Daniel Mminele: A perspective on South African monetary policy

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Rand Merchant Bank Fixed Income Seminar, Cape Town, 28 January 2010.

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1. Introduction

Good afternoon ladies and gentlemen.

Thank you to Rand Merchant Bank for the invitation to participate in this fixed income seminar.

The global crisis has certainly changed the way many people think about things and has changed the manner in which the world operates. It has also taught us that a lot of people actually know far less about how the economy works than they would like others to believe, the implication being that it is particularly when things are going well that we should be asking ourselves "why", and not assuring ourselves that it has been good judgement only[1].

Since the emergence of the global financial and economic crisis, the interest in the role of central banks and their work has risen to an unprecedented level. As you are aware that interest has also been accompanied by a much higher level of scrutiny. South Africa has not been an exception and indeed the debate is continuing.

My speech today will initially briefly touch on recent monetary policy responses to the global crisis. I will then provide a perspective on the mandate of the South African Reserve Bank, our monetary policy framework and its implementation in recent times, and conclude by making some remarks on the exchange rate within that context, as this is a topic which has also received much attention recently.

2. Monetary policy responses to the global crisis

The global financial crisis that started in 2007 and the ensuing deterioration in world economic growth necessitated drastic adjustments to fiscal and monetary policy in developed and emerging market economies in order to support economies and to ease credit market conditions. The origins of the crisis, its widespread nature and the extent of the financial market turbulence and the spill-over effects to other sectors of the economy prompted central banks to review their monetary policy implementation frameworks and to implement policies that, only a few years back, were not on their radar screens, and certainly outside the "comfort zone" of many. Central banks responded with both conventional and unconventional monetary policies to the global financial crisis. During the early stages of the crisis, central banks adjusted their normal refinancing facilities, for example, they lengthened the maturity of their money market operations and extended the universe of securities they were prepared to accept as collateral for borrowing from the central bank. During this period several initiatives were announced by central banks acting both individually and in concert (e.g. US dollar swap lines between the Fed and various other central banks). This was followed by the introduction of unconventional monetary policy strategies, including various forms of quantitative easing.

These unconventional monetary policies, sometimes called balance sheet policies, involved central banks using their balance sheets to influence broader economic and/or financial conditions during the crisis, particularly when the zero bound for policy rates was reached.

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1 William White, BIS.

These policies were also used to provide liquidity to dysfunctional interbank and credit markets and to prevent the fire sale dumping of assets in order to contain the realisation of excessive losses by banks and investment funds. During the crisis balance sheet policies were employed to target term money-market rates, long-term government bond yields and various risk spreads. In contrast to interest rate policy, balance sheet polices generally result in substantial changes in the central bank balance sheet – in terms of size, structure and risk profile. This stems from the fact that central banks targeted market segments that fell outside the traditional ambit of monetary policy, and that went well beyond the market for bank reserves, which is more familiar territory for central banks, and over which they tend to have more control.

Generally, these interventions did not inject large amounts of liquidity on a net basis, and the increase in bank reserves has not as yet translated into a generalised increase in broad money supply. The balance sheets of commercial banks have contracted, but as financial market conditions normalise and economies recover, private sector credit extension and money supply is likely to accelerate, and with that inflationary pressures may start to build as output gaps narrow. Central banks will have to ensure that exit strategies to reverse quantitative easing do not constrain interest rate policy, and are well timed and carefully sequenced. This unwinding of central bank risks could undoubtedly have far-reaching consequences for debt markets and needs to be well co-ordinated with national governments in order to prevent their operational independence and anti-inflation credentials from coming under threat in the longer term.

While there are clear signs of a modest recovery in the global economy, the challenges for policy makers have not abated. In addition to the reversal of balance sheet policies, policy makers still have to ensure that: the economic recovery becomes sustainable; that national budget deficits revert to levels that could be justified in terms of financial stability and sustainable economic growth; that global imbalances are addressed; that appropriate financial sector reform is implemented and that inflationary pressures are well contained.

We can only hope that the recovery process will not encourage complacency with regard to the significant amount of repair work that still needs to be done, because the idea is not simply to return to where we came from, but to effect changes that will ensure that next time we will be at least better prepared and be in a position to limit the damage and its costs. Difficult as the process is, the work under way in different fora pertaining to the reform of the international financial architecture and enhancing regulatory and supervisory standards needs to continue, and we cannot afford to lose the sense of urgency.

3. Inflation targeting in South Africa

During the global crisis, South Africa was in the fortunate position, where it did not have to consider responding to the economic slowdown with unconventional monetary policy. However, before I look at more recent monetary policy developments in South Africa, I thought that it may be useful to touch briefly on the Bank's mandate. As is the case in many parts of the world, the role and responsibilities of the South African central bank and the appropriate focus of its work has come into much sharper focus.

Section 224 (1) of the South African constitution, from which the Bank gets its mandate, describes the primary objective of the South African Reserve Bank as being "to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic". Therefore price stability is core to the mandate of the Bank. However, it is clear that price stability is not an end in itself, but in the interest of balanced and sustainable growth. It follows then that, as far as the constitutional mandate is concerned, both economic growth and by implication employment, need to be taken into account when making decisions on monetary policy. To give effect to these constitutional imperatives, the Bank has been mandated by government to maintain low inflation within an inflation targeting framework. This framework is a means to achieve the objective. It is not an end in itself.

We note the current debates around the appropriateness of our mandate and questions about how that mandate is executed. The SARB has indicated its willingness to openly engage various stakeholders to both explain its approach and to explore with them any ideas they may bring forward. Governor Marcus has identified improved communication and stakeholder engagement as a priority, and has underlined this by creating dedicated capacity in her office for stakeholder engagement and outreach.

Inflation-targeting was introduced by several countries in the 1990s under relatively benign conditions with generally favourable outcomes. The financial crisis has sorely tested this framework. However, the goal of maintaining low-inflation is inescapable as the alternative of high inflation is unsustainable. The distinction between countries that officially target inflation and the non-targeters is blurred. Irrespective, monetary policy must achieve low inflation, which will provide a stable environment conducive to long-term growth.

Inflation targeting was introduced in South Africa in 2000, with a clear and concise mandate. The democratically elected government sets the monetary policy goal in the form of a pre-announced numerical target, while this goal establishes a benchmark for accountability. The attainment of this goal is the responsibility of the Reserve Bank. In this regard the constitution is again very clear and indicates that the South African Reserve Bank "…must perform its functions independently and without fear, favour or prejudice…" and makes provision for regular consultation between the Bank and the Cabinet Minister responsible for national financial matters. This framework helps to anchor inflation expectations and is transparent. It requires forward-looking policy-decision making based on expected inflation and allows for flexibility to respond to shocks not offered by strict monetary rules and fixed exchange rates. Inflation targeting in effect tries to strike a balance between the application of inflexible policy rules and potentially undisciplined monetary policy discretion, and has been aptly referred to by Bernanke (2003) as a framework of constrained discretion.

In abiding by these principles, the Bank has the latitude that inflation can be outside the target range as a result of first-round effects of a supply shock. The Bank, furthermore, has discretion as to the time horizon for bringing inflation back into the target range. In this regard a distinction is made between so called strict inflation targeters and flexible inflation targeters. The SARB undoubtedly is a flexible inflation targeter. This flexible medium-term focus policy approach adopted in South Africa provides for interest rate smoothing over the cycle, with the focus on second-round inflationary effects of exogenous shocks. This is evidenced by lagged increases in interest rates in response to exogenous shocks, for example the currency crisis during the second half of 2001 and the tightening of monetary policy only in early 2002. Similarly, in the current interest rate cycle, the repurchase rate was reduced, while expected inflation was still somewhat above the inflation target range. This approach was also informed by the forward-looking nature of policy implementation, which took into account the opening output gap and the downward pressure it would exert on inflation going forward, a clear example of how economic growth dynamics have played a role in monetary policy decision-making.

The challenge of the inflation-targeting approach is to maintain monetary policy credibility as measured, among others, by how well inflation expectations have been anchored and, by applying the correct mix of policy discretion together with a broad enough focus that extends beyond inflation to affect output variability or cyclical growth and employment. Monetary policy cannot directly impact on the long-run trend growth. The latter is determined by real variables such as land, labour productivity, capital and infrastructure together with other factors such as regulations, the judicial system and the efficiency of government as well as external factors such as the terms of trade.

With respect to inflation and output variability, a recent study by Kahn (2008) compared the relevant inflation-targeting period (first quarter of 2000 until the second quarter of 2008) with the period from the first quarter of 1991 until the fourth quarter of 1999 and concluded that in the pre-targeting period, CPIX inflation averaged 9,7 per cent and this declined to

6,5 per cent in the inflation targeting period. The average growth rates in the two periods were 1,6 per cent and 4,3 per cent respectively (measured as a percentage change on the same quarter in the previous year)[2]. In South Africa, despite the challenges posed by supply-side and exchange rate shocks, the variability of both output and real interest rates has, therefore, declined during the inflation-targeting period. Fears that the implementation of inflation targeting has been inimical to growth in South Africa are therefore unfounded. This shows that inflation targeting has been consistent with (although not necessarily the cause of) higher average growth. At the very least it would appear that inflation targeting is not the enemy of growth!

Kahn's paper also concluded that there has been greater stability in real interest rates. The real policy rate averaged 5,7 per cent in the 1990s and 3,3 per cent in the relevant inflation-targeting period. Of greater significance perhaps is the relative stability of the real rate in the inflation-targeting period. It is clear that monetary policy has not resulted in a tighter policy stance on average when measured in terms of real interest rate developments.

The South African experience has illustrated the difficulties that are faced when dealing with exchange rate or supply-side shocks. Kahn has also quoted research arguing that the monetary policy decisions taken in response to the sizeable domestic and external shocks have improved significantly during the inflation-targeting period. In response to these exchange rate and commodity price shocks, the MPC adopted a relatively flexible approach and did not attempt to get back to within the target over the shortest possible time horizon. In general, the MPC attempted to look through the short-term impacts of the shocks and to focus on the second-round effects. Some interest rate smoothing was applied as evidenced in the gradual changes that were applied during the interest rate cycles.

Although the recent debate in South Africa has focused on the impact of the inflation-targeting regime on output, there are other positive aspects of the system that should be highlighted. Monetary policy has also become more transparent after the implementation of inflation targeting, reducing uncertainty, and raising the level of investment and the quality of decision-making. Monetary policy has become more predictable, especially if one considers the forward market which has anticipated repo rate changes well and has done so from the very beginning of explicit inflation targeting in 2000. In the absence of an explicit target for inflation, as provided for in the inflation-targeting framework, monetary policy would still have remained focused on achieving price stability, responding to the self-same supply shocks that the economy has recently faced. In my own view, whilst one can argue about the exact timing of certain decisions, I doubt that the trajectory of monetary policy would have been any different.

4. Monetary policy in South Africa during the crisis

The global financial crisis resulted in the widespread adoption of more accommodative monetary policy globally. South Africa's monetary policy easing began in December 2008, and since then the repurchase rate was reduced by 500 basis points to 7 per cent, which is the same as the low point of the interest rate cycle reached in 2005, and the lowest nominal policy rate since the late 1970s. However, the inflation rate in 2009 was significantly higher than that which prevailed in 2005. The decisive downward adjustment in the central bank's key policy rate reflected the severity of the impact of the global downturn on the domestic economy and the consequent dissipation of inflationary pressures. The inflation rate remained outside the inflation target range, but the inflation forecasts of the staff of the Bank consistently showed that the inflation rate was expected to follow a persistent downward trend to within the target range. We continue to be of the view that the consistency of our

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[2] Extending the analysis to the third quarter of 2009 does not detract too significantly from these results.

policy approach will result in inflation readings being back within the target range on a sustainable basis from the second quarter of this year. This should be a clear manifestation of the flexible approach followed by the Bank, which reflects its awareness of the impact of monetary policy on economic growth and the forward looking approach of inflation targeting.

5. The role of exchange rates in monetary policy

Before I conclude I would like to touch on our exchange rate policy as an integral part of monetary policy. The level of the exchange rate has elicited comments from diverse stakeholders, and there have been calls for a more activist approach towards its management by the Bank. Allow me to reiterate and clarify our views in this regard. The South African Reserve Bank remains committed to a flexible exchange rate regime and is of the view that the exchange rate of the rand should be determined by the market. The floating exchange rate regime helped to cushion South Africa from more severe effects of the recent global financial crisis. However, the commitment to a flexible exchange rate should not be misconstrued to suggest that we are indifferent as far as the level of the exchange rate is concerned. The level of the exchange rate is a very important factor in the inflation process and gets taken into account when considering policy within the framework I have just described. Its possible impact on the potential future path of inflation very much forms part of our considerations.

Our current involvement in the foreign exchange market is mainly for the purpose of reserve accumulation and domestic liquidity management. As stated previously, our participation in the foreign exchange market is also informed by volatility conditions, the liquidity situation in the market and cost considerations. As regards the level of the exchange rate and competitiveness, while it is acknowledged that certain sectors of our economy have been affected by what may be perceived to be a relatively strong exchange rate, it is crucial to highlight the importance of inflation management in this regard. If the nominal exchange rate were to depreciate without inflation being controlled at the same time, there would be no improvement in the level of competitiveness. So the real exchange rate is more important.

Any consideration for more active participation in the foreign exchange markets would also have to be carefully assessed against, among others, the prospects of success given the factors that may be driving the exchange rate in any particular direction at any given point in time.

6. Conclusion

Having initially under-estimated the interconnectedness of financial markets, and how powerful a role this interconnectedness would play to transmit loss of confidence across the globe, central banks acted decisively to avert a total meltdown of the world financial system and to prevent an even more severe economic crisis. The challenge facing central banks around the world is planning and timing their exit strategies from unconventional policies so as not to jeopardise the recovery, whilst at the same time keeping close watch on possible inflation pressures that may start to emerge.

The fact that we have stepped away from the brink should not allow complacency to creep in with regard to the repair work still required in terms of the reform of the international financial architecture and enhancing regulatory and supervisory standards in a coordinated manner.

Economic and financial conditions in South Africa did not reach the stage where the Bank had to broaden the scope of monetary policy to unconventional policies. In my view the interest rate policy within an inflation targeting framework and the flexible approach followed by the South African Reserve Bank in its implementation has served the country well and is a good basis to move forward from.

Thank you for your attention.

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