

Daniel Mminele: Macro policy priorities during an extended period of global sub-par growth

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the JP Morgan Investor Seminar, Tokyo, 14 October 2012.

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1 Introduction

Good morning ladies and gentlemen and thank you to JP Morgan for inviting me to share some thoughts with you on what is indeed a very pertinent subject. The topic chosen for my contribution to this seminar, "*Macro policy priorities in an extended period of global sub-par growth*", has indeed become a very real challenge for most policymakers around the world. Not surprisingly, your debates and discussions over the past two and a half days highlight just how much of a challenge it is to generate the kind of growth needed in the pursuit of development in an environment where previous engines of global expansion have almost "stalled". This is particularly so in emerging economies.

The fact is, the global financial crisis is now running into its fifth year and yet normalization still looks a long way away. Projections of economic growth made in the years prior to 2008, when increasingly stable price and policy expectations fostered hopes of stronger expansion on a sustainable basis, now look exceedingly optimistic. Between 2008 and 2012, if we take into account the latest projections of the International Monetary Fund, the world economy will have grown by an average of 2.9 per cent a year, contrasting with 4.8 per cent in the preceding five years. Few countries have been immune to this pattern. In South Africa, based on the latest Reserve Bank projections, the 2008–12 average growth is expected to be around 2.1 per cent, down from 4.8 per cent in the previous five years.

2 The typical policy responses to slowing growth

Economic cycles have been present for as long as economic historians can remember, and even the policymaker equipped with the best knowledge and intentions would struggle to neutralize their impact. Nevertheless, macro policy should aim at smoothing out the potential variations of economic activity over the cycle, and in so doing, limiting the risk of these variations causing unnecessary, permanent damage to different sectors of the economy. The shallower the recession, the lower the risk is that normally-productive employees will be forced into a long period of unemployment that can lead to a permanent loss of skills. The milder the downturn, the lower the risk is that fundamentally sound, yet temporarily illiquid companies may be forced into bankruptcy.

Both sides of macroeconomic policy can play their part. On the fiscal front, maintaining a relatively stable growth rate of public expenditure, even as revenues slow, can dampen the impact of private demand swings on overall activity. On the monetary front, a reduction in interest rates may ensure the continued viability of otherwise threatened capital spending projects; lessen the burden of servicing private debts; limit corporate and individual bankruptcies and discourage the deferment of consumption. Such policies were indeed implemented in South Africa as the economy went into recession in the latter months of 2008. The consolidated government budget balance was allowed to shift from a surplus of 1.0 per cent of GDP in the 2007–08 fiscal year to a deficit of 6.5 per cent of GDP two years later, not through aggressive discretionary spending but by letting the "automatic stabilizers" work as described above. At the same time, the repurchase rate of the South African Reserve Bank was lowered from a cyclical peak of 12.0 per cent in October 2008 to 7.0 per cent by the end of 2009, and to 5.5 per cent by the end of 2010.

3 Dealing with an unusual economic cycle

As 2008 drew to a close, it became evident that globally, the response of policymakers to the sharp deterioration in economic and financial conditions was bearing fruit. By 2010, world economic growth had rebounded to 5.3 per cent, and the South African economy, while lagging the pace of the global upswing, nonetheless reversed a 1.5 per cent contraction in 2009 with an expansion of 2.9 per cent in the following year. Yet as I highlighted in my introductory comments, the pace of activity has fallen short of what we had been accustomed to in previous years. In many countries, including South Africa, the output gaps that opened up in the wake of the 2008–09 recession have not closed, implying that unemployment rates remain stubbornly elevated by recent standards, and that an unusually large number of companies operate far below capacity.

The nature of the imbalances that built up during the pre-recession boom largely explains this subdued, “L-shaped” recovery. Heavily-leveraged financial and household sectors had to undergo a phase of balance-sheet “repair” that in many instances is still taking place. Households took advantage of interest rate relief to repay some of their liabilities, rather than fund renewed consumption of goods and services. Faced with a higher share of non-performing loans, banks tightened lending criteria, dampening the stimulative effect of lower central bank policy rates. As asset prices adjusted to more realistic levels, the implied negative wealth effect reigned in consumption and banks’ appetite for lending. The gradual reduction of excess housing inventories delayed any recovery in residential construction. We did observe these developments in South Africa, even though the pre-2008 degree of private-sector leveraging had fallen short of what was seen in many developed economies, and as a result, the adjustment required was somewhat less brutal.

For a while, the recovery in prices of South Africa’s commodity exports, a direct consequence of Asia’s strong recovery in 2010 and early 2011, partly offset the impact of these internal adjustments. Higher commodity prices boosted the profits of resource exporters; they allowed for some recovery in overall employee compensation; and as the higher terms of trade encouraged a trade-weighted appreciation of the rand, they further boosted real disposable income via a decline in imported inflation. It was no coincidence that growth in South Africa in 2010 and 2011 was strongest in the consumer sector, and in particular goods consumption.

But even this “safety valve” seems to be gradually closing. South Africa’s terms of trade have now declined for three consecutive quarters up to the second quarter of this year. The most obvious impact of this deterioration has been on the current account deficit, which increased from 3.3 per cent of GDP on average in 2011 to as much as 6.4 per cent in the second quarter of 2012, the largest shortfall since the third quarter of 2008. But economic growth has also borne the brunt from poorer terms of trade, as well as slowing global demand, domestic work stoppages, and business concerns over the long-term supply of energy and skilled labour. At the time of the September MPC meeting, the Reserve Bank projected GDP growth to decelerate to 2.6 per cent this year from 3.1 per cent in 2011, and to re-accelerate to 3.4 per cent in 2013, but warned about possible downside risks to this forecast.

4 The room for fiscal support is closing

How can policymakers respond to extended low growth? In most cases, it would be futile, and indeed erroneous to try and prevent some of the adjustments mentioned above. Healthier bank and household balance-sheets, more reasonably valued assets, and the end of demand-supply mismatches in the real estate sector are conditions necessary for a more solid, sustainable recovery. Yet policymakers cannot stand idle and wait for these imbalances to resolve themselves. The experience of the 1930s is there to teach us that failure to act, or an anchoring of policy to standards that are no longer adapted to the economic realities of the day, can easily turn low growth into a recession, and a recession into a depression. If structural adjustments in an economy result in an elevated degree of

slack for an unusually long period, then the macro policy mix should equally be characterized by an unusually long phase of accommodation. This way, the risk of permanent damage to the economic tissue will, if not removed, at least be mitigated.

Yet should it be the fiscal or the monetary policymaker at the forefront of this response? Over an extended period, both policies are not perfect substitutes. Running large budget deficits for several years (say, for as long as the output gap remains sizeable), will quickly raise public debt as a share of GDP. In turn, this will result in a greater share of state resources being absorbed by the service of that debt; a higher risk premium embedded into domestic interest rates as bondholders worry about fiscal sustainability; and potential capital outflows as a consequence thereof. At worst, deteriorating public finances could more than offset the impact of monetary stimulus. It should be remembered that Spain, currently mired in recession and facing an elevated credit risk premium on its sovereign debt, had the second largest budget surplus in the euro zone (2.2 per cent of GDP) in 2007, and a debt ratio of 36 per cent of GDP. In a word, prior to the crisis, Spain did not have a fiscal problem.

Prudent fiscal management for almost two decades means that South Africa does not face at present a meaningful fiscal constraint. At a projected 36 per cent of GDP in the present fiscal year, public debt is way below the levels seen in most developed economies, and relatively in line with the emerging world's average. Nonetheless, the situation leaves no room for complacency, and indeed the scope for responding to the current lack of strong economic momentum with additional fiscal stimulus appears very limited. The South African government has on many occasions reaffirmed its commitment to gradually reduce the budget deficit, so as to ensure that the net debt to GDP ratio stabilizes no higher than 40 per cent. It is in part for that reason that the National Budget presented in February 2012 targets a reduction in the deficit from 4.6 per cent of GDP in 2012/13 to 3.0 per cent in 2014/15.

5 Does the responsibility now shift to the Reserve Bank?

Does this relative fiscal constraint mean that the responsibility of "sheltering" the economy from unnecessary strains largely rests on the shoulders of the Reserve Bank? Once again, such an argument must be nuanced. Monetary policy cannot, on its own, generate stronger and sustainable growth in the long run. Ultimately, all it can do is provide a framework of price and financial stability that facilitates the private sector's decision to invest, save and plan for the future. However, persistent economic slack normally dampens inflationary pressures, and as a result, the central bank should be able to keep the level of interest rates below their medium-term norm without endangering its long-term goals of price stability.

This ability, however, is influenced by other factors, notably the stability of longer-term inflation expectations, the degree of rigidity in the wage and price formation process, and the level of imbalances in the economy and financial sector. Stable inflation expectations are an indication of the credibility of the central bank and of how confident economic agents are that it will not tolerate price slippages in the longer run. This stability therefore significantly reduces the risk of undesirable consequences from a reduction in interest rates. It is encouraging that in South Africa, broad-based measures of inflation expectations – based on surveys of businesses, trade unions as well as market analysts – remain anchored at around the upper end of the target range, despite the recent elevated volatility of the energy and food components of the CPI basket.

South Africa is often described as a country with relatively rigid wage and price settings. There is undeniably some truth in that assertion, and the relatively large losses in private-sector employment in the recession of 2008 and 2009 – both when compared to the contraction in GDP and to international trends – seems to illustrate the sticky, backward-looking pattern of wage settlements in South Africa. Yet, core measures of inflation – including in private services, where labour is a major input cost – remain benign by historical standards. The major impact of elevated wage demands so far seems to have been

more on employment levels, as firms sought productivity gains to avoid having to raise prices more quickly.

Admittedly, the tragedy at the Marikana platinum mine in August this year, followed by a spate of labour protests, some of them illegal and often violent, in other mining or economic sectors, has refocused the attention of financial markets and rating agencies alike on South Africa's labour market challenges. While there are at this stage no indications of a broad-based, sharp acceleration in wages as a result of recent protests, the Reserve Bank will have to carefully monitor possible spillovers of any such development into prices and price expectations. We have already seen an impact on the exchange rate of the rand, which almost touched R9.00 against the USD about a week ago. The rand appears to have decoupled from the EURUSD movements, taking its cue instead from domestic developments, including the credit rating downgrades, widespread strike action and the current account deficit. Growth forecasts will most likely need to be revisited.

As for the recent actions by rating agencies, these were obviously unfortunate and disappointing developments. The South African authorities are concerned about assessment of the South African credit at this point in time by the two rating agencies that recently adjusted their ratings. It has to be acknowledged, however, that some of the challenges they are pointing out, that as South Africans we need to deal with, are not new, are known to us and are in fact valid. As already indicated, we will have to, collectively inside and outside government, and in a coordinated and consistent manner, engage rating agencies, to communicate the strength of the fundamental underpinning of the South African economy and its institutions, and more clearly convey our commitment to addressing areas of weakness and potential vulnerability highlighted, and to put South Africa on a different rating trajectory going forward.

Macro-prudential variables are also key to a central bank's margin of manoeuvre in responding to adverse economic shocks, and the Reserve Bank is paying particular attention to these indicators. Indeed, back in April this year, the IMF pointed out in its World Economic Outlook that emerging and developing economies needed to "avoid over-stimulating activity to make up for less demand from advanced economies", pointing to the risk of overheating pressures from activity, credit growth or high commodity prices. But in contrast to some of its peers, South Africa benefits from a relative absence of such potentially inflationary pressures. Private credit growth has remained in single-digit territory for more than three years now; home prices are failing to display any clear uptrend in real terms; and the banking sector's prudent approach to lending has enabled a decline in impaired advances to 4.4 per cent of total loans and advances, from 5.5 per cent a year earlier. A caveat is the current account of the balance of payments, which has emerged as a risk to the exchange rate outlook.

It is against this background, and noting the increase in downside risks to the economy from global developments, that the Monetary Policy Committee of the Reserve Bank decided on 19 July 2012 to reduce its repurchase rate by 50 basis points, to 5.0 per cent. The MPC still deemed this stance to be appropriate as of its meeting of 20 September 2012, supported by projections of benign inflation over the forecasting period. As of that meeting, the Reserve Bank projected a relatively flat trajectory for consumer price inflation, averaging 5.3 per cent on the final quarter of 2012, 5.2 per cent in 2013 and 5.0 per cent in 2014. The MPC made it clear, however, that future global and domestic developments, and their potential impact on the risks to the outlook, would guide decisions going forward. The potential impact on consumer prices of future wage trends, as well as of the recent rand depreciation – if sustained over the coming months – will of course be closely monitored in that respect.

Ultimately though, additional central bank policy action in response to a weakening growth outlook would only be able to limit deviations in economic output from its potential. To the extent that a prolonged moderation in economic growth is structural and not cyclical, these challenges are most effectively addressed by measures which are geared towards reducing

an economy's rigidities, such as facilitating a fair price formation process and clarifying the long-term outlook for potential investors. The best way a central bank can assist in attaining these goals, is through the entrenchment of price stability over the longer run.

I thank you.