François Groepe: The challenges for domestic monetary policy amid US policy normalisation

Address by Mr François Groepe, Deputy Governor of the South African Reserve Bank, at the Bank of America-Merrill Lynch Investor Conference, Johannesburg, 27 November 2015.

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Introduction

Ladies and gentlemen, good morning. I am grateful to the Bank of America-Merrill Lynch for the invitation to address this fourth edition of their annual Fixed Income Investor Conference. I think that the subject of my speech is a matter that is widely debated. In my address today I will highlight the different channels through which United States (US) monetary policy shifts can affect South Africa's economic, price and financial variables, and how this is likely to impact on domestic monetary policy.

The global rate environment may be changing

There is no denying the impact that the prolonged period of near-zero US short-term interest rates has had on global economies and financial markets. The target for the federal funds rate has now been at zero to a quarter of a per cent for as long as seven years. Since the end of the Second World War, episodes of low US interest rates had not seen rates fall so low for such a long period. Furthermore, the policy response to the Fed was not limited to a near-zero Fed funds target: sizeable purchases of government and agency debt by the central bank, together with "forward guidance" regarding the future path of interest rates, were implemented with the stated aim of lowering interest rates across the whole yield curve. These unconventional policy tools were also not limited to the US. Over time, central banks in the eurozone, Japan and the United Kingdom, among others, moved to a combination of very low policy rates and asset purchases.

The extent to which these measures reduced long-term interest rates in advanced economies and encouraged capital flows towards emerging markets remains a point of debate. Other factors no doubt were at work. These include moderating inflation and slower potential growth in the developed world and, in the immediate years after the global financial crisis, more attractive fundamentals in emerging countries. Nonetheless, various academic studies suggest that unconventional tools, via their effect on term premiums, may have depressed 10-year US yields by as much as 50 to 100 basis points.[1] As for capital flows to emerging markets, it may be no surprise that the era of very accommodative policy in the developed world coincided (according to data of the Institute of International Finance) with inflows in excess of US$ 1 trillion per year from 2010 to 2014, a level that had only been exceeded once before the global financial crisis.[2]

This backdrop, however is likely to change soon. The Fed's FOMC has, of late, repeatedly expressed its confidence in meeting its dual target of full employment and a return of inflation towards its targeted levels. Addressing the House of Representatives on 4 November, Chair Janet Yellen remarked that "*if we were to move, say in December, it would be based on an expectation, which I believe is justified, that – with an improving labour market and transitory factors fading – inflation will move up to 2 per cent.*" In the wake of recent Fed communication

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1 We can refer, among others, to "The macroeconomic effects of the Federal Reserve's unconventional monetary policies" by Eric M Engen, Thomas T Laubach and David Reifschneider, *Finance and Economics Discussion Series 2015–005*, Washington, DC: Federal Reserve Board, 2015.

2 See "Capital flows to emerging markets", Institute of International Finance, 1 October 2015.

and US labour market data, financial market participants are now discounting an approximate 65 per cent probability of a hike in the Fed funds future on 16 December. By the end of next year, market participants see Fed funds around 0,75 to 1,00 per cent, while the median projection of FOMC members currently lies at 1,4 per cent.

Why does it matter for South Africa?

On its own, a slow and gradual normalisation of US monetary policy need not be negative for South Africa, or indeed for the emerging world as a whole. The reasoning being that if the Fed is considering a "lift-off" in its policy rate, it is because in their view the US economy has recovered sufficiently from the legacies of the global financial crisis, and that it can continue growing at a steady and sustainable pace without further need for unusually large accommodation. Secondly, the normalisation path is likely to be very gradual.

Nonetheless, because of the role that US policy played in encouraging inflows to emerging markets in particular and "risky" assets in general, many people are awaiting the prospective US rate "lift-off" with elevated nervousness. Volatility has risen across a broad range of assets; the rand, together with other major emerging currencies, has come under pressure; and some observers have asked the question whether the South African Reserve Bank (SARB) needs to "shadow", or even pre-empt the Fed in raising interest rates.

Before I go more into detail on that subject, let me repeat an important point: the SARB does not have an exchange rate target; it has an inflation target. Furthermore, both theory and experience do show that in the case of the latter, domestic interest rates need not respond to policy rate changes in the US as they would in the event of a dollar peg. If one targets the dollar exchange rate, the interest rate differential with the US is key to sustaining the target. However, if one targets inflation, the role of US rates becomes indirect.

In fact, one could see two main reasons why a rise in US interest rates could justify a similar move in a country like South Africa: first, if the US move reflects an inflationary acceleration in the US economy that looks set to be replicated in South Africa; and second, if the US rate increase affects capital flows to South Africa to the point that the rand depreciates significantly and raises prospective domestic inflation.

The first argument can be dismissed in the present situation. As I previously indicated, the Fed, if it begins to raise interest rates in the coming months, will not do so because of a strong, potentially inflationary acceleration in US gross domestic product (GDP) growth. It will do so to ensure sustained US growth through a gradual reduction in the degree of monetary accommodation. The FOMC's median projection does not see US GDP growth deviating substantially from the current trend in the next two or three years, and most official and private forecasters share that view.

In addition, historical experience seem to indicate that while major cycles in the US economy, including the last recession, influence those in South Africa, there is much less correlation between GDP trends in the two countries during moderate growth cycles, as is now the case. Therefor the "growth transmission channel" will have a limited role.

"Push and pull" factors and portfolio flows

The "capital flows" transmission channel is of much bigger concern at present. In recent years, a lot has been written about the "push and pull" factors that drove private capital flows, and in particular portfolio flows, from developed to emerging economies. On the "push" side, as I alluded to earlier, the mix of very low policy rates, quantitative easing and forward guidance by key major central banks, including the Fed, created an incentive for large investment funds to "search for yield" in other destinations. On the "pull" side, in the first few years following the global financial crisis, a combination of rising commodity prices and a stronger economic recovery in emerging economies, relative to their advanced economy counterparts, enhanced the attractiveness of these countries as an investment destination.

Yet, just as some of the "push" factors look set to recede with the beginning of US monetary policy normalisation, the "pull" factors attracting capital towards emerging markets have been equally waning. The Reuters-CRB index of commodity prices has fallen by nearly 50 per cent since its peak in April 2011; in real terms, adjusted for US inflation, it is back to levels last seen in 2001. Such a large-scale adjustment, unsurprisingly, has led to a marked slowdown in commodities exporters' growth. Yet, even those emerging countries that are net resource importers have experienced a loss of economic growth momentum, in part because of growing economic and financial interconnections within the developing world. In 2011, the growth differential between the emerging and developed world was as high as 4,6 percentage points; in 2015, according to International Monetary Fund (IMF) projections, it will be as low as 2,0 percentage points, the narrowest gap in 15 years.

International capital flow data are already highlighting the impact of these developments on cross-border funding. In a report released last month, the Institute of International Finance (IIF) projected that non-resident capital flows into emerging economies would fall to only US$548 billion in 2015, down from US$1,305 billion two years ago, with bank lending and bond portfolio flows likely to account for the bulk of the decline. At the same time, the IIF projects that private residents of emerging economies will increase their investments in the developed world, resulting in the developing world being a net exporter of capital for the first time since 1988.[3]

The vulnerabilities of South Africa

Recent experience indicates that South Africa is not immune to the risks I have just outlined. The rand has depreciated by around 17 per cent against the US dollar since the start of the year. Whilst the rand is not an exception, it is nonetheless underperforming, on average, its emerging-market peers. Indeed, despite some improvement over the past year or two, our current-account deficit still appears likely to remain elevated, at around 4,2 per cent of GDP in 2015, and around 4,6 per cent next year. With the balance of foreign direct investment flows in deficit, on average, over the past year and a half, this means a continued reliance on portfolio inflows to ensure a smooth financing of the current-account deficit.

Generally, portfolio flows into South African assets do not behave differently from those into other major emerging markets. IIF Portfolio Tracker data show a positive correlation of 56 per cent in the current year, and indeed since 2010, between net non-resident flows into South Africa and into emerging markets as a whole. Non-residents became net sellers of South African bonds and equities in the last three months, coinciding with an underperformance of the domestic bond market and renewed rand weakness. We have noted that for emerging markets as a whole, there seems to be an increased correlation between the performance of local-currency bonds and the exchange rate. This observation also applies of late to South Africa, providing further evidence of the linkages between bond flows and currency trends.

Furthermore, the same data also show that in the past few years net flows into South African securities have become increasingly sensitive to shifts in the US yield curve. Since the "taper tantrum" of May 2013, months when 10-year US Treasury yields rose by more than 10 basis points coincided with net non-resident outflows from South African bonds, whereas other months saw net inflows. Equally, the period since May 2013 has seen, on balance, a negative correlation between US Treasury yields and the performance of the rand, in contrast to what prevailed in the immediate years after the recession. At that time, rising US yields may have been perceived as signalling a stronger global recovery. Nowadays they appear reflective of tighter global financial conditions, with negative implications for the South African rand. The risk of a negative "feedback loop" between US yields, outflows from domestic bonds and rand depreciation is therefore real.

[3] Op. cit., page 2.

The challenges of a slowing South African economy

The prospective normalisation of monetary policy in the US, with the possible implications I have just described, comes at a challenging time for South Africa and for monetary policy. On the one hand, underlying inflation trends and inflation expectations are already relatively high, and the potential for sizable portfolio outflows and ensuing currency depreciation clearly poses an upside risk to the inflation outlook. On the other hand, the domestic economy is weak, and policy tightening could aggravate such weakness.

There is indeed no denying that the South African economic growth outlook is more challenging than a year ago. At present, the SARB is projecting real economic growth of 1,4 per cent in 2015 and 1,5 per cent in 2016. At the time of the November 2014 MPC meeting, these forecasts stood at 2,5 per cent and 2,9 per cent respectively. We are a far cry from the 4,8 average growth rate seen in the five years prior to the global recession, or even from the growth rate that prevailed in its immediate aftermath, when it averaged 2,8 per cent between 2010 and 2012.

Adding to the challenge for monetary policymakers is that such a slowdown in growth reflects a mix of structural as well as cyclical factors. These include slowing growth in some of South Africa's major trading partners, such as China; the negative shock from falling terms of trade; and the moderate rise in the tax burden that has weighed on disposable income growth and, especially in the last few quarters, consumer demand. These developments, coupled with domestic constraints such as reduced and uncertain power supplies, labour market disruptions, and relatively high transportation and logistics costs, have in turn undermined the supply side of the economy. In particular, they constrained private-sector fixed investment, which measured 13 per cent of GDP on average in the first half of this year, down from a peak of 15,4 per cent just before the 2008–09 recession.

The SARB estimates that short-term potential real GDP growth in South Africa has slowed to 1,8 per cent this year, from an estimated pace of 3,25 per cent around 2010. Hence, the country probably has a narrower negative output gap than was assumed a few years ago. Still, some slack persists in the South African economy, a pattern that is confirmed by other indicators such as capacity utilisation in manufacturing, which has actually been declining throughout the current year. Under normal circumstances, one would expect such slack to generate disinflationary pressures and call for an accommodative monetary policy stance to close the output gap. This is particularly the case in situations where fiscal policy is constrained, because of rising debt levels, in its ability to support the economy, as is currently the case in South Africa.

However, monetary policy has already been accommodative for several years, at least judging by the level of real short-term interest rates, which remains unusually low. Furthermore, the impact of such accommodation has not been felt as much as previous cycles would have suggested. In addition to the absence of demand pressures, the relatively subdued growth in money and credit extension, and the lack of significant gains in property prices over the past few years, suggest a lack of appetite among private agents for new borrowing. Most probably, the elevated degree of households' leveraging at the time of the recession has acted as a constraint on their willingness and ability to respond to the sharp decline in interest rates. It is also noticeable that non-resident capital inflows into South Africa have not, in recent years, fed into the kind of fast domestic credit expansion that one saw in several Asian or Latin American economies.

The South African Reserve Bank's policy response

I have already emphasised that the SARB does not target the exchange rate. Amid weaker economic growth, and with the currency depreciating for many reasons, several of which are independent of our domestic environment, raising interest rates aggressively in an attempt to prevent currency depreciation could quickly become a futile, if not counter-productive approach. The IMF recently highlighted in its latest issue of the *World Economic Outlook* that

currency depreciation can play a welcome role as an absorber of shocks, including terms of trade shocks. This is the case, of course, as long as the depreciation does not spill over into lasting and more broad-based price pressures, or threaten the stability of a country's financial system.

The risk of price pressures is where the main focus lies for the SARB. Admittedly, financial stability is also an integral part of our mandate and focus. But at present, the latest rand depreciation does not pose immediate threats to financial stability. Due to prudent financial management by both the public and private sectors, South Africa's foreign currency-denominated external debt represented less than 20 per cent of GDP as of the second quarter of 2015, even though it has risen in recent years.[4] It is true that foreign debt issuance by South Africa's corporate sector has increased quite significantly in recent years. However, it has not reached the levels seen in some other emerging countries, particularly in Asia. Furthermore, the banking sector's foreign assets and liabilities remain relatively low, at 14 and 10 per cent of the banks' total balance-sheets respectively, which means banks enjoy a positive "buffer" of net foreign assets.

The most pressing concern for South Africa, however, would be a sustained, currency-induced overshoot of the 3 to 6 per cent inflation target, which could in turn "unanchor" broader-based inflation expectations from their current levels. These inflation expectations, as measured by the quarterly Bureau for Economic Research survey of analysts, trade unions and business leaders, have recently displayed greater stability than in the early years of the inflation-targeting era. However, they are anchored around the upper end of the inflation target, implying limited "margin for error" in the event of a severe or prolonged price shock. In addition, wage demands typically remain well in excess of the inflation target, and could very conceivably rise in the event of a lasting overshoot of that target, prompting an unfavourable wage-price spiral.

Over the past couple of years, there has been evidence of a reduced exchange rate pass-through to inflation compared with previous cycles of rand depreciation. Core inflation – that is, headline inflation excluding food, petrol and energy – has actually slowed in recent months, from a high of 5,8 per cent in February 2015 to 5,2 per cent in October. Financial market participants have been cognisant of these encouraging developments, as shown by the relatively muted reaction of domestic bond yields to this year's rand depreciation.

This lower inflation pass-through of currency depreciation to consumer prices is not unique to South Africa. It has been observed in other emerging countries. Possibly, the lack of dynamism in demand around the world, the difficulties economies are experiencing in closing output gaps, and the very low inflation rates in the world's major economies are reasons why the transmission channel of imported to domestic prices has been unusually muted. But perhaps because it is not yet well understood, this lower observed pass-through may indeed require increased vigilance. After all, the reaction of domestic prices may not be lower, but merely delayed. Central banks cannot afford any form of complacency.

For this reason, the SARB's MPC had to consider the optimal strategy on how to deal with an inflation path that looks set to remain mostly within target, but with clear and elevated risks of amongst others a more durable overshoot. The MPC could have taken advantage of the recent, moderately positive trends in core inflation to delay a hike in the policy rate and instead wait to assess potential market, currency and portfolio flow developments around the likely start of US policy normalisation. But, such an approach would have carried the risks of a further upward drift in inflation expectations and risks and, eventually, second-round effects that would have required an even stronger policy response. In light of the fragility of domestic economic growth, such delayed but more aggressive responses are best avoided.

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[4] This measure excludes rand-denominated liabilities held by non-residents, which are also counted into the broad definition of external debt.

Conclusion

To conclude, let me again restate that the timing and speed of eventual US policy normalisation may be uncertain, but unless the US economy again experiences a durable loss of momentum, which is in nobody's interest, it appears unavoidable. The best that emerging-market central banks can do is to be ready to respond to any potential negative side-effects on either price or financial stability. Some factors may play in our favour: because of the Fed's concern about generating undue volatility in global financial markets, the general framework of future normalisation has been clearly laid out and, hopefully, well understood by markets. Consequently, one would also hope for a lesser reaction of financial asset prices, when US rates eventually rise, than at the time of the "taper tantrum" in 2013.

Nonetheless, in light of the large degree of leverage in the world's financial markets, and of still-stretched valuations in some categories of assets, relative stability of financial asset prices is far from guaranteed. Higher market volatility, at least relative to a few years ago, may become the norm. The SARB will continue to closely monitor any impact of such volatility on domestic market and economic variables, and react accordingly, if needed.

Thank you.