Gill Marcus: The challenging global and domestic economic environment – implications for monetary policy and the economic outlook

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, at the Wesgro Investor lunch, Cape Town, 19 October 2010.

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Introduction

The global crisis which erupted in 2008 is unfortunately still with us. Whereas it was relatively easy to get unanimity between countries with respect to coordinated responses to the severity of the crisis, it is proving to be far more difficult to achieve this common purpose during the current recovery phase.

The recovery has been very mixed across countries and regions. The emerging markets in general, particularly those in Asia and Latin America, appear to be recovering strongly. By contrast, the US, the UK, the euro area (excluding Germany) and Japan are struggling to get growth going on a sustained basis. These countries' attempts to reinvigorate their growth are having implications for emerging markets, leading to what the Brazilian Minister of Finance has recently described as a currency war.

Although South Africa did not have a banking crisis, we nevertheless experienced the pain of recession along with most other countries. Similarly, we have not been able to avoid the fall-out of the current phase of the crisis: the recent global developments have had a profound affect on the domestic economy through their impact on trade, capital flows and consequently the exchange rate.

The economy has emerged from recession, but it is a fragile recovery. Unfortunately our growth rates are not in line with those of many of the emerging market economies, but are more in line with those of the advanced economies. We need to face up to the challenges, not all of which are external. We face a number of domestic challenges, requiring a concerted and coordinated effort.

In my talk today I shall address the challenges posed to the economy by these international developments and the impact on monetary policy. By way of conclusion I will offer some thoughts as to the type of structural or microeconomic reforms that are required to improve South Africa's growth and competitiveness. Many of the problems of this economy are deep-rooted and require coherent structural reforms, and are not easily solved.

Recent global developments

During 2009 the global economy began to emerge from the worst financial crisis since the Great Depression, and by the beginning of 2010 there was wide-spread optimism in the markets that the extraordinary steps that were taken by monetary and fiscal authorities to overcome the crisis would be reversed relatively soon. The focus at the time was about the appropriate pace and timing of these exit strategies. This optimistic view envisaged US policy rates being increased by the middle of 2010. There were, however, more pessimistic views which believed (and some still believe) that the risk of a double-dip recession was high.

The current emerging consensus appears to be that while the risks of a return to negative growth are not trivial, the most likely outcome is for a protracted period of low growth in the advanced economies while the emerging markets are seen as the new growth engine. In essence, we have emerged from the recession, but not from the crisis.

The reasons for the poor growth outlook vary across countries and regions. In the United States, the consumer is still deleveraging in the face of a housing market that has not fully corrected, and a withdrawal of the fiscal stimulus. In the euro area, the replacement of private credit and expenditure with state credit and expenditure resulted in a ballooning of fiscal deficits and debt ratios in a number of countries where debt to GDP ratios were already under pressure, particularly in southern Europe. Greece and Italy, for example, have debt to GDP ratios of 130 per cent and 118 per cent respectively.

Pressure from the markets as well as the conditionalities related to the IMF-led bail-out packages resulted in the implementation of austerity measures in a number of countries, and fiscal retrenchment became the order of the day at a much faster pace than was originally thought appropriate.

Fiscal adjustment in Greece is planned to reduce the deficit from over 13 per cent of GDP to around 3 per cent of GDP in 2014, while in Spain the objective is to reduce the deficit from 9,6 per cent of GDP to 3 per cent by 2013. In the UK, government spending cuts for the current fiscal year have averaged 25 per cent across departments. The danger with such an approach is that the adverse impact on growth could set in motion negative debt dynamics which would make the overall debt situation even worse. It has been suggested by Desmond Lachman of the American Enterprise Institute, that the Greek austerity programme would result in growth contracting by between 15–20 per cent, leading to an increase in the debt to GDP ratio to 180 per cent.

While there is general agreement around the risks of excessive debt, there is less agreement as to how much is excessive, and how quickly it should be reduced. As George Soros has recently argued, the premature pursuit of fiscal rectitude could wreck the recovery. At best it is likely to cause a continuation of the low growth scenario, persistently elevated levels of unemployment, and in the context of ageing populations in Europe, even further pressures on the fiscus. The current social unrest being observed in many parts of Europe is an outcome of this.

A further implication of these developments is that monetary policy becomes the main countercyclical policy instrument. With interest rates close to their zero bound in a number of countries, quantitative easing has continued. There are some concerns about the possible inflationary consequences of the current policies of quantitative easing, namely that the injection of liquidity will ultimately translate into higher inflation or asset market bubbles. Some point to the gold price, which has reached record levels in recent weeks, as an indication of the market expectations of future inflation.

However long-term interest rates have remained extremely low in the advanced economies, an indication that the markets do not expect an imminent inflationary outcome. To the contrary, there are still lingering fears of deflation in the US and Japan. In the context of persistently wide output gaps and weak household consumption expenditure, global inflationary pressures emanating from the advanced economies appear to be benign. A future challenge will be to withdraw this liquidity at a pace that will not derail the recovery, and at the same time minimise possible inflationary pressures.

The monetary policy stances adopted in these countries imply abnormally low interest rates for longer, and expectations of the normalisation of interest rates have been pushed out to 2012 or even 2013. The resultant increase in global liquidity has resulted in a surge of capital flows to emerging markets, which have higher growth rates, relatively higher interest rates and favourable fiscal environments. According to the Institute for International Finance, private capital flows to the emerging market economies are expected to total US$825 billion in 2010, up from US$581 billion in 2009. These flows are expected to be sustained at similar levels in 2011. Inevitably these flows have had implications for the exchange rates of many emerging markets, including South Africa.

The impact on the South African economy

The South African economy reverted to positive growth in the second half of 2009. However, this growth has been relatively slow and below potential. Our expectation is that growth this year will be in the region of 2,8 per cent, increasing to 3,2 per cent in 2011, which is not sufficient to have a marked impact on unemployment. On the positive side, commodity prices have improved from their lows during the crisis, although they have not recovered to pre-crisis levels.

A notable exception has been the gold price which has almost doubled over this period. Unfortunately our mining industry has not been able to take advantage of this recovery, nor in fact did the sector respond to the pre-crisis commodity price boom.

The manufacturing sector remains under pressure and the recent high frequency data indicate that this sector is likely to experience continued difficulties. While there are indications that household consumption expenditure is recovering, it is still not clear to what extent these trends were temporarily boosted by the World Cup. Growth in gross fixed capital formation remains extremely weak, adding to the fragile growth outlook.

What are some of the implications of the recent global developments for the South African economy? One third of our manufactured exports go to Europe, and slow growth in the region could affect this trade. New markets need to be found in other parts of the world, particularly in Asia, Latin America and other parts of Africa, where growth is generally higher.

However, the more pervasive impact on the economy has come from a rapid rise in unemployment, the changing pattern of capital flows and the impact on the exchange rate, which has appreciated on a trade-weighted basis by about 7 per cent since the beginning of this year.

The increased inflows are partly a result of a positive interest rate differential, but also a result of South Africa's relatively favourable fiscal position. Although the fiscal deficit was allowed to expand in a contracyclical way in response to the recession, the trend is firmly downward and is expected to be lower than the initial deficit estimates. The debt/GDP ratio, currently at around 32 per cent and expected to peak at around 40 per cent, also compares favourably with those of the advanced economies.

Until recently, equity purchases by non-residents were the predominant form of capital inflow. Net bond purchases by non-residents were relatively small by comparison. For example, in the four years to 2007, net purchases of equities amounted to R220 billion, compared with net bond purchases of R34,5 billion. In 2009 the respective net purchases amounted to R75 billion and R15,5 billion. During the latter part of 2009 this pattern of flows began to change, in line with the changing pattern of global flows, and to date in 2010 non-residents have purchased R70,9 billion of bonds and R22,2 billion of equities.

What has also changed is the nature of these inflows into bonds. A significant proportion of the inflows appears to be from pension funds and other asset managers who are investing in South Africa in search of higher yields. Unlike in the past when a large portion of inflows into bonds appeared to be speculative in nature and often did not involve actual currency flows as they were funded domestically, these new inflows involve real money and have a direct impact on the exchange rate.

However, we have to bear in mind that these are not the only drivers of the exchange rate. Apart from these portfolio flows, we have seen reports of a number of high profile potential FDI inflows, a sign of confidence in the economy. Furthermore, a recent BIS survey showed that more than half of total rand turnover takes place offshore which also have an impact on the rand.

There is no doubt that the rand is overvalued relative to its fundamentals, although the extent of the overvaluation is uncertain. The challenge is what can be done about it. There are no clear-cut or easy choices. All options involve significant costs and trade-offs, and there are no guarantees that they will work. Direct intervention is expensive, and is not always effective under current extraordinary circumstances. Controls on capital inflows also have a questionable track record in terms of their effectiveness in reducing the amount of inflows, or the impact on the exchange rate. Some of these policies may be effective in the short run or in changing the composition and maturity of flows, but are less effective in the long run as the markets find ways of circumventing them.

A number of countries have tried various means to lean against these inflows, with limited success. In July, the Swiss National Bank reduced its purchases of euros after reporting losses of SF14 billion related to intervention activities. These activities did not prevent an appreciation of the Swiss franc. Recent Bank of Japan intervention amounting to trillions of Yen a day only had marginal short-term impacts on the exchange rate.

Emerging market economies have also tried to stem the tide through aggressive accumulation of reserves and through imposing taxes on inflows. Brazil imposed an inflow tax of 2 per cent, which was recently increased to 4 per cent. The impact on the exchange rate appears to have been short-lived, while bond rates increased to compensate investors for the tax. Last week Thailand imposed a 15 per cent withholding tax on non-residents who were previously exempt from this tax on bonds.

While we clearly recognise the problem, the solution is not clear-cut. The costs of intervention are not insignificant and involve serious policy choices. Nevertheless the Bank is engaging with the National Treasury, and we are examining the effectiveness and appropriateness of what other countries are doing.

Under current exceptional circumstances, where we are experiencing considerable inflows – FDI, bonds and portfolio – we will act to alleviate some of the pressure on the exchange rate by purchasing the FDI inflows either through direct transactions or from the market. Consequently we are already working with the relevant parties to give effect to this. Apart from possibly contributing to moderating current appreciation pressures on the exchange rate of the rand, such purchases are in keeping with our stated policy of building reserves. In the past few days the Bank has absorbed the foreign exchange inflows related to the Didata transaction.

Although the exchange rate is posing problems for a number of sectors of the economy, we should ensure that we do not miss out on the possible advantages. South Africa, primarily through the state-owned enterprises Eskom and Transnet, but also with regard to rebuilding infrastructure such as health facilities and equipment, has a considerable capital commitment. Much of this will require that the country imports specialist and capital equipment. At current exchange rates, the cost of such purchases could be considerably reduced. Government as a whole, as well as these two SOEs, need to consider ways of front-loading some of these purchases to take advantage of the strength of the currency, and thereby considerably reduce the cost of the build/capital programme.

Implications for monetary policy

What are the implications for domestic monetary policy? Monetary policy is conducted within a flexible inflation targeting framework. By this we mean that although the primary objective of monetary policy is to keep inflation within the target range of 3–6 per cent, this is done with due regard to the impact of our policies on growth, employment and financial stability.

Inflation is at a 5 year low, at 3,5 per cent, and we expect it to remain within the target range at least until the end of 2012. The global developments have had a favourable impact on inflation. Not only is global inflation low, reducing the threat of imported inflation, but the strong rand has also impacted positively on our domestic inflation outcomes. We have seen this effect very directly on petrol prices, where the higher international product prices have been counteracted to some extent by the exchange rate. Since September 2009, the cumulative moderating effect of the exchange rate on domestic petrol price increases has been in excess of 50 cents per litre. The producer price index also shows that while the headline PPI inflation increased by 7,8 per cent, the imported component increased by 2,1 per cent.

This favourable inflation prognosis has allowed us to reduce interest rates to their lowest levels in about 30 years. Our real interest rates are also low by comparison with recent experience. Throughout the 2000s, depending how one measures real interest rates, the average real policy rate was between 3 and 3,5 per cent. In the recent past this has declined to around 1,5 to 2 per cent. Under the conditions outlined, monetary policy is expected to remain relatively accommodative for some time, but contingent on changes in the outlook for inflation and the factors that impact on inflation.

Where does the economy go from here?

South Africa's biggest internal challenge is unemployment, currently in excess of 25 per cent on the narrow definition. There is no doubt that addressing this must be the national policy priority. South Africa's unemployment is of a structural nature, and not something that can be solved by interest rates or the exchange rate alone. As we have noted on numerous occasions, interest rates can have a cyclical effect on growth or employment, but on their own will not be able to solve an inherently structural problem. It is incorrect to look at the interest rate or the exchange rate as the silver bullet that will solve the country's growth problems. The exchange rate is just one element in the story, and excessive focus on the exchange rate could result in the neglect of other factors that would constrain growth even with an appropriately valued exchange rate. To improve South Africa's competitiveness and growth prospects requires concerted policy coordination across government departments. There are some obvious microeconomic reforms or initiatives that should be prioritised, and I will refer to only a few.

A continued focus on infrastructure is essential. Because the World Cup is behind us, there should not be a decline in spending on infrastructure. This is one of the best forms of expenditure that can be undertaken. It is investment in the future as opposed to current consumption. It is productive, it provides jobs, and it helps alleviate constraints to growth and to exports.

While there is a clear need to address the blockages affecting the mining sector, it does not help to increase mineral extraction if the rail infrastructure is unable to get the ore to the ports, and if the ports cannot cope with additional pressure. Our ports are reportedly amongst the most inefficient and expensive in the world. We are well aware of the need for the accelerated build plan of Eskom, as the economy cannot grow beyond a certain capacity without hitting against electricity supply constraints. Currently the civil construction industry is an underperforming sector in the economy, and one experiencing significant job losses. This should not be the case.

Skills development and education are key areas where structural reforms are required. This is a long term issue where formal schooling is concerned. But skills development is not confined to the formal school or academic environment. We need skilled artisans, yet we have far too little by way of apprenticeship training. There remain a significant number of vacancies, which, if they were filled, could contribute to economic growth and job creation.

The response to the recent crisis, when about one million jobs were lost, demonstrates that we do have a fair amount of labour market flexibility. However, if we are looking at job creation as a priority to address unemployment, then current labour legislation, which extends wage determination to all firms in a particular sector, needs to be examined regarding its effects on small and medium enterprises which should be a focus of growth and employment creation. At the same time, competition policy should be enhanced to reduce the occurrence of monopolistic pricing and other anti-competitive pricing policies.

Conclusion

South Africa is one of a number of countries impacted upon by global economic events as the advanced economies attempt to emerge from the crisis. Unfortunately we have not been unscathed by these developments. In the short-term, there needs to be coordination of measures to alleviate the immediate pressures. While the Bank is ready to do what it can to alleviate the impact of the stronger currency, we need to recognise the limits to what can be done by the Bank alone in the face of these extraordinary events.

The various forms of direct intervention on their own will not suffice, as international experience has suggested. Consideration should be given to combining intervention policies with direct special targeted support measures for those sectors of industry that are hardest hit by the exchange rate developments. These could include direct subsidies or using tax concessions to encourage continued production and/or the retention of employment. These are extraordinary times which call for extraordinary measures.

From a longer term perspective, we must also ensure that these exogenous forces do not deter us from introducing necessary structural reforms or policies that will stop further job losses and help improve the overall efficiency and competitiveness of the economy. Policy consistency and coordination is essential if we are to achieve a growing economy capable of absorbing the increasing number of unemployed people in the country.

Thank you.