South African Reserve Bank

An address by Daniel Mminele,
Deputy Governor of the South African Reserve Bank,
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Macroeconomic policy and financial risks – From 2017 into 2018

Introduction

Ladies and gentlemen, good morning.

Thank you for the invitation to deliver the keynote address at this sixth Bank of America Merrill Lynch Annual Summer Macro Investor Conference.

The end of the year is upon us. No later than yesterday did the South African Reserve Bank (SARB) conclude its last Monetary Policy Committee (MPC) meeting for the year. It is around this time when many analysts and forecasters publish their respective outlooks for the year ahead, complete with 'baseline scenarios' and a list of the major risks thereto. But to what extent will these risks differ from those that most of us flagged as the biggest threats 12 months ago? Does the way in which economic agents and policymakers responded to those threats hold lessons for the future? Or do we face as many uncertainties now as we did last year? As American author David Levithan once said: "The mistake is thinking that there can be an antidote to the uncertainty." We have to strive to achieve the best we can under the circumstances.

In trying to tackle the questions I have just posed, I will look back at some of the global risks which both official and private forecasters highlighted at the turn of 2017, to try and gauge the extent to which these risks materialised, if at all. I will also consider whether any new risks are emerging as we approach start of 2018, which may deserve our attention in the year ahead. I will then zoom in on South Africa's situation, analysing how much the global environment has influenced domestic developments over the past year and, equally, how new global uncertainties may combine with local issues to influence monetary policy over the coming year. At the end, I will also briefly touch on yesterday's monetary policy decision, assuming however, that most of you would have seen our statement.

What investors feared most in early 2017

There was a general feeling of economic optimism, albeit a prudent one, at the start of 2017. For example, in its *World Economic Outlook Update* published in January, the International Monetary Fund (IMF) wrote that 'in [the] advanced economies, a modest and uneven recovery [was] expected to continue, with a gradual further narrowing of output gaps'. Yet, in the same document, the IMF also warned that risks to the global outlook remained 'tilted to the downside' and related to 'ongoing adjustments in the global economy'. Fears of disorderly adjustment were indeed numerous, including in the US[1] – the major country which had recovered relatively fast from the global financial crisis even though it had been at its epicentre.

Indeed, because the imbalances created by the global crisis had healed earlier than in other jurisdictions, the US was also the first advanced economy to raise its interest rates from the zero-lower bound. This process was initially very gradual. However, the US Federal Reserve System (Fed) then signalled a likely acceleration in the pace of interest-rate increases (and and that it would embark on the process of reducing in its balance sheet) as it had become increasingly confident of meeting its medium-term growth and inflation goals. In light of the earlier key influence that low US interest rates had exerted on boosting risk appetite and compressing term premiums in global financial markets, investors became concerned about a reversal of these earlier favourable market developments.

[1] United States

The election of a new US administration in November 2016, which pledged large-scale tax cuts and an ‘America first’ approach to external trade, compounded market fears of a disruptive rise in US interest rates and an appreciation of the dollar.

In fact, many observers viewed the 2016 presidential election result in the US as one of many examples – albeit a key one – depicting a general shift of voters in advanced economies towards populist politics and policies, including a rejection of several key tenets of the wave of globalisation over the past few decades. The growing hostility towards these tenets – including free trade, free capital flows, and easier cross-border movement of labour – was seen at its strongest in continental Europe. With key elections scheduled throughout 2017, not least in France and Germany, observers feared a move towards populism that had the potential to torpedo the already delayed eurozone economic recovery.

At the same time, at the other end of the Eurasian continent, economic observers noted some stabilization in the Chinese economy and capital markets, yet doubted whether this pattern would be durable in light of the continued growth in imbalances that it seemed to involve, not least of which was the ongoing build-up of corporate debt, especially in state-owned enterprises. In turn, investors feared that China would continue to suffer capital outflows, which might force the authorities to again allow the kind of depreciation in the yuan exchange rate that had prompted a tightening in global financial conditions in late 2015 and early 2016.

Concerns about the sustainability of economic stabilization in China also raised worries that the prices of many commodities (in particular of metals and minerals) could experience a renewed sell-off in view of China’s key role in shaping demand for these commodities. Furthermore, the last few months of 2016 saw a jump in crude oil prices as key producers, both inside and outside of OPEC[2], somewhat surprisingly agreed on freezing production levels. As the market adjusted to a new supply-demand equilibrium, the possibility of a further rise in oil prices at a time when other commodity prices could be on the back foot posed a risk to the economic recovery of both the advanced economies and the oil-importing emerging economies.

[2] Organization of the Petroleum Exporting Countries

The global backdrop that proved benign in 2017

However, as we look back at the developments over this year, we can be thankful that most of the risks I have listed above did not materialise. In the US, policy normalization continued largely like the Fed had anticipated at the start of the year. The FOMC[3] raised its Federal funds target rate by 25 basis points each at its March and June meetings, and markets largely anticipate a third hike in December, which would bring the funds target rate to 1.25-1.50%, in line with the median forecast of the FOMC participants at the start of 2017. Separately, the Fed began the gradual unwinding of its balance sheet in October.

Yet these steps have not triggered the yield-curve steepening or the sell-off in riskier assets that many feared. In fact, on 17 November, the 10-year US Treasury yield stood at 2.36, which was 8 basis points lower than at the beginning of the year. The yield curve has thus flattened. At the same time, US corporate credit spreads, both investment-grade and high-yield, are lower than at the start of 2017, and the S&P 500 equity index has rallied by 15% over the period.

Several factors contributed to this solid market performance. On the macroeconomic front, while real economic activity in the US continued to expand at a solid pace, price and wage inflation kept undershooting most official and private forecasts. Indications that prices may have become structurally less responsive to an erosion of economic slack, as well as perceptions that potential US GDP[4] may have slowed over time, led the FOMC to lower its medium-term projection for the equilibrium Federal funds rate, even as monetary accommodation was being withdrawn.[5] At the same time, expectations for a quick and sizable fiscal stimulus in the US, which could have been a justification for a faster pace of monetary tightening, gradually faded throughout 2017.

The economic recovery in the eurozone continued to display stronger momentum than had been expected at the start of the year. Consensus forecasts for GDP growth

[3] Federal Open Market Committee
[4] gross domestic product
[5] As of the December 2016 FOMC meeting, its median projection for the medium-term Federal funds rate was 3.0%; it declined to 2.75% by the September 2017 meeting.

in 2017 and 2018, which stood at 1.3% and 1.6% respectively at the beginning of the year, have since been revised upwards by 0.9 and 0.2 percentage points respectively. But the so-called ‘populist risk’ has not disappeared. While the anti-mainstream candidates did not cause major upsets in elections in France or the Netherlands, the results still generally confirmed that a significant portion of the electorate chose candidates who were openly critical of globalisation and of the policy consensus that has prevailed over the past few decades. Nonetheless, this political background did not prevent a further rise in business and consumer confidence in the region. If anything, the current confidence readings in the eurozone stand well above the average of the past decade and their increase has been broad-based across countries.

The Chinese economy also performed somewhat better this year than most analysts had anticipated. While a degree of policy tightening, mostly through stricter regulation, did weigh on certain components of domestic demand, Chinese exports benefitted from an improved global and regional trade environment. At the same time, the authorities’ tighter regulatory stance appears to have succeeded in curbing specific components of private-sector financing (specifically the funding of and by shadow-banking institutions) while keeping bank loan growth relatively stable and thus avoiding a broad-based credit slowdown. Finally, pressure on China’s capital account has continued to moderate, allowing official foreign-exchange reserves to edge up again after the losses of the previous years.

With respect to the oil market, OPEC members appear to have largely complied with their late-2016 deal to limit output, although that agreement has not been the ‘game changer’ that some observers had feared, in part because of the US shale industry’s ability to quickly ramp up production once oil prices exceed the break-even point. Admittedly, oil prices posted significant gains in the latter part of the year, rising from a low of US$44 per barrel in mid-June to US$63 per barrel as of 23 November. Yet this move seemed to be more a reflection of stronger demand (as global economic growth exceeded expectations) than of a supply constraint that could endanger the economic recovery.

Overall, considering that many of the risks feared in early 2017 did not materialise and the fact that the ‘push and pull’ factors have remained favourable, the year saw renewed and solid net non-resident capital inflows into emerging markets, including South Africa. In an October report, the Institute of International Finance (IIF) projected that such flows would rise to US$1.1 trillion this year, or to about 4% of emerging-market GDP – meaningfully higher than the lows of 1.5% in 2015 although still far off the pre-crisis peak of over 9% in 2007. The bulk of the improvement would reflect debt portfolio and banking-related flows. Indeed, the IIF estimates that in the first 10 months of 2017, the former totalled US$162 billion versus only US$37 billion for the whole of 2016.

What should we worry about for 2018?

Of course, the fact that major risks did not materialise in 2017 should not breed complacency about the coming year, even though most official and private forecasters broadly agree about a continuation of the broad-based, relatively inflation-free economic expansion in most regions of the world in 2018. History teaches us that it is often when most observers concur about the low probability of negative scenarios that these unfold. The trigger of the next downturn may well be an event that no forecaster sees as a risk right now. Nevertheless, economic downturns – beyond their immediate trigger – always have deeper underlying causes. Let me list a few of these underlying trends which could be sources of fragility for the world's economy.

First, considerable uncertainty remains about the long-term impacts of the large-scale monetary stimulus put in place by the major central banks since the global financial crisis as well as about the (more short-term) implications of its gradual unwinding. While the degree of global monetary stimulus has so far had surprisingly little impact on inflation, the debate remains open as to whether this pattern will continue once output gaps have fully closed and once legacy issues from the crisis (for instance in the banking sector) have finally been resolved. Equally, analysts debate whether even a gradual unwinding of central banks' balance sheets can trigger a quick decompression of term and risk premiums across major financial assets. Because the size of these balance sheets (relative to world GDP) is unprecedented, guidance from economic history is limited.

Second, the recent cyclical improvement in global GDP growth may mask persistent issues around low trend gains in productivity which, if unresolved, could result in economic agents and financial market participants being over-optimistic about future economic activity. In most of the large economies, both average labour productivity and total factor productivity have slowed in the past decade or so – a trend which, at least in the advanced economies, has predated the global financial crisis. The exact causes of this 'secular stagnation' are not yet fully understood, and economists disagree on how long it may last. As of yet, there are limited signs that this trend is reversing.

Third, despite efforts at deleveraging in some sectors and in some countries, global debt, as a share of GDP, remains higher than before the global financial crisis. Data from the Bank for International Settlements show that, as of the first quarter of 2017, total credit to the non-financial sector (in all reporting countries) stood at 219% of GDP compared to 185% at the end of 2008.[6] While the credit to households has stabilised relative to GDP, the financing extended to general government and non-financial corporations has steadily increased. If unchecked, this rising trend has the potential to trigger phases of financial instability in the future, weighing on growth and undermining financial assets.

In fact, in many cases the market valuations of these assets already appear elevated relative to long-run norms, which increases their vulnerability to any potential repricing of risk. And while these valuations may not be inconsistent across different categories – the equity risk premiums over bond yields, for example, are relatively large – this does not preclude a situation where all asset categories sell off together. The catalyst for such a sell-off need not be an economic one. Geopolitical tensions in regions as diverse as the Middle East, the Korean Peninsula, and the South China Sea indicate that the world is not necessarily a safer place than in previous decades.

The global backdrop and the South African economy

Let me now turn to the influence that this global backdrop has had, and is likely to have, on the South African economy.

[6] These statistics use credit data at market value, converted at PPP-adjusted exchange rates.

As I have mentioned above: the relatively benign global environment, coupled with the failure of key risks to materialise, has supported a continued inflow of capital towards emerging markets in 2017 – and South Africa was no exception. IIF statistics show that, in the first 10 months of the year, net non-resident purchases of South African debt instruments totalled US$4.9 billion, up from US$1.9 billion in the whole of last year.

Such inflows, up to the last couple of months, have helped the country's financial assets to weather unfavourable domestic growth developments as well as political and policy uncertainty without any major, or lasting, consequences. For example, from early January to the end of August 2017, the rand's trade-weighted exchange rate depreciated by only 2.5% and the yield on the benchmark R186 government bond declined by 35 basis points. In addition to global factors, downside surprises in domestic inflation figures for most of the first half of the year as well as a reduced deficit on the current account have contributed to the resilience of domestic fixed-income assets.

Yet, South Africa's domestic problems have prevented the country from fully benefiting from the benign global backdrop that historical experience and international comparisons would suggest. In fact, while the global risks seen at the start of 2017 did not materialise, several domestic risks became a reality, especially later in the year. This was illustrated by the depreciation of 6.3% in the nominal effective exchange rate of the rand and a rise of 53 basis points in the benchmark R186 government bond yield from the end of August to the end of October 2017.

Real economic growth failed to display any meaningful acceleration after a poor performance in 2016, despite the rebound in agricultural production following the previous year's drought. At present, the SARB forecasts average growth of only 0.7% in 2017, after a mere 0.3% last year. Hence, the gap between South African GDP growth and world GDP growth, which was minimal up to 2013, continues to widen.

Disappointing economic growth, together with the surprisingly low buoyancy of major tax revenues relative to their bases, has compounded the fragility of South Africa's fiscal situation.

For several years already, projected fiscal consolidation and debt stabilization have had to be postponed because of GDP growth shortfalls relative to budget projections. However, the *Medium Term Budget Policy Statement* of October 2017 not only saw a meaningful upward revision to deficit estimates for the current year, but also did not project a reduction in that deficit in the outer years. Consequently, the debt-to-GDP ratio is now projected to keep rising throughout the period, approaching 60% by 2020/21. This mixture of weak growth and rising debt – the two concerns repeatedly flagged by ratings agencies – suggests that South Africa must increasingly be wary of possible further downgrades to its sovereign ratings. Following the announcement by Fitch Ratings yesterday that it has affirmed South Africa's BB+ rating (which in their case applies to both local and foreign currency debt), announcements will be made later today by both S&P and Moody's on the outcome of ratings reviews recently undertaken by them.

While exhibiting uncertainty and generating volatility, the recent behaviour of financial markets clearly highlights this risk. Admittedly, as I have indicated earlier, the global economic and financial backdrop has sheltered South African assets for most of the year. Yet they underperformed relative to their emerging-market peers. For example, in the first nine months of 2017, the J P Morgan emerging-market foreign-exchange index appreciated by 5.6% while the rand gained only 1.3% against the US dollar. Such an underperformance was already a warning sign of the relative unattractiveness of South African assets, as generally, in periods of improved global risk appetite, both the rand and domestic bonds tend to outperform their peers. In recent weeks, and in particular since the upward revision to the deficit and debt projections in the *Medium Term Budget Policy Statement*, the sell-off in both the local currency and domestic bonds is a much clearer indication of investors' nervousness about South Africa's rising economic and fiscal risks as we draw the curtain on 2017 and move towards 2018.

Recent monetary policy developments

The SARB cannot ignore this recent shift in the balance of risks affecting South Africa's economy or the way it is perceived by financial markets. Obviously, the

central bank does not target the exchange rate or the level of bond yields, as its mandate is to keep inflation within the 3-6% target range.
Nonetheless, market developments are important inputs in policy formulation – fairly directly for the exchange rate (which impacts on inflation with a lag) and more indirectly for the level of bond yields (which reflects investors' perceived risks to the inflation outlook and how they expect monetary policy to respond as a consequence).

In its July meeting, the MPC of the SARB lowered the repurchase rate by 25 basis points, both in reaction to a sequence of better-than-expected inflation data and a stronger likelihood that inflation would remain comfortably within the target range over the forecast period. In fact, the SARB's projections for both headline and core inflation in 2018/19 had been revised downwards on several instances in the first half of the year. Nonetheless, the MPC guarded against expectations that this rate reduction would mark the start of an easing cycle and warned that any future moves would remain data-dependent. This reflected a high degree of uncertainty about the future inflation profile; the decision was also informed by the MPC's continued discomfort with the broad measures of inflation expectations remaining uncomfortably close to the upper end of the target range.

By its September meeting, the MPC was of the view that the balance of risks to inflation had tilted to the upside and warranted a more cautious approach, and thus decided to leave the policy rate unchanged.

At the conclusion of our MPC meeting yesterday, we decided to leave the repurchase rate unchanged at 6.75 per annum. Our decision to err on the side of caution at the September meeting appears to have been correct, as upside risks to the inflation outlook have increased in the last two months. The Bank's inflation forecast shows some deterioration, with inflation expected to be 0.2 percentage points higher in both 2018 and 2019, at levels of 5.2 and 5.5 per cent, respectively. These revisions were mainly influenced by a weaker exchange rate path, higher international oil prices, and higher average wage growth. Inflation is expected to remain within the target range over the forecast period.

Yet this 'baseline scenario' only tells part of the story. Although inflation is not expected to breach the upper end of the target range over the forecast horizon, as

indicated, the risks to the outlook are currently assessed to be skewed to the upside, at a time when imminent key event risks contribute to an environment of heightened uncertainty.
In light of the growing fiscal risks and increased domestic financial market volatility, the MPC has to be cognisant of the possibility that the inflation outlook could deteriorate further. The MPC also has to weigh the risks I have outlined earlier, including the possibility that the global environment could turn less favourable, which, in the current circumstances, could exacerbate the downward pressure on domestic financial assets.

At the end of the day, the MPC is well aware of the current weakness in economic growth, with continued downside risks, and will, wherever possible within its mandate, strive to support an improvement in economic activity through an appropriate monetary stance. However, in an environment characterised by elevated uncertainty, where inflation expectations could become unanchored, the best approach for the SARB is to minimise the number of threats to price and financial stability. Consequently, the MPC will continue to closely monitor both global and domestic developments as well as their implications for the inflation outlook, and will act accordingly.

Conclusion

While acknowledging that five weeks can be a long time in economies and markets, I think we can reasonably safely already draw the conclusion that the global backdrop in 2017 proved to be more benign than many had anticipated. For the first time in many years, the outlook is finally looking promising, with global growth gathering momentum, without yet generating too much inflation. Financial markets have generally performed well.

South Africa faced a particularly challenging domestic environment, which affected growth performance, mainly because of low business and consumer confidence. We failed to fully take advantage of the global cyclical upswing. The inflation outlook improved during the year, and inflation is expected to be inside the target range over the forecast horizon. But more recently upside risks to the inflation outlook have been intensifying, which will require careful monitoring.

As Niels Bohr said: “Prediction is very difficult, especially if it’s about the future”. We do not know what 2018 has in store for us, and how the global risk profile will unfold.

The relatively benign global backdrop in 2017, should not make us complacent, but rather encourage us to take advantage of the current cyclical economic upswing to strengthen our structural reforms and implement growth-friendly policies that are needed to boost economic growth and create employment.

In South Africa, 2018 provides an opportunity to press the “reset button” and, through a collaborative approach, to try and break the self-reinforcing negative feedback loop of policy uncertainties, low private-sector confidence, subdued investment in productive capacities, and poor competitive performance.

Thank you.