Daniel Mminele: South African monetary policy amidst an uncertain and volatile global economic backdrop

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at The Economist Annual Investment Agenda Conference, Johannesburg, 20 October 2015.

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Good morning ladies and gentlemen.

Thank you to the Economist for the invitation to deliver the welcome keynote address at “The Investment Agenda Johannesburg 2015”. The first part of the title of the Investment Agenda, “No Man Is An Island”, is taken from a poem of John Donne. To quote a little further from that poem: “No man is an Island, entire of itself; every man is a piece of the Continent, a part of the main…”

This expression can be related not only to our personal lives, but lends itself particularly well to the world of financial markets and economics. Each part of the economic and financial system, while separate, is driven by similar factors with many interdependencies. For example, the global financial crisis of 2008/09, started off as a crisis in the housing sector, but quickly broadened to money markets and other areas of the financial sector. In addition, the crisis was not contained but spread from the US to other advanced economies (AEs) and ultimately to emerging markets (EMs). It had serious ramifications for economic growth, employment and inflation, and ultimately elicited strong responses from both fiscal and monetary authorities. Some have argued that these responses sowed the seeds of other crises, citing the European sovereign debt crisis, and more recently, the increasing talk of a possible EM crisis on the back of a credit crunch fears as capital flows decelerate or reverse.

In my remarks today, I would like to delve a little into the global economic environment, particularly as it pertains to monetary policy as a source of financial volatility and the more recent developments in China and how this is impacting on Africa. I will then conclude with a few remarks on monetary policy in South Africa against this backdrop.

Global monetary policy

Monetary policy has been one of the dominant topics in financial circles over the past few years. The current nuance of concern is how the conduct of monetary policy in AEs is influencing financial market developments and the spillover effects to EMs. I am sure you have been inundated with information on this topic. However, please indulge me a little since, after all, it is a source of substantial uncertainty and volatility in financial markets and is most certainly a factor of significant concern for monetary authorities, including the South African Reserve Bank (SARB).

The SARB is one of 23 monetary authorities worldwide to have tightened monetary policy during the course of 2015 thus far. It is interesting to note that with the exception of Iceland, the remaining 22 countries with tighter policy stances are developing economies, for the majority of which the policy stance is intended to try and suppress inflationary pressures, particularly second round effects, rather than suppressing domestic demand per say. In fact, inadequate or subdued demand is a feature that most of these economies share at the moment. The conundrum of balancing inflation and growth concerns is nothing new to central bankers, but our nous is certainly being tested presently. However, this tightening bias is hardly a global trend as 45 other monetary authorities have in fact eased their policy stance this year. This is the first time since the onset of the financial crisis that such a divergence has existed in the global monetary policy environment.

If we narrow our focus to the two largest global economies, potential policy divergence in the near future is a stark reality that policymakers will have to face. Since the inception of the

ECB at the turn of the century, the policies of the ECB and the Federal Reserve have generally been complementary. Today, as the world awaits the first change in the Federal Funds Target Rate in seven years, the ECB by contrast is only in the first half of an ambitious quantitative easing program. Much has been said about these two moves and the unprecedented nature thereof, but I am not quite sure that we fully understand the exact implications of this development going forward.

The SARB has mentioned in the past that whilst the timing of the first movement by the Fed is significant, the timing and magnitude of future hikes are just as important. After all, the latest "dot plots" of the FOMC suggests that participants consider the appropriate long-term nominal interest rate to be at between 3 and 4 per cent, which is a fair distance away from the current policy stance. On the other hand, there are indications that the ECB could expand its current QE program, potentially both in terms of scope and duration. This highlights the uncertainty around the current environment, where spillovers from divergent policy between the two largest global players might imply that each could pull harder in opposite directions in order to achieve the desired effect in their respective economies. This implies that potentially the policy challenge will entail larger and more unpredictable spillovers into the global real economy.

Naturally this has implications for the domestic financial environment. The exchange rate of the rand against the US dollar has been mentioned time and again as a significant risk to the domestic inflation outlook with implications for the pace of domestic policy normalisation. Whilst part of the Fed's normalisation may have been priced into the domestic currency, it isn't at all clear by how much. Furthermore, it is important to note that the domestic policy response isn't as simple as responding to each Fed hike, as some analysts sometimes seem to suggest. Instead the implications and spillovers of Fed rate hikes have to be viewed alongside other domestic and global factors, which have a bearing on the domestic economic outlook and the mandate of the SARB.

The euro area as a region remains our largest merchandise export destination and hence, a recovery in euro area domestic demand is in our mutual interest. However, should the ECB expand its QE program – which appears increasingly likely – and in so doing, cause another round of euro depreciation, this could be to the detriment of our exporters. However, in this case the impact on the rand might actually be secondary to the financial market volatility that these spillovers might create.

A week from now the FOMC will emerge from their penultimate meeting of the year and may take the decision that will end months of speculation and set the wheels of normalisation in process. A decision that may serve to heighten or reduce volatility in global markets and such a decision rather than providing certainty may merely push the focus to the timing of the next rate hike. Alternatively, the FOMC could continue in the current holding pattern and take the familiar „wait and see" approach that most AEs are adopting, which again may also induce more volatility. It's almost a matter of „damned if you do, and damned if you don"t". Whichever decision the Fed takes, clear communication will be vital in influencing the market impact, something that has received increasing attention in monetary policy since the financial crisis.

China adds another dimension

Amidst this highly uncertain monetary policy backdrop, China has added another twist. According to the IMF[1], China's economy is expected to slow to 6.8 per cent in 2015, from 7.4 per cent last year. This slowdown is in line with the government's target of around 7 per cent and reflects progress in addressing vulnerabilities, particularly a much needed moderation in real estate investment. This is also nothing new, as we have known for some

[1] World Economic Outlook, IMF, October 2015.

time that China is slowing and that a rebalancing towards consumption-led growth and what the People's Bank of China (PBoC) has termed the „new normal" is under way. What this entails is growth of around 6 to 7 per cent over the next 5 years, significantly lower than the double digit levels that we had become accustomed to. What was of note however, was the recent market correction of share prices, following a period of extraordinary growth whereby equity prices in China grew by almost 160 per cent between mid-June 2014 and 2015.

The correction in the stock market resulted in an outflow of capital, exacerbated by the double devaluation of the renminbi in August. Chinese authorities undertook a number of measures to stabilise markets, including a cut in the benchmark interest rates and regulatory reserve requirements, relaxed rules on margin financing, a restriction on short-selling, pledging central bank liquidity support for the China Securities Finance Corporation and initiating a share buyback programme for state-owned enterprises. It is also speculated that the PBoC spent over US$90 billion defending the currency in August alone[2].

However, the IMF and PBoC do not believe that the stock market correction will derail the ongoing adjustment to a slower yet more balanced growth path. It is generally agreed that this adjustment is preferable to relying on an unsustainable growth model of excessive credit and investment, which could lead to large vulnerabilities in the fiscal, real estate, financial, and corporate sectors. In line with the above mentioned slower growth forecasts, recent indicators such as the manufacturing PMI, point to weaker growth for the remainder of the year. As imports continue to fall faster than exports, China will likely record a large trade surplus. China's current account surplus on the other hand, has come down from heady levels of around 10 per cent of GDP, to current levels of around 2.7 per cent of GDP.

Indeed, the recent article in the Economist titled "The Great Fall of China", asserts that this is not the hour of China's crisis and that the financial tumult is misleading. While questions remain about true health of the Chinese economy, this sentiment of China not being in crisis was also borne out in discussions at the recent the IMF/World Bank Annual Meetings in Lima, Peru. The Asian Development Bank also noted a number of reasons to remain optimistic despite the slowing growth outlook, notably a growing services sector and resilient consumption amongst others. Deutsche Bank, in a recent article[3] notes that a "hard landing" scenario in China is not on the cards and interpret recent evidence as pointing to, at worst, a gradual decline in growth such as has been evident over the past couple of years. Deutsche Bank argues that while China's credit/GDP ratio is rising, the inherent advantages of a current account surplus, high net foreign assets (13 per cent of GDP) and low external debt burden (about 10 Per cent of GDP) offer a significant counterweight to the risks of a crisis posed by a high credit/GDP ratio. Therefore, it is unlikely that there would be a „sudden stop" of international capital, such as the kind that in the past has triggered crises. In addition, it is argued that China doesn't need to import capital to sustain credit growth, neither are banks in China likely to voluntarily suspend financing to borrowers.

What does this all mean for Africa?

The current low level of commodity prices has had a significant impact on some commodity exporters. If we take oil as an example, Nigeria as an oil exporter has seen a dramatic slowing in growth to 2.4 per cent in the second quarter of 2015 from 6.5 per cent a year earlier. The oil market accounts for more than 90 per cent of foreign exchange earnings and about 70 per cent of government revenues in Nigeria. The central bank has spent reserves and more recently implemented capital controls to defend the currency. It is also worth noting that the IMF has significantly revised downwards the sub-Saharan Africa growth outlook for 2016, from 5.1 per cent in July, to 4.3 per cent in the October 2015 World Economic Outlook.

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[2] http://www.brookings.edu/blogs/order-from-chaos/posts/2015/09/21-chinese-currency-devaluation-dollar

[3] Global Economic Perspectives, A hard landing in China? Deutsche Bank, 5 October 2015.

While China is Africa's largest trading partner, it does not follow that because China slows, that it is all doom and gloom for Africa. We should remember that Africa's average growth rates have exceeded 5 per cent since 2000, double the pace of the 1980s and 1990s. With the outbreak of the financial crisis in 2008, Africa remained resilient as borne out by strong growth numbers. While it is true that the boom in commodity prices during the 2000s provided a significant boost to export revenues, this was only part of Africa's broader growth performance.

There has been a steady rise in the contribution of domestic demand to gross domestic product (GDP), owing to a fast-growing middle class in many African countries. On the supply side, the rise of the services sector has been one of the defining characteristics of the structural change in African economies. Telecommunications, banking, and the retail sector have been flourishing in many countries. This has contributed to the improvement in Africa's growth prospects, which in turn, has attracted the attention of foreign investors. The concerted efforts of policymakers to address some of the major binding growth constraints, which were previously neglected, have also played a significant role in Africa's enhanced growth performance. In the 2015 World Bank *Doing Business Report* SSA was reported to have accounted for the largest number of regulatory reforms, making it easier to do business in the past year.

Over the past decade Africa has increasingly been earmarked as a profitable investment destination by international investors. Foreign Direct Investment (FDI) to Africa increased from approximately US$10 billion per year in 2000 to more than US$50 billion in 2012. The institutional and political changes, coupled with the continent's enhanced growth potential have been the main factors underpinning investor confidence in Africa. Africa is also seen as an attractive FDI destination by those multinational investor groups that are keen to benefit from the intra-Africa trade opportunities that currently exist. In addition, other investors that already have operations in Africa are looking to expand their footprint on the continent, to ensure that they are well positioned to benefit from the favourable growth prospects that prevail in many countries. It is also worth noting that intra-continent FDI has been growing at a healthy pace. In fact, the share of African countries in total FDI in the continent more than doubled between 2003 and 2012; whereas in 2003 some 8 per cent of FDI into African countries came from other African countries, by 2012 this share had risen to 18 per cent.

Thus, given the aforementioned successes and progress made in Africa, particularly on the investment front, there should not be an overly negative impact on Africa as a result of these global developments. However, given the increasing concern around tightening financial conditions on account of the global developments that I discussed earlier, it is incumbent upon us on the continent to work harder to counter persistent misconceptions and investor scepticism when it comes to investing in Africa, especially in infrastructure. We need to market project opportunities better and leverage off initiatives such as the World Bank's Global Infrastructure Facility. To quote the 2015 Ernst & Young attractiveness survey: "We remain confident that, despite economic headwinds, the „Africa rising" narrative remains intact and sustainable."

Some challenges to monetary policy formulation in South Africa

So where does the SARB stand amidst this complicated global backdrop? Monetary policy in South Africa is being conducted against the background of a global economy experiencing a deceleration of growth, a rotation from AE to Ems as drivers of growth, a transition in China to a new growth model, and amid uncertainty over the timing and scale of US interest rate hikes, and increased volatility in financial markets.

Like many other emerging market central banks, monetary policy in South Africa has also faced the dilemma of sharply slowing growth and rising inflation. The domestic growth outlook has deteriorated significantly, as reflected by the SARB"s downward revisions. At the beginning of the year growth for 2015 was revised lower from 2.5 per cent to 2.2 per cent, and more recently to 1.5 per cent. In its October 2015 WEO, the IMF downgraded South Africa's growth forecast for 2015 to 1.4 per cent, a downward revision of 0.6 percentage points from its previous forecast. The IMF forecast for 2016 was revised downwards by 0.8 percentage point to 1.3 per cent.

South Africa's second quarter economic performance reflected a contraction in growth, with the weakest performances recorded in the primary and secondary sectors of the economy, although the tertiary sector also witnessed a slight moderation. Consumer demand is weak and the outlook is one of a constrained consumer given a backdrop of slow employment growth, declining disposable income growth and rising inflation. Confidence indicators for business have also deteriorated. Growth will remain constrained by global developments as well as low confidence levels and domestic bottlenecks such as limited electricity supply.

On the upside, South Africa's wide current account deficit of the past few years has narrowed for four consecutive quarters. This can, in part be attributed to temporary factors, but there is also some indication that both import and export volumes are responding to the depreciation of the rand and the weaker economy. How global headwinds, including China's slowdown may alter this outlook, remains to be seen.

As you know, the SARB targets inflation within a flexible framework, which allows for temporary breaches of the target being tolerated under certain circumstances. The inflation forecast has been somewhat erratic, impacted by the combination of a weaker exchange rate on the one, hand and falling oil prices on the other. However, the rand exchange rate remains the one of the biggest upside risks to the inflation outlook. The ZAR has fluctuated in a range of between R11.30 and just over R14,00 against the US dollar since the beginning of the year, depreciating to a historic low of R14.16 against the US dollar, but more recently we have seen some correction. On a year-to-date basis, the rand is almost 12 per cent weaker against the US dollar. This is in the mid-range of other EMs currencies, some of which have depreciated by over 30 per cent (such as Brazilian real) and others by around 3 per cent (such as the Indian rupee).

The most recent inflation forecasts point to an average inflation rate of 4.7 per cent in 2015. Temporary breaches of the target are expected in the first quarter, and again in the final quarter of 2016. Much of this is due to base effects. For 2017, inflation shows a slow downward trend.

The SARB Monetary Policy Committee (MPC) remains on a gradual normalisation path and is of the view that monetary policy remains accommodative. The MPC has to achieve a fine balance between realising its core objective, and not unduly undermining growth in the short-term. While we have raised the policy rate in July 2015 by 25 basis points, bringing the cumulative increase in the policy rate since the first upward move in January 2014 to 100 basis points, in real terms monetary policy remains accommodative as pointed out in our recent MPC statement, released in September 2015.

The current environment requires policy makers to remain vigilant and to carefully analyse incoming data, and not hesitate to act if the risks of a more persistent breach in the inflation target materialise and inflation expectations become unanchored, thus posing a threat to inflation outcomes over the medium term.

Thank you.