Gill Marcus: A perspective on the global and domestic economic outlook and the challenges facing monetary policy in the current environment

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, at the South African Institute of Chartered Accountants (SAICA) Business Breakfast, Rosebank, 10 June 2014.

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Good morning and thank you for the opportunity to be with you today at this event organised by the South African Institute of Chartered Accountants. According to the World Economic Forum, South Africa was again ranked number one globally in strength of auditing and accounting standards. This ranking is a tribute to SAICA and to all of you here today. Unfortunately, these rankings while pleasing, are not enough and there is no room for complacency. While the financial sector generally compares very favourably with the rest of the world, with deep and liquid markets and our banks ranked number three in the world for soundness, the broader economy performs less favourably on many of the other measures. While the accuracy of these measures can be debated, we only need to look at the recent growth rate of the economy, –0,6 per cent in the first quarter of this year and concerns for second quarter growth amid unresolved and intensifying labour disputes, to recognise that we have enormous challenges ahead of us.

While the global backdrop remains difficult as the advanced economies emerge from the very deep financial crisis of the past seven years, it is no longer the main cause of South Africa's weak domestic economic performance. The slowdown we have experienced is domestically driven, largely self-inflicted and we cannot blame external factors alone. This does mean, however, that the solutions are in our own hands, and as a country instead of focusing on whether we are entering a recession or not, we should all be striving to restore the economy to the strong growth path that it is capable of achieving. This morning I will present a perspective on the global and domestic economic outlook and the challenges facing monetary policy in the current environment.

The recent global crisis has reminded us that financial crises take a long time to repair themselves. Such crises are characterised by high levels of leverage and debt, whether households, firms or the state, and the loss of wealth associated with the start of a crisis means that it takes a long time to repair these balance sheets. The process of deleveraging implies low levels of consumption and investment by households and firms, while banks will be reluctant to lend. There are now encouraging signs that some of the advanced economies have been through this process are on a path of sustained recovery. The US economic recovery appears to be taking hold, with a clearer path of fiscal consolidation and stronger bank and corporate balance sheets. Households deleveraging has also occurred, and the housing market has shown signs of improvement. However, severe weather conditions earlier in the year resulted in a contraction in the first quarter, and it will be difficult for the economy to achieve the 2,8 to 3,0 per cent growth forecast recently by the US Fed. Nevertheless, the underlying strength appears to be there, and the market consensus is for an annual growth rate of around 2,5 per cent.

The UK economy also appears to have moved to a sustained recovery path, with growth of around 3 per cent expected this year. Unfortunately, the outlook for the Eurozone, an important export market for South Africa, is much less favourable. Although the region has emerged from recession, growth is expected to be anaemic, with continuing concerns about deflation, particularly in some of the European periphery. Consequently, the ECB has taken significant measures in an endeavour to stimulate growth in the region. The German economy appears to be sound, but France has recently slowed down significantly. Although the Japanese economy recorded strong first quarter growth of 5,9 per cent in anticipation of

the introduction of consumption taxes, this is not expected to be sustained, and the outlook remains uncertain with an annual growth rate expected to be around 1,5 per cent.

The mixed signals emanating from the advanced economies have important implications for emerging markets, including South Africa. The abnormally low interest rate environment in the advanced economies, coupled with quantitative easing, led to an almost undiscriminating wall of money flowing into emerging markets. These flows suddenly reversed following the announcement by the US Fed in May last year that it was considering tapering its programme of quantitative easing. The initial impact on emerging market bond and foreign exchange markets was severe, particularly those markets which were relatively open and liquid, including South Africa. The uncertainty surrounding the timing and speed of tapering resulted in a highly volatile period for emerging markets. When tapering was eventually confirmed in December last year, attention then focused on the timing and speed of US policy normalisation, which is the increase of the policy rate from the zero bound to more "normal" levels. So while tapering is steadily continuing, and is expected to be completed later this year, there is a great deal of uncertainty about the outlook for short term interest rates. Any changes in perception concerning the timing and intensity of the US interest rate cycle are likely to elicit reactions in global financial markets. Thus while the recovery in the US is good news for emerging markets in that this breaks the synchronised downturn in advanced economies and that a growing US economy is critical to global recovery, it does have implications for emerging market financial markets.

We are therefore in for a bumpy ride, with the prospect of a series of "risk on" and "risk off" scenarios as global risk perceptions change in response to unfolding developments. We can expect financial markets, including the rand exchange rate, to remain volatile in response to these changing perceptions. The outlook is complicated by the fact that a synchronised normalisation in the advanced economies is not expected. The Bank of England is most likely to move in line with the US, but the Eurozone and Japan are still in an easing cycle. Only last week, the ECB cut interest rates again, and announced a range of new measures to induce banks to increase lending, including measures to expand bank liquidity, and hinted at the possibility of some form of quantitative easing in the future. The ECB also indicated that this accommodative stance was likely to remain in place for a protracted period. The Bank of Japan is also likely to maintain its highly accommodative monetary and fiscal stance for some time.

The bottom line is that normalisation will happen: it will not be a synchronised event, and the timing and speed of the cycle is uncertain and will be dependent on the pace of the recovery in the advanced economies. The more uneven these recoveries, the more volatile capital flows to emerging markets are likely to remain. But the era of abundant flows to emerging markets appears to be over: the volume of flows is likely to be lower and more discriminating than was the case in recent years. And of course this applies more strongly to countries such as South Africa, where sustainability of current account deficits are perceived to be an issue.

These developments come at a time when emerging markets in general are slowing, and the previous optimism that emerging markets are the new epicentre of global growth may have been a bit misplaced. Despite this, emerging markets remain an important driver of global growth, but the outlook is fragile. The Chinese economy is expecting to slow to levels of between 7–7,5 per cent, growth rates that would be the envy of many countries. The slowing growth trajectory has already impacted adversely on South Africa through weaker commodity prices, and there are concerns the Chinese growth outlook could be undermined further by developments in the shadow banking sector and the housing market. South Africa's other BRICS partners, particularly Russia and Brazil, are also facing slowing growth scenarios. More positively, sub-Saharan Africa, where South Africa's trade and investment links have expanded, is expected to remain one of the fastest growing regions in the world, although weaker commodity prices remain a risk to the outlook.

While the global environment shows signs of improvement and there are real opportunities for South and sub-Saharan Africa, there are also new challenges. It is against this backdrop that the South African economy contracted by 0,6 per cent in the first quarter of 2014. This contraction arises largely from the negative growth of 24,7 per cent and 4,4 per cent in the mining and manufacturing sectors respectively in the first quarter. The rest of the economy, excluding mining and manufacturing, recorded growth of around two per cent, and while at least positive, is still inadequate. This follows a disappointing growth outcome of 1,9 per cent in 2013, following more optimistic expectations earlier on in the year.

There has been much speculation as to whether the country is headed for a recession, defined as two consecutive quarters of negative growth. To give some perspective of how bad things will have to be in order to get to this point: if zero growth in each of the remaining three quarters of the year were to be recorded, the economy would still achieve a positive growth rate of 0,8 per cent for the year. To get to a negative growth rate in the second quarter, and assuming the rest of the economy continues to grow at rates of around 2 per cent, we would have to have significant further contractions off the already low bases in both the mining and manufacturing sectors, and such contractions would have to be of similar orders of magnitude as in the first quarter. Given that the platinum strike covered more than two months of the first quarter, it is unlikely that a further contraction of that order of magnitude will occur in the second quarter. Therefore, we do not believe that a recession is the most likely outcome. Should it transpire, it would be a very grim outcome indeed. But even if a recession is avoided, it will be cold comfort if the growth rate is a weak positive number. Therefore it behoves all of us – government, business and labour – to rebuild the confidence and trust that is an imperative to change the negative trajectory that the economy is presently on.

The Bank’s most recent growth forecast, as indicated in the May monetary policy statement of the MPC, is for growth for this year of 2,1 per cent, but with a downside risk. This follows a progressive downward revision of these forecasts since November last year when a growth rate of 3,0 per cent was still forecast. The main downside risks to the growth outlook were the continuing strike in the platinum sector and electricity supply constraints. The platinum mines affected by the strike account for about 40 per cent of platinum production in South Africa. The contraction in platinum output accounted for about 19 percentage points of the total mining sector contraction of around 25 per cent in the first quarter. In the meantime the strike is continuing, and even if a settlement were achieved today and workers returned to work soon thereafter, it would take weeks for normal operations to resume. It is also possible that a number of shafts will never re-open.

In the meantime the costs to both workers and the mining companies continue to escalate. According to the Chamber of Mines, workers have lost R9,6 billion in wages foregone, while the companies have lost R21,5 billion in earnings. The knock-on effects of the loss of earnings go well beyond the 70,000 workers and their dependents directly affected by the strike. There are numerous accounts of how the communities and businesses in the Rustenburg area and parts of the Eastern Cape are being impacted by the loss of earnings. It also impacts on the upstream and downstream industries that are connected to the sector.

While the strike has already been felt in the economic growth outcome, it has not as yet been fully reflected in the export data. The mining companies had significant platinum inventories that they have been able to use to meet their contractual commitments. However, these inventories are being depleted, and the longer the strike continues, the sooner the adverse effects on exports will be felt. The deficit on the current account of the balance of payments is often regarded as the Achilles heel of the South African economy, particularly in the light of a relatively slow export response to the rand depreciation. Some tentative positive signs in this respect was evident late last year with the deficit contracting from 6,4 per cent of GDP in the third quarter of 2013 to 5,1 per cent in the final quarter. Import compression is constrained by the fact that a large proportion of the country’s imports are capital goods related to the infrastructural expenditure programme of government. We would not want to

see such imports declining as improved infrastructure increases economic efficiencies by unblocking domestic bottlenecks in the economy, and allows for future exports.

Therefore, a strong export performance is essential. It is difficult enough to achieve this in the context of weak growth in the Eurozone, one of our main trading partners. But to have a concurrent decline in platinum exports is an unnecessary self-inflicted wound at a time when the mining sector should be responding positively to the rand depreciation. The platinum group metals accounted for about 8 per cent of our total merchandise exports in 2012 and almost 9 per cent in 2013, so the impact of a total cessation of exports by the three affected companies is very clear.

A number of looming strikes in other sectors also threaten the growth prospects of the economy. Nevertheless, unless these stoppages turn out to be far worse than anticipated, the Bank's base case remains one of positive growth for this year, although it may be difficult to achieve a better outcome than last year. The growth forecast of 3,1 per cent for 2015 is predicated on a more stable industrial relations environment and an improvement in the electricity supply situation, with new generating capacity coming on stream early in 2015. There are, however, downside risks to this forecast. On the positive side, government infrastructural expenditure is set to continue, and this should underpin current and future growth. The recent growth numbers also show that there is life in the construction sector, which grew by 4,9 per cent in the first quarter of 2014. In March, the real value of building plans passed increased by 13,6 per cent on the 3-month-to-3-month basis, and by 5,9 per cent on a year-on-year basis. These positive developments are also consistent with the improvement in the construction sector business confidence indices. However, the recovery needs to be more broad-based. In particular, the mining sector needs to get back to work, and the manufacturing sector needs to stay at work. This is also an imperative to ensure we retain the jobs we have, and do not have further job losses and increased unemployment.

So what role can monetary policy play in this context? Unfortunately, monetary policy has a limited role in kick-starting the economy, particularly given the causes of the slowdown. Notwithstanding the interest rate increase in January, monetary policy is still accommodative and the repo rate low by historical standards, with the real repo rate being slightly negative. In effect, the 50 basis point increase simply offset the recent increase in actual and expected inflation. The problem of low growth and unemployment is therefore not high interest rates. The recent slowdown is clearly related to a fractious labour relations environment, while the unemployment rate is primarily structural in nature, and not something that monetary policy can solve. As we have stressed many times in the past, monetary policy can impact on the margin on cyclical growth and employment, but it cannot determine the potential real growth path of the economy. This is the domain of other policies that can directly influence the structural constraints on the economy.

The primary mandate of the Bank remains the achievement of price stability. Inflation moved outside the target band in April, in line with the Bank's forecast, and we expect it to remain outside the target for the next four quarters. We also see an upside risk to this forecast, with the main risks coming from the exchange rate (for reasons elaborated on above) and food prices. Other potential risks come from wage settlements should they significantly exceed productivity growth.

In response to these inflation pressures, combined with the prospect of normalisation of monetary policy in the US, the MPC embarked on a tightening interest rate cycle in January, but stressed that the cycle would be moderate given the weak growth outlook. The MPC is sensitive to the fact that it risks being pro-cyclical, and it could undermine growth at the margin.

This is the dilemma that monetary policy faces – that of rising inflation and slowing growth. Monetary policy decision-making in a flexible inflation targeting framework needs to be sensitive to the general state of the economy. So any given inflation forecast may elicit a different monetary policy response, depending on the economic outlook. For example, the

current inflation forecast may have produced a much stronger reaction had the economy been performing much better than it currently is. In other words, in a simple Taylor rule world, the smaller the negative output gap, the stronger the interest rate response for any given deviation of inflation from the target.

The monetary policy dilemma is compounded by the fact that the economy is not experiencing significant demand side inflation. Real growth in consumption expenditure by households has been steadily declining, from 4,9 per cent in 2011 to 2,6 per cent in 2013. While a contraction in consumption expenditure is not expected, we believe that it will remain constrained by a variety of factors, including rising inflation, high household debt levels, and subdued levels of credit extension to households in particular. The slow growth environment means that employment opportunities are limited, and job security is reduced. Since the 2009 recession, employment creation in the formal non-agricultural sector of the economy has been mainly by government. Private sector employment growth is likely to remain muted as long as investment confidence remains low, and government is constrained by the need to maintain its fiscal consolidation path, limiting the possibility of further significant employment creation.

The issue then is, how can monetary policy deal with inflation driven primarily by cost-push pressures, and under such conditions should we not simply ignore these inflation pressures? Inflation expectations are central to price formation, and expectations of future monetary policy actions are an important element in this. If there is a view that the central bank is not concerned about inflation, it will undermine credibility of monetary policy and impact adversely on inflation expectations. Inflation expectations, as measured in the quarterly BER survey, have been relatively well anchored for some time, although at the upper end of the target range. While we can take some comfort from the fact that they have not deteriorated, these expectations are uncomfortably high, in line with the precarious level of the actual inflation rate. We would not want inflation or these expectations to become embedded at the upper end or worse, at a higher level.

We know that monetary policy cannot prevent the impact effects of supply side shocks. For example, if international oil prices increase, domestic petrol prices will increase in the absence of an offsetting appreciation of the rand. But we do need to watch out for possible second round effects of these increases – that is, the extent to which increases are passed through to other prices, resulting in more generalised inflation.

A similar example would be the impact of exchange rate changes. We have noted that despite the significant depreciation since 2011, pass-through to generalised inflation, while still positive, has been lower than during previous depreciation episodes. We ascribe this to the weak state of the economy, where retailers find it difficult to pass the full increases on to consumers for fear of losing market share. But there will always be a temptation on their part to try and recoup their margins. Under such circumstances, if there is a perception that monetary policy will accommodate these inflationary pressures they are likely to increase their prices. However, if there is a tightening bias in monetary policy, firms are more likely to be constrained in their price setting.

There is a view that is sometimes expressed that inflation may come down more quickly than we expect, or even if it does not, and if the Bank's forecasts are correct, inflation will be back inside the target range next year. Under such circumstances, is there not a case for ending the tightening cycle, or even to consider a cut in interest rates? Although we have been more tolerant of inflation at the upper end of the target range, given the negative output gap, we do not see the upper end of the target range as being the inflation target. Currently our forecasts, and most other forecasts, are for inflation to remain uncomfortably close to the upper end of the target range in the next two year, and we assess the risks to be on the upside. While we do not target the mid-point of the band, we would prefer to be more comfortably and sustainably within the target, as this would provide more room for monetary policy to act as need be, and better anchor inflation expectations at a lower level.

We also do not believe that the current level of real interest rates is sustainable. As I have mentioned previously, there is a great deal of uncertainty surrounding the post-crisis new normal level of interest rates, both domestic and global. But in the same way that it is clear that the current abnormally low interest rates in the advanced economies cannot be sustained indefinitely, the same applies to our interest rates. As we have stressed, the timing and speed of adjustment will be data dependent, in part influenced by monetary policy developments in the advanced economies. That is not to say that we simply follow US monetary policy. A flexible exchange rate framework does give us a fair degree of monetary policy independence, but it is not absolute. This is in contrast to longer term bond yields which are more highly correlated with those in the US, and over which the Bank has no direct control. We live in a highly integrated financial world and we cannot ignore these developments.

To reiterate the MPC position, the interest rate increase in January was not a one-off move. It is part of a necessary cycle to deal with the inflation risks and to normalise interest rates in the economy. However, the speed and extent of tightening will be sensitive to domestic growth considerations, and to the pace of normalisation in the US which is likely to impact on the South African economy indirectly through the exchange rate. At this point in time, we are in what we assess to be a moderate extended cycle. That means the interest rates will not necessarily be adjusted at each meeting, or move by the same amount.

In this context, we are often asked if a 25 basis point adjustment is a possibility. Yes, it is. When the repo rate was in double digits, a 25 basis point change would make little impact. But at current levels of the repo rate, it is an option. Can 25 basis points make an impact? Perhaps not on its own, but seen in the context of a longer cycle, it could be part of a cumulative increase, particularly should the MPC wish to see a smoother and more gradual adjustment. The disadvantage of such a strategy, however, is that it could mean that we "fall behind the curve", which may require even stronger moves later on. A more moderate approach, on the other hand, could allow for easier adjustment to changing circumstances, and a less volatile interest rate environment in the short to medium term.

In conclusion, the domestic economy is facing enormous headwinds, many of which are of our own making, and therefore within our capability to resolve. High on the list is the currently debilitating labour relations environment, and it is incumbent on all parties to resolve these issues. All parties need to recognise their own roles in bringing about this toxic environment, and consider the significant costs to the individual workers, the affected companies and the country of not resolving these disputes.

Monetary policy cannot resolve these issues, nor can it deal with structural constraints to longer term growth. Rather, the role of monetary policy is to contribute to a stable macroeconomic environment conducive to inclusive higher growth. The National Development Plan is a broad blueprint for dealing with these structural issues and the focus should remain on implementation of this plan. The South African economy has enormous potential, but it also faces significant social demands in the context of high unemployment.

Let us all work together so that we get inclusive growth going again and realise the great potential we have as part of a growing region.

Thank you.