Gill Marcus: The implications of the crisis for monetary policy

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, at the Bureau for Economic Research Annual Conference, Sandton, 6 June 2013.

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Ladies and Gentlemen, thank you for inviting me to be part of this important conference.

At a recent IMF conference, the managing director Christine Lagarde suggested that central banks have emerged as the heroes of the crisis. In her view, one which is also widely held, the extraordinary actions undertaken by central banks, particularly in the advanced economies, probably saved the global economy from a far worse fate than we are currently experiencing. But this view of central banks as the heroes places inordinate pressures on them, not least because it leads to unrealistic expectations or a perception that they have become too powerful. In either instance this could ultimately lead to a backlash. What is clear is that the crisis has changed expectations of what central banks should do, and mandates have generally been broadened markedly. While price stability remains a core objective of central banks, the persistence of the global crisis has raised expectations about what central bank can and should do and, in particular, how their expanding mandates regarding economic growth and financial stability should interact with their price stability objective.

The SARB faces similar challenges in South Africa, which have become all the more pressing given recent domestic developments that have focused increasing attention on the Bank. While the global crisis continues, the challenges have been compounded by recent South African idiosyncratic developments. I will address these issues today, and make a few comments about the current stance of monetary policy.

The global crisis continues to mutate and it is still not clear what direction it is going to take next. Systemic banking issues, liquidity, fiscal deficits, unsustainable sovereign debt, recession and extremely low growth, fiscal austerity and rising unemployment, particularly in the Eurozone, as well as the danger in some countries of deflation, remain the key challenges facing many of the advanced economies. It is also evident that there is no decoupling of the emerging market economies, many of whom have seen slowing growth, upside inflation risks and capital outflows.

The one bright spot appears to be the United States where private sector investment and the housing market are showing signs of sustained recovery. However, the big risk facing the US economy is the nature of the fiscal contraction. The fiscal policy political gridlocks have led to what is in effect haphazard fiscal contraction. The possible headwinds from this could be quite significant and pose a risk to the sustainability of the recovery. Ironically, a rapid US recovery poses other risks, as we have seen in the past few weeks arising from the possibility of an earlier-than-expected reduction in quantitative easing. There is not only uncertainty about the timing of this reversal, but also of the implications for capital flows and bond markets in emerging markets.

Global factors are again coming to the fore, particularly in the market overreaction to the Federal Reserve's possible tapering off of QE, which it has clearly stated that should this commence, will be done very slowly and would be highly conditional. This is affecting many emerging markets. For instance, since late April both the Brazilian real and the Mexican peso have depreciated by between 6 and 7 per cent against the US dollar. So part of what we have seen in the rand depreciation can be attributed to the question of QE expectations.

At the same time, although the risks of a break-up of the Eurozone have receded significantly following the announcement of support measures by the ECB in the form of the (still unused) Outright Monetary Transactions, the growth outlook has deteriorated further. The recent OECD report suggests that the Eurozone will contract by 0,6 per cent this year, and only grow by 1,1 per cent next year. Although the UK shows tentative signs of recovery, it is still

very weak. A big question mark hangs over Japan, as it remains unclear how the recently implemented stimulus packages will impact on the real sector.

Systemically important emerging markets such as Brazil, India and China have slowed. In particular, the slowdown in China and the shift from fixed investment towards domestic consumption has contributed to lower global commodity prices, negatively affecting South Africa's export earnings. There has been increasing attention paid to many parts of the African continent, which is expected to maintain a growth rate in excess of 5 per cent for the next few years. But all in all, there is a very difficult export environment for South Africa.

This difficult trading backdrop is only part of the challenge facing the domestic economy. Although the economy recovered relatively quickly from the 2009 recession and grew by 3,1 per cent 3,5 per cent in 2010 and 2011 respectively, growth moderated to 2,5 per cent in 2012 and since the crisis has lagged that of our emerging market peers, as has our export growth. Growth moderated further in the first quarter of 2013 when it measured 0,9 per cent, the lowest growth rate since the 2009 recession. Furthermore, employment is still below levels attained before the crisis. The combination of lower competitiveness and declining terms of trade led to a widening of the current account of the balance of payments. This was exacerbated last year by the widespread wildcat labour disputes and high wage demands in the mining sector in particular, while the related work stoppages negatively impacted on exports.

South Africa has to contend with these issues at a time of heightened vulnerability. The current account deficit needs to be financed, particularly at a time of uncertainty with respect to global capital flows. This is compounded by a threat of downgrades from the ratings agencies, while non-residents already hold a sizeable proportion of both domestic government bond (around 38 per cent) and domestic equities (around 42 per cent). The country also has a relatively low level of foreign exchange reserves. Household debt ratios remain high, while the fiscal deficit leaves limited fiscal room to respond to a further deterioration in the economy. Electricity supply constraints have also emerged as a risk to the growth outlook.

These developments and vulnerabilities have adversely affected both domestic and international business confidence and investor sentiment towards South Africa. This has been reflected in the currency, which has depreciated by about 12 per cent on a trade weighted basis since the beginning of this year. Although the rand is part of the adjustment mechanism, the disorderly nature of the movements and the risks to inflation are a major cause for concern.

It is against this difficult global and domestic backdrop that monetary policy has to operate, while at the same time learning the lessons from the crisis for macroeconomic policy. There are a number of aspects worth noting. First, while there is no doubt that fiscal expansion was called for at the onset of the crisis, an important lesson was just how quickly that fiscal space can run out. Many believe, erroneously, that the current problems of the Eurozone were due to profligate spending by governments. But many countries entered the crisis with low fiscal deficits and low debt ratios. For example, in 2007, government debt to GDP ratios in Ireland and Spain were 25 per cent and 36 per cent respectively, and by 2012 these ratios were 118 per cent and 91 per cent. Similarly the respective US and the UK ratios were 62 per cent and 44 per cent and by 2012 they had increased to 107 per cent and 89 per cent. The speed with which countries ran into fiscal constraints and the need to rein in these deficits focused increasing attention on monetary policy to provide a stimulus to growth and employment.

Second, monetary policy has still got some traction when it is at the zero bound, as seen in the unprecedented quantitative easing in a number of the advanced economies. But it is clear that these interventions are more of a holding operation, and we still do not know what, if any, the unintended consequences of these policies will be. In particular it is uncertain what the impact will be when this liquidity is withdrawn. There are increasing concerns about the

risks that this could pose, especially if such withdrawal is disorderly, as well as about the ability of the monetary authorities to fine-tune these exit strategies.

Third, and perhaps most significantly, the crisis taught us the importance of focusing on financial stability, as an overly narrow focus on price stability can lead to imbalances in the financial sector, with potentially disastrous consequences. This is where much of the debate around macroeconomic policy currently revolves, and is creating challenges for central banks generally.

The crisis focused attention on two particular issues: firstly the role of monetary policy with respect to output stabilisation or economic growth, and the second on the objective of financial stability. For some time it has been widely accepted that the core objective of monetary policy is price stability. During the 1990s inflation targeting was increasingly accepted as the preferred monetary policy framework, and during the 2000s, in the lead up to the crisis, the world experienced what became known as the great moderation, with inflation seeming to have been tamed in almost all countries.

The continuing accommodative monetary policy stance in many countries has raised the question of whether growth is now a new objective for monetary policy with a retreat from the price stability objective. There are countries such as the United States where monetary policy has an explicit dual mandate. But in a flexible inflation targeting framework a concern about output growth is in reality an implicit target of monetary policy. In effect, monetary policy places some weight on the output objective in addition to the primary price stability objective, but these relative weights may differ over time depending on circumstances. In situations where inflation diverges from the target, the speed with which monetary policy aims to bring inflation back in line with the target is dependent on the concern about what is happening in the real sector of the economy. So when output is significantly below potential, and inflation exceeds the upper end of the target range, the policy horizon can be lengthened in order to reduce possible adverse impacts of tighter monetary policy on economic growth. This also implies that even if inflation is within the target, but uncomfortably close the top of the target range, monetary policy may be more accommodative than in the event of a zero or positive output gap. In other words, a relatively higher weight is placed on the output stabilisation objective under such circumstances.

Monetary policy actions in the wake of the crisis can be seen in this context. In the immediate aftermath, monetary policy also focused on trying to ease liquidity in dysfunctional segments of the financial markets, although such interventions were not required in South Africa. Monetary policy has been focused on growth in a number of the advanced economies, but not necessarily because they have become “soft on inflation”. In many instances the absence of inflationary pressures gave policy makers the space to focus more on stimulating growth. In other instances there was a risk of deflation, and expansionary monetary policy responses are appropriate under such circumstances. But there have been cases, for example in the UK, where above-target inflation has been tolerated for extended periods against the backdrop of low growth and a tight fiscal policy stance.

There are three important issues here: one is the behaviour of inflation expectations. When inflation expectations are firmly anchored, monetary policy has a much wider scope to tolerate these deviations. It is significant that despite the abnormally low interest rates and the enormous amounts of liquidity that have been injected into various of the advanced economies, inflation expectations have remained remarkably well contained. Second, monetary policy may be effective in affecting cyclical growth, or the deviation of actual output from potential output, but it is not very effective in determining the path of potential output itself. This is the task of structural policies, including those related to infrastructure provision, education and skills, the quality and quantity of capital etc. Finally, the fiscal-monetary policy mix is important. The tighter fiscal policy is, the greater the room for looser monetary policy. However, an accommodative fiscal policy stance constrains the room for monetary policy to act as the main countercyclical policy.

Our own monetary policy reactions have been very much in line with this approach. The current stance of monetary policy is accommodative in the sense that the real policy rate is negative, around minus one percent, compared with a positive pre-crisis average of around 3,5 per cent. At the same time, notwithstanding an appropriate consolidation path, fiscal policy is also relatively accommodative, and the inflation outlook is very close to the upper end of the target range, with upside risks. Our tolerance of this uncomfortable position, however, is recognition of the weak state of the economy which justifies this stance. The output gap is negative and growth is below potential and expected to remain so for some time. But the monetary policy stance is also dependent on the fact that our inflation forecast does not suggest that inflation will accelerate significantly away from the target, and that inflation expectations remain more or less anchored, albeit at the upper end of the target range. In addition, inflation appears to be driven primarily by exogenous factors, while core inflation appears to be relatively contained.

The question that can reasonably be asked is whether there is room for further accommodation. Our view is that risks have increased in both directions. We have limited room for manoeuvre, despite the lower-than-expected first quarter GDP growth outcome and further downside risk to our growth forecast of 2,4 per cent. Apart from the weak global environment, the longer term structural constraints and other shorter term domestic issues outlined above have undermined confidence, both domestic and foreign, which make the outlook for growth extremely precarious. These interrelated issues are likely to continue to negatively impact on near-term growth prospects, directly and indirectly through the impact on investor confidence. These are not issues that monetary policy can solve.

At the same time, there are significant upside risks to the inflation outlook coming from the exchange rate and possibly from wage settlements in excess of inflation and productivity increases. The Bank's estimate of the pass-through coefficient from the exchange rate to consumer prices is around 0,2 i.e a 10 per cent depreciation results in a 2 percentage point increase in the inflation rate. However, this happens with a lag, and is dependent on perceptions of how permanent the move is and the state of the business cycle. To date, the pass-through from the exchange rate to inflation has been relatively constrained, particularly compared to previous periods of high volatility and currency weakness. This is probably due to low growth and relative lack of pricing power in a number of sectors of the economy. Also, it could be that the recent sharp moves in the exchange rate are seen to be excessive and a sign of overshooting. However, the longer these weaker levels persist, the greater the risk that the relatively benign impact on inflation will end. Some prices are also impacted far quicker than others: for example petrol prices where the pass-through is very quick. We have been fortunate that the impact on petrol prices has been moderated to some extent by the weaker international oil price. Nevertheless, should current levels of both product prices and the exchange rate persist, we can expect a sizeable increase in the petrol price in July.

In essence, while monetary policy remains tolerant of inflation at the upper end of the target range or of temporary breaches, the increasingly risky outlook for inflation, and its possible impact on inflation expectations, does constrain further accommodation. More importantly, monetary policy cannot deal with structural constraints. All too often it seems easier to place expectations on monetary policy to respond and thereby avoid the more difficult task of dealing with these constraints.

While the trade-offs between output and growth are well-understood, the bigger challenge comes from the expanding financial stability mandates. Prior to the crisis, in many countries financial stability was an implicit objective of central banks, and in many instances was conflated with the health of individual banks and the stability of the banking system. In retrospect this is quite surprising, given that monetary policy is intermediated through the financial system, and therefore a dysfunctional financial system would effectively block the transmission mechanism of monetary policy.

In the early part of the 2000s there was disquiet about emerging asset price bubbles with some voices, most notably at the Bank for International Settlements (BIS) arguing that central banks should lean against these developments. The standard central bank response at the time was that, with inflation generally under control, low interest rates were appropriate. Furthermore, it was argued, central banks were not well placed to recognise bubbles, let alone prick them, but were best placed to clean up in the event of a bubble popping. Unfortunately, central banks are still cleaning up from the on-going global crisis.

Having recognised that price stability is not sufficient for financial stability, the need to focus on financial stability is clear, given that the fall-out of the crisis has been so protracted and costly. Cleaning up is no longer the only option. The focus is now on macroprudential oversight, which focuses on the financial sector as a whole, rather than on individual banking institutions, which is the domain of the microprudential regulator. However, despite a broad agreement on the need for macroprudential oversight, there is still much thinking and work to be done. At the IMF conference that I referred to above, Andrew Haldane of the Bank of England argued that the thinking about macroprudential policy is more or less where the thinking of monetary policy was in the 1940s. In other words, still a long way to go!

He further argued that the design features are still rudimentary, not clearly defined and poorly articulated. First, there is still no general agreement on the objective of macroprudential policy - are we concerned about protecting the financial sector from swings in the real economy or protecting the real economy from cycles and swings in the financial sector?

Secondly, we have an idea of what some of the macroprudential instruments should look like, but these are not well developed, and as yet untested in many instances. Furthermore, because the efficacy of these instruments is dependent on the nature and structure of the financial system, their usefulness may differ from country to country and therefore are not necessarily generally applicable. Should we be using price-based or quantity-based instruments?

Monetary policy is generally conducted through a short-term policy interest rate. At this point there is no single policy instrument that is associated with macroprudential policy in the way that the policy interest rate is closely identified with monetary policy in most countries. This is not surprising, given that financial instability could emerge in different parts of the financial system, and therefore may require different and more focused policy instruments. In fact, many of these “new” instruments are tools that were previously used as anti-inflation policies, but ultimately fell into disuse because they were too narrow in focus to deal with broader inflation. The proposed tools are largely implemented through microeconomic policies, and include regulators setting maximum loan-to-value ratios, imposing countercyclical buffers or additional capital requirements, as well as determining margin and/or reserve requirements.

Thirdly, there is no general agreement on the most appropriate governance, or its relationship to monetary policy. There are two broad views on this issue and their differences have their roots in the differing views of the role of monetary policy in the lead-up to the crisis. One view, for example that of Claudio Borio of the BIS, argues that an overly narrow focus of monetary policy on price stability and a disregard for financial sector imbalances led to low interest rates and excessive leverage, contributing to high consumption expenditure and asset price bubbles. This view suggests that the financial cycle is at the core of understanding the macroeconomy, and that because the financial cycle has a lower frequency than the business cycle, a focus on inflation and the business cycle results in too short a time horizon for monetary policy. Monetary policy should explicitly take financial stability issues into consideration, either as a secondary objective or as an objective with an equal footing. This implies that the policy interest rates should be part of the macroprudential tool-kit and is likely to result in tighter monetary policy in a low inflation environment when asset prices are seen to be rising. It also creates the possibility of conflict between monetary and macroprudential policy.

The alternative view, and one that appears to be evolving into the current "wisdom" or "best practice", is that the crisis did not represent a failure of monetary policy, but rather a failure of regulation, both at the micro and macroprudential levels. Furthermore, the interest rate is a blunt instrument to deal with financial crises, and the collateral damage of excessively high interest rates could be quite high. According to this view, monetary policy and macroprudential policies have different objectives and therefore require different tools and different committees. Under such circumstances, there are possibly fewer implications for monetary policy, but clearly coordination will be required, and the potential for conflict between the two still exists. But this is true of conflicts between monetary policy and other policies such as fiscal policy. This approach does not necessarily imply that macroprudential policy should be conducted by the central bank. However, having monetary policy and macroprudential policy under one roof, (and indeed microprudential policy), facilitates coordination, but implies more responsibilities for the central bank.

The approach that we have adopted in South Africa is in line with this second approach. In terms of the Twin Peaks regulatory architecture, the responsibility for financial stability and macroprudential policy has been given explicitly to the Bank. At present, this function is undertaken by the Bank's Financial Stability Committee (FSC) which includes all members of the Monetary Policy Committee. It is envisaged that once legislation has been enacted, the current FSC will be replaced by a Financial Stability Oversight Committee (FSOC) which will have both coordination and policy formulation responsibility with regards to financial stability and the implementation of macroprudential instruments or tools. The proposed legislation envisages that the Governor will chair the FSOC, which will include the market conduct regulator as a member and the National Treasury as an observer. This additional responsibility creates both intellectual and resource challenges for the Bank.

The responsibility for financial stability may have possible implications for central bank independence. As Mervyn King, the retiring Governor of the Bank of England has argued, the expansion of mandates to include financial stability makes independence harder to define. Financial stability oversight is essentially a shared responsibility with other organs of government. Furthermore, it could at times involve the use of tax payers' money to bail out institutions in difficulty. But more generally, macroprudential policies could have highly distributive impacts.

In conclusion, central banks are facing a difficult environment as the weight of expectations on them increases. The crisis has led to extraordinary measures being taken by central banks. There is little doubt that current levels of real interest rates, both abroad and in South Africa, are not the long run "new normal". However, it is still unclear where the new long run level will be, or when the normalisation will take place, or indeed how the process of normalisation will unfold. Despite what some would like us to believe, monetary policy is not the panacea for growth. Had low interest rates been all that is needed, the global economy would be in over-drive. Monetary policy has prevented the global economy from going into free-fall, but it is no substitute for structural reforms that are needed. The new focus on financial stability will endeavor to prevent a recurrence of global financial crises, but much of this is unchartered territory – all the more so given that the crisis continues to mutate, wreaking on-going devastation and enormous hardship.

This in South Africa we now have an explicit financial stability mandate, which imposes new and arduous responsibilities on the Bank. Domestically, we are facing challenges of crisis proportions that require a coordinated and coherent range of policy responses, which are largely beyond the scope of monetary and macroprudential policies alone to deal with.

Since the advent of democracy, South Africa has had a growth rate that averaged almost 3,5 per cent. According to the IMF, the policies that have been implemented have resulted in a 40 per cent increase in real per capita GDP, and a drop in the poverty rate of around 10 per cent. These are significant, meaningful achievements. Notwithstanding this the recent dismal growth performance and the vulnerabilities referred to earlier mask layers of

deep-rooted structural problems that manifest themselves in high levels of unemployment and massive inequalities. These in turn are caused by weak competitiveness, a poor skills profile and an educational system that, in parts, is dysfunctional, low domestic savings, low investment, uncompetitive product and labour markets and spatial distortions.

South Africa's response should be focused on three strands. Firstly, as a country, we require clear actions to stabilise the labour relations environment. Secondly, the country has to take steps to address some of the areas of short term vulnerability. Thirdly, a clear programme of reform is required to boost medium to longer term growth. Much more important than the precise elements of a strategy is for government to be decisive, act coherently and exhibit strong and focused leadership from the top. There is clear recognition that South Africa faces significant challenges; what is required is decisive leadership from all role players that consistently demonstrates a coordinated plan of action to address them. This will go a long way to restoring confidence, credibility and trust.

The Bank will continue to focus on its expanded mandate and stands ready to play its part in such a coordinated national effort.

Thank you.