Lesetja Kganyago: Monetary policy and South Africa's economic objectives

Keynote address by Mr Lesetja Kganyago, Governor of the South African Reserve Bank, at the Fedusa Collective Bargaining Conference 2015, Muldersdrift, 17 February 2015.

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Good morning ladies and gentlemen.

Thank you for inviting me to address you today as you prepare to participate in collective bargaining across a range of industries. In particular, I would like to thank Mr. Koos Bezhuidenhout, the President of Fedusa and Mr. Dennis George, General Secretary of Fedusa. The South African Reserve Bank has enjoyed a healthy and productive relationship with your Federation for many years, a relationship I wish to continue.

You have asked me to address the pertinent question of whether monetary policy is still supportive and accommodative of South Africa's economic objectives. My emphatic answer to the question is yes, monetary policy is still accommodative and supportive of South Africa's economic objectives. In elaborating on this short answer, I will discuss three broad issues. Firstly, what is the mandate of the Bank in achieving South Africa's economic objectives? Secondly, I will explain in an historical context why monetary policy at the present moment is highly accommodative; and thirdly, I will discuss some of the longer term policy challenges confronting workers and the South African economy in general. This third part of the answer will provide some context, both in answering your question and points for you to ponder as you prepare for the next round of collective bargaining.

The Constitution mandates the Bank to protect the value of the currency in the interests of balanced and sustainable growth. The value of the currency in your pocket is its buying power. Our aim is to maintain the buying power of each rand you earn or have saved. We do this by aiming to keep inflation low. Hence our primary mandate is price stability. The Bank also plays a key role in regulating the financial sector with the aim of maintaining financial stability. We do this to protect workers and the economy from shocks that may arise in the financial system.

Why do we pursue price stability and how does this objective fit into South Africa's overall economic objectives? Indeed, you may legitimately ask, what does balanced and sustainable growth mean and is low inflation a prerequisite for balanced and sustainable growth? These are critical questions in understanding South Africa's economic policy architecture. There are very few things that economists generally agree on. The necessity of price stability for the sound functioning of an economy *is* one of the few elements of economics that most economists agree on. With about two hundred years of evidence and hundreds of countries as natural experiments, countries with low and stable inflation generally grow faster and more sustainably over a longer period of time than countries with higher inflation or erratic price changes.

Since these conversations take place not only here in South Africa, but also in other parts of the world, allow me to quote Mark Carney, the Governor of the Bank of England addressing the 2014 Trade Union Council congress in the UK:

"By maintaining price and financial stability, we put in place the foundations for sustainable job creation and income growth. Stability gives workers the confidence to invest in skills or to change jobs. And it gives firms the confidence to hire new workers, invest in new equipment, introduce new products and pursue new markets. We need workers with the right skills and we need companies taking strategic initiatives to grow productivity. That productivity is needed to ensure real wage increases over the medium term."

These words although referring to the UK economy, they could be easily applicable to the South African economic situation as well. We pursue price stability not because it is good for government or for the financial sector. We pursue price stability because it is good for workers, for job creation and for poorer sections who lack the means to hedge or to protect themselves against inflation.

It is true that there can be short term economic and indeed employment benefits from more accommodative monetary policy. It might be the case that if we lowered interest rates substantially, for a short period of time, consumption and possibly employment would rise. If, however, the economic conditions do not warrant such policy, then the effect will be temporary. Worse still, the effect could be to raise employment for a short period of time only to lower it by much more a few quarters down the road. South Africa, under apartheid, had a history of boom bust episodes. So yes, it is possible to increase employment with monetary policy and monetary policy has a special role to play to support employment during economic downturns. Monetary policy, however, cannot affect the level of employment over the longer term.

Monetary policy is only one aspect of economic policy. Together with fiscal policy and exchange rate policy, form our macroeconomic policy stance. Our priority for macroeconomic policy is to provide a stable environment for business and workers to pursue growth, employment and investment opportunities. If we do our job well, we create a foundation for sustained prosperity. Without such a foundation, sustained wealth creation by households is unlikely. Despite its fanciness, macroeconomic policy has little influence over the level of potential or trend growth. Therefore, we actually play little role in the size or speed of wealth accumulation or employment creation.

Other policies, policies ranging from education to broadband connectivity, economic regulation to agriculture, trade policies and the quality of infrastructure (especially electricity provision) all play a role in determining the speed limit or potential growth of an economy.

It is important for policy makers, such as ourselves, to understand the limits of our powers, but it is also important for South Africans to understand the limitations of, in this case, monetary policy.

Most countries, including our own, have independent central banks because it could sometimes be in the short term interests of governments and even firms to borrow from tomorrow to deliver goods today. Naturally, a key role of the financial sector is to intermediate between savers and borrowers, including between generations. However, some economic actors have the power to borrow more from future generations than they have the capacity to repay. Governments do this by running unsustainable budget deficits. Firms could pursue short term profits but leave society with longer term costs; such as with events that led to the financial crisis. The task of the Reserve Bank is to dissuade governments, firms and households when they attempt to borrow too much from tomorrow. Because this is sometimes a politically difficult task, our Constitution assigns this role to an independent central bank.

Government has a set an inflation target of between 3 to 6 percent. They set this target because, at the time that it was set, this target was broadly in line with the inflation rates of our major trading partners. It is important that we keep our inflation rate broadly at these levels. If we fail to do so, it means that we are losing competitiveness. Some unions and indeed some workers argue that inflation doesn’t matter. Whether inflation is 5 percent or 20 percent, they say, I’ll still get an inflation-related salary increase at the end of the year, so I am okay. This is patently untrue and I will illustrate with an example. If inflation is 20 percent a year, it means that prices rise by about 1.5 percent a month. Each month, the purchasing power of your salary is eroded by 1.5 percent. By the twelfth month, just before your salary increase, you would have lost a major part of the buying power of your monthly salary. Let’s assume that at the end of each year, you receive a 20 percent salary increase. After five years, your purchasing power has been eroded by a cumulative 40 percent; even though you think you are doing fine because you receive an annual salary increase equal to inflation. Now let's assume that inflation averages 5 percent a year for those five years. After 60 months, the cumulative loss of purchasing power is about 10 percent; a loss nonetheless, but a far smaller one. This simple example illustrates that higher inflation is not good for workers, even if your salary gets topped up by inflation each year. Lower inflation is more conducive to rising real incomes. Lower inflation begets lower interest rates; higher inflation begets higher interest rates.

Having made the case for low inflation, let me also argue that the Reserve Bank is not populated by inflation nutters. Within our mandate, we have been tolerant of periods of higher inflation when we think that higher inflation would be temporary or has been caused by an external shock. There have been several periods in the 15 year history of inflation targeting where inflation increased either because of once-off shocks to the price of fuel or food or because of a sharp exchange rate movement. Our pattern has been to see through the first round effects of such shocks and to respond only if we think that there is a likelihood of second round effects (that is, a feed through into more generalised inflation) or if we think inflation would be permanently higher as a result of the shock. In 2013, inflation breached the target band for one quarter. We did not raise interest rates. In 2014, inflation breached the target for much of the year. Over 2013 and 2014, the rand depreciated by over 40 percent. Notwithstanding the breach of the inflation target and the risks of an even longer breach posed by the exchange rate; we raised rates by a modest 75 basis points. That demonstrates the benefits of our flexible inflation targeting framework.

The SARB has been accommodative, without compromising our primary mandate. In historical terms, South Africa's interest rates are lower in real and nominal terms than at any point in our recent economic history. It is true that there were periods during the late 1970s and 1980s when real interest rates were negative. In our view, negative real interest rates for such a long time structurally damaged the savings performance of the economy. In 2008, when the impact of the global financial crisis became evident, we reduced interest rates sharply to 5.5 percent. In 2009, inflation spiked to over 11 percent, leaving real interest rates highly negative. As the crisis abated, real interest rates increased, but remained negative for several years and only in late 2014 did they become positive.

In our view, this was the correct response to the global financial crisis. It helped mitigate the effect of the crisis on workers and on firms. Together with counter-cyclical fiscal policy, monetary policy helped to support the recovery. But real interest rates cannot remain negative for ever. They were a specific response to an economic crisis. Over time, interest rates will have to normalise. It is unsustainable to provide savers with negative returns while enabling borrowers to borrow at artificially low rates forever. As pointed out earlier, the long period of negative interest rates in the 1980s structurally damaged South Africa's savings performance; a trend we are yet to truly recover from.

Workers of the world have not had a good millennium. In general, workers have seen increased job insecurity and depressed wage growth, while younger workers have found it hard to break into stable, formal employment. There are three broad factors that explain this negative situation for workers. Firstly, the fall of the Berlin Wall and China's embrace of the global trading system saw over a billion workers enter the global economy. This greater competition amongst workers depressed wages for most workers around the world. Secondly, work has become more skills intensive, implying higher rates of return for skilled workers and, in many cases, falling returns for lower skilled workers. These pressures were partly offset by lower-priced goods from China and from an abundance of credit for workers. Then came the financial crisis; a direct result of global imbalances and an excess of credit in advanced economies. Since the financial crisis, employment gains have been modest whilst income growth has stagnated. Increased globalisation and financial integration has increased the returns to capital, further pressurising workers' wages.

While South African workers have had to bear the consequences of these global trends, the picture in South Africa has some interesting nuances. In general, workers' wages have increased in real terms throughout this millennium; albeit at a slower pace than profit growth. In South Africa, the bulk of these global adjustments have been placed on young workers, new entrants and those with minimal skills. Unlike in many other countries, workers' wages in South Africa did not fall during the global financial crisis. In SA, the burden on the crisis was felt on vulnerable workers and on new entrants into the labour market. Most of the one million or so workers who lost their jobs in 2009 were young, unskilled and new entrants into the workplace. In many ways, we traded better pay for fewer jobs, a trade-off that has significant social consequences for the present unemployed and for future generations.

Unemployment is South Africa's single biggest challenge. It is simply unsustainable to run an economy when fewer than half of all adults are in employment. The inevitable social strains will quickly undermine even the best of policies and drag the country down. South Africa's unemployment challenge is neither new nor under-analysed. We know what the problems are and we know what to do about them. The National Development Plan provides a comprehensive diagnostic analysis of our challenges and a plan to remedy these flaws. In the main, key structural rigidities in the economy include poorly functioning labour markets, uncompetitive product markets, a poor skills profile, spatial development patterns that exclude the poor and a low savings ratio which makes us heavily reliant on foreign capital flows, which are often fickle and short-term in nature. These structural rigidities occur on top of already high levels of poverty, inequality and unemployment; the major legacies of apartheid.

South Africa's recovery after the financial crisis was in line with the global recovery. Economic growth recovered to 3.0 percent in 2010 and to 3.2 percent in 2011. Since 2011, our economy has slowed again. There is an international and domestic dimension in explaining this slowdown. Globally, the recovery began to falter in late 2011 with Chinese growth slowing, commodity prices falling and Europe re-entering recession territory. Europe and China are our two largest export markets. Slower growth there and in particular falling demand for commodities has impacted on our growth levels. Since its peak in 2011, the platinum price has fallen by 35 percent, coal prices by 49 percent and iron ore prices by 63 percent (in dollar terms). Added to this mix, the past three years have seen unprecedented volatility in global financial markets, impacting on the rand exchange rate and on capital flows to emerging markets. Depending on whether it is a risk on or risk off day in the markets, the rand could strengthen or weaken by over a percentage point in a day.

In addition to these global factors, domestic growth has been weak because of our own own-goals. Lengthy and sometimes violent strikes, electricity supply constraints, perceived or real concerns about economic policies and a slow breakdown in trust between major social partners have deducted from growth and investment. In 2012, the Marikana strike and its consequences knocked exports as well as confidence; confidence in our ability to manage our social stresses. In 2013, the motor industry strike and related strikes in the automotive component sectors and transport sectors knocked over 0.5 percent off our growth. In 2014, the five-month-long platinum strike and the four week manufacturing sector strike knocked over one percentage point off our GDP growth.

While electricity constraints have become more binding in recent months, the lack of supply capacity has cost us foregone investment for much of the past five years. National Treasury estimates these costs to be about 0.3 to 0.4 percentage points of GDP a year, and this was before load-shedding resumed in December 2014. Lower electricity capacity for the next three to four years is a major reason behind the Bank's downward revision to GDP growth for 2015 from 2.5 percent to 2.2 percent. We hope that business, labour and government can join together to manage the electricity constraint in a manner that does least damage to the economy.

Strike activity and a slow breakdown in trust between major social partners have impacted on business confidence and hence on investment. Add to this weak consumer demand, and it appears as though the economy is in a rut: weak demand leads to low investment, weak investment means no growth in employment and household incomes.

How does one break out of such a rut? There is little space for macroeconomic policy in this context. Fiscal policy, having been used successfully to offset weak demand for six years has reached its limits. A failure to consolidate the fiscal position would leave the country vulnerable in the face of another global shock, and if the country's credit rating is further downgraded, would raise borrowing costs for the entire economy. Fortunately, in the 2014 MTBPS, the Minister of Finance outlined a clear path towards fiscal consolidation in South Africa. Monetary policy is constrained by the fact that inflation has either been close to or above the target band for a significant period over the past two years.

In the absence of macroeconomic policy space, which has to be gradually rebuilt, faster employment and economic growth can only come about through selling more to the rest of the world or through implementing the well-known structural reforms outlined in the NDP to get us to a higher growth path.

The lower oil price does provide us with a shot in the arm. It will boost the economy through greater discretionary spending amongst households and through a lower imported fuel bill. If however, because of the tighter electricity constraints, the economy cannot supply the additional goods demanded, the benefit to the economy may be smaller than we think. The lower oil price provides an opportunity for households to pay down debt.

Furthermore, even though the lower oil price provides a boost to consumers, lower prices for our key export commodities such as coal, iron ore and platinum mean that South Africa loses out on valuable export earnings. Because the prices of both imported oil and exported commodities have fallen, the net positive effect for South Africa is still positive, but minimal.

The benefit from the lower oil price, even if it is to be realised, is likely to be temporary, for two reasons. Firstly, unless oil prices continue falling, the lower oil price provides a once-off reduction in inflation. We do expect the oil price to recover, and so it has recently, rising by over 25 percent from its low point in January. We expect oil prices to recover further, even though we do not think it would go back up to $100 a barrel anytime soon.

The second reason why we think that the benefit from the lower oil price is only transitory is that price setters in the economy do not appear to be using the lower oil price and lower inflation in the present to lower price expectations about the future. Put bluntly, even though inflation in January came in at 5.3 percent and the February number is likely to dip below 4 percent, average wage settlements are still in the realms of 8 percent. Similarly, many price setters for goods and services are not passing on the benefits of lower prices to consumers. A classic example is taxi fares. Do they ever come down when petrol prices fall? Another example is retailers, who are quick to adjust their prices in response to rising distribution costs when the fuel prices rise, but not so quick to reduce them when fuel prices fall. The reason why these prices remain high even with lower cost structures suggests that there is a lack of adequate levels of competition in some of these industries.

If however, we can dream; and lower fuel prices *are* passed on to consumers and lower prices *are* reflected in lower nominal salary settlements, then inflation could be structurally lower than it has been. This would give the Monetary Policy Committee serious food for thought and in general would imply lower rates or at least a more gradual normalisation of interest rates. It could be a win-win-win scenario. If only we could dream!

The South African economy is in a difficult space. We are negatively impacted by global developments, especially in Europe and in China. Combined with domestic concerns that I have outlined earlier, we do not anticipate robust economic growth or employment creation in the medium term. We hope we are wrong. It is possible for South Africa to enter a virtuous cycle of rising confidence, rising investment and stronger growth fuelling employment gains;

leading to still higher levels of confidence. It will require strong leadership across the economy to create such a virtuous cycle.

Let me turn more directly to the challenges of collective bargaining. Wage negotiations and the process of wage setting are important in the central bank's thinking because wages are a key price in the economy. You would have often heard central bank governors decry periods when salary settlements are in excess of inflation and productivity growth. I would like to make clear what the Bank's thinking on this matter is. We are not opposed to workers receiving real salary increases. Firstly, we feel that there should be an equitable sharing of productivity gains between workers and investors. An unequal sharing of such gains in either direction is unsustainable. Secondly, there must, especially in the South African context, be an appropriate sharing of productivity gains between workers and senior managers. Thirdly, productivity gains should be shared between existing workers and new additions to the workplace. If existing workers take all the productivity gains, then there is little scope to increase employment.

The trend in recent years in South Africa has been for workers to receive salary settlements in excess of inflation and productivity gains. Firms respond to this situation by reducing staff numbers. This is clearly an unsustainable and undesirable development.

The simple point that successive Reserve Bank governors are making is that in general, lower inflation enables larger real salary increases and higher productivity leads to higher incomes, higher investment and more employment.

In conclusion ladies and gentlemen, I would like to leave you with a lesson from John Nash, who won the Nobel prize in economics for his work on game theory. His simple lesson is as follows: In a one shot game, a player may win by cheating or by deceit (withholding information from an opposing player). However, in a game with multiple rounds, the best strategy to survive and win is by always being trustworthy and by cooperating. If you have to approach wage negotiations as a one-shot game, you could probably win by taking the most reckless or deceitful strategy. However, in the world where there are repeated rounds, the best strategy is to build trust by being open about one's intentions and building a cooperative relationship. It is about taking a long view. I appeal to you as you enter into this round of bargaining by taking a long view. This call is not just to workers but also to the employers and other price setters in the economy to take a long view; as such an approach is in our collective best interest.

Thank you.