Daniel Mminele: South Africa's monetary policy, developments, challenges and the road ahead

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the South Africa Tomorrow Investor Conference, New York City, 8 October 2014.

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Introduction

Good morning Honourable Minister Nene, Ambassador Rasool, the SA Consul-General in New York, Mr Monyemangene, ladies and gentlemen. Thank you to the Johannesburg Stock Exchange, UBS and Standard Bank, and the South African National Treasury for organising this second South Africa Tomorrow Investor Conference and creating an opportunity for us to interact as policy makers, business leaders and investors. We meet at a time when global financial markets are increasingly focusing on the consequences of eventual monetary policy normalisation in the world's major economies, and emerging countries with large and liquid financial markets, like South Africa, come under the spotlight once again.

At the inaugural South Africa Tomorrow Conference last year, I was able to take stock of the major economic and financial market developments that had occurred in South Africa in the twenty years since the advent of democracy. In particular, I focused on the recovery in economic growth in the decade leading up to the 2008 financial crisis, the structural changes the economy has undergone, and the growth and deepening sophistication of our financial markets. Despite the challenges which the country is currently facing, these achievements, among which was the early establishment of macro-economic policy credibility, are still being built upon, and the National Development Plan (NDP) which Minister Nene has just talked about in detail, provides a framework for ensuring further progress towards a more successful and fair economy. Yet at present, a lot of questions are being asked of policy in general and monetary policy in particular, and it is mostly on this latter point that I will focus my remarks today.

SA's monetary policy framework and post-crisis developments

Last year I pointed out that the flexible inflation-targeting framework which the country adopted back in 2000 had delivered clear benefits, contributing to a decline in the level and volatility of both inflation and nominal interest rates. These benefits remain visible today. In particular, measures of inflation expectations – for example, as computed every quarter by the Bureau of Economic Research from the views of businesses, labour unions and financial analysts – appear more strongly anchored than they did in the past. Whereas these expectations used to be adaptive, responding with a lag to the actual inflation cycle, they now display a greater degree of stability, albeit currently (and of some concern to the central bank) around the upper end of the 3,0 to 6,0 per cent inflation target range.

On balance, it is probably fair to say that the greater stability in inflation and inflation expectations generated over time by our policy framework has allowed the Reserve Bank to respond more flexibly to the shocks which South Africa has faced since the global financial crisis. These shocks did not require the use of "unconventional tools" of the type that several central banks in the developed world, but also in some parts of the emerging world, used at the time. The solidity of South Africa's banking system enabled it to withstand the crisis without meaningful disruptions, and as a result, the central bank did not have to intervene in either the interbank or the FX markets to ensure their proper functioning and an adequate supply of liquidity. Nonetheless, South African growth experienced significant headwinds post crisis, with GDP contracting by as much as 1.5 per cent, in real terms, in 2009. Thanks to a subsequent period of decelerating inflation, the South African Reserve Bank was able to respond with a cumulative reduction of 650 basis points in the repo rate between December

2008 and November 2010. A further 50 basis-point cut followed in July 2012, which brought the repo rate to a thirty year low of 5.0 per cent per annum, a level that prevailed until January of this year.

As the nominal policy rate was being lowered, the real interest rate eventually moved into negative territory, when compared with either actual inflation or broad-based inflation expectations as measured by the Bureau of Economic Research’s surveys.

These negative real rates helped cushion the impact of the recession on both the corporate and the household sectors, limiting the impact of weaker growth on business liquidations and enabling households to gradually reduce their leverage ratio without dramatic cutbacks in consumption. Thus, the household debt-to-income ratio fell from a peak of 83.0 per cent in the first quarter of 2009 to 73.5 per cent in the second quarter of 2014, while real household consumption expenditure still grew by an annual average of 3.2 per cent over that period. Admittedly, more recently, household consumption expenditure has come under pressure, with growth rates exhibiting a declining trend since the second quarter of 2013.

Recent challenges and developments

The current environment in which South Africa’s monetary policy operates, however, has become increasingly more complex over the past year and a half, owing to a mix of both domestic and external factors, which have impacted growth and inflation. The country currently faces a mix of subdued economic growth and relatively high inflation, with risks skewed to the upside. In part, but not exclusively, because of supply constraints, including a lengthy strike in the platinum mining sector and delays in the completion of new power-generating capacity, real GDP has stagnated in the first half of the current year. Real GDP contracted 0.6 per cent in seasonally-adjusted, annualized terms in the first quarter, and this was barely reversed in the second quarter. On a year-on-year basis, growth has slowed to 1.0 per cent in the second quarter, the lowest reading since South Africa exited the recession at the end of 2009.

At the same time, though, inflation has drifted gradually higher and breached the top end of the 3.0 – 6.0 per cent target range in April of this year. Part of this overshoot reflected above-average inflation for petrol and foodstuffs, some of which fortunately is already moderating or likely to moderate in light of lower international agricultural prices or improved domestic crops since the beginning of the year. Nonetheless, underlying prices have also been picking up, and the Bank’s preferred measure of core inflation (excluding food, non-alcoholic beverages and petrol) has climbed to 5.8 per cent as of August 2014, following a sustained uptrend from a low of 3.0 per cent in early 2011. While demand-driven price pressures remain largely absent, amid slowing final domestic demand growth and moderate expansion in credit to households, the marked and sustained depreciation in the rand’s exchange rate since early 2011 has clearly contributed to the upward trend in core consumer prices, which is of concern to the Monetary Policy Committee.

Beyond the challenges posed by divergent trends in growth and inflation, the persistence of negative short-term real interest rates is not desirable from a longer-term perspective, as they could exacerbate existing, or generate new imbalances in the economy. Beyond the well-known impact that negative interest rates can have on the allocation of financial resources to different sectors of the economy, or on the price of financial assets, it also important to point out their impact on the attractiveness of savings, especially in a country like South Africa, where the low level of domestic savings remains a factor behind the elevated structural current account deficit.

All in all, these factors have led the Reserve Bank to embark on a gradual policy normalisation process, though one that remains data-dependent, as it acknowledges the complex factors behind the price outlook. The Bank first raised the repo rate by 50 basis points in January 2014, a decision informed by a significant deterioration in the inflation forecast (indicating the possibility of inflation being outside the target range for an extended period), amid concerns that a sustained depreciation in the exchange rate of the rand would significantly raise the risks to the inflation outlook. Although we had generally observed a lower level of pass-through when compared to previous episodes of currency depreciation, the extent and duration of the depreciating trend meant that the risk profile was worsening. Allow me to reiterate that while the Reserve Bank does not target a particular level or range of the exchange rate, we are nonetheless mindful of the potential negative consequences of accelerated rand depreciation on the outlook for inflation, as well as broad measures of inflation expectations. The January rate hike was followed by a second increase, in July 2014, of 25 basis points, bringing the policy rate to its current level of 5.75 per cent per annum.

Before I leave this part of my speech which looked at recent challenges and developments, I thought, given the audience of today, I should briefly touch on the decision during August 2014, to place African Bank Limited (African Bank) under curatorship, even if I am digressing from the main focus of my speech (being monetary policy), to which I shall return in a few moments.

After an extended period of more intensive regulatory monitoring of and interaction with African Bank, and following a loss of confidence by its shareholders and funders, the Registrar of Banks placed African Bank under curatorship on 10 August 2014, as announced by the Governor. Curatorship was the most suitable legal structure while the enabling legislation for a new regulatory framework, which will include provisions dealing with resolution, is still in the process of being finalised. Some of the support measures recently announced as part of the resolution package for African Bank were informed by the principles contained in the Financial Stability Board's Key Attributes for Effective Resolution Regimes, which are expected to feature in the new legislation. The decisive intervention led by the South African Reserve Bank helped to limit the risk of contagion to the rest of the financial system.

The support measures announced, which are currently being implemented by the curator under the oversight of the Registrar of Banks, are intended to facilitate an orderly, structured, and fair approach to addressing the challenges at African Bank in an effort to secure a viable future on the basis of a transformed business model, while ensuring minimum disruption to our financial and credit markets. At the time of curatorship, African bank's total asset size amounted to R58 billion, or 1.44 per cent of total banking sector assets. However, lessons from the financial crisis indicate that systemic risk should not only be defined with reference to the size of an institution, but also in relation to its "interconnectedness", i.e. links to other banks, financial market participants and financial products.

The proposed solutions were developed in a collaborative process between the public and private sector. The leadership and commitment shown by South African commercial banks and the Public Investment Corporation in underwriting the capital raising for the envisaged "good bank" bears testimony to the strong underpinnings of our banking and financial system, the resilience of which will be enhanced by these measures. The issues around African Bank were unique to the business model of that bank, and it would be incorrect to deduce any fundamental concerns around either the South African banking system or the business of unsecured lending. The South African Reserve Bank wishes to reaffirm that it has no concerns about the quality of South Africa's banking system, which continues to be robust and healthy, based on good levels of capitalisation, liquidity and profitability.

What the road ahead could entail

Where do we go from here? Based on the Bank's projections for growth and inflation over the coming years, and of the uncertainties that surround these projections, it would be reasonable to infer that a gradual, data-dependent, normalisation path remains appropriate. The Bank's most recent inflation forecast indicates that CPI inflation may have peaked at 6.5 per cent in the second quarter, and is expected to average 6.2 per cent for 2014 and

5.7 per cent in 2015, before a (marginal) re-acceleration to an average of 5.8 per cent in 2016, mainly reflecting the assumption of a faster increase in electricity prices. As indicated before, the MPC sees the risks to the headline inflation forecast skewed to the upside, with possible renewed pressure emanating from the exchange rate. Core inflation is expected to remain within the target range for its headline counterpart, reaching a peak of 5.8 per cent in the first quarter of 2015 before moderating to an average of 5.5 per cent in 2016.

At the same time, real GDP growth, which the Bank projects to recover to 2.8 and 3.1 per cent, respectively, in 2015 and 2016 from a subdued 1.5 per cent in the current year, probably will not be strong enough to engineer a quick disappearance of the output gap, notwithstanding uncertainties as to the actual pace of potential growth in the economy. Thus, the persistence of slack would appear to reduce the likelihood that demand-driven price pressures could emerge in South Africa within the near future. The key challenge remains implementing structural reforms that will help lift the potential growth of the economy. Many of these have been identified in the National Development Plan and form part of Government's infrastructure investment plans and other measures, such as those directed at enhancing education and skills, and supporting small and medium enterprises.

Let me touch on some of the risks we see to the inflation outlook. On the domestic front, wage settlements in several key sectors have been well above current and expected inflation rates, and there have been some worrying signs of an apparent de-linking of wage demands (as well as some actual settlements) from underlying inflation and productivity growth trends. On the external front, the Bank is extremely mindful of the potential vulnerability of the domestic capital markets, and the exchange rate, to shifts in international portfolio flows as monetary policy in some major economies, especially the US and the UK, eventually moves towards a more conventional stance. In an environment where South Africa's current account deficit remains elevated and is only expected to narrow gradually over the next two years, the risk of abrupt swings in portfolio flows into South Africa's capital markets cannot be under-estimated.

Implications for South Africa of global financial developments

The experience of the "taper tantrum", as the episode which followed the first clear mention by the US Federal Reserve in May 2013, of the need to eventually wind down its open-ended asset purchases became to be known, illustrated the sensitivity of domestic financial markets to the global backdrop. Between the beginning of May 2013 and its lowest level at the end of January 2014, the rand's nominal effective exchange rate depreciated by as much as 26 per cent, while over the same period, the yield on the benchmark R186 government bond increased by more than 230 basis points. Expectations of future policy action embedded in derivatives like the forward rate agreements, or FRAs, moved in sympathy, with the FRA curve quickly pricing in not just an earlier but also a speedier pace of interest rate hikes by the Reserve Bank.

Part of this selloff probably represented more a re-pricing of risk at longer maturities – i.e. a higher "term premium" – rather than changes in actual expectations of future policy rates. It was indeed striking to see how strong the correlation had become, during the taper tantrum episode, between the longer ends of government yield curves in South Africa and the United States, and this, despite the meaningful differences in economic and policy fundamentals between the two countries. The depth of domestic capital markets, which were able to absorb significant net sales of SA bonds by non-residents (R68 billion from the beginning of May 2013 up to the end of last week, according to JSE data) also played a part. The renewed reduction in that "term premium" in major fixed-income markets in 2014, as policy guidance by the Federal Reserve seemed to reduce investors' uncertainties as to the future path of US rates, probably was a key factor towards the renewed decline in South African yields and the relative stabilisation in the rand since the end of January up until August[1]. Certainly, in terms of communication, central banks have progressed somewhat over the past couple of years, and particularly since the taper tantrum, the associated volatility in financial markets related to monetary policy communication, has also declined.

The big question remains, however, how sustainable is the recovery that we are currently experiencing? Or are we at risk, when US policy rates finally rise in 2015, assuming the median projections of both FOMC members and market participants prove to be correct, of a repeat of the market snapback that we witnessed in 2013? It is not possible to answer this question with a great degree of confidence, for even if we assume that US policy tightening is largely "priced" into markets, the potential for a renewed rise in risk premiums exists, especially in light of the current low levels of implied volatility in a broad range of markets. Nevertheless, several factors could usher in a different scenario from that of the "taper tantrum".

Admittedly, the more the US economy continues on its "healing" path following the shock of the 2008–09 global financial crisis, the more eventual policy normalisation becomes unavoidable, and the less likely it is that the Federal Reserve would delay policy action because of, say, more elevated volatility in the US Treasury market. Nevertheless, the Federal Reserve has equally made it clear that considerable uncertainty surrounds its baseline economic outlook, and that it remained watchful of potential developments that may hinder the US economic recovery. In testimony to the Joint Economic Committee of the US Congress on 7 May 2014, Federal Reserve Chair Janet Yellen referred to some specific risks, indicating in particular that "*one prominent risk is that adverse developments abroad, such as heightened geopolitical tensions or an intensification of financial stresses in emerging market economies, could undermine confidence in the global economic recovery*." Therefore, the pessimists among market participants may err in fearing that US policy normalization will proceed irrespective of global developments, and in particular, of its effect on financial conditions in both the major developed and emerging economies.

At the same time, the global economic recovery remains highly uneven, and this has translated into a growing policy divergence between the major central banks. In particular, the Eurozone has in recent quarters experienced a renewed loss of economic momentum and a drift in inflation rates towards very low levels, which have prompted the European Central Bank to provide additional accommodation, first in the form of targeted long-term repo operations, and then via the announcement of a programme to acquire asset-backed securities and covered bonds on the central bank's balance-sheet. The mix of lower Eurozone inflation and expectations of additional central bank liquidity appear to have been key in driving Eurozone government bond yields lower this year; and in turn, this may be another reason why yields on major emerging bond markets, like South Africa, have also trended lower. Provided, as the market consensus expects, that there is no quick reversal of current inflation and policy trends in the Eurozone, developments in that region may continue to dampen, in the future, the impact of US policy normalisation on flows into, and prices of, SA financial assets.

Whatever the outcome and wherever we may find ourselves next year this time, I believe a lot of progress has been made by policy makers around the world, and particularly within the G20, where there is greater cooperation and greater awareness and efforts made towards understanding the impacts of policy actions across countries, in particular the spill overs and feedback loops and therefore how this might influence not only individual countries but also the global growth trajectory. Our level of crisis preparedness has also been enhanced through various global financial safety nets which have been strengthened since the crisis,

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1 Between the end of August and end September, the ZAR depreciated from 10.66 to 11.30 against the USD as strong economic data from the US resulted in the market pricing in the possibility of a more aggressive monetary tightening by the Fed.

not just in terms of the IMF toolkit, but also regional financial safety nets, and more recently, the BRICS Treaty on the Contingent Reserve Arrangement, which was signed by the BRICS countries at the Fortaleza Summit in July this year.

We can also be optimistic about the efforts of the G20 to lift global growth and ensure that this growth is more balanced and sustainable. As you may know, the G20 is committed to developing new measures that aim to lift our collective GDP by more than 2 per cent by 2018 above the trajectory implied by policies in place at the time of the St Petersburg Summit in 2013. We have been working hard towards this goal during 2014, and have made some headway in developing growth strategies that talk to this ambition. As indicated in the most recent communique in Cairns, preliminary analysis by international organisations such as the International Monetary Fund and the OECD indicates that measures committed to thus far by G20 countries will lift our collective GDP by an additional 1.8 per cent through to 2018, including from important positive spill overs. We also continue to focus on the need for global rebalancing and appropriate macroeconomic policies as a means to achieve strong, sustainable and balanced growth. We trust that by the time of the Leaders' Summit in November, additional commitments made will lift this number to 2 per cent. Structural reforms will be important in lifting growth, reducing unemployment and enhancing trade. These commitments will not just end there, as there will be a process for monitoring and ensuring implementation.

Conclusion

To summarise, it would seem that South African monetary policy will continue to face conflicting challenges, with respect to both the economic growth and the inflation outlook, in the times ahead. A global economic recovery would normally improve the domestic economic outlook and create a more stable backdrop for domestic policy normalization, however, it is at risk from the present lack of sustained economic upswing in regions like the Eurozone or Japan. Rising US policy rates risk complicating the financing of South Africa's current account and placing pressure on the rand, however, this upside risk to inflation could be mitigated by the very consequences of slow growth in some of the world's major regions, mainly the pursuit of stimulative monetary policies.

These conflicting challenges, and the uncertainties that surround them, call for particular vigilance on behalf of monetary policy-makers, and for a readiness to adapt one's monetary stance to a changing macroeconomic environment. At present, the Monetary Policy Committee remains of the view that interest rates will have to normalise over time. While the balance is delicately poised with regard to the timing of any policy adjustments, and requires careful judgement to avoid pre-mature action in the wake of an already weak economic growth environment, it is similarly important that the Bank, in following a forward-looking approach to monetary management, does not allow any doubting of its preparedness to act when necessary and in keeping with the commitment to its primary objective.

Thank you.