T T Mboweni: Monetary policy decision making in an uncertain international economic environment

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at a business breakfast organised by the Graduate School of Business, University of Kwazulu-Natal, Durban, 2 November 2006.

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Honoured guests
Ladies and Gentlemen

1. Introduction

Thank you for the opportunity to address you in Kwazulu-Natal. I should note that my presence here is due to the persistence of Dr Singh who has been berating me for some time for neglecting your province. It is indeed true that it has been some time since I have made a public address in Kwazulu-Natal but I can assure you that this has not been by design.

My address today relates to recent international economic developments and how they impact on our own monetary policy decision making. South Africa is very much part of the global village and as such is heavily influenced by international economic developments. Many of these developments have resulted in increased uncertainty and risks. The emergence of China as an economic powerhouse means that the world is a different place to what it was just a decade ago. Most parts of the world have also been experiencing a period of robust world growth, but while it may be true that every cloud has a silver lining, sometimes a silver lining may have a cloud. In some respects this holds true for the current world growth performance. Some of the current uncertainties relate to the issues of global imbalances, asset price movements, oil prices and tighter conditions in financial markets. These issues add to the uncertainty within which monetary policy has to be conducted.

2. World economic growth

In the recent World Economic Outlook published by the International Monetary Fund, the global economic environment is characterised by economic activity that has exceeded expectations, and signs of a build-up of inflationary pressures. These pressures originally emanated from oil and other commodity prices, but more recently have been a result of emerging capacity constraints. Central banks have responded by generally tightening monetary policies. Global imbalances however remain large. The balance of risks to the global outlook is seen to be biased to the downside, and although a benign market-led process of unwinding of global imbalances is seen to be the most likely outcome, the potential for a disorderly unwinding remains.

Estimates by the IMF show that world growth has averaged 4,2 per cent since 2000, as compared to 3,2 per cent for the preceding decade. Current projections indicate that the economic expansion is likely to continue with growth rates being very close to 5 per cent in 2006 and 2007. In fact, the global expansion since the turn of the 21st century ranks amongst the highest since the early 1970s.

While the global expansion has in general been broad based, the improved growth performance of developing and emerging economies relative to those of developed economies has been most noteworthy. For example, in 2005, emerging economies accounted for more than half of total world gross domestic product (GDP) in purchasing-power parity terms; around 43 per cent of world exports; about 70 per cent of the world’s foreign exchange reserves, half of the world’s energy consumption and around 80 per cent of the growth of oil demand in the past five years.

China was the fastest growing economy over the last few years and in 2005 the country became the world’s fourth largest economy (at market exchange rates) after the United States, Japan and Germany. It is the second largest economy in purchasing power parity terms after the United States. China is becoming increasingly important in the world economy by a wide range of measures. The country’s average contribution to global GDP growth in purchasing-power-parity terms, for example, has increased from 9,5 per cent in the 1980s to 18,0 per cent in the 1990s and further to 24,5 per cent in the six years to 2005. The United States’ average contribution to global growth, on the other hand, has decreased from 23,3 per cent in the 1980s to 20,2 per cent in the 1990s and further to 16,3 per cent since 2000.

Chinese economic growth has been accompanied by an increase in the demand for raw materials which, in turn, has reinforced the boom in commodity prices. For example, China accounts for 40 per cent and 33 per cent of the world demand for cement and coal respectively. Furthermore Chinese demand accounts for over 20 per cent of steel, copper and aluminium.

The emergence of China means that the world economy is probably less dependent on the US for overall global growth. It used to be said that if the United States sneezes, then the rest of the world catches a cold. Although a slowdown in the US will have implications for the world economy, the global economy may not be as susceptible to a US slowdown as it was a decade or so ago when the US cycle was almost synonymous with the global cycle. Today, the outlook for world growth and commodity prices is also dependent on the growth outlook in Asia in general and China in particular.

Global growth has implications for our own monetary policy through a number of channels. Higher global growth may, in the absence of productivity growth, result in either higher world inflation or tighter monetary policies in high growth economies. At the same time, strong world growth is generally positive for commodity prices, which may cause the rand to be stronger. Often the implications of world growth developments for monetary policy are far from clear, and this underlines the uncertainties we face.

3. Global imbalances

Although the world economy may have achieved a degree of immunity from cyclical downturns in the United States, it is probably still true to say that if the US had to catch a cold, the rest of the world would run the risk of catching a bad case of flu. The possible disorderly unwinding of global imbalances is a case in point. The main manifestations of the global imbalances are the current account deficit in the United States and the current account surpluses in a number of Asian economies and the oil exporting economies.

The dominant view in the market appears to be that it is not a question of if, but rather when and how the adjustment will take place. As I noted earlier, the IMF view is that although there is a risk of a disorderly adjustment, a smooth market-led adjustment is the most likely outcome. By contrast, in the 2005 annual report of the Bank for International Settlements it was noted that the unwinding of the imbalances could be uncomfortable, either through profound market turbulence or a protracted period of slow world growth.

A number of solutions to the problem of global imbalances have been proposed. In his keynote address to the recent conference on macroeconomic challenges that was organised by the Bank, Professor David Llewellyn argued that none of the proposed solutions would be sufficient on their own, and that unless a number of solutions were implemented concurrently, a negative outcome was more likely. In his view, the required adjustment includes increased savings in the US including a reduction in the fiscal deficit; reduced savings in China, combined with improved social security safety nets in that country; a move away from the dollar peg by Asian economies and a depreciation of the US dollar; and a rise in aggregate demand in Japan and the euro area, accompanied by structural reform in the latter.

Unfortunately there does not appear to be a co-ordinating mechanism to bring about the adjustment, and it is also unclear how long these imbalances will persist. The persistence has already confounded a number of analysts who have been predicting a major readjustment of the US dollar for at least the past 4 years.

Going forward, there is always the concern that the underlying international imbalances could be resolved through a significant realignment of global exchange rates. Estimates of how much exchange rates would have to adjust vary greatly. In 2005, Obstfeld and Rogoff for example, argued that the dollar adjustment could exceed 30 per cent. An adjustment of this order of magnitude will inevitably impact on the rand, but it is not clear whether under these circumstances the rand would find itself moving with the dollar, or in the opposite direction. Much will depend on how world growth and risk perceptions are affected in such a scenario.

Whether or not there will be an orderly or disorderly unwinding of these imbalances, there is very little that some economies such as South Africa can do to pre-empt these effects. The onus is on the large industrialised countries to try and ensure an orderly adjustment or to minimise the negative consequences that may ensue in the wake of a disorderly resolution.

4. International interest rate and inflation developments

At the beginning of the 1990s, world inflation averaged around 30 per cent compared to an estimated 3,8 per cent in 2006. In 1992 there were 44 countries with inflation rates in excess of 40 per cent compared to 3 in 2003. At the Jackson Hole conference organised by the Federal Reserve Bank of Kansas City in 2003, one of the issues that was hotly debated was the cause of this decline. Central bankers of course claimed the credit, arguing that it was because of more disciplined monetary policies. Others however argued that it was the forces of globalisation and the emergence of China. As one commentator observed, it reads a bit like an Agatha Christie mystery. The questions are, who killed the victim, how was the victim killed, and is the victim really dead?

I think it is true to say that monetary policy has become more disciplined in the 1990s, but globalisation has probably played its part as well. There is no doubt that China has had an impact despite the upward pressure on commodity prices. For example, footwear and clothing prices, which have a weight of just over 4 per cent in our CPIX, have been falling since October 2003. In the year to date, footwear and clothing prices have fallen by 6,6 per cent. There is no doubt that this has had a moderating effect on our domestic inflation.

Recently there have been signs that the victim has been showing signs of life, and world inflation has risen somewhat, although the IMF still expects world inflation to remain under control and to average 3,7 per cent next year. Some of the pressures are a result of rising international oil prices, although more recently high levels of capacity utilisation and strong consumer demand have also been observed. Consequently we have seen a general monetary policy tightening cycle globally. In the past year for example, most industrialised and emerging market central banks have raised interest rates at some point.

We are often asked if we follow the world interest rate cycle. There is not a simple interest rate cycle. Interest rates in the United States, the United Kingdom and the euro area have not followed exactly the same path. We do not and cannot slavishly follow international interest rate developments. The fact that we have adjusted our monetary policy stance recently is not in response to interest rate developments abroad. Our interest rate decisions are determined by the domestic inflation outlook. Of course, this outlook in turn may be affected in some instances by the same factors that may cause monetary policies to be tightened in general, but this is not necessarily the case.

5. Asset prices and international liquidity

Much has been said in the past few years about the impact of increased international liquidity which is in part a consequence of the global imbalances. Stock markets and property markets around the world have reached record highs and emerging market spreads have narrowed significantly. South African equity and property prices have also reached record highs. The question that is often raised in this context is whether the market is correctly pricing risk, and whether the system is vulnerable to a reversal.

Our asset markets have a significant degree of participation by non-residents. For example, since the beginning of 2006 to 26 October, non-resident net purchases of South African bonds and equities totaled R20,8 billion and R64,7 billion respectively. However, as an open emerging-market economy we are always vulnerable to changes in international sentiment which may have little to do with domestic economic developments. The appetite for South African financial assets is, to a certain extent, influenced by developments in global bond and equity markets.

Asset price developments have important implications for monetary policy although the appropriate response is far from clear. The wealth effects that are generated by high asset prices have an impact on consumer demand and, therefore, potentially on inflation. Various issues emerge here. Firstly, it is not always easy to recognise a bubble. Secondly, there is the question of whether or not monetary policy should try and prick asset price bubbles in order to avoid the consequences of the bubble popping at even higher levels with the attendant risks to financial stability.

Generally the response of central banks has been to argue that the best monetary policy can do is to try and anticipate the impacts of asset price movements on inflation, and to react in the same way that we react to any factor that can cause inflation to rise beyond the inflation target. This is in essence our approach as well. However in most countries there is not a full understanding of how these wealth effects affect the inflation process and the transmission mechanism of monetary policy.

6. International oil prices

In any discussion of international developments we cannot ignore the oil price. As we all know, international oil prices have increased significantly over the past few years. It is almost unbelievable that the price of Brent crude was around US$11 per barrel in January 1999. By January 2004 Brent crude oil prices had exceeded US$30 per barrel and had subsequently reached a high of around $80 per barrel during August 2006. Since then there has been some moderation and the price has fallen to current levels of below US$60 per barrel. The causes of these increases have been the tight supply and demand conditions in the market, as well as periodic bouts of geopolitical tensions.

The increases in oil prices have had a significant impact on domestic petrol prices. During 2006 for example, the price of 95 octane petrol in Gauteng increased from R5,49 per litre in January to peak at R7,04 per litre in August. Fortunately, as a result of falling international prices, we have experienced three successive declines totaling R1,07.

The contribution of transport costs to CPIX inflation provides an indication of the direct inflationary impact of petrol price increases. This has averaged around 15 per cent of the overall monthly increase in the CPIX during 2005 and around 17 per cent during the first 9 months of this year. We also saw that for most of 2004 and 2005, most of the volatility observed in CPIX inflation was directly attributable to petrol price movements. More recently, other factors have also been exerting upward pressure on CPIX inflation.

We have often emphasised that it is not the first round effects of oil price increases, that is, the direct impact on petrol prices, but rather the second round effects that are of primary concern for monetary policy purposes. While there is little we can do about first round effects, we have to ensure that these effects do not adversely affect inflationary expectations and become more generalised and stimulate inflationary impacts across the economy. If sustained, the recent decline in oil prices augurs well for inflationary developments going forward. Nevertheless, given the underlying market conditions and the vulnerability of oil prices to geopolitical tensions, these lower prices cannot be taken for granted and oil prices continue to pose an upside risk to our inflation outlook.

7. Conclusion

Monetary policy has to be formulated against the backdrop of increasingly integrated goods and financial markets. This increases the uncertainty surrounding the workings of the monetary transmission mechanism. Monetary policy making becomes more complicated since the nature and extent of influence of exogenous shocks on the domestic economy is difficult to determine in advance. With highly integrated money and capital markets, changes in sentiment, whether justified or not, can have profound implications for our economy. Similarly, changes in growth prospects in the industrialised countries or emerging Asian economies will also affect us. The exact nature and timing of these developments are always uncertain. As is often said in monetary policy circles, the only certainty is uncertainty. This is highly applicable to the uncertain impact of international developments on domestic monetary policy.

I thank you.