South African Reserve Bank

‘The interest rate cycle during and after the COVID-19 pandemic’
Keynote address by Ms Fundi Tshazibana, Deputy Governor of the South African Reserve Bank, at the Absa Annual Fixed Income Conference, 7 October 2019

1. Introduction

Ladies and gentlemen, thank you very much for allowing me the opportunity to deliver the keynote address at your Fixed Income Conference. While, sadly, I do not have the pleasure of standing in front of you today − the COVID-19 pandemic is not allowing it this year − I am nonetheless confident that this conference will stimulate pertinent and challenging discussions. The pandemic has changed many aspects of our life in 2020, and interest rate setting is one of them. The rate decisions taken by both the South African Reserve Bank (SARB) and its global counterparts in the past nine months are set in broad macroeconomic trends that have been in place for years, and which have made this speedy and sizable reaction to the COVID-19 pandemic possible. Now, will these trends remain in place in the coming years? Will the pandemic exacerbate them or, on the contrary, will it usher in structural changes that call for a different calibration of monetary policy in the future? These are some of the issues I will attempt to address today.

2. A long trend towards lower interest rates

The start of the long-term downtrend in global interest rates can be traced back to the early 1980s, in the wake of the United States (US) Federal Reserve’s (Fed) decision to tighten policy sufficiently to uproot what was, at the time, seen as structurally high inflation. As US inflation started its long decline, so did interest rates: from averaging 10.0% in the 1980s, the federal funds rate declined to averages of 5.1% in the 1990s and 2.9% in the 2000s. As other countries, first in the developed and then increasingly in the emerging world, followed the US example and made price stabilisation a priority, a global trend towards lower interest rates set in. The Reserve Bank of New Zealand was a pioneer in the field of inflation targeting in 1990; 20 years later, the majority of advanced and large emerging economies had a similar framework in place. This not only allowed for lower average inflation around the world, but also for lower dispersion of inflation rates across countries. Global drivers of inflation gradually gained in importance at the expense of domestic factors, allowing for a broader international diffusion of major economies' disinflationary trends.[1]

The shift towards lower trend, or equilibrium, interest rates continued in the wake of the global financial crisis, although it could not be solely attributed to better control of inflation and inflation expectations. In fact, in several advanced economies, central banks for the first time struggled to raise average inflation towards targeted levels, and undershooting became the norm. In this context, the use of unconventional policy tools to circumvent the effective lower bound did succeed in lowering longer-term interest rates, flattening yield curves and compressing risk premiums; yet it failed to lift most countries out of their low-growth, below-target inflation paradigm.

Several explanations have been sought for what economists increasingly referred to as 'secular stagnation', including demographic trends; a growing propensity to save, exacerbated by rising income inequalities; a structural break in investment-to-gross domestic product (GDP) ratios in dynamic Asian economies; widening productivity gaps between 'high-tech' firms and others; and a growing investor preference for safe assets.[2] What seems likely is that most of these factors contributed to structurally lower interest rates, not just in advanced economies but also in the emerging world – even though many emerging markets and developing countries are still far from the 'technological frontier' and could be expected to grow faster.

[1] See for instance 'Understanding global inflation synchronization', in *Inflation in emerging and developing economies: evolution, drivers and policies*, The World Bank, 2019, pp 93−141.

[2] These topics are discussed, among others, in L Rachel and T D Smith, 'Secular drivers of the global interest rate', *Bank of England Working Paper No. 571*, December 2015.

South Africa was no exception to these trends: in the past decade, our policy rate averaged 6.1%, down from 15.4% in the 1990s and 9.9% in the 2000s. On the positive side, greater compliance with the 3−6% inflation target range[3] and lower inflation volatility have allowed for lower average policy rates and lower volatility of the monetary policy cycle. On a less favourable angle, the trend in real GDP growth lost momentum throughout the past decade, a pattern which is only partly attributable to global trends but mainly reflects domestic supply constraints such as limits to the availability of electricity or critical skills.

3. The COVID-19 pandemic required lower interest rates

It is important to recall the macroeconomic and financial trends that pre-dated the COVID-19 crisis, as they informed the ability of central banks to deliver a speedy and large enough response to the crisis. When compared with the onset of the global financial crisis about 12 years earlier, as of July 2008, the average inflation rate in advanced economies had climbed as high as 4.6%, from 1.8% a year earlier; the average for large emerging countries had followed a similar trend, albeit at higher levels. Many central banks were still tightening policy even as the crisis was setting in. The SARB was one of them: in July 2008 the Monetary Policy Committee (MPC) had raised the repurchase (repo) rate as high as 12.0% − a total increase of 500 basis points over 26 months − to fight an inflation rate that had reached double-digit levels on the back of rising food and fuel prices and strong credit growth.

By contrast, a large number of countries – South Africa included – entered the COVID-19 crisis with inflation rates that were not only stable but also below, or within, target levels. Consequently, central banks in those countries did not have to first unwind restrictive policy stances before pushing for monetary stimulus. They were also able to quickly utilise tools, such as asset purchases programmes that had been 'tried and tested' in the previous crisis. And indeed, a quick response was warranted, especially as the combined health and economic shocks associated with the pandemic and subsequent lockdowns threatened at first to be accompanied by

[3] Since 2010, monthly inflation readings have been within target 78% of the time versus 40% in the previous decade.

a disruptive financial shock. In late March 2020, Bloomberg's measure of US financial conditions stood about six standard deviations in restrictive territory; major equity markets had shed between 25% and 35% in the space of five weeks; and commodity prices had plunged, with Brent crude, in particular, falling as low as US$17 per barrel, from an average of US$64 per barrel in January.

The strong global response of both fiscal and monetary authorities allowed a quick normalisation of financial conditions. Equity market and commodity prices have rebounded; corporate and sovereign spreads have narrowed; funding conditions in offshore dollar markets have improved, helped by bilateral swap lines made available by the Fed; and most emerging market currencies have stabilised, even though they remain much weaker than pre-crisis levels. South Africa is no exception: the South African rand is currently trading at about R17.00/US$, weaker than the January 2020 average of R14.40/US$ but much improved from early April lows of R19.00/US$. Shorter-dated government bond yields are now trading lower than at the start of 2020, though yields on longer-dated bonds are higher, probably reflecting higher credit risk and debt issuance.

4. Interest rates are likely to stay low over the next two years

The economic shock from COVID-19, however, will probably take longer to subside than its financial counterpart, despite the combination of fiscal and monetary support provided. Global activity has rebounded from the lows of April (when most of the world faced a strict lockdown), as restrictions on economic activity and people's mobility have been lifted. But activity indicators are still significantly below pre-crisis levels, and as activity gradually converges towards 'normal' levels, the pace of convergence slows. Some commentators argue that the harder part of the economic normalisation begins now. In most countries, private and official institutions, on balance, do not project a return of real GDP to pre-COVID-19 levels until late-2021 or even late-2022. Negative output gaps are expected to be the norm. With respect to unemployment, the consensus view is that normalisation will take even longer.

South Africa has been gradually lifting restrictions on economic activity since late April; both fiscal and monetary policies were eased significantly to help facilitate the economic recovery. On the monetary front, the SARB's MPC lowered the repo rate by a cumulative 275 basis points between March and July; the bulk of the reduction (250 basis points) occurred between the March and May meetings − a fast response by the standards of large emerging markets. To facilitate the flow of credit to cash-constrained businesses and individuals, the SARB injected liquidity in money markets through larger and more frequent repo operations. It also temporarily relaxed some regulatory capital requirements for banks. Finally, the SARB purchased government bonds in the secondary market to ensure liquidity and the smooth functioning of the bond market.

Nonetheless, the plunge in second-quarter economic activity, when real GDP fell at an annualised rate of 51%, could not be reversed. Base effects, admittedly, will result in spectacular growth rates in both the third quarter of 2020 and 2021 as a whole. But they can be misleading. In level terms, our model only expects real GDP to gradually converge back towards pre-COVID-19 levels. At the time of the September MPC meeting, the Quarterly Projection Model (QPM) pointed to a large output gap that will only gradually narrow over the remainder of the forecasting period and remain negative even in 2022.

The combination of ongoing economic slack, an undervalued real effective exchange rate and a recent decline in medium-term inflation expectations suggest that inflation should not be a problem for the next two years or so. The QPM projects that both headline and core inflation rates will remain largely within the lower half of the target until the end of 2022, with the exception of a short-lived spike in the headline inflation rate in the second quarter of next year as a low base distorts energy price inflation. Baring 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. Indeed, the latest QPM projections are consistent with a rise in the policy rate to 4.0% by the end of 2021 and 5.0% in 2021, which would still be 100 basis points below the average of the past decade.

5. Can there be a new paradigm in the long run?

In summary, there appears to be a growing consensus – both among forecasters and policymakers – that the interest rate cycle in the next couple of years, both globally and in South Africa, is going to be one of gradual normalisation. But towards which levels are interest rates going to normalise, and what is going to be their average over the longer term – say, a horizon of five years or longer? Few economists presently seem willing to make forecasts over such a horizon, at a time when it is not yet clear how long the pandemic will be with us. Will the past few decades' trends towards lower equilibrium interest rates persist or, on the contrary, will COVID-19 usher in structural changes that are consistent with higher interest rates over time?

Economic theory tells us that equilibrium interest rates should reflect potential real GDP growth, inflation expectations and a risk premium that varies with the term of the loan and the creditworthiness of the borrower. The outlook for all three appears, at present, to be marred with varying degrees of uncertainty. Many are concerned with downside risks to global potential growth, which would be highly relevant for the trend in the growth outlook in an open economy such as South Africa. Uncertainty about the longer-term impact of the pandemic may in itself result in lower global capital accumulation, especially at a time when corporate profit rates are declining and global trade, which is historically a driver of investment, is still contracting.[4] Indeed, supply concerns experienced at the height of the pandemic – for example, in the procurement of medication or personal protective equipment – may entice authorities to reduce reliance on global value chains, or at least reduce the length in the supply chains and reliance on single suppliers.

Some economists also highlight the possibility of durable labour market 'scarring', which would risk the permanent loss of skills, and make it more difficult to match labour supply and demand in the future.[5] Admittedly, other shifts could be more positive for potential growth. The sudden imposition of the lockdowns certainly forced many firms to speed up their adaptation to different ways of work and of doing business, which, if implemented on a larger scale in the coming years, could

[4] See 'Productivity and GDP prospects: some gain, much at risk', *Global Economic Outlook and Strategy*, Citi Research, August 2020.
[5] See J Kozlowski, L Veldkamp and V Venkateswaran 'Scarring body and mind: the long-term belief-scarring effects of COVID-19', 2 September 2020.

boost productivity. Automation, e-commerce and remote working are all likely to play a greater role in economic activity in the coming years. Yet it is not clear whether all economic sectors would benefit equally from such changes and, also, whether these changes in the ways of work could be implemented as easily in emerging economies that still rely more heavily on primary and secondary industries.[6]

And what about inflation? Economists at a large global investment bank recently reviewed major ‘regime shifts’ in the inflation of key economies over the past century, and found that common drivers are a combination of supply-side constraints or reforms, exogenous shocks, fiscal issues and institutional changes.[7] At present, central banks across the world remain, by and large, committed to inflation targeting, and when changes are being made to the framework, these are generally moderate and aim to correct durable undershoots of targets rather than to ‘shift the goalposts’.[8] However, several of the potential influences on real economic growth I just mentioned could also alter inflation in the future. Productivity-enhancing shocks such as automation and e-commerce may further weigh on prices; at the same time though, further trends towards deglobalisation, as well as more active policies to reduce inequality, mean that some of the major disinflationary forces of the past few decades could wane.

Rising government debt levels also present a risk to equilibrium interest rates in the future. Up to now, public debt has risen in most jurisdictions over the past decade, without seemingly affecting the level of interest rates. Perhaps, as Larry Summers and Lukasz Rachel argued in 2019, rising public debt just prevented equilibrium real interest rates from falling even lower.[9] Nevertheless, in countries whose currencies are not reserve currencies, the risk of fiscal dominance – even if it is not strong enough to meaningfully lift inflation expectations – may raise the risk premium that investors require on longer-term interest rates. Consequently,

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[6] Potential long-term structural implications of the COVID-19 pandemic are analysed in ‘The post-COVID economy’, Equity Gilt Study, Barclays Research, July 2020.
[7] ‘Could COVID-19 trigger an inflation regime shift? An historical perspective’, *Focus Europe*, Deutsche Bank Research, 15 July 2020.
[8] ‘New economic challenges and the Fed’s monetary policy review’, Speech by Chair Jerome H Powell at the Jackson Hole Symposium, US Federal Reserve, 27 August 2020.
[9] L Rachel and L H Summers, ‘On falling neutral real rates, fiscal policy, and the risk of secular stagnation’, *Brookings Papers on Economic Activity,* March 2019.

countries with vulnerable public finances may face permanently steeper yield curves.

6. Implications for future South African interest rates

All the long-term drivers of interest rates I just discussed have implications for South Africa. However, determinants of the equilibrium interest rate would be somewhat different in an open economy such as ours, with a structural current account deficit, than in a large and relatively closed advanced economy where most drivers of equilibrium rates are internal. When a country is dependent on external financing, it requires an equilibrium interest rate that attracts foreign as well as domestic savings to finance investment. Indeed, the SARB's models link the domestic neutral real interest rate to both its global counterpart and a South Africa-specific risk premium.

Hence, a lower global equilibrium interest rate would – everything else being equal – imply that the policy rate should also be lower, on average, in South Africa. Equally, in a world where global drivers of inflation have, over time, played a greater part in influencing country-specific price developments, continued moderation in global inflation may make it easier for inflation expectations to remain low and stable in South Africa.

However, there is no certainty that the risk premium which investors require on South African assets will remain low over the medium term. Of course, the major central banks in advanced economies have indicated they are in no rush to raise rates from very low levels, or reverse the continued increase in the size of their balance sheets. As they did in the aftermath of the global financial crisis, these policies should provide incentives for global fund managers to seek higher returns outside traditional 'safe' markets, encouraging capital inflows towards emerging market securities. In light of the size and liquidity of its markets, South Africa should benefit from these trends.

Yet the COVID-19 crisis has exposed differences in vulnerability between emerging market countries − those countries that enjoy stronger public finances have been able to respond more effectively to the macroeconomic shock and, hence, have been able to potentially limit medium-term economic losses. Some economists are also arguing that in a world where globalisation forces are on the decline, the economic and financial cycles of respective countries may become less synchronised.[10] In that respect, the unfavourable debt/growth dynamics of South Africa[11] may reflect in the country's sovereign risk and potentially perceived risks of fiscal dominance. Furthermore, South Africa's loss of its investment-grade status could expose us to greater volatility of non-resident capital flows in the future, with a higher risk premium required to compensate for such volatility.

7. Conclusion

In conclusion, I would again like to stress that decades of gains in stabilising inflation and inflation expectations, both in South Africa and abroad, have assisted central banks in responding quickly to the COVID-19 pandemic, limiting financial sector spillovers that would otherwise have made the economic recovery even more challenging and lengthy.

As we enter a new decade, fraught with uncertainties about whether and how the pandemic will have lasting consequences on key macroeconomic and financial variables, an important tool in enhancing the resilience of our economy is for the SARB to ensure that we retain this monetary margin of manoeuvre in the future. This involves a continued anchoring of inflation expectations around the midpoint of our target range in the coming years and ensuring that financial markets are functional.

At present, achieving our goals appears consistent with a relatively low level of interest rates, in the next year or two, compared with the average of earlier cycles. But we must remain vigilant and watch for potential changes in drivers of equilibrium interest rates in the future.

[10] See Barclays Research, op. cit.

[11] The International Monetary Fund is projecting a rise in South Africa's gross government debt/GDP ratio from 62.2% in 2019 to 85.6% in 2021, the largest among major emerging economies. See *Fiscal Monitor*, International Monetary Fund, April 2020.