Gill Marcus: Assessing the risks to the inflation outlook – the challenges to monetary policy in highly uncertain times

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, to the Swiss Chamber Southern Africa, Johannesburg, 15 November 2011.

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Thank you for the opportunity to address the Swiss Chamber today. One of the many demands of being a Governor is that of travel. And it is in this capacity that over the past two years I have had the privilege of visiting Switzerland on a regular basis, as Basel is the home of the Bank for International Settlements (the BIS) – the bank for central banks. It is indeed a beautiful country, and one of the advanced economies that is experiencing the challenges arising from significant inflows of capital as investors seek safe havens.

South Africa has had long-standing trade and financial ties with Switzerland, and in these troubled times it is important that such relationships are not only preserved but enhanced. We are certainly living in interesting but difficult times, because the possibility that things can go horribly wrong are very high. A break-up of the Eurozone, previously unthinkable, is now being mentioned by some of the European leaders who had previously dismissed such speculation. But even a less catastrophic scenario of a disorderly Greek default could have a disproportionate impact on the global economy. Unfortunately we do not know how long this process is going to take, and various attempts to resolve the problem have simply kicked the can forward, and perhaps bought more time. The dramatic leadership changes over the past week in both Greece and Italy demonstrate just how urgent the need for concrete and credible action is. We do know that we are getting closer to the end game at what seems to be increasing speed, but we do not know when that will happen and what form it will take. This makes policy-making extremely complicated, as it is difficult, if not impossible, to meaningfully quantify the risks, and build them into policy decisions.

It is against this heightened global uncertainty that the Monetary Policy Committee met last week, and decided to keep the repurchase rate unchanged at a 30 year low of 5,5 per cent. The MPC assessed the risks to the inflation outlook to be on the upside, and today I will expand on two interconnected risks that featured strongly in the MPC deliberations, namely the global outlook and the impact of the exchange rate.

As has been the case for the past two years or so, risks to the global outlook coming from the advanced economies have predominated policy discussions. There are three interrelated issues: the sovereign debt crisis in Europe, the unfolding banking crisis in Europe, and the inability of the advanced economies to generate sustainably higher growth.

This is indeed an irony and a change from previous decades when the majority of the global risks emanated from emerging markets. And while these risk events, such as the Asian crisis of 1997/8, had contagion effects they were generally limited to other emerging markets, and the impact on advanced economies was minimal.

In the MPC meeting, the global growth assumption in the forecasting model had been revised down, but did not reflect the worst case scenario for Europe. As the Eurozone crisis has engulfed Italy and parts of the European banking system, the stakes have increased. It was difficult enough to get agreement on actions to provide liquidity to the smaller countries, and Greece in particular. It is debatable whether the partial solutions that have been devised are adequate to build a fire-break around Italy, whose financing needs dwarf those of the combined European periphery. Rates on newly issued 5-year Italian debt exceeded 6 per cent yesterday (14 November) and at 6,29 per cent was the highest rate paid by Italy since June 1997. Rates on Spanish debt also exceeded 6 per cent. Thus it is clear that we are no longer talking about the periphery of Europe.

Compounding the debt problem is the slow growth that is being experienced in the Eurozone, with the ECB now expecting a mild recession in the region. The European Commission sees stalled growth in the Eurozone until at least the middle of 2012, and has revised its forecast for Eurozone growth in 2012 from 1,8 per cent to 0,5 per cent. The Commission sees a high probability of a protracted period of economic stagnation. Italy is expected to grow by 0,1 per cent in 2012, due in part to fiscal austerity measures. Some analysts forecast a deep recession in Italy which would exacerbate the negative debt dynamics of that country. The Greek economy is expected to contract by –2,8 per cent. The AAA rating of France now at risk, and the European Financial Stability Facility (EFSF), which was established as a means to provide liquidity support to member states, is experiencing problems leveraging their funds. Despite its AAA rating from two of the main rating agencies, spreads on EFSF 5-year bonds have more than trebled in the past weeks, and lack of bids in a recent auction resulted in a failed auction with only €3 billion of an anticipated €5 billion worth of bonds being issued.

The stability of the European banking system is also being brought into question as a result of the large exposures of French and German banks in particular to peripheral debt. At the same time, the requirements of Basel III have also meant that banks have had to increase their capital ratios. With bank share prices at low levels, the incentive is for banks to achieve their required ratios through deleveraging, i.e. through reducing lending. A credit crunch is a distinct possibility at a time when the region is already heading into a recession.

Cumulative fiscal tightening in Greece and Portugal over 2011 and 2012 is around 8 percentage points of GDP, while in France, Italy, and Spain cumulative fiscal tightening over those two years of between 3 ½ to 4 percentage points of GDP is expected. Fiscal tightening on this scale would constitute a significant headwind to growth at the best of times. However, the headwinds are amplified as this fiscal tightening is being applied at a time when Europe as a whole looks like it is moving into recession and may be at the early stages of a credit crunch.

There are no easy solutions to the European debt problem. There is a need for adjustment and for financing, and much of the policy paralysis is a result of different parties wanting to minimise their share of the burden. Not surprisingly, the creditor countries such as Germany see the solution for debtor countries to come from increased austerity. But not all countries can be creditors simultaneously. For every creditor there must be a debtor, and these debits and credits have their counterparts in the current account deficits and surpluses of these countries. For every net exporter there has to be a net importer. As Martin Wolf has recently reminded us, since the world cannot trade with Mars, creditors are joined at the hip to debtors, and any adjustment cannot be one-sided.

These developments in the euro area have important lessons for other single currency areas, including moves towards monetary integration in Africa. Some of these lessons include the following:

- It is not sufficient to have macroeconomic convergence criteria. This is a static approach, in the sense that once achieved, the pressure is off. Recent experience shows how quickly these ratios can be reversed. An effective monetary union needs to ensure that there are effective mechanisms to ensure that these criteria are sustained. The Growth and Stability Pact failed because there was no real sanction involved for countries that transgressed the rules.
- This points to the need for a single fiscal authority. While this was previously recognised, the political difficulties of achieving agreement on this, and to allow politically sensitive issues such as tax policies, expenditure requirements, and fiscal transfers to be made by a supranational body, would have significantly delayed or even perhaps stymied the implementation of the single currency.
- It is increasingly apparent that a further weakness in the design of the Eurozone was the lack of a lender of last resort. While in principle the ECB can, and has been in

effect playing this role and taking a large amount of risky assets onto its balance sheet, it is questionable whether it can continue to do so without intense political pressure from some of the member states who feel that the ECB is operating outside of its mandate. At present it is the individual central banks that stand behind the ECB. There is no unified fiscal authority that guarantees its activities.

- It would be wrong to think that sorting out the fiscal issues would have prevented the crisis. These issues are a manifestation of a deeper problem of divergent levels of competitiveness. The underlying assumption of a monetary union is that competitiveness will remain constant, i.e. the internal real exchange rates will be unchanged. In the past ten years the peripheral countries have lost competitiveness to varying degrees, in the case of Greece by about 30 per cent. There is no internal mechanism to prevent this, and in fact the single currency allowed for automatic and continuous financing of these divergent trends at low rates of interest. Italy's problem is not only fiscal in nature. Italy is after all running a primary surplus. In the absence of an exchange rate adjustment mechanism, the only way to adjust is through an internal devaluation, implying falling nominal and real wages, and fiscal austerity. This is the classic expenditure reduction case under fixed exchange rates. The inability to change the nominal exchange rate imposes severe adjustment costs.

While exchange rate flexibility would ease the burden of adjustment, countries that find themselves with appreciating currencies in response to developments elsewhere find it extremely uncomfortable as well. Countries with stable macroeconomic environments are better placed to shield themselves, but it is almost a truism that no country can actually escape the fall out of the global uncertainties that are currently prevailing. Switzerland, as a model of macroeconomic rectitude and with its safe banking system, is a good example of this. In the context of increasing risk aversion, there is a search safety rather than for yield. The interest returns from investing in Switzerland are minimal or negative, yet the country continued to receive significant capital inflows causing the Swiss franc to appreciate to uncomfortably strong levels. Attempts to stem the tide in 2010 through intervention were eventually abandoned after losses of around CHF 30 billion were incurred. At that stage the Swiss franc exchange rate was around CHF 1,45 to the euro. More recently, when the franc reached close to CHF 1 against the euro, the Swiss National Bank reentered the market and announced its intention to prevent the franc from appreciating beyond CHF 1,20. To date they have been successful, but it is unclear whether this will be sustainable in the face of an extreme bout of risk aversion in financial markets. While flexible exchange rates help with adjustment, these adjustments are not easy or without costs.

South Africa's attractiveness to capital flows and consequent appreciation pressures was in part due to the search for yield in an environment of abnormally low interest rates in the advanced economies. But the exchange rate response to risk aversion is the opposite to that of the Swiss franc. Since late July, as the Eurozone crisis intensified, the rand, along with numerous other emerging market currencies depreciated. Since July 2011, the rand has depreciated by about 20 per cent against the US dollar, and has traded in a range of between R6,65 and R8,50. As is often the case, the rand tends to be one of the more volatile currencies. Nevertheless these movements have been mirrored in a number of other currencies, for example the Mexican peso and the Brazilian real.

These exchange rate developments have implications for monetary policy. As was noted in the MPC statement, the exchange rate is now seen to impart an upside risk to the inflation outlook.

How inflation responds to exchange rate movements depends on a number of complex factors, including the speed, duration and the extent of the depreciation. Small changes usually have a relatively small impact on inflation, as is the case where the depreciation is expected to be of limited duration. Furthermore, the extent to which pricing was done at the previous level of the exchange rate could determine the extent to which producers can absorb the increased prices and costs. We must also distinguish between a once-off depreciation and a continuous depreciation. The latter is likely to lead to much more severe impacts on inflation, and most likely to lead to a price-wage-exchange rate spiral. A once-off depreciation would be expected to elicit some price response, but the impact on inflation is likely to be of limited duration, once the pass-through has occurred.

So from a monetary policy perspective the challenge is not only to take a view on the future path of the exchange rate, but also the impact of these moves on inflation. The view of the MPC at this stage is that underlying support for the rand is still there, as the factors that led to the strong rand in the first place still prevail, and interest rates in the advanced economies are expected to remain lower for longer.

However in the short run the volatility of the rand will be determined by bouts of risk aversion in global financial markets. The general expectation, as reflected in the consensus forecasts, is that the rand is unlikely to return to previous elevated levels of below R7 to the dollar, but is expected to appreciate somewhat from current levels. This view would seem to assume some orderly near-term resolution of the Eurozone crisis. Because the MPC assessed the risks emanating from the global economy to be on the downside, it sees an upside risk coming from the exchange rate. Does this necessarily imply that should the Eurozone crisis deteriorate, any further exchange rate depreciation would ultimately lead to a tightening of monetary policy? The answer clearly depends on what is happening to other factors as well. We should recall that at the height of the crisis in 2008/09 monetary policy was loosened despite the much more pronounced depreciation that is currently being experienced. At that stage there were a number of offsetting effects that meant that a more benign inflation outlook could be expected. These factors included the widening output gap and associated contraction in domestic expenditure, and the collapse of global commodity prices.

We should not forget that the weaker rand also comes with its advantages. It makes our exports more competitive, and imported goods more expensive, which should provide a boost to domestic producers. This is in effect an easing of monetary conditions for domestic producers. However this advantage will be short-lived if offset by higher wage and other input costs which offset the advantage faced by producers.

The decision to keep the repurchase rate unchanged was an outcome of a careful weighing up of the different risks to the inflation outlook, including the contradictory pressures coming from the exchange rate and the global economy. The MPC was of the view that monetary policy was sufficiently accommodative to support the economy at this stage, but at the same time it was concerned about the upside risks to inflation, which is now expected to breach the target for a longer period than previously anticipated.

It still appears that inflation is being driven by cost-push factors, as illustrated by the benign core inflation outcomes. However, the interaction between higher headline inflation and inflation expectations of wage and price setters is critical. To date inflation expectations appear to be anchored at around the upper level of the target range, but the longer inflation remains outside the target, particularly if it surprises on the upside, the more precarious these expectations become, and the greater the upside risk to the inflation outlook.

The Bank sees medium-term inflation outside the target range at this point, and regards the breach, although extended, to be temporary. In addition, the weak state of the economy also impacts on the approach taken. But we have to be vigilant on both sides. There is always a possibility of upside surprises to growth or a dislocation of inflation expectations from the target range, which could take inflation well above the target range. However, on the other side, although our assumption for European growth has been lowered, it does not contain the worst case scenario of a meltdown in the Eurozone which would have severe implications for the global economy and South Africa. Although this is seen as a tail risk, it is not a remote possibility. As noted in the recent statement, the MPC is prepared to take appropriate action should the need arise.

In conclusion, the European environment holds many uncertainties and possible unthinkable consequences, and it is difficult to preempt this in our policy choices. At the same time, the combination of rising inflation and sluggish domestic growth holds the risk of a stagflationary environment. Monetary policy will maintain its focus on achieving the inflation target over the medium term, but will remain sensitive to the domestic economic situation.

However, an accommodative macroeconomic environment cannot on its own generate the higher rates of growth that this economy requires for employment creation. Part of the solution will need to come from improving much needed infrastructure, such as energy, rail and ports, which will strengthen the country's export capacity. There is also the need for sustained efforts to enhance South Africa's ties with its traditional trading partners such as Switzerland, and also to develop new trading relations outside the Eurozone.

These are indeed very challenging times, a time of great uncertainty. Nevertheless it is a time that needs thoughtful answers, collective action, courage and integrity. It is a time that questions what we know, what we thought we knew, and the paradigm of our thinking.

Thank you.