South African Reserve Bank

The outlook for monetary policy

Address by
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Over the past five years or so, emerging markets got used to bad news. Growth has been slowing, and growth forecasts have been marked down repeatedly. For a number of countries – particularly commodity exporters and countries with substantial external financing needs – inflation has also been accelerating.

From the vantage point of late 2016, however, it seems possible we are at a turning point. In South Africa, for instance, we see inflation returning to target in early 2017 and then staying within the target range throughout the forecast period. Growth is expected to recover slowly from 2016 lows, and our growth forecasts have lately been revised up slightly, breaking a multi-year trend of downward revisions. Furthermore, the rand may just about end the year stronger than it started, for the first time since 2010.

In the late 2000s, and in the immediate aftermath of the Global Financial Crisis, many emerging markets probably got more credit than they deserved for strong economic outcomes. Now, on the other side of the cycle, the pessimism may be overdone. Indeed, at the moment it is the advanced economies which have enjoyed the strongest recoveries – specifically the United States and the United Kingdom – that now seem less robust, given political surprises and abrupt reversals in growth forecasts. By contrast, a number of major emerging markets are doing, if not better, at least less badly.

Let me set out some tentative reflections on our most recent global shock, the potential for a shift in US macroeconomic policy. Let me stress that we are aware of the risk, and considerable time was spent at our MPC meeting this week discussing the issue. The basic idea is for a shift from fiscal consolidation with accommodative monetary policy to fiscal expansion with tighter monetary policy. This new combination will result in investment shifting out of bonds and into equities, with repercussions for both asset prices and currencies, and considerable volatility in the near term. The cost of financing debt has risen, and this will place pressure on over-stretched economies, at least until we see whether the shift results in better real economic growth outcomes.

But that outcome will remain unclear for some time. Stronger US and global growth rates could entail improvements down the line in emerging market exports and commodity prices, and an improvement in South Africa's current account deficit. But much depends on whether higher tariff barriers are realised and on how capital markets assess US fiscal policy. If a larger US fiscal deficit does not generate strong growth, then higher financing costs could weigh quite heavily on the global economy. This combination, weak global growth, higher rates and risk premia is where we are already coming from. It is the set of conditions that we hoped we were exiting from this year, and should, therefore, in mitigation spur us on to work harder to reduce our macroeconomic risk profile and take steps to encourage more rapid economic growth here at home.

Today, I'd like to discuss the outlook for recovery and the role of monetary policy. This is necessarily uncertain. It is easy to imagine shocks which could throw us off course, both from the global economy and domestically. Some important political shocks have recently occurred, and it will take time for their full economic meaning and impact to be felt – a point I will return to in the conclusion.

Yet our policy thinking can't simply be about waiting for new information and complaining about uncertainty. Being data dependent is sensible in as much as you should revise your strategy in line with new facts, but it is not a substitute for strategy. As former US Treasury Secretary Tim Geithner reminded us during the Crisis, 'plan beats no plan'.

Inflation

I will start with inflation, because it is our primary mandate, and because it is important for the economy's overall trajectory. As you will all know, inflation has been outside the 3-6% target range for much of this year. It is currently expected to return to within the target sometime in the second quarter of next year. The main drivers of the breach have been higher food prices and pass-through from currency depreciation. Apart from these shocks, however, inflation would still have been quite elevated for an economy with almost no growth. This is because wage and salary settlements continue to come in above inflation and productivity gains, and because some administered prices like electricity are still being adjusted higher in real terms.

The policy response to this set of challenges has been nuanced. We are flexible inflation targeters, which means we are mindful of the origins of shocks as well as the broader economic consequences of our decisions. Administered prices and food prices are classic supply shocks, and we think of short term volatility in the exchange rate the same way. This means we prefer to focus on the so-called second round inflation effects. If inflation is higher due to these shocks, but inflation expectations don't move and broader prices and wages don't accelerate, then shocks will have only temporary consequences and we can afford to look through them.

If the consequences are that inflation will deviate from the target in a more permanent way, however, then policy should respond. Of course, it is difficult to determine if shocks will be permanent. We have forecasts and surveys to help guide our judgement, but these are imperfect tools. Furthermore, by the time you have firm proof of second round effects, the policy response is sure to catch out economic agents that have already increased prices, causing economic dislocation. This implies that we need to take into consideration the *expected* second round price effects of shocks.

In late 2015 and early 2016, policy was tightened. We were experiencing large and simultaneous price shocks – a major drought and sustained depreciation. Inflation expectations were already close to or above 6%, and core inflation was over 5% and climbing. So there was minimal room for error. The inflation forecast showed a protracted breach of the target range. It was therefore likely that without a policy response, inflation would have shifted outside the target range in a more sustained way. The gradual policy adjustments helped prevent this outcome, while recognizing the relatively weak economic environment. We have not had to tighten policy sharply to achieve high real interest rates, as has been necessary in countries such as Brazil, Russia, Ghana and Zambia.

All this is in the past. The rate hikes from late 2015 and early 2016 are only beginning to affect the economy now. Those hikes help explain why inflation is returning to target. Any new decisions will shape economic outcomes in about one to two years' time. We are therefore focussed on the outlook for late 2017 and 2018. We see the shocks of 2016 dissipating. Food price inflation is expected to slow from the first quarter of next year as weather conditions normalise. The exchange rate has recovered some ground, and although its volatility reminds us how rapidly these gains could unwind, the rand has appreciated roughly 15% against the US dollar from January's lows. Accordingly, our forecasts show inflation reaching 5.5% by the end of 2018. The MPC noted in the last two policy statements that if these forecasts prove durable, the end of the hiking cycle may be close.

One of the biggest questions is over inflation expectations, which remain clustered around 6%, where they have been for about six years. We are relieved they have not shifted markedly higher despite above-target inflation in 2016. On the other hand, we are concerned that expectations are not anchored more comfortably within the 3-6% target range. Indeed, the main reason inflation is not moving much lower even as the food and currency shocks dissipate is because expectations are elevated: price and wage setters continue to believe they must demand increases close to 6% just to maintain the real value of earnings. The forecast decline in inflation is a consequence of supply shocks falling away, not a moderation in underlying inflation. This implies that we need to continue to look through the first round effects and focus on second round effects. This means inflation expectations remain central to policy.

Our understanding of inflation expectations is that they are a mix of forward-looking and backward-looking views. Expectations are sometimes dismissed as completely backward looking, and therefore of no real value to policymakers. This is incompatible with the evidence. After all, the oil shock lowered inflation to 4.6% in 2015, yet even as short term expectations adjusted, longer term expectations didn't move lower. Similarly, higher inflation in 2016 has affected current year expectations but not longer-term views. This shows that respondents have a reasonable sense of current or actual inflation, but do not let it fully define their views for the future.

Still, there is little evidence that expectations are exclusively forward-looking. There are few if any examples of this in the real world. Guiding expectations lower therefore involves a mix of optimising communication and delivering lower inflation. Cutting rates as soon as inflation edges under 6% would be a clear signal that we are targeting the very top of the target range, so rational expectations would stay there. Meanwhile, backward looking expectations are unlikely to adjust without an experience of lower inflation. Either way, it would be premature to ease policy without a corresponding improvement in expectations, so that they are anchored more comfortably within the 3-6% target range.

Growth and interest rates

What about growth? In our communications over the course of the hiking cycle, we have repeatedly emphasised a policy dilemma – slowing growth alongside rising inflation. The outlook shows this dilemma easing from both sides: more growth, moving closer to the economy's potential and though inflation is slowing, it is still outside, or too close to the upper end of the target range. This weakens the case for lowering interest rates. In particular, three considerations stand out.

First, as I have mentioned, the policy stance has been accommodative and has moved closer to neutral. But we have to treat neutral rate estimates with some scepticism. The available methods produce divergent results. It is clear, however, that we are not like Brazil, where rates were recently cut for the first time in several years, but from the very high starting point of 14.25% (and a real rate of nearly 9%). Had we raised rates by 700 basis points, for example, the inflation outlook today might justify easier monetary policy. In our case, a cumulative increase of 200 basis points to 7 per cent translated to a real repo rate of just over 1 per cent. This compares to a potential real GDP growth rate of about 1.5%.

Second, the way we exited from the global financial crisis and its accompanying drop in growth currently limits the impact of our accommodative policy on growth. The standard macroeconomic justification for lower interest rates is to address a demand shortfall caused by excessive saving. South African saving habits can rarely be described as excessive. Household debt levels remain high in comparative perspective. Government debt is closer to international norms at about 50% of GDP, but the pace of debt accumulation has been unusually rapid. Our current account deficit is expected to remain over 4% of GDP for the foreseeable future, and we have to keep on importing foreign savings to make up for domestic shortfalls. The financing cost of debt remains quite low, but our debt stock, counting both the public and private sectors, is uncomfortably high.

Private sector credit extension has been muted through much of the post-crisis period, reflecting both an ongoing reluctance to borrow and supply constraints related to regulations to limit the growth in household debt burdens.

Rapid credit growth has been seen in some sub-sectors, such as unsecured lending, but the larger credit aggregates for households have not moved significantly. This has been true both before and after we started raising rates. For these reasons, proponents of lower interest rates irrespective of the inflation rate remind me of the proverbial dogs chasing cars. The dog is unlikely to catch the car, and will be in trouble if it does – credit extension may continue to be weak while inflation rises. This characterises the 2011 to 2014 period well. There are, of course, some forms of credit growth we would like to see, particularly those which support investment, but a strong rise in household debt seems like an unsustainable growth model.

Third, we need to keep an eye on international competitiveness. A depreciated rand makes our goods and services relatively attractive, but inflation counteracts this – naturally, the more we raise prices, the more expensive we get. South African inflation tends to be higher than that of our trading partners, so as the exchange rate recovers, our real, inflation-adjusted exchange rate appreciates quite rapidly. Unfortunately, the line between cheap and expensive is not always that clear. The real effective exchange rate still looks highly depreciated, relative to its historical average, and on a purchasing power parity basis. However, more sophisticated exchange rate models, such as those which incorporate variables such as productivity differences and current account balances, put the fair value of the rand much closer to current levels.

These latter estimates tell us something about one of the puzzles of the post-crisis period, which is that rand depreciation has not brought about all the trade benefits we would normally expect. In 2010, with the rand close to seven to the dollar, we were repeatedly urged to intervene with the message that a rand closer to nine or ten to the dollar would do wonderful things for exports. Yet as the rand passed ten, then twelve, then fourteen, then sixteen, net exports stayed weak. In part, this reflects global factors. For instance, falling commodity prices lower export values. With the spread of global value chains, moreover, national exchange rate movements have smaller effects on trade: higher import prices offset lower selling prices.

In addition, domestic factors may have played important roles. New research demonstrates convincingly that constraints such as electricity shortages, as well as product and labour market rigidities, have reduced the stimulatory effect of a cheap exchange rate.[1] There is also compelling evidence that policy uncertainty has further weakened net exports.[2]

[1] Anand, Rahul, Roberto Perrelli, and Boyang Zhang (2016), "South Africa's Exports Performance: Any Role for Structural Factors?" *IMF Working Paper WP/16/24*.

[2] Hlatshwayo, Sandile and Magnus Saxegaard (2016), "The Consequence of Policy Uncertainty: Disconnects and Dilutions in the South African Real Effective Exchange Rate-Export Relationship", *IMF Working Paper WP/16/113*.

This lack of a trade response to rand depreciation is one of the biggest missing parts of the recovery. It would have made two vital contributions, supporting growth and moderating the current account deficit. As it is, we can feel confident that rand depreciation has at least supported existing exporters, such as our miners. We should also anticipate a stronger net export response if some of the constraints on the economy loosen, as we expect them to do over the next few years. As such, it is important for growth and rebalancing that inflation moderates and we maintain the beneficial effects of a depreciated rand.

Raising potential growth

I should be clear, the growth recovery envisioned in our forecasts is hardly robust. Monetary policy can provide support to short-term growth by closing gaps between actual growth and the economy's potential. And while our forecasts are starting to improve, from a broader perspective, growth rates under 2% are very disappointing, below both the longer run South African average of 3% and the National Development Plan aspiration of over 5%. Higher growth rates should be achievable.

We have on our side what Larry Summers and Lant Pritchett have called "perhaps the single most robust and empirical relevant fact about cross-national growth rates", which is that different countries revert to the same growth average over time. They say that "… current growth has very little predictive power for future growth".[3] That is ominous when you're China and growing above average rates and it is reassuring when your current performance is below average.

Nor is it that difficult to imagine how growth would improve. Business and consumer confidence is exceptionally subdued amid acute policy uncertainty. Investment growth is weak, with private sector investment growth negative. If confidence returns to more normal levels and investment recovers, both actual growth and the economy's potential growth rate should be expected to rise, clearing a path to higher growth without rising inflation.

[3] Lant Pritchett and Larry Summers (2014) "Asiaphoria meets regression to the mean" *NBER Working Paper 20573*, available at http://www.nber.org/papers/w20573.pdf

Conclusion

Today, I have set out a view for policy based on the existing forecasts. We expect better growth and lower inflation. We would like to see inflation expectations moderate so that they are more comfortably within the inflation target range, to help us permanently and structurally lower inflation and therefore interest rates. We expect lower inflation to yield benefits, including for growth. By contrast, given pricing behaviour in the economy, achieving lower rates as soon as possible may not have benign consequences for inflation expectations and competitiveness. Given our current forecast trajectory, we may be closer to the end of the hiking cycle, but the bar for cutting rates is very high.

It is possible that some shock could make the ideas I have discussed today seem fanciful and obsolete. That is part of the job: there are usually surprises, and we are always ready to adjust policy in line with new developments. As the boxer Mike Tyson remarked, 'everyone has a plan till they get punched in the mouth'. If the punches do not land, however, we should know what we want to do with policy. The answer is to get inflation down into the target range and prepare for another period of sustainable growth. For all the talk of policy dilemmas, of short term growth and inflation trade-offs, we should remember that in the long-run low inflation and growth reinforce each other. The world's most successful economies have both, and the worst failures have neither. We should look forward to inflation trending lower and growth moving higher, a positive prospect which implies no great dilemma for the central bank.

Thank you