Daniel Mminele: Thoughts on South Africa's monetary policy

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the JP Morgan Investor Conference, Washington DC, 16 April 2011.

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1. Introduction

Good afternoon ladies and gentlemen.

Thank you to JP Morgan Emerging Markets Research Group for inviting me to share with you some thoughts on South Africa's Monetary Policy.

In the years prior to the most recent global financial crisis, central banks in general appeared to have almost perfected the conduct of monetary policy.[1] Inflation targeting central banks were given operational independence to vary the short-term interest rate in order to achieve an inflation target. While this worked very well for some time, the global financial crisis showed us that achieving price stability by no means equated to achieving financial stability. This has resulted in somewhat of a paradigm shift for traditional monetary policy, and it seems we may be on the cusp of a new era in central banking.

I would like to briefly discuss global economic developments and the changing role of central banks, highlighting the challenges and lessons learnt from the global financial crisis. I will then talk about South African monetary policy, as that is the reason for which I was invited to speak to you today.

2. Global economic developments and monetary policy

The International Monetary Fund's (IMF) latest World Economic Outlook (WEO) reflects a similar picture to that of a few months ago. The global economic recovery proceeds at an uneven pace and although it is broadening, the divergence in economic activity remains wide. The growth momentum in advanced economies is gaining traction, but is insufficient to meaningfully impact on unemployment.

Emerging markets, on the other hand, are characterised by robust growth with signs of overheating in certain economies. The IMF projects that global growth will moderate in 2011 to 4,5 per cent from 5 per cent in 2010. Advanced economies are forecast to expand by 2,5 per cent and emerging economies by 6,5 per cent.

The IMF has also identified a number of old and new risks, including the threat of spill overs from the euro area periphery to core Europe, exacerbated by continuing weakness among many European financial institutions, a lack of clarity on exposures and weak sovereign balance sheets. This last point is not confined to Europe, but a risk to advanced economies in general and the US and Japan more particularly. It is plausible that this state of affairs, if not addressed, could result in an abrupt increase in interest rates, which could destabilise global bond markets and emerging markets more particularly. In emerging economies, the IMF highlights the risk of overheating and the threat of a hard landing. The IMF is of the view that policy responses so far have been inadequate to address these pressures. Finally, oil and food price risks are also on the upside.

The combination of these factors makes central banking a somewhat more complex environment to operate in. The global economy has emerged from recession, but has not yet

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[1] BIS Working Paper 326, November 2010, The changing role of central banks, CAE Goodhart.

returned to pre-crisis levels of output and employment. The very actions taken to mend the global economy have contributed to a new set of challenges, in particular, ballooning sovereign debt ratios. At the same time, inflation is picking up speed, owing to the spike in food and oil prices, and the very tools central banks use to combat inflation run the risk of attracting even more capital inflows into emerging economies. Monetary policy in the developed world remains accommodative, policy rates are still close to zero and quantitative easing remains a feature of some of the advanced economies.

As with any crisis, there are always lessons to be learned. One of these as I mentioned in the introduction, is the limitations of monetary policy and the fact that the achievement of price stability by itself does not lead to financial stability. We are already seeing greater emphasis on financial stability compared to prior the crisis. Not only will central banks need to pay greater attention to financial considerations in framing monetary policy, but will also most likely play a greater role in macro prudential policy. In this respect, central banks are well placed to deal with these challenges, having the relevant expertise in macro-economic analysis, knowledge of financial markets, overseeing payments and settlements infrastructure and (in many cases) explicit responsibility for the regulation and supervision of financial institutions.[2]

Nonetheless, the financial stability objective of central banks remains clouded with uncertainty. It is unclear to what extent it can be an additional objective of monetary policy, and even if it is, how do central banks adjust the policy response, are there sufficient and appropriate instruments available to central banks to fulfil this dual mandate and would macro prudential policy at times not run the risk of undermining the effectiveness of the monetary transmission mechanism. In addition, there are implications for legislative and governance arrangements. There is much work underway in trying to understand exactly what all this means.

So while central banks may have perfected the art of monetary policy in the last decade, they have also undergone a tectonic shift in the last few years, which still has some way to go.

3. Emerging markets and capital flows

One of the consequences of the easy monetary policy employed over the past few years has been the surge in capital flows to emerging market economies. The Institute of International Finance (IIF) records that net private capital inflows to emerging markets increased from just below US$200 billion in 2002 (1,5 per cent of GDP) to US$908 billion in 2010 (7 per cent of GDP). The IIF estimates that inflows will rise to US$960 billion in 2011 and to over US$1 trillion in 2012. These inflows reflect a combination of greater macroeconomic fundamentals in emerging markets, significant fiscal deterioration and loose monetary policy in advanced economies, and the increased integration of emerging economies into international capital markets.

Many emerging market economies have taken various actions towards curbing capital inflows in an attempt to limit currency appreciation. Measures considered and implemented range from taxes on inflows, limits being placed on government bond investment by foreigners, to pre-announced currency market intervention programmes, just to name a few. South Africa too has experienced large capital inflows, with the resultant upward pressure on the exchange rate of the rand. A favourable fiscal position, deep and liquid capital markets and sound macroeconomic policy have made the country an attractive destination for portfolio inflows. South Africa has studied the measures imposed by other emerging market economies, but questions the efficacy of most of these measures. Furthermore, it is doubtful that such measures would be appropriate for South Africa given our savings/investment

[2] The role of central banks after the crisis, Mr Jaime Caruana, General Manager of the BIS, January 2011.

imbalance and dependence on portfolio flows to finance our current-account deficit. Like the Philippines, where measures to encourage greater capital outflows were implemented, so too has South Africa lifted some of the limits on outward investments for local pension funds, insurers and individuals.

South Africa has also taken advantage of strong capital inflows to increase the level of foreign-exchange reserves. Gross reserves have increased by approximately US$9,6 billion since January 2010 to US$49,3 billion in March 2011. Of this amount, an increase of about US$5,5 billion was recorded in the first quarter of 2011. During the 2010 calendar year, the South African Reserve Bank purchased US$7,4 billion for foreign-exchange reserves accumulation, while approximately US$3,8 billion was purchased during the first quarter of 2011. The Bank's policy continues to be that the exchange rate remains market-determined, and therefore the policy is to accumulate reserves and not to defend or achieve a particular level for the exchange rate.

4. Recent domestic economic developments

The improvement in global economic activity and in international commodity prices, along with domestic monetary and fiscal stimulus, resulted in a cyclical improvement in the South African economy. After emerging from recession in third quarter of 2009, growth accelerated to 4,8 per cent in the first quarter of 2010, but moderated to 4,4 per cent in the fourth quarter of 2010. On an annual basis, real GDP growth contracted by 1,7 per cent in 2009 but improved by 2,8 per cent in 2010. There was a marked turnaround in manufacturing production in 2010. After contracting by 10,4 per cent in 2009, the manufacturing sector grew by 5,0 per cent in 2010. Despite the increase in activity, manufacturing production remains well below the peak reached in 2008 and has been primarily driven by the motor vehicle sector. In general, a lack of new private sector investment projects, relative strength of the rand and unfavourable economic developments in some of the country's key export markets, led to a subdued performance. High commodity prices and strong export demand also lifted mining output in the fourth quarter. The economy, however, continues to be characterised by a significant degree of underutilisation of productive capacity, measuring 80,7 per cent in the fourth quarter of 2010, well below the pre-crisis average of around 85 per cent.

Among the expenditure components, real final consumption expenditure by the household sector contracted for five successive quarters before resuming an upward trend from the final quarter of 2009. In the fourth quarter of 2010, real final consumption expenditure by households increased by just over 5,0 per cent, reflecting positive consumer sentiment and disposable income growth. Credit extension figures show a better take-up of credit by businesses, implying that the recovery in investment spending will pick up and that subdued growth in gross fixed capital formation will improve. However, while the Bank is of the opinion that consumption expenditure may remain relatively robust, it is unlikely to accelerate to excessive levels in the short-term, owing to continued high levels of household indebtedness (77,6 per cent of disposable income). The ratio of impaired advances to gross loans and advances has remained at elevated levels of around 5,8 per cent for some time, but has stabilised. Bank credit extension to the private sector is also relatively subdued, with total loans and advances growing by 4 per cent since September 2010, house prices are either declining or growing at low nominal rates, while equity prices will most likely also have a moderating impact on wealth effects and consumption.

The Bank forecasts that growth will average 3,7 per cent in 2011 and 3,9 per cent in 2012. Various high frequency indicators suggest a positive growth momentum going forward. The composite leading business cycle indicator has remained in positive territory, both business and consumer confidence levels are relatively high, and the Purchasing Managers Index for the manufacturing sector maintained a level above the key 50 threshold. Notwithstanding these developments, unemployment remains very high. Even the improved growth rates are

insufficient and well below what is required to significantly impact on the unemployment rate, which measured 24,0 per cent in the fourth quarter of 2010.

As with any forecast, there are many risks. Notably, global developments present some challenges. Peripheral Europe and the unfolding sovereign debt crisis remains a wildcard, the US economy is still fragile despite substantial stimuli, events in North Africa and the Middle East and their impact on oil prices, and the recent disasters in Japan could all derail the nascent global recovery and hence, South Africa's economic outlook.

5. Recent monetary policy developments

The global inflation outlook has deteriorated somewhat over the past few months, driven by higher prices for food and oil. Inflationary pressures in emerging market economies are more pronounced, resulting in a few emerging economies already embarking on monetary tightening. For South Africa, cost-push pressures have increased the upside risks to the inflation outlook, while demand driven pressures remain subdued. The year-on-year inflation rate for consumer prices increased by 3,7 per cent in February. Despite rising global food prices, food price inflation in South Africa is still relatively low, helped by recent bumper maize crops and exchange rate developments. But recent data releases clearly show an accelerating trend at both producer and consumer levels.

The Bank's CPI forecast has been adjusted higher, but still reflects that inflation should remain within the target range over the forecast period to the end of 2012. CPI inflation is forecast to average 4,7 per cent in 2011 and 5,7 per cent in 2012, peaking at 5,8 per cent in the first quarter of 2012. Much of the increase in inflation is based on higher assumptions for international oil prices. The most recent survey shows that inflation expectations of financial analysts have deteriorated slightly, but expectations of business and trade unions have shown some improvements. The Bureau for Economic Research Inflation Expectations Survey shows that inflation is expected to average 5,3 per cent in 2011 and 5,7 per cent in 2012, compared to 5,5 per cent and 6,2 per cent in the previous survey.

One of the key upside risks to the inflation outlook has been high real wage settlements. There are, nonetheless, indications of a moderation in wage settlements, with the overall wage settlement rate amounting to 8,2 per cent in 2010, compared to 9,3 per cent in 2009. Nominal unit labour cost growth has similarly moderated, from 9,3 per cent in the third quarter of 2010 to 7,7 per cent in the fourth quarter. Food and administered prices remain significant upside risks to the inflation outlook, most particularly, oil prices. It seems likely that oil prices will remain at elevated levels, even if current geo-political challenges can be resolved.

The Monetary Policy Committee has kept the repo rate steady at 5,5 per cent since November 2010. While the risks to the inflation outlook are tilted to the upside, they are predominantly of a cost-push nature, but need to be monitored very closely for any second round effects.

6. Conclusion

In summary, the past year has brought some recovery in global economic activity, although the momentum has slowed somewhat. There are still many risks on the horizon, and South Africa is subject to the same risks facing the global economy.

The economic recovery in South Africa is on track and short term economic indicators suggest that we will continue to see further improvements. However, growth continues to be at levels that are insufficient to meaningfully address unemployment.

Inflation has picked up, but is expected to remain within the target range over the forecast period. At the conclusion of its last meeting, the Monetary Policy Committee deemed the

policy rate to be at an appropriate level. However, inflationary pressures will be monitored, especially insofar as second round inflationary pressures may negatively impact the inflation outlook, so as determine when policy adjustments may be required.

Thank you. Enjoy the rest of the conference.