand's exchange rate and decline in government bond yields are encouraging signs that investors do not see our policy actions as jeopardising our credibility.

However, as we contemplate an uncertain future with respect to potential growth and other variables, allow me to reiterate some familiar but important points. Monetary policy cannot on its own improve the potential growth rate of the economy or reduce macroeconomic risks. These should be addressed by implementing prudent macroeconomic policies and structural reforms that lower costs generally and increase investment opportunities, potential growth and job creation. Such

steps will enhance the effectiveness of monetary policy and its transmission to the broader economy.

Over the medium term, the SARB will need to remain data-dependent in its policy decisions. Indeed, we stand ready to utilise our tools, as appropriate, within our mandate to support the economy and to ensure that financial markets are functional. As financial markets themselves move towards new post-crisis equilibriums, we will continue to closely monitor developments in asset prices and leverage that information in our formulation of monetary policy.

Thank you.