Kuben Naidoo: Monetary policy in South Africa

Address by Mr Kuben Naidoo, Deputy Governor of the South African Reserve Bank, at the FEDUSA Leadership and Collective Bargaining Conference, Muldersdrift, 19 February 2016.

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Distinguished guests, ladies and gentlemen

I would like to thank the Federation of Unions of South Africa (FEDUSA) for the opportunity to address the delegates of its annual Leadership and Collective Bargaining Conference. I am honoured to be part of a programme with such an illustrious group of speakers and panellists.

This year's theme, 'Decent work and decent life for all', is particularly relevant when one considers the challenging economic backdrop in South Africa and in many other developing countries. It is wonderful to be able to debate the broad set of pertinent issues that are outlined in this programme. I believe that we can tackle South Africa's economic challenges through open dialogue and engagement across all spheres of our society.

Today, I will address one specific economic challenge: that of monetary policy formulation. I will frame the monetary policy debate with an assessment of the global and local economy before concluding with some remarks on the upcoming round of wage bargaining.

Global prospects

The world economy is once again experiencing a period of slowing growth, only this time the key areas of weakness are found in the emerging markets. Some argue that eight years after the onset of the global financial crisis we are still not out of it yet. What started off as a sub-prime crisis in the United States became a crisis for the global financial system, morphing into a government debt crisis in Europe and now, potentially, a crisis for the emerging markets.

The International Monetary Fund (IMF), estimates that global economic growth slowed to 3,1 per cent last year, down from 3,4 per cent in 2014. This was driven by a considerable slowdown in emerging market growth to a six-year low of 4 per cent from 4,6 per cent in 2014. Meanwhile, gross domestic product (GDP) growth in advanced economies increased marginally to 1,9 per cent last year.

The slower pace of economic expansion in China played a major role in the weaker performance of emerging market economies last year. Emerging market growth was constrained through the channels of slower export growth into China, lower commodity prices, currency weakness, and financial market volatility. These factors, along with domestic challenges, saw emerging market economies like Brazil and Russia suffer recessions in 2015.

Looking ahead, the IMF expects a modest rebound in emerging market growth this year. However, it warns that the risks to this outlook are skewed to the downside due to geopolitical uncertainties, China's shifting growth model, and the possibility of escalating financial market volatility.

Advanced economies continued on a path of recovery last year, albeit at a mixed pace. The US and the UK appear to be leading the recovery, while Japan and the euro area find themselves in an earlier phase of their economic upswings. The ongoing improvement in US economic activity and employment prompted the US Federal Reserve (Fed) to lift the benchmark US interest rate last December for the first time in nine years. The Fed is expected to continue on a gradual path of interest rate normalization over the medium term. As public- and private-sector borrowing costs in many parts of the world are referenced off US interest rates, a rising US policy rate threatens to push up the cost of capital globally. A second symptom of the impending US hiking cycle is that it has seen the dollar strengthen substantially against most other currencies since mid-2014. This has been driven by a flow of capital into the US and, to some extent, out of emerging markets. Meanwhile, in Europe and Japan, central banks are aggressively easing policy in an attempt to fight off deflation and low growth.

Global economic growth has persistently disappointed since the financial crisis hit in 2009. This is due, in part, to high levels of indebtedness, excess capacity as well as weak fixed investment growth in many parts of the world. However, these challenges are being exacerbated by longer-term trends such as falling productivity growth, the technological displacement of jobs, and a downshift in global trade.

While these trends present both opportunities and challenges, it appears as if emerging market economies are most at risk in the current environment, especially from an employment perspective. In an increasingly globalized world, it is important for South Africa to improve its competitiveness so that we can grow our export base and avoid increased import penetration.

Domestic prospects

Let us turn now to an examination of the domestic economy.

As Governor Kganyago pointed out in the statement of the Monetary Policy Committee (MPC) last month, GDP growth is expected to come in at only 0,9 per cent this year. If the forecasts of the South African Reserve Bank (SARB) are correct, economic growth in 2016 will be the weakest in seven years.

South Africa, like other commodity-exporting nations, is facing a terms-of-trade shock as a result of the persistent decline in commodity prices since 2011. This has been exacerbated by periods of protracted labour unrest and electricity supply shortages. More recently, the severe drought conditions have begun to weigh on activity in the agricultural sector. At an aggregate level, corporate profit growth in the third quarter of 2015 (known as the gross operating surplus) was at its lowest level on record at 0,3 per cent year-on-year. This was due to declining profitability in agriculture, mining, and manufacturing. Pressure on corporate income suggests that investment, consumption, and hiring by the private sector will be muted in 2016. SARB's leading indicator of economic activity has declined on a year-on-year basis for the past 12 months. This supports our view that the risks to the growth outlook are skewed to the downside.

Meanwhile, the inflation outlook has also deteriorated. After averaging 4,6 per cent in 2015, inflation is expected to accelerate to 6,8 per cent in 2016 and 7 per cent in 2017. The elevated inflation trajectory is largely as a result of multiple supply-side shocks which are expected to feed into consumer prices over the forecast horizon. These include a sharp depreciation of the exchange rate, a spike in domestic maize prices, and above-inflation electricity tariff increases. The domestic drought conditions have forced South Africa to import maize, which means that the depreciated exchange rate is now a determinant of the local maize price. As a result of this double whammy, food inflation is expected to reach 11 per cent this year. Even the sharp drop in the international oil price is unlikely to provide much reprieve to consumers as the rand's depreciation means that petrol prices are likely to be slightly higher this year than in 2015.

Persistent weakness in the South African economy poses very real risks to employment and investment growth over the longer term. Ultimately, this means that the collective gains in prosperity which we as a nation have achieved are at risk of being eroded.

Monetary policy

Against this difficult economic backdrop, the Reserve Bank must continue to execute its mandate of protecting the value of the currency in the interest of balanced and sustainable economic growth. Protecting the value of the currency means that we aim to maintain its purchasing power. The purchasing power of the rand is influenced by inflation. As inflation rises, one is able to purchase fewer goods for a given number of rands. Therefore, we aim to protect the purchasing power of the currency by attempting to keep inflation low. We have an inflation target range of 3–6 per cent, which informs our policymaking.The Reserve Bank is also responsible for regulating parts of the financial sector. Regulation of this nature helps to reduce the risk of financial crises, which over the long run is likely to result in improved economic performance. Furthermore, financial regulation can promote fairness as financial sector stress tends to weigh disproportionately on the most vulnerable in our society.

While protecting the value of the currency is, of itself, an important objective, it also serves a greater overarching purpose: that of providing a stable foundation for sustained economic growth. This is because most economic activity takes place on the basis of trust in the value of a currency, not just today, but also in the future. People are far more likely to save for the future if they are confident that the purchasing power of their savings will at least be maintained over time. Similarly, companies are more likely to enter into long-term contracts with each other if they are confident that inflation will not materially reduce the value of the contract once the job is completed. By providing stakeholders with a credible inflation target range and a commitment to maintain inflation within that target range, we are making the business environment more predictable and ultimately more efficient over the long run. This is an indirect benefit of a sound monetary policy framework.

To put it differently, a large body of literature shows that monetary policy can directly affect economic growth and employment only in the short run. For example, if the Reserve Bank maintains an interest rate that is artificially low, we may be able to temporarily boost GDP growth and employment. However, this will come at the cost of rising inflation and significant uncertainty about future inflation outcomes. Over time, this uncertainty may result in inflation expectations rising, which can lead to an inflation spiral as wage demands and price increases continuously rise to match future inflation expectations. The cost of bringing inflation back into the target range once inflation expectations have become dislodged is high. It would require aggressive policy action in a short space of time. As such, the temporary benefits associated with an overly accommodative monetary policy would be quickly eroded and replaced by a more difficult and uncertain operating environment for business and consumers. It would, therefore, be short-sighted of the Reserve Bank to overlook inflation and consider only short-term economic growth in its decision making.

Instead, what we try to do is balance the need for stable economic growth and low levels of inflation. We are cognizant that the current interest rate hiking cycle will have a short-term detrimental impact on the economy. However, the cycle thus far has been gradual and shallow by historical standards. This measured approach to monetary policy tightening reflects the difficult balancing act that we currently face.

The Reserve Bank operates within a flexible inflation-targeting framework, which allows us a degree of discretion in responding to inflation target breaches. If we expect a breach to be temporary or to be caused by an external shock, we may opt to look through such an event. An external shock could be a once-off food price increase or a depreciation of the exchange rate. In the case of such a shock, we may look past the first-round impact and act only if we see evidence of second-round effects (that this, if the shock feeds through more broadly into inflation). For example, in both 2012 and 2013 inflation briefly breached the 6 per cent level. The breaches were temporary, so we were able to look through them and leave interest rates on hold at that time.

The inflation outlook has unfortunately deteriorated since then, which has called for higher interest rates. Last month, the MPC opted to lift the repurchase rate, or repo rate, by 50 basis points. This was due to a revised inflation forecast, which sees headline inflation remaining above the 3–6 per cent target range throughout the forecast period. Our inflation forecast was revised higher in January due to the multiple supply-side shocks that I referred to earlier. While we are able to tolerate a single external shock for a limited period of time, we cannot tolerate multiple simultaneous shocks that are likely to keep inflation elevated for two years. Shocks of this nature raise the risk that inflation expectations for the coming years will recalibrate to a significantly higher level.

Our monetary policy response going forward will depend largely on how surveyed and implied inflation expectations play out over the course of this year. We use the Bureau for Economic Research survey of inflation expectations among trade unions, financial analysts, and business people as a guide. But a crucial indicator of implied inflation expectations is the level of actual wage settlements in the economy. Wage settlements that are above inflation and productivity growth threaten to undermine employment and pose a significant upside risk to the inflation outlook. Settlements of this nature may force the Reserve Bank to adopt a tighter monetary policy stance in order to curtail their second-round inflation impact.

I would like to emphasise that monetary policy is only one aspect of our country's macroeconomic policies. The aim of monetary policy is not to drive growth directly, but rather to contribute towards a stable macroeconomic environment. Growth can and must be raised through better education; sound public institutions; healthy relationships between government, business and labour; and a legal and policy environment that provides incentives for long-term investment and employment growth. While we encourage these policies, they fall outside of the direct mandate of the Reserve Bank. We call on all in society to pull together in support of these economic reforms as they will boost confidence in our economy and facilitate longer-term prosperity.

Concluding remarks

We are acutely aware of the high levels of inequality in our country and the need for the fair sharing of profits between the owners of labour and capital. I would therefore appeal to all stakeholders in the upcoming round of wage bargaining to take a view on what is good not only for existing workers today, but also for society at large over the longer term.

In conclusion, I would like to thank FEDUSA, in particular General Secretary Mr Dennis George and President Mr Koos Bezuidenhout, for the healthy relationship that we have had over many years. FEDUSA has always been willing and able to engage in robust and at times difficult discussions with the Bank on our policies, our work, and our approaches to fighting inflation. As Mahatma Gandhi once said: "Honest differences are often a healthy sign of progress." We look forward to ongoing engagement in these difficult times. South Africa's problems are complex and can only be solved by honest dialogue between all parties who are committed to making South Africa a better place.

Thank you.