Lesetja Kganyago: The outlook for monetary policy

Address by Mr Lesetja Kganyago, Governor of the South African Reserve Bank, at the 2016 SA Tomorrow Investor Conference, New York City, 4 October 2016.

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Good morning Ladies and Gentlemen. It is a great pleasure for me to be here today to highlight recent monetary policy developments and the outlook.

Monetary policy continues to face a difficult environment. Targeted inflation has been outside the target range of 3–6 per cent during the first half of the year, and despite a decline to within the range, to 5,9 per cent in August, this respite is expected to be temporary.

For some time we have been lamenting the fact that we are experiencing the classic central banker dilemma: one of low and slowing growth alongside high and rising inflation. This combination has been driven by exogenous factors interacting with the particular price and wage determination processes of South Africa, which compounds the dilemma. We have focused on reducing inflation to within the target range and containing inflation expectations, while at the same time limiting the possible negative impact on growth. Since January 2014, we have raised our policy rate by 200 basis points, from 5 to 7 per cent, or a little more than 1 per cent in real, ex ante terms.

Our most recent policy statement reflects the sense of the committee that monetary policy actions have helped to better contain inflation expectations and that the outlook has improved for some of the external factors impacting on the inflation forecast. We still face considerable uncertainty, but we believe downside and upside surprises are now about equally likely, allowing the committee to assess the balance of risks to be neutral.

The challenge for monetary policy is that we have experienced repeated exogenous shocks which have fed into core inflation and wages. As a result, we now expect core to reach 5,9 per cent, almost at the top of the target range, while inflation expectations have converged on 6 per cent. These sorts of shocks pose a different sort of problem to excess demand enabling ongoing price increases. During the past three years, these shocks have included the exchange rate, domestic electricity prices, international oil prices and food prices. They have coincided with negative growth shocks. Global growth has been relatively weak in recent years and commodity prices have fallen since 2011, limiting foreign demand for South African exports. Meanwhile, domestic demand has decelerated. In the mid to late 2000s, household debt levels reached unprecedented highs. In the aftermath of the crisis, however, credit extension to households has been subdued, reflecting a moribund housing market, regulatory demands and pro-cyclical behaviour by financial institutions – despite historically low interest rates.

Meanwhile, fiscal policy was used to provide a counter-cyclical response to weaker domestic and global demand, yet as government’s debt metrics deteriorated and growth kept slowing, while US monetary policy normalisation raised interest rate risks, it became clearer that government needed fiscal consolidation. These headwinds to growth were reinforced by more idiosyncratic shocks, including electricity shortages and drought. The final result was a mix of stagnant growth and higher inflation.

As monetary policymakers, we have over time looked through the first-round or impact-effects of exogenous shocks, and tried to assess second-round effects, where higher prices translate into higher generalised inflation and higher wage settlements.

With modest economic growth and robust wage growth, partly in response to these exogenous forces, unit labour costs have remained an underlying support to core inflation. Stronger growth in investment, exports or productivity resulting from sustained real exchange rate depreciation should have provided greater lift to growth in disposable income and helped to moderate unit labour costs. In recent years, this hasn’t transpired, keeping core and headline inflation high, and pushing down on potential growth. This has limited the scope for maintaining low real interest rates.

Over the past few months we have downwardly revised our inflation forecasts. Since the January MPC, the expected average inflation rates for 2016 and 2017 have declined from respective averages of 6,8 per cent and 7,0 per cent to 6,4 per cent and 5,8 per cent; the peak on the inflation forecast, which has been consistent for the fourth quarter of this year, declined from 7,8 per cent to 6,7 per cent; and the length of the breach of the target has been shortened, with inflation now expected to return to within the target range during the second quarter of 2017, rather than in the fourth quarter of 2017 as forecast in January.

These are sizeable revisions. However, before we get too complacent we should note that the revisions to the 2018 forecasts have been a lot more modest. While the expectation remains for inflation to be within the target range for the whole of that year, the trajectory, at an average of 5,5 per cent, remains uncomfortably close to the upper end of the target range. Similarly, our forecasts of core inflation also show a persistence well above the 5 per cent level over the forecast period.

There are two main reasons for the more favourable forecasts. In part, the rise in the repurchase rate of 200 basis points since January 2014, with the most recent increases this year in January (50 basis points) and March (25 basis points), has helped to guide expectations of future inflation. As the forecasts that we consider in MPC meetings are based on an unchanged policy rate, the forecast in January would not have incorporated the cumulative 75 basis point increase that transpired in that and the subsequent meeting.

The second part relates to changed assumptions regarding the exogenous variables in the model. In particular, the assumption regarding the rand exchange rate outlook has improved as a consequence of greater stability and appreciation over the course of the year. The international oil price assumption has been increased from its low point in January, but not sufficiently to offset the positive revisions.

There has also been a change to how we see the risks to the forecast. In January, the risks were seen to be unambiguously to the upside. An upside risk was maintained for the next three meetings, despite downward revisions to the forecast, and in July the MPC assessed these upside risks to have moderated. In the September meeting, the risks were seen to be more or less balanced. However, as the MPC pointed out, while the outlook has improved, these improvements are highly vulnerable to changes in the risk factors affecting inflation, and these factors can change very quickly.

I will now highlight some of these risk factors.

The global growth outlook continues to be challenging. Growth in the advanced economies remains subdued. Uncertainty about the strength of the US recovery has contributed to a delay in further monetary policy tightening in the US. These delays have supported the rand and other emerging market currencies. While an interest rate increase in the US is inevitable, the timing continues to remain uncertain. This uncertainty, and changing perceptions, is likely to keep the rand relatively volatile. This may be tempered somewhat by a more muted trajectory for US rates.

These developments have impacted on the pattern of global capital flows. Data from the Institute for International Finance show a sustained recovery of capital flows to emerging markets since earlier this year, following the pronounced decline in the second half of last year. The predominance of flows into emerging market bond markets suggests that the search for yield remains a driving factor. Reflective of this pattern, since the beginning of the year, non-residents have been net sellers of South African equities, but net purchasers of South African government bonds.

Apart from US monetary policy, other potential global risks pertain to China and Brexit. The effect of a slowing Chinese economy on South Africa is mainly through commodity prices. The ultimate impact on our terms of trade however will depend on the extent to which oil prices are also affected. Nevertheless there is no doubt that falling commodity prices are negative for South African growth, the value of our exports and the exchange rate. While the outlook for China has improved since the beginning of the year, concerns about the stability of the financial sector persist.

The impact of the UK decision to leave the EU is still unclear, but the high degree of market volatility that followed the decision subsided somewhat. For now it seems that the impact will be mainly contained within the UK, with some fall-out on the EU. But until the full terms of the withdrawal are clear, uncertainty will persist, which will impact negatively on investment sentiment in the UK. The direct short-term impact on South Africa is expected to be fairly limited, but there could be longer term impacts on trade and financial links, and on tourism from the UK into South Africa, should a sharp growth decline transpire. We are also likely to be affected indirectly to the extent that there are broader negative global spillovers than currently expected.

A consequence of the decline in commodity prices has been a slowdown in growth in Sub-Saharan Africa (SSA), for many years one of the world's fastest growing regions. The IMF forecast for SSA growth for this year is 1,6 per cent, compared with the past decade average of 5,5 per cent. With the region accounting for almost 30,0 per cent of South Africa's manufactured exports, we are particularly exposed to this slowdown and will weigh against a sustained improvement in our trade balance (as is discussed in our recently released Monetary Policy Review).

Most of these developments impact the exchange rate, either directly or indirectly. The rand remains an important determinant of inflation, and therefore we need to have a careful assessment of the risks. This is complicated by the fact that the observed pass-through from the exchange rate to inflation appears to have declined in recent years. Given the pressure this places on the margins of South African firms, the monetary policy committee has been concerned for some time that this subdued pass-through could reverse at any stage.

The rand started off the year in a particularly vulnerable spot following domestic developments in December that raised risk perceptions, followed by renewed concerns in January regarding the outlook for the Chinese economy. Since its low point in late January, while remaining volatile, the rand has appreciated by about 24 per cent on a trade-weighted basis, and by about 15 per cent year to date. Appreciation has been pronounced against troubled advanced economy currencies, but less so compared to other commodity producers and emerging market economies. The Chinese economy appears to have stabilised, capital flows to emerging markets have resumed, and US monetary policy has remained on hold. Domestically, the positive second quarter growth outcome and the significant narrowing of the current account deficit, and more recently speculation regarding the large M&A transaction in the market also helped to underpin the rand's recovery.

Going forward, it is uncertain whether the rand will sustain current levels. The rand remains vulnerable to global factors, as well as domestic risks, including a possible ratings downgrade, though the rating got affirmed during the course of the mid-year. Unfortunately, predicting the rand is extremely difficult, given the multiplicity of factors affecting it. In our model, we make a simplifying assumption of a stable real effective exchange rate over the forecast period, (implying a nominal change in line with inflation differentials) and then try to assess the risks to this assumption.

The starting point is critical. We generally set the starting point at the prevailing level of the real effective exchange rate, unless we believe that that level represents a clear over- or undervalued position. At the most recent meeting of the MPC, the risks to inflation from the exchange rate were seen to have moderated somewhat, given recent positive developments.

I should emphasise that our focus on the rand is not because we would like to see a particular level of the rand. Rather, our focus is on the possible impact of the rand exchange rate on the inflation outlook. This needs to be assessed in conjunction with all the other factors that are impacting on the inflation outlook at that time. We would also need to assess the extent to which any movement is likely to be persistent, or if it is merely short-term volatility.

A related point concerns the questions recently raised as to whether we would be purchasing dollars in the M&A transaction. Our position on the rand and reserve accumulation remains unchanged.

First, we remain committed to a flexible exchange rate, determined by market forces. However, in the event of abrupt movements in the rand exchange rate that could threaten the orderly functioning of markets, the SARB will consider becoming involved by way of facilitating the smooth execution of trades, with the objective of ensuring orderly market functioning.

Second, in the case of inflows that display somewhat more permanent characteristics (such as FDI or M&A related inflows), we may seek to increase our foreign exchange reserves when these opportunities arise and/or market conditions are conducive. Any changes in our foreign exchange reserves position will be published in our monthly statement of asset and liabilities. Any such purchases will be for the purpose of accumulating reserves, rather than to achieve a desired exchange rate outcome.

Not all the drivers and risks to inflation are external. For some time food prices have been an upside risk to the inflation outlook in the face of the protracted drought experienced in the country. For the past few months our food price forecasts have been more or less in line with outcomes, and we expect prices to peak in the third quarter at over 12 per cent. This assumes that normal rainfall patterns that are currently predicted do in fact occur. Alternatively, should crop estimates surprise on the upside, food prices could fall faster than expected, and pose a downside risk to the inflation outlook. This is despite the fact that meat prices are expected to remain elevated as farmers restock their herds. The global context, however, also matters, and we have seen FAO data showing global prices to have ended a sustained deflationary trajectory.

A final consideration in the inflation forecast is the role of wage growth in a weak economy. Our forecast includes some decline in private employment which, alongside some pickup in the aggregate growth rate, results in a rise in productivity per worker and moderates growth in unit labour costs.

The domestic growth outlook remains a concern, despite the favourable second quarter outcome, which followed a quarter of contraction. We assess the outlook to remain relatively subdued, but our forecast was revised up for this year to 0,4 per cent, and to 1,2 per cent and 1,6 per cent in the next two years. We assess the risks to this forecast to be more or less balanced. Our estimate of potential output for this year is 1,4 per cent, rising to 1,7 per cent by 2018. This suggests below-potential growth and a negative output gap over the forecast period. However, because our estimates of potential output growth have been revised down during the past year or so, the output gap is not as wide as previously thought.

Lower potential growth and a small output gap suggest that the cyclical stimulus that monetary policy can give to growth is limited. The growth constraint is structural in nature, and should be tackled through structural reforms, for example those envisaged in the National Development Plan.

Nevertheless, in a flexible inflation targeting context we have to be mindful of the impact of our actions on the cyclical element of growth. For this reason, the current interest rate cycle has been very moderate, particularly in comparison with previous interest rate cycles.

At our most recent meeting, we highlighted the moderation of the inflation forecast, and the balanced nature of the risks. We noted further that, should current assumptions and expectations transpire, we could be close to the end of the tightening cycle. This implies that policy remains very data dependent. Calling the peak of a cycle with precision is difficult at the best of times. Under current conditions of heightened uncertainty both globally and domestically, it is even more difficult.

However, even if it turns out that we are at the end of the cycle or close to it, this does not mean that further accommodation is imminent. As I underlined earlier, the expected inflation trajectory, while within target, is uncomfortably close to the upper end of the target range, leaving little room for error. We would prefer to see an inflation trajectory more firmly and sustainably within the target range. For this reason we see the bar for a cut in interest rates as being set high.

Part of our concern relates to the impact of wage settlements and inflation expectations in contributing to inflation persistence at levels near the top of the target range. While we are pleased that inflation expectations have not become unanchored during the current inflation target breach, the longer term expectations remain at the upper end of the target range. Similarly, average wage settlement rates have been consistently above inflation, contributing to inflation persistence at higher levels.

At current levels of the real interest rate, monetary policy is assessed to remain accommodative. But a lot depends on where we see the neutral interest rate, which is notoriously difficult to calculate. Since the global financial crisis, many countries have progressively reduced their estimates of their neutral interest rates, alongside declining estimates of potential output. However, there are different views as to whether these revisions represent short-term deviations from longer term unchanged values, or whether these represent a longer-term “new normal”.

One complication in estimating neutral real rates is that most models don’t explicitly assess the role of external factors, nor other structural and shorter run determinants. In particular, long-run determinants like the savings culture of households and decisions by fiscal authorities, or shorter-run factors like the impact of policy uncertainty, and critical drivers of capital stock growth such as the exchange rate, are not clearly identified in the models, but would seem to be quite important.

Generally speaking, for emerging-market economies, global surplus saving pushes down neutral real rates, while structurally weak domestic savings pushes them back up. This suggests that neutral real rates should be below long-term averages, but well above the levels applying in advanced economies. Where investment-saving imbalances are sticky and risk premia reflect sustained higher inflation or weakening policy frameworks, neutral rates should probably be higher.

In conclusion, it is almost trite to say that monetary policy is always made under conditions of uncertainty. Since the crisis in particular, we have been experiencing a prolonged period of elevated uncertainty. We have, however, benefitted in recent months from movements in from some global and domestic factors that have aided downward revisions to our inflation forecast. We also know that the positive factors underlying the more favourable outlook can change very quickly, and therefore there is no room for complacency. A continued rise in inflation would put at risk our current low interest rate environment and its cyclical support, and threaten long run sustainable economic growth and employment.

The SARB remains committed to its constitutional mandate. We will pursue this mandate vigorously and without fear, favour or prejudice. We would continue to do that within a flexible inflation targeting framework. We can do this with confidence in the knowledge that our constitution guarantees our independence. Of late South Africans from all walks of life have defended the SARB. Our strength and credit lies with the institutions of our democracy. The SARB is one such institution. Together with National Treasury, we remain a pillar of strength in macroeconomic management and we remain resolute in pursuing our mandate.

Thank you.