Lesetja Kganyago: South Africa and the normalisation of world monetary policies

Address by Mr Lesetja Kganyago, Deputy Governor of the South African Reserve Bank, at the Merrill Lynch 2nd Annual Fixed Income Investor Conference, Sandton, 27 November 2013.

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Introduction

Since the onset of the world economic crisis, monetary policy in the major advanced economies has been extremely loose. This has been helpful in supporting economic recovery in those economies, which has had positive spillover effects for developing countries, including South Africa. In line with other emerging markets, we have also benefitted from capital inflows which have boosted growth, lowered our borrowing costs and reduced inflation, through a stronger currency. However, these trends have started to reverse following signals from the US Federal Reserve that it plans to reduce the pace of bond purchases and ultimately tightening monetary policy. Today, I will discuss what this change means for South Africa.

The unmoved mover: US monetary policy

The prospect of Fed tapering moved to centre stage in world financial markets on the 22nd of May, when Chairman Ben Bernanke told the US Congress that he envisioned slowing or tapering the Fed's quantitative easing programme this year. The result was a worldwide increase in medium and longer term interest rates and outflows of capital from emerging markets, as investors responded to better rates of return in advanced economies. For emerging markets, the shock appeared most visibly through weakening exchange rates, especially in the countries with large current account and fiscal deficits.

By September, this strong market reaction had achieved a *de facto* world monetary tightening which had only to be validated by an actual Fed decision to taper. Yet this, to the surprise of many, was not forthcoming. The reasons the Fed declined to fulfill expectations were really quite persuasive. The Federal Open Market Committee had attempted to provide forward guidance on interest rates using unemployment as its main indicator, with 7% unemployment as the guideline for ending QE and 6.5% the threshold for raising rates. By September, unemployment had fallen to 7.3%, suggesting that tapering would need to happen rather quickly if QE were to be finished when unemployment reached 7%. However, unemployment was actually an unreliable indicator of the health of the US economy. This was because most of the improvement was being achieved not through people finding jobs but through people leaving the labour force. When unemployment hit 7.3% the labour force participation rate fell to 63.2%, the lowest level since 1978. The Fed therefore seemed unwilling to reduce its stimulus when so many people remained without jobs. Furthermore, the US economy was threatened by a fiscal shock from the budget and debt ceiling standoffs, to which the Fed was reluctant to add a monetary shock.

For emerging markets, delayed tapering offered some respite from currency depreciation. However, it remains inevitable that advanced economy monetary policy will start to normalize, beginning in the United States. South Africa is in some ways vulnerable to this process, and I will detail our main weaknesses and the ways in which we might be affected, before discussing the proper policy responses.

Vulnerabilities

Our most important vulnerabilities are the twin deficits: the ***fiscal deficit*** and the ***current account deficit***. We are also concerned about household indebtedness and therefore exposure to higher interest rates.

At the moment, South Africa is running a ***current account deficit*** worth more than 6% of GDP. In comparison with other emerging market deficit countries, our deficit is the product of both weak export and strong import performance. In Brazil and Indonesia, current account deficits have come mainly from falling prices of commodity exports, whereas in India and Turkey deficits have grown mainly because of rising imports, with exports little changed. In South Africa, export performance has been disappointing and imports have been growing at a brisk pace.

To fund the current account deficit we rely on capital inflows, and as they become scarcer the deficit will have to narrow. If this is to be achieved mainly through reduced imports the consequences for growth will be severe, especially as these imports include capital goods that are crucial to investment. It is therefore urgent that we improve on the country's export performance. Furthermore, rising import penetration in the context of an output gap suggests that the tradeable sector as a whole has lost competitiveness, not just exporters.

Regarding ***fiscal policy***, the SARB's repo rate stands at 5%, a more than three-decade low. Although we do not provide forward guidance on rates, should the rates rise, that will add to the cost of government borrowing. National Treasury has signaled smaller deficits in the future, as fiscal policy shifts from stimulus to consolidation, but smaller deficits will still add to SA's debt. QE made borrowing much cheaper, with SA Government bond yields unusually closely correlated with US Treasury bonds. It was appropriate to capitalize on record low rates and provide stimulus during the crisis, but these conditions are now passing. As rates rise, interest costs will consume a greater portion of GDP. Our attempts to estimate this effect point to an extra R11 to R30 billion in interest payments annually, averaged over the next four years and depending on the interest rate path. It is therefore important that fiscal policy adjust appropriately to more normal interest rates. National Treasury's most-recent MTBPS shows that this exigency has been well-understood by the fiscal authorities, and we are confident that it charts a sustainable course for South Africa.

In addition to the fiscal and current account deficits, South African ***consumers*** are also likely vulnerable to higher interest rates. As the SARB's September 2013 *Financial Stability Review* shows, households have used low rates to increase their debts, driving the ratio of debt to disposable income to almost 76%. The number of consumers with impaired credit records has climbed steadily since 2008, to nearly half the total. Although South Africa's banks are well-capitalised and therefore capable of withstanding higher default rates, this raises concerns both for consumer demand, an important driver of GDP growth, and the well-being of these financially vulnerable households.

Will South Africa experience a "sudden stop"?

Given South Africa's vulnerabilities, the question is not *if* world monetary normalization will affect us but rather how quickly and dramatically it will do so. The worst-case scenario is that we suffer a sudden stop, meaning inflows abruptly cease.

One helpful definition of a sudden stop offered in the literature specifies a year-on-year fall in the financial account greater than two standard deviations from the mean. Other scholars have expanded this to a fall greater than one standard deviation, with the added requirement that the decline in inflows must exceed 5% of GDP, to exclude cases where low volatility

produces small standard deviations.[1] By either definition, this has never happened in democratic South Africa. Indeed, some of these writers pick out South Africa as a special case, a country which has experienced large currency swings but no sudden stops.

By contrast, other emerging markets have a long history of "sudden stops", and these have often been growth disasters; Indonesia, for instance, took about a decade to recover the GDP levels it had attained before the Asian Crisis of 1998. Sudden stops have also affected advanced economies – although some of them stopped being advanced economies after suffering sudden stops. As Olivier Accominotti and Barry Eichengreen have recently argued, the economic crises in Europe after 1929 and 2009 should both be treated as sudden stops. In 1927, Austria, Germany and Hungary were running current account deficits of around 5% of GDP. In 2008, Greece, Portugal, Italy, Ireland and Spain had an average current account deficit of 6.7[%.2]. When foreign funders suddenly refused to finance these deficits, crises resulted.

Could a sudden stop happen here? We consider it unlikely. Partly, this is because world monetary policies are likely to normalize slowly, with very low rates likely to persist for several years in the United States, the Euro Area and Japan. Perhaps more importantly, South Africa's vulnerabilities are manageable. The literature flags three main domestic drivers of sudden stops: ***current account deficits, fixed exchange rates*** and ***foreign currency denominated debt.*** I will discuss each of these in turn.

The main reason current account deficits help precipitate sudden stops is that they exert downward pressure on the currency. Additionally, as a matter of economic identities the Current Account is equal to Aggregate Demand less gross national product (GNP). If the current account deficit closes suddenly demand has to fall as quickly, unless GNP expands enough to cover the gap, which it is unlikely to do in the short term. South Africa has a large current account deficit, but this is mitigated by our currency and debt policies.

When a country with a fixed exchange rate experiences capital outflows, the peg comes under pressure and needs to be defended. This normally entails raising rates sharply and selling reserves, which suppresses output, exacerbates local debt problems and often fails anyway, especially when speculators bet against the fixed exchange rate. Furthermore, an overvalued exchange rate in the context of a current account deficit just exacerbates the problem, because imports are unrealistically cheap and exports are penalized. The rand, however, is a free-floating currency. This liberates us from vain or harmful attempts to manage its value, and ensures that there is liquidity in the foreign currency market at all times. Depreciation also provides the right incentives to producers and consumers of tradeables. The floating rand acts as a shock-absorber for the South African economy and is one of our best defences against a sudden stop.

Foreign currency denominated debt, from the public or private sectors, may be an even more serious problem. Ricardo Hausmann has described it as the "Original Sin" of emerging markets, by which he meant that EMs are unable to borrow long-term in local currency, leading to debt profiles riven with currency and maturity mismatches. The problem with foreign currency debt is that if the exchange rate falls, the debt burden rises. The results can be likened to a bank run, with rising debt burdens deterring foreign lenders, weakening the currency and pushing debt burdens even higher, deterring more lenders, and so forth. South

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[1] Guillermo A. Calvo, Alejandro Izquierdo, and Luis-Fernando Mejía, "On the Empirics of Sudden Stops: The Relevance of Balance-Sheet Effects" NBER Working Paper No. 10520, http://www.nber.org/papers/w10520.pdf, May 2004, See Pablo E. Guidotti, Federico Sturzenegger, Agustín Villar, José de Gregorio and Ilan Goldfajn, "On the consequences of sudden stops" Economía, Vol. 4, No. 2 (Spring, 2004), pp. 171–214; Calderon, C. and M. Kubota (2013): "Sudden Stops: Are global and local investors alike?", Journal of International Economics, Vol. 89, pp. 122–142

[2] See http://www.voxeu.org/article/mother-all-sudden-stops.

Africa's debt, however, is mostly rand-denominated, so investors bear the currency risk. We do not suffer much Original Sin.

South Africa is therefore equipped to handle a shock like the end of QE without suffering a sudden stop. Although the current account deficit should prompt depreciation, a flexible currency and rand-denominated debt protect SA.

This confidence that we can avoid a sudden stop is also supported by independent measures of country vulnerability. Nomura Global Economics has recently compiled an index meant to show vulnerability to a currency crisis, meaning a shift of three standard deviations from the two year average. South Africa is comfortably within the safer group of countries, ahead even of countries like China, Israel and Chile. In September 2013 *The Economist* magazine produced a similar index, measuring the likelihood of a capital freeze. This showed a much more disturbing result: South Africa was revealed as the third-most vulnerable country, after Turkey and Colombia. But this bad news, it turned out, was thanks to a spreadsheet error. When corrected, South Africa suddenly moved to 16th out of 26, a much less precarious position.

Thinking through the likely outcomes

For these reasons, we feel reassured that a sudden stop is unlikely. This clears the way for us to think about the more plausible outcomes as world monetary policies normalise. To assist with this task, we have modeled a range of scenarios, from growth in the advanced economies to renewed recession. The headline finding for this exercise is that the end of QE is neither good nor bad, in itself. What matters are the circumstances surrounding the exit.

Advanced economy central banks are most likely to end QE and raise rates as growth improves – indeed, this is the whole point of monetary stimulus and the basis for forward guidance. This outcome is good for SA as faster world growth translates into higher domestic growth. Stronger exports plus depreciation would also narrow the current account deficit.

It is possible exit from unconventional monetary policies could occur with world growth still disappointing. After all, this remains uncharted territory for central banks, and we cannot assume they will definitely get the timing right, or that they will not be compelled to tighten monetary policy earlier than they would like by unacceptable increases in asset prices or inflation. In this case, growth would be weaker but a depreciating rand would still boost inflation, requiring higher interest rates (although the effect is muted by the larger output gap). A weaker currency would also shift the current account towards balance.

Getting policy right

How should policymakers respond to the end of QE and fast-depreciating currencies? There is a danger, during currency sell-offs, of losing focus. One mistake is to treat the exchange rate as a crucial indicator of prestige. Another may be to look back on previous exchange rate crises (such as India's in 1991, Indonesia's in 1997/1998 or Brazil's in 1998), and worry about losing the last war again. It may even be that currency rates, which change throughout the working day, are reported on so intensively that they assume outsize importance. Nonetheless, the exchange rate should not dominate our thinking.

For the Reserve Bank, our policy stance is clear. As flexible inflation targeters, the proper response to a weakening currency isn't to defend its value, as the priority, but rather to target the pass-through from the exchange rate to inflation. The Bank's normal estimate of this is 20%, meaning about a fifth of the change in the currency's value shows up in the CPI. The scale of the pass-through varies from time to time, however, and at present it appears to be lower, probably as a consequence of reduced pricing power in a subdued economy.

Although inflation moved outside the target during the third quarter it has since returned to the target band, as forecast, registering 6% in September and 5.5% in October. We have

therefore not changed rates so far this year, nor have we introduced other policy measures to influence the exchange rate.

This contrasts with the responses seen elsewhere. Brazil has raised rates by 225 points this year, Indonesia by 150 and India by 50 points. Central banks have also resorted to less orthodox policies including tightening overnight rates, implementing some capital controls and creating new swap auctions – essentially, opening forward books.

Comparing the performance of the rand with the currencies of these other countries, we see little evidence that a more activist and experimental approach would have changed the rand's direction in a meaningful way. Furthermore, there are advantages to our approach, not the least of which is a less volatile output, inflation and interest rates.

Conclusion

In essence, South Africa is not a fragile country. Rather, our system is anti-fragile, like a well-designed building in an earthquake zone: it moves with the shocks so it doesn't collapse.

- Our monetary policy stance is clear and appropriate;
- Fiscal policy is vigilant in anticipation of the normalization of interest rates;
- A sudden stop is relatively unlikely for South Africa;
- The end of QE is not plainly bad for SA, and could be a good thing if it heralds a return to growth in the advanced economies.

Thank you.