# Daniel Mminele: Normalising monetary policy in an uncertain world – the outlook for monetary policy in South Africa

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Bank of America Merrill Lynch Fixed Income conference, Johannesburg, 28 November 2014.

*   *   *

## Introduction

Good morning ladies and gentlemen. Thank you to Bank of America Merrill Lynch for inviting me to address you on the issue of monetary policy normalisation in an uncertain world. This must be the single-most important issue that central banks around the world have been grappling with for quite a while now.

We are now in the sixth year post the global financial crisis (GFC). Six years seems rather instructive, because this is approximately the amount of time of that Reinhart and Rogoff originally suggested it would take to recover from the financial crisis.[1] There is now a fairly strong consensus view among economists across the world that the US has paid its dues and set itself up for a period of economic growth and subsequent monetary policy normalisation.

In the case of the US, normalisation is generally taken to mean that the Federal Reserve (Fed) will stabilise the size of their balance sheet, raise the Federal Funds rate and allow the yield on US treasury bonds to move more freely. As a consequence of the US's favourable interest rate and growth differentials *vis-a-vis* the rest of the world, the US dollar is likely to continue to strengthen as capital flows back to higher yielding opportunities in the States.

Although normalisation and the consequent moves to higher policy and bond rates are probably one of the most expected and anticipated consensus trades that the collective market has ever anticipated, two things remain uncertain – namely timing and the degree of adjustment, both in the US and elsewhere. In a normalising yield environment in the US, most investors expect emerging market (EM) currencies to come under pressure – particularly of those EMs running large (twin) deficits and vulnerable to capital flow reversals. South Africa is unfortunately part of this latter group of countries.

If this is not challenging enough, we are also faced with stagflation – i.e. low growth and high inflation. On the one hand US policy normalization suggests that we need to tighten policy, but on the other hand raising rates carries the risk of weakening our own already weak recovery. Consequently, the combination of an uncomfortably high current account and fiscal deficits requires a pragmatic and balanced policy response that will contribute to a more sustainable growth path for our economy.

In an effort to do justice to the topic I was asked to address today, I will try and assess how we got into this unpleasant juncture, and what policy can do about it.

But let me first say a few words about monetary policy in major advanced economies and its effect on South Africa, given just how important a swing factor this is for our policy considerations.

[1] Carmen M. Reinhart and Kenneth S. Rogoff examined the evolution of real per capita GDP around 100 systemic banking crises. They found that on average, it takes about eight years to reach the pre-crisis level of income; the median is about 6½ years. See American Economic Review Papers and Proceedings, May 2014; Recovery from Financial Crises: Evidence from 100 Episodes* http://www.nber.org/papers/w19823.

## Diverging policies global monetary policies

We know that the onset of the global financial crisis saw a synchronised response by central banks across the world. There was a coordinated effort to loosen monetary policy to cushion the world economy against what would probably have been a devastating collapse. These accommodative policies have indeed succeeded in helping to protect against a protracted global recession, and have also underpinned a global economic recovery. However, the pace and extent of recovery has been uneven, which has resulted in diverging policies across the major developed economies.

After a disappointing start to the year, the ***US*** economic performance has been better than expected in recent quarters. The weather-related contraction of the first quarter was followed by a strong rebound in growth in the second quarter, with the strong momentum maintained into the third quarter. The economy is estimated to have grown at a better-than expected 3,9 per cent in the third quarter, with leading indicators such as the PMI pointing to strong growth in the final quarter of the year. The job market has also improved considerably, with the unemployment rate declining to 5,8 per cent in September, the lowest level since June 2008. In line with this stronger than expected performance of the economy, the Fed concluded its quantitative easing programme in October and this has raised expectations of a policy rate hike in mid-2015. The pace and timing of normalisation of policy rates, as repeatedly stated by the Fed, will largely depend on the economic and inflationary developments and the Fed's interpretation thereof. With a lot of slack still remaining in the US labour market, one would expect the Fed to be cautious to not impede the recovery by moving too soon and too aggressively. Inflationary pressures are also expected to remain largely contained by a strong dollar and lower energy costs. The Fed will therefore face a less difficult trade-off between above-target inflation and consolidating growth. As such, the base case appears to one of a gradual normalisation of the Fed's policy rate.

The ***UK*** recovery also appears to be on track, with the economy growing 2,8 per cent in the third quarter and the unemployment rate falling faster than expected, reaching 6 per cent at the end of the third quarter. Although the Bank of England has maintained its asset purchases at £375 billion and interest rates at 0.5 per cent, sentiments are slowly shifting with some policymakers starting to vote for a policy rate hike. However, with the decline in the inflation rate to below the 2 per cent target, faltering growth in Europe, and soured trading and financial relations with Russia, a delay in policy normalisation appears likely.

In contrast to the positive developments in the US and the UK, growth in the euro area and Japan has stalled, with policymakers in these countries indicating their willingness to take strong remedial action to mitigate against a protracted recession and extremely low inflation.

The outlook for the ***euro area*** has deteriorated over the year, with growth forecasts by the European Commission having been revised downwards in November, from 1,2 and 1,7 percent to 0,8 and 1,1 per cent for 2014 and 2015 respectively. More worrying has been the shift of the weakness from the periphery to the core, notably France and Germany. The euro zone is also battling with extremely low inflation, with CPI growing by a meagre 0,4 per cent in October, uncomfortably close to deflation and far below the ECB's target of close-to-but-below 2 per cent. The ECB has responded to these challenges by cutting its policy rate further in September and introducing a new stimulus plan[2] involving the purchase of investment-grade asset backed securities issued by the non-financial private sector as well as covered bonds of the financial sector. And we have had strong indications from policy makers again during this week that should these measures prove to be insufficient, the

---

2 The ECB expects that the purchases of asset-back securities and covered bonds under the new programme, together with the targeted longer-term refinancing operations (announced in June 2014), would increase the size of its balance sheet by roughly 1 trillion euros to 3 trillion euros, a level last seen in early 2012.

Governing council will consider in the first quarter of 2015 whether to embark on a sovereign bond purchase programme.

***Japan's*** economic performance has also disappointed, with the hike in the value-added tax (VAT) partly to blame. Pre-emptive buying ahead of the VAT increase in the first quarter of the year resulted in a positive performance, but this was followed by contractions in the second and third quarters, pushing the Japanese economy back into recession. Furthermore, although inflation is above the 2 percent target, this is largely due to the VAT increase and inflation is expected to fall in the early months of 2015. In response to recessionary conditions and still muted inflation, the Bank of Japan (BOJ) responded by raising its monetary expansion programme in October by an additional ¥10–20 trillion to ¥80 trillion (an equivalent of just under US$700 billion) per year.

Clearly, we are seeing a divergence of policy in the major advanced economies. This suggests that central banks need to weigh the spill-over effects of tightening policy in the US against accommodative policies in Europe and Japan in determining their own monetary policy trajectories. Our sense is that the impact of US tightening will dominate, but that it would be tempered somewhat by ECB and BOJ stimulus plans.

However, it is clear that global financial conditions have become less hospitable for countries with large external financing requirements. This process has already delivered a bumpy ride for South Africa, as it has for some other countries.

## Impact of normalisation on South Africa

Like most emerging markets, South Africa benefited from the massive liquidity injection into the global financial market following the Great Recession. Inflows of capital meant that the current account deficit was comfortably financed, while it also resulted in significant appreciation of the rand. This in turn helped to contain inflation, allowing room for accommodative monetary policy over a fairly extended period. However, these trends started to reverse in May 2013 in anticipation of US monetary policy normalisation, following indications to that effect from the Fed. This saw a widespread depreciation of emerging market currencies, which intensified with the actual implementation of the US Federal Reserve's asset purchase tapering programme starting from January 2014.

The rand depreciated quite sharply in line with emerging market currencies, with the weakness exacerbated by a widening current account deficit. The rand weakness contributed to rising inflationary pressures, with inflation breaching the 6 per cent target in April and reaching 6,6 per cent in May and June before retreating to 5,9 per cent in September and October. The moderation in food and petrol prices contributed to lower inflation outcomes in recent months. In particular, the abrupt and significant decline in international oil prices to below US$80 per barrel in November has had a positive impact on the medium term inflation outlook. The Bank's latest inflation forecast reflects an improved outlook, with headline inflation now expected to average 6,1 per cent and 5,3 per cent in 2014 and 2015 respectively, compared with the previous forecast of 6,2 per cent and 5,7 percent. However, there is a lot of uncertainty around the sustainability of the decline in oil prices, while the exchange rate also continues to pose upside risks to the inflation outlook, as it still remains vulnerable to changing perceptions about global monetary policy normalisation, and the large current account deficit. As we have indicated previously, wage settlements that are de-linked from inflation and underlying productivity trends also pose an upside risk to the inflation outlook. Furthermore, the Bank remains concerned about the elevated level of core inflation which remains close to the upper target level.

Domestic growth outlook also remains weak. The economy contracted by 1,6 per cent in the first quarter and grew by a marginal 0,5 per cent in the second, with much of this weakness due to prolonged strikes in the mining and manufacturing sectors amid already weak global conditions. Growth improved to 1,4 per cent in the third quarter, however this was off a low base. The Bank revised its growth outlook for 2014 downwards to 1,4 per cent, as

announced after our most recent MPC meeting last week, compared with 1,5 per cent previously. The 2015 and 2016 projections were also downgraded from 2,8 per cent and 3,1 per cent respectively to 2,5 per cent and 2,9 per cent. Domestic growth prospects remain constrained by short-term and long-term structural supply factors such as strike activity, rising input costs and electricity shortages, as well as slowing consumer demand. Falling commodity prices and weak economic conditions in the country's major trading partners also add to this subdued outlook.

The combination of uncomfortably high current account and fiscal deficits (in the face of global monetary policy normalisation), high inflationary pressures, and weak domestic growth pose a challenge for both monetary and fiscal policy. These have required a balanced policy response in an effort to ensure a sustainable growth path for our economy.

**So how is South Africa doing?**

Let me quote you a paragraph from last week's Economist magazine:

> *"It was great while it lasted. In a golden period from 2003 to 2010 …. economies grew at an annual average rate of close to 5%, wages rose and unemployment fell, … people were lifted out of poverty and the middle class swelled…. But now the growth spurt is over. What some worried would be a 'new normal' of expansion of 3% a year is turning out to be far worse. The …economy will on average grow by only around 1.3% this year."*[3]

No, in this case the Economist is not referring to South Africa – the quote is actually for the Latin American region. But it is very much also our own story. Indeed, the ongoing emerging market slowdown serves to remind us of the protracted nature of previous crisis episodes, including the 1997–1998 Asian crisis and the 2008–09 world financial crisis. However, there are limits to similarities among EMs, which may lead to differentiation when assessing countries.

For example, South Africa's export performance relative to a number of peers remains poor – irrespective of whether they are commodity exporters (Australia), or have also experienced significant exchange rate depreciation (India, Turkey), or both (Brazil and Chile). The fact that South Africa has grown its exports less than its peers, implies that the domestic economy is suffering from something more than weak global demand and declining commodity prices.

South Africa's weak performance is also visible in the country's declining share of world exports, which declined from around 0.7% of world merchandise exports to 0.55% over the last 10 years. Perplexingly, SA's portion of global exports has remained roughly stable since 2011, at about the level last attained at the height of the Great Recession, despite pronounced currency depreciation over that entire period.

With global growth – particularly in the EU, our largest trading partner – under severe pressure, we increasingly relied on the domestic non-tradeables sector to prop up domestic growth as it would have been difficult to ramp up exports.

Unfortunately not all growth is equal. The quality of growth matters at least as much as the quantity of growth, and there are reasons to believe SA's non-tradeable growth in the post-crisis years has been of inferior quality. It has been driven by consumption, not investment, which has been financed by debt, meaning it reduces future consumption and investment

[3] The Economist, "The great deceleration: The region's economies have slowed far more abruptly than anyone expected" 22 November 2014. See http://www.economist.com/news/americas/21633940-regions-economies-have-slowed-far-more-abruptly-anyone-expected-great-deceleration.

capacity. Furthermore, the growth has been based on large quantities of imported inputs, resulting in an unsustainable current account deficit.

Credit growth to the private sector appears sustainable and consistent with macroeconomic fundamentals. Since the first quarter of 2011, credit extended to households increased by 22.3 per cent (or 4.9 percent when deflated with headline CPI), slightly less than the 6% increase in GDP over the same period. Household credit has weakened quite significantly in recent months, with growth slowing to an annual rate of 3,7 percent in September compared to 7,5 percent in the same month last year. However, the moderate overall increase in credit could be masking several unwelcome developments.

For instance, "good credit" extended for mortgages increased by much less than other categories, notably instalment sale credit (mostly used for vehicle financing) and unsecured credit. With credit extended to households shifting from relatively low interest (and lower margin) mortgages to more profitable (higher margin) categories, it is not surprising that the real value added in the financial sector also increased by a cumulative 9.5 percent since 2011q1 – on par with the real growth recorded in the retail sector. In fact the retail and finance sectors together contributed almost 60 percent of GDP growth since 2011q1 – significantly larger than their 37 percent share in GDP.

The growing size of the non-tradeables sector may also explain a weakening economy-wide response to a weaker real exchange rate.

### Potential growth has slowed

Another reason why South Africa has so far experienced a relatively weak recovery from the 2008–09 recession, relates to faltering potential growth. According to the OECD, "estimating potential growth rates is always an imprecise exercise, and all the more so for a country (such as SA) with such a high rate of inactivity and where the responsiveness of wage and price inflation to changes in unemployment is low. In addition, in recent years the task has been further complicated by uncertainty over the extent to which electricity supply limitations have constrained potential output growth in South Africa".[4]

Replicating work by Borio, Disyatat, and Juselius (2013, 2014) at the Bank of International Settlements (BIS), which incorporates financial cycle characteristics into the estimation, some estimates suggest that South Africa's potential growth rate declined from 4 per cent in 2007 to around 2½ per cent in 2013, compared to earlier estimates which suggested that current potential growth rates was around 3 to 3½ percent[5]. This development is not unique to South Africa as several studies show that potential growth may have been over-estimated in many emerging market economies.

### Monetary policy response

The operating environment for South Africa's monetary policy has become increasingly complex, with growth and inflation dynamics being influenced by a range of global and domestic factors, which call for delicate trade-offs in terms of policy settings.

Recent developments suggest that the period of relatively low volatility has come to an end. Market participants and policy makers now have to grapple with the possibility or risk that the lift-off of rates in US may occur sooner than they anticipate, while in Japan and the Eurozone more easing seems to be on the way, while risks assigned to geo-political risks, which the

---

[4] OECD (2013), *OECD Economic Surveys: South Africa 2013,* OECD Publishing. See http://www.oecd-ilibrary.org/economics/oecd-economic-surveys-south-africa-2013_eco_surveys-zaf-2013-en.

[5] Anvari, V., R. Steinbach, and N. Ehlers (2014). A semi-structural approach to estimate South Africa's potential output. South African Reserve Bank Working Paper WP/14/08.

market seems relatively relaxed about, may intensify. All these factors are likely to increase volatility. Recent experience has shown us how sensitive our domestic market are to the international backdrop. Against the background of South Africa's elevated current account deficit, which is expected to only correct slowly, the risk of abrupt swings in capital flows cannot be under-estimated.

This environment calls for continued vigilance from policy makers, and preparedness to respond to the fast-changing economic and financial markets environment, and readiness to act to changes one's monetary policy stance when deemed appropriate. It also calls for ongoing dialogue, exchange of information and appropriately calibrated communication in order to strengthen policy credibility. As you are aware, we embarked on a gradual, data-dependent, policy normalisation process at the beginning of this year, which will continue, but will also take account of the unfolding situation as it affects the inflation trajectory and growth dynamics. More recent developments on the inflation front have been encouraging and resulted in an improved headline inflation forecast, which gave the MPC some flexibility in the short-term, while it expressed concern about sticky core inflation, and reiterating that the need to over time realign our real interest rates better with our emerging market peers remains.

As indicated in our MPC statement last week, the timing of future interest rate increases will be dependent on a range of factors, including the evolution of inflation expectations, the timing and speed of normalisation of monetary policy in the US and the state of the domestic economy.

As we have said before, while monetary policy should and in South Africa will play its role within the confines of its mandate, a concerted effort is needed by other key role players in agreeing and effectively implementing the necessary structural reforms that will deliver higher trend growth.

Thank you.