Gill Marcus: Has monetary policy independence been undermined?

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, to the 1926 Rand Club, Johannesburg, 30 November 2010.

* * *

Introduction

We are nearing the end of a difficult year, a year that began with so much promise but is now ending on a note of high uncertainty. On the global front, the expectations of a normalisation in the advanced economies were proved to be wrong, and indications are that low growth and accommodative monetary policies are likely to be sustained for some time. This has contributed to the strength of the rand exchange rate as capital continues to flow out of the advanced economies in search of higher yields. Domestically, growth has also disappointed. However the strong rand has contributed to the more benign inflation environment which, along with a persistent negative output gap, has contributed to lower interest rates.

During the year there has been a focus on issues relating to monetary Policy Independence in response to the letter from the Minister of Finance clarifying the mandate of the Bank, as well as the recent New Growth Path document, in which reference was made to a looser monetary policy stance.

There are perceptions that these documents have undermined the independence of the Bank, and there has been a tendency to over-interpret monetary policy actions in terms of these discussions. For example, when the repo rate was reduced at the previous meeting, some analysts argued that because there was no economic rationale for this move, it therefore must have been politically inspired. A few days later, when the disappointing growth figures were announced, these analysts conceded that our decision was vindicated on economic grounds. There are some who believe that any reference we make to growth or unemployment is an indication that we are not independent enough. At the same time there are elements in society who believe that we are too independent and that the goals of monetary policy should be changed.

In my talk this evening, I will state the Bank's perspective on these issues and then briefly review our monetary policy actions over the past year.

Monetary policy independence

In discussing the issue of monetary policy independence, it is useful to distinguish between goal independence and instrument or operational independence. The former refers to the setting of the objectives of the central bank, while the latter relates to the actual implementation of the mandate that is given to the bank. It is generally accepted that the goal of monetary policy should be set by the elected representatives of the country. But even here choices are constrained by what monetary policy can achieve. The objectives should be set within the parameters of what monetary policy can achieve, not what we would like it to achieve but is unattainable. Monetary policy independence generally relates to operational independence, and derives from the need to avoid using monetary policy for political expedience and to avoid the so-called political interest rate cycle, where there was a temptation for some governments to reduce interest rates before a general election and then raise them soon thereafter.

In South Africa, monetary policy independence is enshrined in the Constitution. In terms of the Constitution, the primary objective of the Bank is to "protect the value of the currency in the interest of balanced and sustainable economic growth … The South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without

fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters."

There are three important issues that come out of this. First, the goal of monetary policy is to maintain the value of the currency, which means low and stable inflation. The current framework is one of inflation targeting with the actual target set by the government. This is very much in line with the practice in many countries. But it is important to note that the objective of low inflation is not for its own sake, but in the interest of sustainable and balanced growth. In other words it is a recognition that monetary policy should contribute to long-term growth, which it does through providing a conducive environment for growth. But as we have stated before, we also have to recognise the limits to our impact on growth. Monetary policy can and does affect cyclical growth around long run potential output growth. In other words, we can affect the size of the output gap by impacting on cyclical growth. However, our impact on potential output itself is limited – this is really the job of micro-economic and structural policies.

Second, while the Bank does not have goal independence, it has independence in the application of monetary policy. Thus it is we who are responsible and accountable for how we implement policy within a given goal. Third, we are required to consult regularly with the Minister of Finance. This is not an undermining of independence, but rather a mechanism to ensure effective macroeconomic coordination.

It should be clear then that central bank independence is not absolute. We are an integral part of the economy and therefore not independent of the economy. We are not an ivory tower, or in our case a glass and granite tower that is independent of and impervious to the economy in which we operate. We also take our cue with respect to our goals from the constitution and from government.

The "mandate letter"

We are aware that there is still some uncertainty in the public domain relating to the letter that was sent by the Minister of Finance to myself in February, in which he clarified the mandate of the Bank.

The letter very clearly confirms that the primary objective of monetary policy is the containment of inflation within the target range of 3 to 6 per cent. Furthermore the letter confirmed the flexibility of the mandate in allowing for deviations from the target in the event of exogenous shocks, and the need to avoid unnecessary instability in output and interest rates under such circumstances. This is the essence of flexible inflation targeting.

At the same time it is stated that in taking monetary policy decisions, we should have due regard to the factors that might impact on the attainment of balanced and sustainable growth. These factors include the output gap, credit extension and asset bubbles, employment and other labour market developments and the stability and competitiveness of the exchange rate. These factors are not only taken into account with respect to their impact on inflation, but our actions have also been affected by a concern for the impact of our actions on these variables. A number of studies have borne this out, including a 2007 paper by Ortiz and Sturzenegger in which the reaction rule of the Bank was estimated and found to be in line with those estimated for a number of advanced economies. The study showed that compared to emerging markets, South African monetary policy has been more stable, with a more consistent anti-inflation bias but with a somewhat larger weight on output, although a low weight on the exchange rate.

There is nothing in the mandate letter that we feel undermines our independence with respect to monetary policy implementation. There was however an additional aspect to the letter which is often overlooked. That is the additional specific mandate for financial stability that was given to the Bank. Although the role of financial stability is generally implicit in the mandates of central banks, it is often not explicit. The financial crisis underlined the

importance of clarifying the roles of the different institutions in the economy with respect not only to normal microprudential regulation and supervision of the banking sector, but also to broader macroprudential oversight. The central role of the Bank in this respect was reaffirmed in the recent Medium Term Budget Policy Statement. A great deal of work is currently under way in various international fora to get a deeper appreciation of what macroprudential oversight actually entails, and the organisational structures and legal framework that needs to be in place.

Monetary policy and the New Growth Path

Government's new growth path was published recently and places employment creation at the centre of government's strategic focus. Given the high rate of unemployment in the economy, this is as it should be. While I would not want to comment on the detail of the plan, it would be appropriate for me to say a few words about the proposals that affect the Bank directly. But before doing so, I wish to emphasise an aspect that came through strongly in the Growth Path proposals: that is, the need for policy cohesion and coordination. Apart from the need for common purpose, different elements of policy can only work effectively if there is an appropriate policy mix, and if the different policies are coordinated. Policy consistency, coordination and sequencing are essential requisites for policy success. The macroeconomic proposals outlined in the new growth path should be seen in this context.

According to the New Growth Path, the macroeconomic stance will be guided by "a looser monetary policy and a more restrictive fiscal policy backed by microeconomic measures to contain inflationary pressures and enhance competitiveness … The monetary policy stance ***will continue to target low and stable inflation*** but will do more to support a more competitive exchange rate and reduced investment costs through lower real interest rates. This will be accompanied by measures … to contain inflationary pressures and enhance competitiveness". These latter measures include more effective competition policies, and a review of administered prices to ensure that their increases are not higher than inflation unless there are compelling reasons. Furthermore, the proposals include a social accord to moderate or cap wage and salary increases.

Our interpretation of this is that the proposals recognise that the Bank's mandate remains the achievement of low and stable inflation. In a low inflation environment, nominal and possibly real interest rates will be lower, and the real exchange rate will be more competitive because our prices and wages will not be increasing relative to those of our competitor countries.

Monetary policy actions are guided to a large extent by the pressures that are being placed on inflation. For a long time we have noted that the main risks to the inflation outlook are administered price increases, many of which are significantly above inflation, as well as wage increases that are unrelated to inflation and productivity increases. The lack of competition in some sectors of the economy has also been identified as a constraint to price-setting that is more responsive to domestic demand conditions, and therefore more responsive to changes in the monetary policy stance. Improvements in these areas can help to reduce inflation and create the space for a more accommodative monetary policy stance.

The same is true for a tighter fiscal policy. There is a clear theoretical rationale for a tight fiscal policy and loose monetary policy mix, and this was at the heart of the macro-economic proposals of the Harvard-led international panel in 2007.

Theoretically, lower interest rates will allow for a weaker exchange rate because of the narrowing of interest rate differentials which make it less attractive for foreigners to buy interest-bearing securities. But because of the inflationary impacts of the low interest rates and the weaker currency, fiscal policy needs to compensate for this by reducing expenditure and providing the additional policy instrument.

At this stage further work needs to be done to determine the degree to which fiscal policy needs to be tightened in order to support monetary policy in this way. It is also not clear that

fiscal policy has the flexibility to take over the role of monetary policy as an antiinflationary policy on a cyclical basis. Discretionary changes to the fiscal policy stance take time to implement, unlike in the case of monetary policy.

The current fiscal policy stance is tighter than it was at the height of the crisis, but the estimated structural deficit of around 4 per cent represents a much looser stance than was the case during 2000–2008 when it was generally well below 2 per cent. Similarly, real interest rates are currently much lower than was the case over the past years. The long term real repurchase rate has averaged between 3–3,5 per cent over the past decade. The current real repurchase rate, assuming an expected inflation of around 4,5 per cent, is equivalent to 1 per cent. Should inflation surprise on the upside, this real rate would decline as well.

This suggests that currently both fiscal and monetary policies are relatively loose, which in our view is appropriate for the current state of the economy and the low global real interest rate environment. However, should the economy, particularly domestic expenditure, start to pick up significantly, this mix would have to be changed.

We must also not forget the issue of sequencing and coordination. Some of these proposals may take some time to implement and to be effective. Monetary policy cannot be loosened in advance of these other reforms unless there is a clear notion of the extent of fiscal tightening and certainty about the time horizon over which microeconomic reforms can be effectively implemented and achieve results.

In the absence of such coordination, excessively low real interest rates will not necessarily bring about increased investment. They are more likely to result in higher inflation and consequently higher long term interest rates, which will impact negatively on the cost of government borrowing and the cost of capital. Under such circumstances, real long term interest rates are likely to rise even further because of a possible increase in the risk premium.

The proposals as set out, *if successful*, will help to contain inflationary pressures and thereby give an additional degree of freedom to monetary policy and allow for the "looser" monetary policy stance that is proposed. Such a stance of monetary policy would in fact follow automatically under such circumstances, particularly under conditions of weak domestic demand.

The Bank's view therefore is that the independence of monetary policy is not undermined in the New Growth Path proposals. Our mandate remains the attainment of low and stable inflation, and to the extent that other policies and micro-economic interventions are supportive, we will have greater flexibility in the conduct of monetary policy.

However, as I indicated above, we have to be realistic about what monetary policy can achieve in solving an unemployment problem that is essentially structural in nature.

Part of the rationale for the monetary policy proposals were to deal with the strong exchange rate. The New Growth Plan recognises that intervention in the foreign exchange market is not a simple solution as intervention is expensive and not necessarily effective. Nevertheless further intervention is not ruled out and is consistent with the Bank's activities in the foreign exchange market.

However we must bear in mind that competitiveness of the currency refers to the real exchange rate i.e. the nominal exchange rate that is adjusted for relative inflation rates. Achieving a more depreciated nominal exchange rate will not help with competitiveness if it is simply offset by higher inflation. Therefore the need for low and stable inflation cannot be overemphasised, and this is apart from the adverse effects that inflation has on the poor in particular.

In advocating the macroeconomic policy mix of tight fiscal policy and loose monetary policy, there is an underlying assumption that the main determinant of the exchange rate is the

interest rate differential, and that lower domestic interest rates will reduce interest sensitive capital flows. However, experience has shown us that reality is not so simple. There have been periods in the past, and this was true for much of the 2000s, when capital inflows were dominated by flows into the equity markets. In other words, capital was attracted by growth prospects rather than interest rate yield differentials. To the extent that lower interest rates improve the growth outlook, the decline in interest-sensitive inflows may be more than offset by flows into the equity market or to direct investment.

Finally, I should emphasise that while the proposals may have an internal economic logic, the reality may be far more complicated. In particular, it is not always possible to achieve the goals of low and stable inflation, a competitive exchange rate and low real interest rates simultaneously. There are unfortunately times when conflicts between these objectives will arise, and the bank should be in a position to act independently, in line with its constitutional mandate, when such a situation arises.

Recent monetary policy

The past year was a challenging one for the conduct of monetary policy. At the beginning of the year, the view that policy normalisation in the advanced economies would begin by the middle of the year implied an expected moderation of capital flows to emerging markets during the year. Domestic growth was also expected to be positively affected by the improved global environment. At that stage, when the repurchase rate was still at 7 per cent, the exchange rate was at around R7,60 against the dollar and inflation expected to average just under 6 per cent over the year. It was also our view that we had possibly reached the bottom of the interest rate cycle. The interpretation of the high frequency data at that time was also complicated by the distortions created by the World Cup.

As the year progressed, it became increasingly apparent that the monetary policy environment in the advanced economies was likely to remain highly accommodative for longer, and this view was reinforced by the emerging sovereign debt crisis in Europe. This had implications for the rand exchange rate and its expected future path, as well as for the outlook for domestic inflation. Domestic growth was also expected to be negatively affected by these events. As a result, our inflation forecast was progressively revised downwards. For example, at the March meeting, the expected low point for inflation in the third quarter of 2010 was 4,9 per cent. By the September meeting this had been revised down to 3,7 per cent.

Furthermore, and of greater significance, the longer term expected trend of inflation was also revised downward to the extent that the entire expected inflation trajectory over the forecast period was seen to be comfortably within the inflation target range. The forecast in November 2010 indicated that inflation was expected to be 4,8 per cent at the end of the forecast period in the final quarter of 2012.

Against the backdrop of relatively weak domestic demand, we felt that there was room for further monetary accommodation to help stimulate the economy without jeopardising the inflation target. If inflation is, or is expected to remain within the target, monetary policy will have greater flexibility to focus on growth issues, particularly when the growth rate is below potential. This is entirely consistent with a flexible inflation targeting framework.

The repurchase rate was reduced by 50 basis points on three occasions: in March, September and November. On each occasion it was the view of the MPC that we were either at or close to the bottom of the interest rate cycle and we had signalled that the room for further cutting was limited. However, in subsequent meetings, as I have said already, the outlook had changed significantly, and in effect the real interest rate was increasing with the decline in expected inflation.

It is important to reemphasise that any signal is not a commitment, but a signal conditional upon no significant changes in the outlook. Under periods of heightened uncertainty, as we

have been experiencing, it is likely that conditions will change more rapidly, although the direction and extent is not always clear. As we signalled in our most recent meeting, the room for further rate cuts is limited by the fact that we are now seeing more definite signs of a sustained recovery in household consumption expenditure and domestic credit extension.

Conclusion

Monetary policy is always made under conditions of uncertainty. The lags in the impact of monetary policy mean that policy has to be made on the basis of expected developments and expected inflation outcomes. The more uncertain the environment is, the more difficult it is to have a clear future path of interest rates.

Monetary policy settings will need to change in line with changing circumstances. At the very least, we should strive to be consistent on the basis of how we view the rapidly changing world. Our actions have been and will continue to be guided by how we see and interpret these developments, and we will continue to implement monetary policy independently, but mindful of the impact on other variables in the economy.

The policy rate is currently at its lowest level in over 30 years, the real rate is below its long term average and the inflation rate is expected to remain within the inflation target range for the forecast period. These developments are a result of a consistent application of a flexible inflation targeting mandate. As always the Bank stands ready to play its part in contributing to longer term sustained economic growth in the economy by ensuring a low inflation environment. Low inflation or price stability can contribute to long-term growth by providing greater stability and reducing uncertainty, which will be positive for longer term investment.

Thank you.