Daniel Mminele: Monetary policy in volatile and uncertain times

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the breakfast of the Association of Corporate Treasurers of Southern Africa, Johannesburg, 27 May 2011.

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1. Introduction

Good morning ladies and gentlemen.

Thank you to the Association of Corporate Treasurers of Southern Africa (ACTSA) for extending this invitation to share some thoughts with you this morning on monetary policy. However, before I delve into issues related to monetary policy, I would like to provide a brief overview of the global policy agenda, how it has been shaped by the crisis and efforts underway to restore macroeconomic and financial stability and a more balanced global economy.

As the title of my speech suggests, the global economic and financial environment is one fraught with volatility. While we may have emerged from the crisis, the recovery has been difficult and risks remain large. Sovereign debt difficulties in peripheral Europe as well as in some other advanced economies, banking systems still in need of repair, and geopolitical risks, all compounded by natural disasters, are issues we need to grapple with. It is within this highly uncertain environment that central banks need to manoeuvre and find ways to best deal with rising inflationary risks without jeopardising the recovery and creating threats to financial stability.

2. An uncertain and volatile global landscape

The sovereign debt crisis in peripheral Europe shows little signs of abating. Speculation around a possible Greek debt restructuring or, in some quarters even around an eventual exit from the euro zone is gathering momentum and threatens the outlook for Ireland and Portugal, and could possibly cause disruptions in Spain and core Europe. We have recently seen further rating downgrades and revisions to rating outlooks by rating agencies. Martin Wolf,[1] in an article in the Financial Times, relates the euro zone's approach to the fiscal crises to the story of a man sentenced to death by his king. The king tells him that he can keep his life if he teaches the monarch's horse to talk within a year. Surprisingly, the condemned man agrees. Asked why he did so, he answers that anything might happen: the king might die; he might die; and the horse might learn to talk. In essence, Martin Wolf argues that policymakers have decided to play for time in the hope that the countries in difficulty will restore their creditworthiness. The significant rise in the cost of borrowing for peripheral European countries shows that, if this indeed was a deliberate strategy, it is not succeeding. It is unclear how a debt restructuring would affect markets and the real economy. Some argue that this would be the most practical solution for Europe, while others say that, given the interconnectedness of sovereign debt markets and the banking systems in Europe, this has the potential to trigger developments similar to what was witnessed around the Lehman Brothers collapse.

The International Monetary Funds' (IMF) latest World Economic Outlook and Global Financial Stability Report (April 2011) reflects a recovery that appears to have solidified. However, growth on average remains below pre-crisis levels, unemployment is high, and

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[1] The euro zone's journey to default, 10 May 2011, FT

inflationary risks have picked up. The story of the two-speed economic recovery is well known – modest growth and still high unemployment in advanced economies, contrasted with robust growth in emerging market economies, but marred by high rates of youth unemployment and rising inflation. In many emerging economies output gaps have become positive, inflation is rising and capital flows from developed to emerging economies continue unabated. The combination of weak sovereign balance sheets, weak real estate markets, high funding requirements for sovereigns and banks in advanced economies, together with overheating and booming asset markets in emerging market economies, tilts the balance of risks to growth to the downside. Political and social unrest in the Middle East and North Africa as a result of rising food and commodity prices also threatens to add to already heady inflationary pressures.

Thus, while the global recovery may be on a firmer footing than a year ago, it is questionable whether growth is more balanced than before the crisis. Improved growth prospects in developed countries have largely been driven by fiscal spending and loose monetary policy, although more recently, certain advanced economies have begun to reduce the fiscal stimulus and started raising policy rates. On the other hand, emerging markets reflect robust consumer spending and private sector investment. Such an uneven recovery could fuel further imbalances and delay the current recovery while also sowing the seeds of future crises.

3. The global policy agenda and South Africa

Global imbalances were one of the foremost causes of the crises and therefore, have become a significant agenda item for the G20, which effectively replaced the G8 as the leading forum for international economic co-operation and coordination. Since 2008, the status of the G20 has been elevated, recognising that co-operation on a global scale is required to successfully and sustainably deal with the crisis. To this end, the vital role of emerging market economies was recognised, and rightly so. Over the past five decades, the global balance of power has shifted towards emerging-market economies, whose share of global GDP has increased alongside the decline in that of advanced economies. Between 1960 and 1985, advanced economies on average accounted for about 75 per cent of global GDP (based on purchasing power parity weights), this share declined gradually to 57 per cent in 2009. In contrast, over the same period, the share of emerging market and developing economies increased steadily from 17 per cent to almost 40 per cent.[2] At the height of the financial crisis during 2008 and 2009, emerging markets were the sole engine of world growth.

In 2009, G20 countries committed to a new framework for strong, sustainable and balanced growth (referred to as the Framework), as well as a Mutual Assessment Process (MAP). The Framework is intended to ensure that the individual country actions contribute to a coherent path forward, while the MAP is intended to gauge the degree of collective consistency of G20 macroeconomic policy actions. To this end, a number of indicators have been agreed upon to enable the identification of globally systemic imbalances and to ensure that preventative and corrective action is taken timeously. The co-operation to a large extent proved to be highly effective in the immediate aftermath of the financial crisis, but is now facing some challenges given the increasingly divergent developments across countries and regions.

There is wide recognition that there is a need for an adjustment in exchange rates in order for global rebalancing to occur. This process is also referred to as demand rotation and requires deficit economies to save more and consume less, while surplus economies are required to spend more and save less. Surplus countries are therefore expected to shift

[2] Emerging Markets come of Age, Finance and Development, December 2010, Vol 47, No 4

focus from external demand to domestic demand in order to sustain growth. In contrast, deficit economies will need to rely more on external demand. This implies that exchange rates will adjust, with the exchange rates of deficit economies depreciating, while the surplus economies will need to let their currencies appreciate. As you can well imagine, this is a contentious issue amongst G20 countries, given that developed and developing economies have differing policy priorities. However, what is important is that co-ordination does exist on various economic aspects, including sustainable, balanced growth, financial sector reforms, and reform of international financial institutions.

Excess global liquidity on account of easy monetary policies in advanced economies, coupled with the combination of promising growth prospects, improved governance and capital account liberalisation, made emerging market economies very attractive investment destinations. Consequently, currency tensions came to the fore early last year as volatile capital flows returned to emerging market economies, resulting in currency appreciation and thereby eroding export competitiveness and disrupting macroeconomic stability. Apart from currency appreciation, these inflows have also increased the possibility of bubbles in asset prices in emerging economies. There have been a range of responses to the surge in capital inflows, from outright intervention to the imposition of capital controls. The thinking behind the management of capital flows has shifted somewhat in the process. In essence, where previously much criticism was directed at measures to deal with capital inflows, it is now widely accepted that under certain conditions this can be a legitimate component of policy responses to deal with the surge in capital inflows. To this end country-specific circumstances are an important consideration when deciding what measures may be appropriate or not.

Accordingly, although an old topic in economic literature, the G20 under the French Presidency has added a new agenda item, namely, the "Reform of the International Monetary System". A working group was established to discuss the future global monetary system, with a view to achieving a more stable and representative system. A key focus area of this working group centres on developing a better understanding of the consequences and causes of capital flows, with a view to developing a framework of non-prescriptive guidelines to govern currency interventions in the face of volatile flows. This agenda item is very much aligned with the Framework.

Movements in currency markets over the past few years are indicative of global developments, where the US dollar's role as the sole global reserve currency is increasingly being questioned. Other currencies, including those of major emerging market economies (when they satisfy relevant criteria) are likely to play a larger role in future. But, it will be a long journey before there is any significant change to the US dollar's status as the world's reserve currency.

South Africa, being the only African country represented on the G20, supports efforts towards strong, balanced and sustainable growth and the reform of the international monetary system, and officials from the National Treasury and the South African Reserve Bank actively participate in G20 working groups. There is certainly a need for global co-operation, as we have clearly seen, economic and financial disruptions in one place can cause not just ripple effects elsewhere, but crises of significant proportions. Co-operation at the global level is essential to ensure that the seeds of the next crisis are not inadvertently sown in the measures currently being developed and implemented, and to ensure that we will be adequately prepared to tackle future challenges.

In April this year, South Africa was also accepted officially as a fully-fledged member into the BRIC (Brazil, Russia, India and China) bloc, bolstering its position on the global economic arena, and strengthening political and trade ties within the bloc. South Africa accounts for about a third of gross domestic product in sub-Saharan Africa. This membership is mutually beneficial, opening up vast opportunities for Africa, while at the same time offering BRIC members improved access to mineral resources and approximately one billion consumers on the continent. It is important for South Africa to harness the opportunities that come with its membership of BRICS and to leverage its position to support growth, development and employment creation initiatives in the country.

4. South Africa's growth outlook

Although the South African financial system has to date emerged relatively unscathed from the financial crisis, largely owing to sound financial regulation and supervision, the real economy did suffer. The economy contracted by 1,7 per cent in 2009, following growth of 5,6 per cent in 2006 and 2007 and 3,6 per cent in 2008. Growth in real gross domestic product has improved since the recession experienced in 2009, but is insufficient to address the burgeoning joblessness rate, which measured 25 per cent in the first quarter of 2011. The output gap remains negative, as growth remains below trend and output below levels achieved prior the crisis.

The accommodative monetary policy stance of the Bank over the past few years has certainly helped to prop up household consumption expenditure. Household consumption expenditure has been the main driver of growth, making the largest contribution of 2,8 percentage points to growth in GDP during 2010. Even so, growth has not been excessive and there are tentative signs that this positive momentum may be levelling off, as suggested by recent economic data in the form of retail sales, motor vehicle sales and credit growth. Consumers remain relatively highly indebted, while impaired advances as a percentage of total loans and advances have remained somewhat sticky since the end of 2009 at levels close to 6 per cent. High levels of household indebtedness together with the elevated level of the number of consumers with impaired credit records, is likely to constrain consumers to some extent going forward.

Positive trends in the composite leading business cycle indicator and the Kagiso/BER Purchasing Managers Index suggest that the recent trends and outlook for the manufacturing sector has improved. The details in the various business confidence surveys confirm this view. The year-on-year increase in the physical volume of manufacturing output measured 4,6 per cent in March, following the 5,7 per cent increase registered in February. On a three-month on three-month basis, the increase was 4,0 per cent. These developments are encouraging especially when viewed against the backdrop of the appreciation in the currency. However, there is still a substantial degree of slack in the manufacturing sector.

The Bank's forecast reflects GDP growth averaging 3,6 per cent and 3,9 per cent in 2011 and 2012, respectively. These forecasts are somewhat lower than those of some other emerging market and developing countries.

5. South Africa's monetary policy response

Inflation in a number of emerging market countries has been rising steadily over the past year, driven by the rise in global food and commodity prices. The large share of food and energy in the CPI baskets of many emerging market countries is a major factor behind rising inflation. In addition, in many cases output gaps have closed, resulting in a tightening of monetary policy in many emerging market economies.

In contrast, South Africa has maintained a repo rate of 5,5 per cent since November 2010, following the reduction in the policy rate by 650 basis points since March 2008. South Africa's inflation picture has been somewhat benign compared to other emerging markets. Domestic CPI reached a low point of 3,2 per cent in September 2010, at a time when other emerging market countries inflation rates had already started rising owing to rising commodity prices. South Africa's inflation rate has risen steadily since then, with CPI measuring 4,2 per cent in April 2011.

At this stage there are no discernible inflationary pressures coming from the demand side of the economy, the output gap remains negative and there are tentative signs that the momentum in consumer demand may be levelling off. Furthermore, core inflation readings, when measured by adjusting overall CPI for food, non-alcoholic beverages and energy prices, were relatively subdued at 3,4 per cent in March.

However, the inflation outlook has deteriorated over the past couple of months, largely due to external cost-push factors. The main factors behind the upward trend in inflation have been food, and transport prices. Food price inflation increased from 3,5 per cent in February 2011 to 4,8 per cent in April, while petrol prices increased at a rate of 16,3 per cent. Other administered prices also placed upward pressure on prices, with electricity increasing by 19,0 per cent in April. Administered price inflation increased by 10,7 per cent in April, driven by a 12,1 per cent increase in the regulated component. If one excludes administered prices from CPI, the CPI would have measured 3,1 per cent in April. So far, these developments have not filtered through to broader price pressures and the appreciation bias in the rand exchange rate for most of this year, has helped to contain price pressures. That said, April inflation data does suggest that core measures may be beginning to rise.

The Bank has revised higher its inflation forecasts over the past few MPC meetings. The main risks to the inflation outlook continue to emanate from cost push pressures, including administered prices. While annual inflation rates are expected to average 5.1 per cent and 6.0 per cent in 2011 and 2012, respectively, our latest forecast shows that inflation is expected to breach 6 per cent in the first quarter of 2012 and to peak at 6,3 per cent. Inflation is expected to return to within the target range thereafter, but remain close to the upper end of 6 per cent. The breach is likely to be temporary, but is also dependent on further developments in food and oil prices and the potential second round effects, and the risk that these price pressures feed through to more generalised inflation. The recent decline in oil prices and moderation in international food prices to some extent alleviates some of the inflationary pressures that have confronted the South African economy. Another risk factor on the domestic front is the developments in wage inflation. Despite high unemployment, wage increases remained in excess of inflation and in the first quarter of 2011, measuring 8,2 per cent according to Andrew Levy Employment Publications. At the same time, labour productivity has declined, resulting in an increase in unit labour costs.

Despite the upward revision to the inflation forecasts, the repurchase rate was maintained at 5,5 per cent at the most recent MPC meeting in May. This is essentially due to the large influence of exogenous factors on current and projected inflation trends. The MPC is however cognisant of the current cost-push pressures and the potential of these to filter through to more generalised price pressures. These pressures will be closely monitored, and the MPC will take timeous action to ensure that second round effects do not take hold and that inflation pressures are kept in check.

6. Conclusion

To conclude, uncertainty in the global environment has not abated, as reflected by increased volatility in financial markets. While the global recovery has proceeded at a moderate pace, it remains unbalanced and uneven. To this end, the G20 is addressing issues of global imbalances and also reflecting on the future global monetary system. Such developments will have an impact on South Africa and policy developments going forward, as we are part of the global economy and one of the more liquid amongst emerging market financial markets.

South Africa’s growth outlook has improved, although it remains below pre-crisis levels and below that of other emerging and developing countries. Inflation has recently trended higher, and while the Bank’s forecast shows that CPI will breach the upper end of the target range, based on current information the MPC expects that this will be a temporary breach. However, developments will be closely monitored for any second round effects which could result in broader based price pressures.

Thank you.