Daniel Mminele: The role of monetary policy in encouraging and supporting economic growth

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the University of KwaZulu-Natal Business Management Conference "Innovative and creative solutions for economic growth strategies and sustainable futures", Durban, 26 August 2016.

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Good morning, ladies and gentlemen

I thank the University of KwaZulu-Natal, for inviting me to speak at this 4th Business Management Conference. The theme of this conference is well-chosen and very relevant to our current context as, eight years after the global financial crisis, strong, sustainable and balanced growth remains elusive, and policymakers across the world, including in South Africa, are indeed grappling with finding innovative and creative solutions for generating growth.

South African GDP[1] growth has been decelerating since 2011, registering a mere 1,3 per cent in 2015 following a similarly disappointing growth rate of 1,6 per cent in 2014. This is a far cry from the growth rates of almost 6 per cent that we celebrated prior to the global financial crisis. A number of domestic and external factors have been responsible, including electricity supply constraints and one of the most severe droughts to affect the agricultural sector, the slowdown in China and lower commodity prices (adversely affecting mining and manufacturing production), as well as weak demand in both advanced and emerging market countries, including those in sub-Saharan Africa.

According to the most recent forecasts of the South African Reserve Bank, released at the time of the Monetary Policy Committee (MPC) meeting in July, growth prospects remain challenging, with the economy not expected to grow in 2016 and growth rising to 1,1 per cent next year and to 1,5 per cent in 2018. By contrast, our forecasts show inflation remaining above the target range in 2016, averaging 6,6 per cent this year before declining to 6 per cent and 5,5 per cent over the next two years respectively.

In my remarks today, I will discuss the role of monetary policy in encouraging and supporting economic growth – a role complicated by the current context of structurally low growth.

In an environment characterised by such weak expansion, there are two obvious questions for monetary policymakers. First, why is the MPC not doing more to support growth? Second, what is the long-term role of monetary policy in encouraging and supporting sustainable growth?

Monetary policy and short-term growth

Since January 2014, the MPC has increased the repurchase rate – or repo rate – by a cumulative 200 basis points, to the current 7 per cent. While it may seem counterintuitive to increase interest rates when growth is weakening, the Bank has been facing a policy dilemma in the face of this weaker growth being accompanied by rising inflation risks over this period, mainly in the form of rising food prices and currency depreciation.

Core inflation, which measures underlying inflationary pressure, has continuously exceeded 5 per cent since February 2013, indicating limited space for unfavourable shocks. In addition, inflation expectations remain at uncomfortably elevated levels.

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[1] Gross Domestic Product.

While policy decisions need to appropriately take account of growth dynamics, monetary policy cannot influence growth outcomes in the long run – and there is broad consensus that South Africa needs structural reforms to increase output. The MPC has, however, shown caution in this hiking cycle – and has emphasised the importance of data dependency in making its decisions to ensure that the Bank's response is calibrated to changing economic conditions. This approach has resulted in rates being hiked more gradually, and by a lower magnitude, than in previous hiking cycles in South Africa. Consider the difference: from January 2002 the MPC increased the repo rate by 400 basis points over 16 months, whereas in the past 31 months we have increased the rate by 200 basis points.

As a small open economy, South Africa is highly exposed to exogenous shocks that can affect inflation. Often – with the recent exception of falling international oil prices – these shocks are inflationary, such as the continuous currency depreciation since 2011. The gradual hiking cycle has been a response to the concern that repeated shocks would drive inflation persistently above the target range, which could create a 'new normal' target of 6 per cent plus a supply shock in the public's consciousness. If that were the case, then a shock pushing headline inflation above 6 per cent could in turn pull inflation expectations and/or wage growth with it, causing a generalised, economy-wide increase in prices via these second-round effects. The shock would then embed itself permanently into prices instead of having only a temporary impact.

This year, the disinflationary impetus from lower oil prices has dissipated while domestic food price inflation has increased above 10 per cent as a result of the severe regional drought I mentioned earlier. Food prices last rose this sharply in 2011 and, as with an even sharper upsurge in 2008, they were followed by spikes in wage inflation. The MPC is thus cognisant of the increased possibility of second-round effects if the shock is to food prices.

Admittedly, we have seen some encouraging developments recently, mainly as a result of renewed search-for-yield strategies based on changed perceptions about the pace of US policy normalisation and easing measures elsewhere. But the currency remains an important risk factor as recent trends can quickly reverse should global risk perceptions change. Even taking near-term improvements into account, the rand has depreciated 11,7 per cent against the US dollar and, on a trade-weighted basis, by 8,6 per cent over the past year – significantly in excess of inflation differentials with our major trading partners.[2]

Between May and July, the Bank lowered its inflation forecasts. Yet inflation is still anticipated to remain above the target range until the middle of 2017, peaking in the fourth quarter of this year at 7,1 per cent. At its July meeting, the MPC stated that recent developments had allowed for a pause in the hiking cycle. This pause is evidence of the MPC's flexible approach to inflation targeting, but is in part also due to the Bank having increased interest rates earlier in response to inflation risks.

Although the MPC is removing accommodation gradually, monetary policy is not yet tight. Our real interest rate is not high when compared to other emerging markets such as Chile, India and Mexico. Household credit growth is weak but this is very much linked to still-high household debt as a percentage of disposable income.[3] Meanwhile, the credit extended to corporates has in fact accelerated since interest rates have risen, and averaged 13 per cent over the past year.[4]

Such indications add to other evidence that interest rate hikes have not been the primary constraint to growth outcomes over the period. Unusually severe shocks – including the strikes in 2014, electricity shortages in 2015, and the drought in the past two years – have hit

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[2] This is the change from June 2015 to July 2016.

[3] Household debt to disposable income measured 76,6 per cent in the first quarter of 2016.

[4] This is the average year-on-year growth from July 2015 to June 2016.

the domestic economy. Our cyclical recovery has been hampered by disappointingly low global trade and world economic growth. More important, however, is the fact that domestic growth is also weak for structural reasons, as illustrated by the repeated downward revisions to our estimates of potential growth. This last problem requires structural reforms rather than a monetary policy response. Our most recent estimates show potential growth remaining under 2 per cent into 2018; this is well below the rate needed for meaningful per capita increases in income and faster job creation.

Lately, there has been speculation about the end of the hiking cycle possibly having been reached. While the recent improvements to the inflation outlook are a positive development, the risks in the policy environment remain too numerous to be able to say definitively that the hiking cycle is over. We will continue to be guided by the evolving data and our collective understanding as the MPC of what any new data and information suggests for the inflation trajectory.

Monetary policy and long-term growth

This brings me to my second question, about the role of monetary policy in fostering long-term economic growth.

It is now widely accepted that the appropriate role of monetary policy is in focusing on price stability in the medium to long run. It can also assist in smoothing short-term growth fluctuations provided that this does not compromise price stability.

Monetary policy helps to provide a stable, growth-friendly environment but it is most effective if the broader environment is similarly geared towards encouraging investment and unlocking growth potential. In South Africa, we have made progress with alleviating infrastructure constraints over the past few years but now – as in the majority of emerging markets – we urgently require structural reforms. Without reforms, growth will not accelerate significantly – irrespective of the appropriateness of monetary policy settings.

Structural reforms required refer to, for example, policies aimed at increasing competition in product and labour markets. Many South African sectors are highly concentrated and the barriers to entry for small or new firms are high in an environment dominated by a few long-established firms. Small firms tend to be relatively more labour intensive than large firms, so if the barriers to entry were lowered and more small firms entered the sectors, employment would rise – and it would likely rise faster if this shift were accompanied by labour market reforms. Both these policies would not only improve the competitiveness of the economy but also make it more inclusive, providing opportunity for the unemployed, existing small firms and potential entrepreneurs, many of whom are currently locked out of the formal economy. The International Monetary Fund's recent Article IV assessment of South Africa reiterates the need for these reforms, which have also been recommended by the World Bank and the OECD[5].

Fortunately, South Africa has a long-term growth and job creation strategy encapsulated by the National Development Plan that includes many of these policies. And although structural reforms take time to implement, demonstrable progress with regard to implementation will likely increase business confidence from its current low level and thus also boost the economy in the short term.

The South African Reserve Bank also has a growth-supportive role to play, which I would like to explain. We have two mandates, namely price stability (as our primary mandate) and financial stability. Financial stability, expressed in a more explicit manner, is a relatively new mandate, in line with international best practice following the global financial crisis.

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[5] Organization for Economic Cooperation and Development.

By various measures – including currency liquidity[6], stock market capitalisation[7], and local-currency bond demand[8] – South Africa has exceptionally deep and sophisticated financial markets for a middle-income country. Indeed, the country is ranked 12th in the world in terms of financial market development, as measured by the World Economic Forum.[9]

The finance sector has become an increasingly important contributor to growth, rising as a proportion of total real gross value added from 17 per cent in 2000 to 22 per cent in 2015. Stability in this sector is thus important to the South African economy as a whole – and also supports a more efficient transmission of monetary policy.

Fortunately, South Africa has an established history of financial stability. In a recent comprehensive study of banking development, South Africa was identified as one of only four large countries that granted large amounts of domestic credit and had not experienced any banking sector crises since 1970.[10] This combination of financial stability and relatively adequate credit is rare, and the Bank has an important role in safeguarding it.

Price and financial stability alone cannot create growth. Rather, they provide a platform enabling medium- and long-run growth. Financial stability means that institutions and markets are well regulated, which ensures adequate capitalisation and prevents excessive risk-taking. As a result, the economy has sufficient access to credit for investment and growth. Price stability means that investors are assured of a competitive and predictable inflation environment, leading to greater certainty over future business conditions and therefore lower long-term interest rates.

In South Africa, we define price stability as meeting our continuous 3-6 per cent inflation target. The flexible inflation-targeting framework that we implement relies on anchored inflation expectations, especially among price and wage setters. This framework has led to an improvement in our inflation performance. From 1970 to 2000, inflation averaged 11,2 per cent. Since 2002 – the first year in which we committed to a target – inflation has averaged 5,9 per cent, despite two severe spikes in 2002 and 2008. That said, inflation targeting is still relatively young as a policy, and our inflation rate remains structurally high – higher, in fact, than in other emerging markets and in the countries of rival exporters.[11] It is thus especially important to ensure that expectations in South Africa are appropriately anchored.

Inflation expectations have become much less volatile during the inflation-targeting period, indicating increased trust in the Bank's commitment to the target. However, since 2008, when severe food and energy price increases hit South Africa, we have suffered exogenous price shocks that have repeatedly driven inflation outside the target range. Inflation expectations have shifted upwards as a result. From an average of 5 per cent from 2004 to 2007, inflation expectations[12] rose to average 6,1 per cent between 2011 and 2013. They have remained stable since then, but are unfortunately stable right at the top of the target

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[6] The Bank for International Settlements conducts a triennial survey of global foreign exchange markets. It has found the rand to be the 18th most traded currency globally as of 2013.

[7] The Johannesburg Stock Exchange is the 19th largest stock exchange in the world by this measure. See https://www.jse.co.za/about/history-company-overview.

[8] For example, only 10 per cent of national government debt is foreign currency-denominated.

[9] This is South Africa's most recent ranking on the Global Competitiveness Index (2015/16).

[10] Calomiris, C W and Haber, S H. 2014. *Fragile by design*. New Jersey: Princeton University Press.

[11] The comparison with other emerging markets relies on International Monetary Fund (IMF) *World Economic Outlook* (*WEO*) data for 2001-2015. The inflation rate for rival exporters was calculated using IMF *WEO* and United Nations Comtrade data, with a weighted inflation rate calculated for 2011-2015 using South Africa's nine largest export categories (73 per cent of total) from 2012 to 2014.

[12] As measured (for two years ahead) by the Bureau for Economic Research.

range. A situation where expectations are lower, and the target range is thus more resilient to shocks, provides more flexibility for accommodative monetary.

Flexible inflation targeting allows us to look through once-off shocks to prices from exogenous sources, such as the petrol price increases that pushed inflation above 6 per cent in July and August 2013. However, this is possible only if second-round effects do not occur as a result of the shock. If they do occur, they can set off a chain of price increases in the economy with the possibility of persistently driving inflation higher. In such a context, the MPC would need to act. Much of the current hiking cycle has been about preventing second-round effects from manifesting, in turn preventing the need for steeper, more rapid interest rate increases later on.

Second-round effects relate directly to central bank credibility. Simply put: if price makers in the economy trust the central bank to maintain medium-term inflation within the target range, then they expect exogenous shocks to be temporary and are less inclined to increase their prices in response. If, however, they do not trust the central bank's intent or ability to contain inflation within the target range, then, rationally, they will react.

The South African Reserve Bank has worked hard to build credibility with the public, especially with price and wage setters. Not long ago, central bankers had the reputation of being aloof and opaque; in fact, unpredictability seemed central to the design of monetary policy. We have shifted our framework, but also our public engagement, to be more transparent and accessible, not least to groups who do not always agree with our policy approach. In addition, our economic round tables include representatives from the public and private sectors as well as organised labour. We do national roadshows around our biannual policy publication, the *Monetary Policy Review*. We have press conferences after each MPC meeting and publish our growth and inflation forecasts, as well as key assumptions. And we publish all public engagements by policymakers, such as this speech, on our website.

In our view, this kind of engagement is necessary to ensure that the public understands the goals and instruments of monetary policy. In general, though, we believe it is good public policy to encourage broad social participation in policy discourse. Everyone in our society should be committed to sustainable growth, lower unemployment, and a more inclusive, high-growth economy. A credible, well-communicated monetary policy is one of our most important contributions to those goals.

Allow me to use this opportunity to clarify that our outreach programmes with stakeholders, particularly in the media, should not be misconstrued to represent formal briefings by the MPC. These engagement by the Governor, Deputy Governors and senior officials are aimed at deepening the understanding of the work of the SARB with stakeholders, explaining what the SARB does, what decisions it makes, and, where relevant, how such decisions were arrived at. In keeping with our commitment to transparency, any formal interaction or announcement by the MPC as a committee will be pre-announced.

Conclusion

The economic performance of South Africa has been weak recently. Monetary policy can mitigate cyclical downturns, provided that inflationary pressures are contained, but monetary policy is not effective in combating structural growth problems. Such problems can only be addressed by implementing structural reforms.

The South African Reserve Bank remains focused on containing medium-term inflation. The best contribution that central banking can make to growth outcomes is to play a facilitative role aimed at implementing policies that provide a stable macroeconomic and financial markets environment.

Thank you.