South African Reserve Bank

An address by Daniel Mminele,
Deputy Governor of the South African Reserve Bank,
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Economic and monetary policy developments in South Africa

Introduction

Ladies and gentlemen, good afternoon.

It is my great pleasure to address this distinguished audience of fellow central bankers as we gather here in New York City to compare the current economic and financial developments across the major regions and to discuss the conduct of monetary policy in a world that finds itself in a transition.

For many of the previous years, as we gathered for the annual meetings of the International Monetary Fund and the World Bank, we had to discuss the reasons for the continued disappointing performance of global growth, and the most appropriate role that monetary policy could play in contributing to remedying the shortfalls.

This year, I am pleased to say, the outlook is finally looking somewhat promising: global economic growth, especially in the advanced economies, is gathering some momentum, is generally stronger than most observers expected a year ago, and looks sustainable, even if medium-term risks, which need tackling to safeguard these encouraging developments, cannot be ignored.

As much as these developments are welcomed by the emerging economies, some of which have struggled with sub-par growth in recent years, there are some accompanying challenges. For example, stronger economic growth will continue to reduce the degree of economic slack in the advanced economies, calling for ongoing monetary policy normalization and, eventually, higher real interest rates across the world. For the emerging economies that have become used to elevated capital inflows of late, this may force unpopular policy adjustments.

My remarks today will focus on the South African experience and how our monetary policy is negotiating the present challenges of low growth, inflation risks, and a benign yet uncertain global environment.

The dilemma of slowing growth and stubborn inflation

In its conduct of monetary policy, the South African Reserve Bank (SARB) has faced a growing dilemma in recent years: that of slowing economic growth coupled with inflation that is stubbornly rigid above the midpoint of its 3-6% target range. Following the short-lived rebound in the aftermath of the global financial crisis, which saw real GDP[1] expand by about 3% in both 2010 and 2011, the economy's growth rate has gradually slowed, reaching a low of 0.3% in 2016. The average growth of 1.6% in the past five years is a far cry from the 4.7% seen in the five years leading up to the 2008/09 recession. Our forecasts currently see real GDP registering growth of only 0.6% in 2017 before recovering moderately to a similarly weak 1.2% in 2018 and 1.5% in 2019.

Yet inflation has not shown a typical response. From a low of 3% in late 2010, the year-on-year rate of increase in the consumer price index (CPI) has mostly hovered around the upper end of the SARB's 3-6% target band, breaching it on the upside on five occasions – the last time between September 2016 and March this year. Even if we look at the core rate of inflation – which excludes the volatile food, non-alcoholic

[1] gross domestic product

beverages, fuel, and electricity components – the picture is quite similar. From a low of 3.6% year on year in the early months of 2011, core inflation rose for most of the following five years, only declining since the beginning of this year.

Why has this happened? To a large extent, the answer lies in the structural nature of the economic slowdown. A self-reinforcing cycle of poor private-sector confidence, coupled with subdued business investment and infrastructure bottlenecks (in particular in the electricity sector), has led to a gradual but sustained deterioration in the potential rate of economic growth. From the 3-4% range seen for most of the 2000s, the SARB's estimate of potential growth has slowed to no more than 1.1% for this year, with only a mild pickup expected in the next two years. Consequently, while we estimate that actual GDP is currently about 1.7% below potential, this output gap explains only a minor part of the poor growth performance of recent years.

Yet, even the presence of an output gap for most of the past eight years has not had a major impact on inflation. Indeed, our internal models suggest that the degree of slack in the economy has a lesser impact on the formation of price trends than other factors do, for instance exchange rate developments – which, incidentally, have been unfavourable over the past few years. Several other factors are frequently cited to explain this relative lack of responsiveness, including rigidities in the wage formation process, insufficient competition in many sectors of the economy, and the adaptive and backward-looking nature of inflation expectations.

Recent improvements in the inflation outcome and inflation outlook

Admittedly, the last three quarters have seen an encouraging improvement on the inflation front, despite the stickiness above the midpoint of the target band. The headline rate of inflation, which peaked at 6.7% in December 2016, fell to 4.6% in July 2017. Part of this slowdown reflects the more benign developments on the food and energy fronts. Helped by a strong rebound in grain production following the 2015/16 drought, which sharply reduced the prices of cereals, food inflation has fallen to 5.7% from a high of 11.8% last December. Fuel inflation is still off its early-year highs, while the modest gain in electricity prices in July 2017 has improved the overall year-on-year CPI comparison.

However, not all of the inflation slowdown is attributable to these transitory factors. Encouragingly, after a long upward drift, core inflation fell from a peak of 5.9% last December to 4.6% in July. Furthermore, this moderation was stronger than both the market consensus and the SARB expectations at the start of the year, as evidenced by the regular downward adjustments to our inflation projections. True: a large part of the deceleration in core inflation occurred in the goods sector, especially in those subsectors where import penetration is elevated, and these subsectors clearly benefitted from a recovery in the rand from early 2016 to March 2017 (an improvement of 37% in nominal, trade-weighted terms). Yet the magnitude of that slowdown in inflation, just like the absence of upside price pressures in the services sector (in particular in housing and insurance), surprised most observers.

The marked improvement in the inflation forecast, as well as the significant deterioration in the growth outlook coupled with an assessment by the Monetary Policy Committee (MPC) of the risks to the inflation outlook being more or less balanced, gave the MPC room for a moderate reduction in the repurchase rate of 25 basis points to 6.75% at its July meeting.

The current rates of inflation are not expected to fully persist, in large part because they still reflect the lagged impact of last year's rand recovery, which has already partly reversed. Indeed, the SARB's latest projections see inflation rising back to 5.3% by the third quarter of 2018 and stabilising around these levels over the remainder of the forecast period. By the time of the MPC's September meeting, while the inflation outlook was more or less unchanged and the growth outlook had improved moderately, the risks to the inflation outlook were assessed to be somewhat on the upside, resulting in the MPC opting to keep rates unchanged at that meeting.

Risks to the more benign environment

While the overall situation looks more benign when compared to previous periods, this should not allow a sense of complacency to creep in. The exchange rate of the rand, whose recovery over the past year has been key to the decline in inflation, remains volatile but does not display any major deviation, at present, from what our internal models suggest as fair valuation. Yet the risks to the rand are probably skewed towards renewed depreciation, for both internal and external reasons.

On the internal front, factors such as the combination of political and policy uncertainty, growing fiscal challenges of addressing growth-induced revenue shortfalls, the continuing upward drift in the debt-to-GDP ratio as well as growing funding needs for state-owned enterprises could all add to currency vulnerability.

Global market developments could also easily compound the rand's vulnerability. So far this year, the combination of low global market volatility, relatively flat government bond yield curves, and compressed risk premiums across a broad range of financial assets has largely sheltered South African assets from domestic causes of volatility. Net portfolio inflows into the local bond market have remained positive, and even in instances where domestic developments did put local assets under pressure, such tension proved short-lived. Yet the recent upward correction in interest rate expectations in several advanced economies, including the US[2] and the UK[3], serves as a warning that even a gradual pace of monetary policy normalization – after years of very loose global monetary conditions – may not be without adverse consequences for emerging market currencies such as the rand.

Other factors present upside risks to inflation over the coming two years. On the exchange rate front, we must also remember that the 2016 and early 2017 appreciation was greatly helped by a recovery in South Africa's terms of trade.[4] But the recent developments in commodity prices, including the stronger prices of crude

[2] United States
[3] United Kingdom
[4] The SARB's broad measure of South Africa's terms of trade, including gold, increased by 7.1% year on year as of the first quarter of 2017; it was relatively stable in the second quarter.

oil and the downward correction in the prices of iron ore, indicate that this improvement could partly reverse. The possibility remains for a larger electricity tariff increase in 2018 than the 8% assumed in the SARB's forecast. In addition, in the longer run, the implementation of minimum wage legislation could put upward pressure on labour costs, even though the size and timing of that impact is not yet fully understood.

Monetary policy's unclear margin of manoeuvre

Amid such elevated uncertainties, and despite the subdued nature of domestic demand, it is not clear how much space exists, if at all, for additional policy rate cuts by the MPC in the coming quarters. However, this does not mean that the SARB does not take the weakness of real economic growth into consideration. It certainly does. Indeed, estimates by the SARB's Quarterly Projection Model (QPM) of a Taylor rule based on the historical policy rate path show that the output gap has played a role in determining that policy rate.[5]

Furthermore, the policy stance is, at present, probably not far from what can be perceived as 'neutral'. According to estimates from the above-mentioned QPM model, the current real interest rate is not far from its equilibrium, or 'neutral', level. Admittedly, estimates of this 'neutral' level are fraught with high uncertainty, in South Africa and elsewhere. Nonetheless, such calculations suggest that the SARB does not have the kind of 'room to ease' it had when policy was unambiguously tight, for instance at the start of the 2008/09 recession.

Arguably, because of the existence of an output gap, monetary policy could – under normal circumstances – be allowed to loosen somewhat, with a real interest rate that is moderately below its 'neutral' level. This bias must, however, be weighed against both the upside risks to inflation (which I have already highlighted) and the stubbornly high level of inflation expectations. While expectations are currently less volatile, and probably less adaptive than in the early years of the inflation-targeting

[5] See the *Monetary Policy Review* published by the SARB in October 2017.

regime, they remain above the midpoint of the target range and uncomfortably close to its upper end. The consequence is a relatively large risk of persistent above-target inflation in the event of an inflationary shock to the economy – and it is the mandate of the MPC to mitigate such a risk.

As indicated earlier, in light of the balance of risks to the outlook and to the current policy stance, the MPC decided to keep the policy rate unchanged at its September meeting. This does not prejudge any future moves. Rather, because of the elevated level of uncertainty we are currently facing, the MPC feels a particularly strong need to reassess the balance of risks at every meeting. Consequently, monetary policy decisions, now more than ever, have to be data-dependent.

The most recent decision of the MPC appeared to surprise domestic money markets somewhat, as they had come to discount a 25 basis points rate cut in the wake of the July move. We prefer not to surprise markets. In fact, we see policy transparency and consistency as crucial in ensuring an effective transmission of rate decisions to the economy.

Yet in a fluid environment, where even small changes in the balance of risks can tip the policy scales one way or another, it is not possible to systematically come up with fully predictable policy decisions – just as it is not possible, in such an environment, for the MPC to give the kind of forward guidance that some call for. If anything, domestic financial market indicators seem to broadly echo the SARB's view that the uncertain environment is forcing a cautious approach to policy. Thus, forward rate agreements only discount a short and shallow easing cycle while the yield curve is positively sloped – a sign that investors are cognisant of the upside risks to inflation, and therefore to policy rates, in the medium to long term.

Conclusion – the continued relevance of the inflation target range

The challenges that South Africa has had to face over the past few years – in particular the combination of slow growth and relatively high inflation – may have led some observers to question whether the current inflation target range remains relevant for the country at this stage. In my view, raising or even contemplating abandoning the inflation target band would be a misguided approach. Both economic theory and historical experience show that whenever the price and wage formation process is rigid and price expectations are adaptive rather than well anchored, the cost of negative shocks tends to be higher and longer-lasting in real economic terms. South Africa’s own experience of the most recent global financial crisis, which saw the country suffer a relatively high number of job losses, illustrates the merit of such a strong and credible price anchor.

In fact, many emerging economies, including those at a similar level of development as South Africa, have enjoyed both stronger economic growth as well as lower and more stable inflation since introducing inflation targets. This observation has continued to apply since the global financial crisis. Equally, the adoption of a different anchor – for example the exchange rate – would be very difficult for South Africa as we are a commodity exporter and therefore regularly exposed to large terms-of-trade fluctuations.

The truth of the matter is this: low and stable inflation is the best contribution that monetary policy can make towards stronger and more sustainable economic growth and poverty reduction. As the saying goes: “Facts do not cease to exist because they are ignored.”

There is no better way to contribute to the socio-economic well-being of a nation than to protect the cost of living of its citizens. In his speech titled ‘Whip inflation now’, US President Gerald Ford warned that inflation would ‘destroy our country, our homes, our liberties, our property, and finally our national pride’.

As the SARB, we remain committed to formulating and implementing monetary policy aimed at controlling inflation at low levels, in line with the independence that the Constitution guarantees us, while remaining relevant to the context in which we operate.

Thank you.