South African Reserve Bank

Address by Lesetja Kganyago

Governor of the South African Reserve Bank

at the Annual Convention of the South African Chamber of Commerce and Industry (SACCI)

Emperors Palace, Johannesburg

20 October 2016

Distinguished guests, ladies and gentlemen.

Thank you for the opportunity to address the annual convention of SACCI. The theme of institutions and competitiveness is particularly apt in today's economic and political environment. Strong and sound institutions are essential for the smooth functioning of society, as they prescribe the behaviour of individuals, and set out the "rules of the game". Well-functioning institutions are what investors look for when making long-term decisions to invest in a country. Institutions and the institutional framework are generated over time through interactions in society in general, and are dynamic and endogenous. In other words, they change over time and can be expected to both affect, and be affected by, the current political and economic dispensation. Furthermore, institutional arrangements in society are often self-perpetuating with strong institutions creating incentives for further institutional improvements and vice versa. But their dynamic nature means that we cannot be complacent, and we have to resist attempts to undermine strong institutions.

Often people think of competitiveness in terms of the exchange rate. However, this is only one limited aspect of competitiveness. While relative prices matter, it is the institutions that underpin the economy that count. The exchange rate, to a certain extent, simply reflects the strength or weakness of institutions, or changes or threats to their integrity.

In the recent Global Competitiveness Report, the areas in which South Africa fared well are those that are underpinned by strong institutions and governance such as the strength of auditing standards, the protection of minority shareholder interests, the efficacy of corporate boards and the efficiency of the legal framework and judicial independence. The soundness of banks is also highly ranked. South Africa was one of the relatively few countries whose banking system emerged largely unscathed from the global financial crisis.

In my address today I will reflect on the place of the Reserve Bank within the current institutional framework, the relationship between the exchange rate, competitiveness and institutional strength, and make a few comments on the financial stability mandate.

The Bank's role in South Africa's institutional landscape

The Bank has a long and proud history of supporting South Africa's institutional strength. In fact, in June the Bank celebrated its 95th anniversary. The role of the Reserve Bank and its independence is clearly enshrined in the Constitution. The South African Reserve Bank, in pursuit of its primary objective, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters." But this notion of the Reserve Bank as an independent institution is often misunderstood. Independence does not mean that we sit in our glass and granite tower and make decisions independently of the needs of the economy or of the overall goals of government policy.

In this respect, it is useful to distinguish between goal independence and operational independence with respect to monetary policy. Goal independence refers to the setting of the objectives of monetary policy, while operational independence relates to the implementation of the mandate that is given to the central bank. Globally it is generally, although not exclusively, the case that monetary policy objectives are set by elected representatives of the country. That is how it should be. But these policy objectives can only be set within the constraints of what monetary policy can achieve, and not what some people would like it to achieve.

Monetary policy independence usually relates to operational independence, and has its roots in the need to prevent monetary policy being used for political expedience. In particular, to avoid the so-called “political interest rate cycle” phenomenon where rates are lowered in advance of elections and then raised again thereafter.

This dichotomy is in fact consistent with the Constitution of South Africa, where it is stated that the primary objective of the Bank is to “protect the value of the currency in the interest of balanced and sustainable economic growth. The Constitution therefore does not give the Bank goal independence, but our operational independence is explicit. The inflation targeting framework, which is a good example of an evolving institutional structure, aligns well with this aspect of the Constitution. The goal of monetary policy, the inflation target, is set by government. The current target is for us to be within a range of 3-6 per cent. But within that context, the Bank has full operational independence to implement appropriate policies to achieve that goal. We are given the responsibility for protecting the value of the currency, but we are also accountable for this responsibility. Government cannot dictate interest rate policy to the Bank, and the requirement to consult regularly with the Minister of Finance does not undermine our independence, but is a mechanism to ensure effective macroeconomic coordination and information sharing.

To us, protecting the value of the currency means maintaining the purchasing power of the rand in South Africa by containing inflation. By adjusting monetary policy or through its communications, the MPC aims to influence both demand conditions in the economy, as well as the inflation expectations of businesses and consumers. The commitment to an inflation target acts as a signal to these stakeholders that broad-based price or unit labour cost increases above the target will influence the monetary policy stance.

Through this process the SARB is working to build the credibility of the inflation target to the extent that, during inflation spikes, labour unions and businesses do not meaningfully raise their expectations for future inflation. Achieving this goal ensures that the country avoids an inflation spiral wherein wage demands and price increases persistently ratchet up in response to current inflation outcomes. Embedding the inflation target within the minds of the general public, through various communication strategies and initiatives, is a task which the Bank has been working at for the past sixteen years.

The inflation targeting framework is a good example of an institutional structure which reduces uncertainty for businesses and households. This increased certainty, in turn, facilitates long term investment and economic growth and this is the main contribution that the Bank can make to balance and sustainable growth. At the same time, maintaining price stability helps to protect the poor in particular, who are most vulnerable to the ravages of inflation. It also helps to prevent the erosion of our international competitiveness, a point to which I will return later.

In recent years, the Bank has been confronted with a challenging economic environment in which GDP growth has been slowing, with a deteriorating inflation outlook. In order to avoid a persistent breach of the inflation target, the MPC began a gradual interest rate hiking cycle in January 2014. Since then the repo rate has been increased by 200 basis points. Part of the challenge has been that inflation has been driven primarily by supply-side factors, particularly the exchange rate and food prices. Our approach has been to try and look through these shocks and focus on second round effects. Given the persistence of inflation expectations at the upper end of the target range, and wage settlement rates in excess of inflation, it has been difficult to avoid a tightening cycle.

More recently there has been some improvement to the inflation outlook. The Bank's latest inflation forecast is for an average of 6,4 per cent in 2016, 5,8 per cent in 2017 and 5,5 per cent in 2018. The moderating inflation trajectory reflects recent policy tightening by the Bank, an expected deceleration in food price growth and an improvement in the exchange rate outlook relative to previous forecasts. The MPC is of the view that should the forecasts materialise, the hiking cycle may be nearing its end. However, this does not mean the interest rate reductions are imminent, as we would like to see inflation more firmly within the target range on a sustainable basis over the forecast horizon. We are also clear that the bar for any future rate cuts has been set very high.

Although our mandate is inflation, it does not mean that we ignore growth considerations. The Constitution states that what we do should be in the interest of balanced and sustainable growth in the Republic. We have to be clear, however, about what monetary policy can achieve in this respect. Our view is that long-term trend growth or potential output is determined by real factors in the economy. These include infrastructure, education, labour and product market efficiency, productivity growth, and institutional strength, to name a few. Monetary policy can only impact on cyclical variations of growth around the growth trend. Monetary policy cannot be an engine for sustained growth. This requires structural reform, in order to arrest the declining trend of potential output that we have observed over the past few years.

However, implementing structural reform is difficult and it requires strong institutions and political management. Some of it requires changes in processes that are expenditure neutral, for example product market reforms, and changing competition laws or labour laws, while others could require huge investment layouts, as in the case of infrastructure. These are political decisions, which are often difficult, and inevitably involve entrenched interests. It is often difficult to get societal buy-in or to change expenditure priorities when the country's requirements are diverse and the means limited. In South Africa, we do have a structural reform framework in the form of the National Development Plan, which has been adopted by all parties. It is not the plan that is lacking, rather its implementation.

It is far easier to look for a quick fix such as monetary policy. This is not a peculiar South African phenomenon, however. Monetary policies, in conjunction with fiscal policies, were instrumental in avoiding worse outcomes to the global financial crisis. But monetary policy is not the appropriate policy to raise potential output. Yet, in the absence of meaningful structural reforms, the focus globally remains on monetary policy to provide the solution. This creates a challenge for central banks. As Mohamed El-Erian has noted in his recent book, central banks are now seen as the "only game in town" due to slow progress in the implementation of structural reforms. This inability to do so creates unreasonable expectations for monetary policy to achieve objectives that it is not competent to deliver. Ultimately it could lead to an undermining of central bank credibility and institutional strength, even in those areas where it is best suited to operate.

The exchange rate and competitiveness

As I mentioned earlier, when people think about global competitiveness, the exchange rate immediately comes to mind. Central Banks talk about the exchange rate and global competitiveness, we are referring to the real exchange rate, or the nominal exchange rate adjusted for inflation differentials between South Africa and its trading partners. A depreciation only improves competitiveness if it is not eroded by higher inflation. In other words, if it is a real depreciation. So the Bank's contribution to keeping inflation low is relevant in this respect.

Our constitutional mandate to protect the value of the currency is often interpreted as a mandate to keep the nominal exchange rate stable. In the absence of other shocks, the exchange rate should remain stable if our inflation rate is the same as that of our trading partners. But assuming our inflation rate is higher and we attempt to maintain a stable exchange rate (and assuming that we have the means to do that), our real exchange rate will in fact be appreciating. In other words, we will be losing competitiveness, as the cost of producing goods domestically will have increased relative to our competitors. This persistent overvaluation of the currency will not be sustainable.

Since the beginning of 2011, the real effective exchange rate has depreciated by 26,8 per cent, in contrast to the nominal effective depreciation of 41,9 per cent. So on this measure we are more competitive, but we have not seen a strong adjustment to this, as evident in the persistent current account deficit.

There are a number of possible explanations but I will highlight a few points. It is important to understand what the key drivers of the depreciation have been. While there are a whole range of factors that impact the rand on a day to day basis, terms of trade changes and capital flows have been among the key underlying drivers or determinants. Falling commodity prices since 2011 have been an important factor in the weakening of the rand. This does not necessarily provide an impetus for increased production of commodities, but rather it shields the rand value of mining output. It does make non-mining exports more attractive, and that is how the adjustment is supposed to work. In other words, a real depreciation is supposed to be positive for growth.

Capital flows are multidimensional. Some are driven by interest rate differentials, and the current global low interest rate environment makes emerging markets a desirable portfolio investment destination. These inflows have given support to the rand over the past few years. But periodic reversals of these flows, for example during global risk-off scenarios and risks of interest rate increases in the US have impacted negatively on the rand. Portfolio inflows into equity markets are growth sensitive, and this explains why non-residents have been net sellers of South African shares in recent months.

To some extent, the rand has followed the pattern of commodity-producing emerging market economies over the past few years in response to changes in terms of trade and the pattern of global capital flows. However, there have been important divergences relating to domestic idiosyncratic events which have resulted in heightened perceived political risk, and reflected in the weaker exchange rate. The increased risk premium is often associated with falling business confidence. The resulting exchange rate depreciation is consequently unlikely to be a big boost to investment and exports. Rather, it will reflect weakening institutions. The adjustment is then unlikely to come about through increased exports, but through import compression, in the form lower investment and consumption expenditure. A weakening currency in the face of heightened political risk is therefore not a sign of increased global competitiveness, and is unlikely to be accompanied by higher growth.

Currently, South Africa remains under threat of a possible downgrade from the rating agencies to sub-investment grade. One of the explicit factors contributing to some of the agencies maintaining our investment grade rate in the past few months has been the strength of some of our critical institutions. There is no doubt that should a downgrade transpire, it will be reflected in the exchange rate (to the extent that it is not already reflected). This will not be a sign of increased competitiveness, rather an adjustment to a deterioration in our competitive standing globally as an investment destination. The impact of strong institutions on our global competitiveness cannot be underestimated.

The financial stability mandate

Aside from price stability, the Bank has now also been given an explicit mandate to oversee financial stability as envisaged in the Financial Sector Regulation Bill (FSRB), which is currently before Parliament. The bill defines financial stability in two important ways. Firstly, it is the ability of financial institutions to provide products and services within the confines of the law, without interruption, regardless of changing economic circumstances. Secondly, it means that the public has confidence in the financial sector and its ability to function appropriately. The FSRB also provides for a Twin Peaks approach to financial sector regulation, which, when enacted, will expand the SARB's scope of prudential regulation beyond banks, to include insurers and financial market infrastructures, resulting in the establishment of the "Financial Sector Conduct Authority" focusing on the conduct of financial institutions towards their clients. Whilst South Africa's financial sector is widely seen as globally competitive and soundly managed, the reforms contained in the FSRB are likely to add additional institutional strength in this sector. This is because an explicit separation between the conduct and prudential regulator will allow for improved oversight.

The responsibility of ensuring financial stability and the soundness of financial institutions and the financial sector is complementary to the Bank's current mandate of price stability. Both objectives are seen as necessary conditions for sustainable and balanced long-term economic growth. Furthermore, financial stability provides a platform for the implementation of monetary policy. Without a well-functioning financial sector, it is impossible to effectively transmit monetary policy through the economy.

The Bank constantly strives to strengthen the public's confidence in our financial sector because it is only through the assurance of financial stability that South Africans will save and invest for the long term. This institutional strength also contributes to giving confidence to foreign investors to invest in the country. While the role of the Bank in regulating and supervising the individual banks has been well established, (i.e microprudential oversight), we also have an important evolving role to play in macroprudential oversight. Here the focus is on the financial system as a whole and our role is to monitor and act against financial excesses that threaten to undermine the broader economy.

The pre-Crisis approach by central banks was that they did not have the ability to recognise bubbles and the best they could do was to clean up after the bubble had popped. Central banks also believed that price stability and micro-prudential supervision were sufficient to ensure broader financial stability. However, the Global Financial Crisis taught us that financial excesses can emerge during times of low inflation and strong individual bank metrics. The current view is that these excesses should be nipped in the bud by appropriate policies that constrain lending, either through macroprudential policies directed at the particular market segment, or through some form of targeted brakes on bank lending or higher interest rates. Our approach currently is for interest rate policy to be focused on inflation, and for the Bank's Financial Stability Committee (FSC) to use other macroprudential policies to moderate financial stability risks. While our tool-kit is still being refined, we have implemented the framework of a countercyclical buffer for banks which will be over and above the capital requirements of individual banks. This provides the FSC with a tool to change capital requirements in order to protect the banking system from the boom and bust phases of the financial cycle, and is an integral part of the internationally agreed standards for risk-based capital requirements. Currently, given the weak state of bank lending, this buffer is set at zero.

Concluding remarks

In many ways, strong institutions are constraints on the abuse of political and economic power that society puts in place. As such, there is always the danger that there are incentives for some to undermine some of these institutions. We must therefore ensure that strong institutions are supported by society. It is important to regularly question whether our institutional arrangements are providing the right incentives to the stakeholders in our society. Furthermore, we must ensure that our institutions encourage broad-based participation in the economy and do not give rise to alternative forms of collusion between interest groups. But it is also important to bear in mind that institutions are not static. We live in a changing world, and institutional change is inevitable. But we must ensure that change is positive and in the interest of the broader society.

The Bank will continue to pursue its constitutional mandate within a flexible inflation targeting framework without fear or favour. We have built a strong reputation as a respected institution within our young democracy. Together with the National Treasury we will continue to strive to bring about a stable macroeconomic environment, conducive to long term growth and development.

Thank you.