South African Reserve Bank

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# The monetary policy outlook and challenges in South Africa

Distinguished guests, ladies and gentlemen.

Thank you for having me here today.

During my speech, I will discuss the outlook for the South African economy and the current stance of monetary policy. I will also touch on recent trends in the global economy and the influence that these are having on South Africa.

## Global economic developments

Global economic developments can increasingly be characterised as asynchronous and risk-prone.

Growth in the United States (US) appears to be diverging from that of other advanced economies. The International Monetary Fund (IMF) projects growth in the eurozone, the United Kingdom (UK) and Japan to be slower in 2018 than in 2017, moderating to 2.0%, 1.4% and 1.1% respectively.[1] Meanwhile, US economic growth is forecast to accelerate this year to 2.9% from an already strong level of 2.2% in 2017.

The opening up of a significant growth gap is, in part, related to the fiscal stance of the US relative to other large advanced economies. The US budget deficit for 2018 is

[1] International Monetary Fund. (October 2018). *World Economic Outlook*.

expected to rise to 4.7% of gross domestic product (GDP) – the largest in six years. Conversely, Germany is expected to record its largest budget surplus in a decade, while Japan is forecast to narrow its deficit to 3.7% of GDP. The UK has recently moved to a slightly more stimulatory stance, with its 2018 deficit rising marginally to 2% of GDP, but this remains a small budget shortfall relative to every other year of the past decade.[2]

A strong fiscal impulse in the US alongside low levels of unemployment and gradually rising inflation is providing the justification for further US monetary policy tightening. One could argue that US monetary policy has been diverging from that of other large advanced economies for a number of years. But, with the latest fiscal stimulus, this divergence looks set to widen further.

As of last month, the Federal Reserve (Fed) had hiked its benchmark interest rate eight times in less than three years – on each occasion by a quarter of one per cent. Meanwhile, the so-called 'dot plot' published by the Fed's Federal Open Market Committee indicates that the measured pace of US interest rate increases is likely to continue in 2019.

In Japan, the benchmark interest rate is in negative territory and large-scale asset purchases remain underway. The European Central Bank is gradually becoming less accommodative as it tapers its asset purchase programme, but it is guiding for its benchmark deposit rate to remain slightly below 0% for at least another year. The UK, meanwhile, has hiked its benchmark interest rate twice since last year when it was at its lowest level of the cycle.

Thus, two important trends are apparent. First, monetary policy in the advanced economies is becoming less accomodative overall. Second, the US is far more advanced in its tightening cycle, no longer describing its policy stance as accommodative. As a result, global financing conditions are tightening.

[2] International Monetary Fund. (October 2018). *World Economic Outlook Database*.

It has historically been the case that upswings in the US interest rate cycle have given rise to growth and financial stability risks in the emerging markets. On the whole, emerging markets appear to be relatively more resilient today than they were in the 1990s, for example, when rising US interest rates precipitated a widespread crisis. This resilience has in part been supported by the development of domestic capital markets (which reduces reliance on external debt), a movement towards more flexible exchange rate regimes, and increased self-insurance through the build-up of substantial foreign-currency reserve buffers.

Nevertheless, US policy continues to meaningfully affect financial conditions elsewhere due to the widespread use of US Treasury bonds as a global risk-free benchmark as well as the dominant role that the dollar plays in global trade and finance. Furthermore, it has recently been estimated that countries representing more than half of global GDP have principally anchored their currencies to the US dollar[3], which implies a link between the monetary policy of these countries and that of the US.

For many emerging markets, the tightening global financing conditions are giving rise to capital outflows. While the forecast for emerging market and developing economies is one of gradually accelerating growth over the medium term[1], these capital outflows are exposing vulnerabilities in some countries. Moreover, they are giving rise to currency weakness and, in turn, higher inflation across a number of emerging economies. South Africa has been no exception.

Global financial market volatility is being exacerbated by trade tensions between the US and various other large economies, in particular China. Increased tariffs, if they persist, threaten to reduce global trade volumes and disrupt complex supply chains.

The recent rise in oil prices is a further challenge, driving up inflation and weighing on the trade balance of oil-importing countries. The price of Brent crude oil has doubled since early 2016, but remains well below the high of approximately US$154 reached

[3] Ilzetzki, E., Reinhart, C. and Rogoff, K. (2017). *Exchange arrangements entering the 21st century: which anchor will hold?* National Bureau of Economic Research Working Paper 23134.

in 2008. However, when priced in the currencies of emerging markets like Brazil, Mexico or South Africa, Brent crude oil is back near its historical highs.

Notwithstanding these concerning developments, global growth on aggregate remains relatively strong and is expected to moderate only marginally over the medium term. This trend is also reflected in the forecasts for South Africa’s major trading partners where, on average, GDP growth is expected to slow slightly from 3.6% in both 2017 and 2018 to 3.5% in both 2019 and 2020.

South Africa faces two key external risks over the coming months. The first is a possible sharp and sustained drop in capital inflows, as US interest rates increase. The second is a further substantial rise in oil prices. The two could also conceivably occur simultaneously. If so, South Africa would face increased inflationary pressure and a further drag on household disposable income.

**Domestic economic developments**

The domestic economy has substantially underperformed in 2018 relative to expectations formed at the beginning of the year and the longer-term trend. Indeed, the technical recession recorded in the first half of the year surprised most economic analysts.

At the January meeting of the Monetary Policy Committee (MPC), we had forecast GDP growth of 1.4% for this year. By the September MPC meeting, this was revised down to 0.7%. The weakness in economic activity witnessed in 2018 reflects a combination of transitory factors and more persistent constraints. Poor weather conditions exacerbated the fall in agricultural output from 2017’s elevated level. Meanwhile, ongoing policy uncertainty and weak domestic demand resulted in a lack of business investment and hiring.

Moving into 2019, we are anticipating an economic rebound driven largely by an export recovery and improved growth in fixed investment. Household and government spending growth is projected to remain stable. We believe that the relatively weak level of the exchange rate, alongside firm global growth, will provide support to the export sector over the coming quarters. This, in turn, is projected to gradually lift private-sector capital formation. Furthermore, as the transitory shocks of 2018 fade, the low base that they would have established will support the 2019 growth rate somewhat.

In order to determine whether the economy is operating with spare capacity, we estimate a level of potential output and compare it to the actual level of output. Based on our estimates, potential growth has fallen substantially: from levels in excess of 4% per year in the mid-2000s to an average of 1.2% since 2015. This reflects, among other things, a sharp slowdown in the growth of fixed investment, skills constraints, and weak productivity gains.

Even with an unusually low level of potential growth, the South African economy has consistently failed to reach its potential. This has been underscored by the recent recession, which produced a more negative output gap estimate of -1.5% of GDP for the second quarter of 2018 – the widest gap in a decade. Given the weak starting point, the output gap is now projected to close only in the final quarter of 2020 – a full six months later than the MPC had predicted at its July meeting.

The relatively large output gap, alongside low food prices and the effect of an exchange rate appreciation in 2017 and early 2018, has constrained inflation. For example, in August, core inflation had moderated to 4.2% year on year. This was the 11th straight month in which core inflation had remained at, or below, the 4.5% midpoint of the South African Reserve Bank’s (SARB) inflation target range. However, headline inflation that same month was higher at 4.9% year on year.

Much of the gap between these two measures reflects demand-insensitive administered price growth, which in August stood at 12.1% year on year. In this regard, it must be highlighted that greater restraint over the rise of administrative prices, to the extent that it is within the control of the relevant price-setters, could serve to provide the MPC with increased monetary policy flexibility and potentially with room for a relatively more accommodative stance than would otherwise be the case.

As monetary policy operates with a lag, the level of inflation that the MPC must consider is that which is expected to prevail over the coming 12-24 months.

Unfortunately, the inflation forecast is far less benign than the levels currently being experienced. Headline inflation is expected to increase from an average of 4.8% in 2018 to 5.7% in 2019 and 5.4% in 2020. This includes a forecast peak of 5.9% in the second quarter of 2019. The upward trajectory of inflation is driven by the pass-through from the recent exchange rate weakness, rising food and oil prices, a narrowing output gap, and our expectation that nominal wage growth will remain above the upper end of the inflation target range over the forecast horizon.

The SARB's Quarterly Projection Model (QPM) forecasts inflation simultaneously with the repurchase rate (repo rate) as part of its general equilibrium framework. Given the outlook for the exchange rate, the output gap and inflation, the QPM forecasts five interest rate hikes of 25 basis points each by the end of 2020. All other things being equal, if monetary policy tightens by less than the model predicts, inflation may come out higher than is currently expected.

The repo rate forecast of the QPM is merely a guideline and does not fully account for the balance of risks or for the uncertainty around the variables, both included in and excluded from the model. The MPC may well diverge from this endogenously generated interest rate path. Nevertheless, the key point is this: if the inflation forecast plays out as expected, monetary policy tightening will be required to stop inflation, and potentially also inflation expectations, from moving outside of the SARB's target range for an extended period of time.

The likelihood of slightly higher nominal interest rates over the medium term must be put in context, however. Monetary policy has been, and remains, accommodative. Had the economy not been so weak, the policy stance would in all likelihood have been different.

It is also worth bearing in mind that it is the real repo rate that is relevant when thinking about the policy stance. Thus, monetary policy can remain accommodative of the large negative output gap, even as the nominal interest rate rises, if it is rising alongside higher expected inflation.

From this discussion, it should be clear that the MPC faces a challenging outlook. It is difficult to balance the large negative output gap and downside risks to growth against the rising inflation trajectory and upside risks to inflation. This is further complicated by significant uncertainty around the forecast for key variables, including the oil price and the exchange rate, not to mention the possible consequences of escalating trade tensions.

During periods such as the one we are currently in, calls for much easier monetary policy become more common, for understandable reasons. However, as we have been at pains to point out, the main drivers of the current weakness in economic activity are structural in nature. Monetary policy is rather constrained in the support it is able to provide under such circumstances.

Indeed, it would be imprudent to provide additional monetary stimulus in the face of elevated inflation projections, emerging market turbulence, and a domestic environment characterised by policy uncertainty and lofty risk premiums. Under these conditions, the growth benefits of such a stimulus would likely be muted. But, more importantly, monetary easing would raise the spectre of an upward inflation spiral. This is not merely theoretical; there are numerous examples of such outcomes among emerging markets today. We simply will not allow our hard-won credibility to be squandered in that way.

Those who call for increased monetary accommodation often do so in the name of the poor. However, recent IMF research shows that the poor benefit most when inflation is low and they are least adversely affected by rising interest rates.[4] This is because the poor are less able to shield themselves from the effects of inflation and tend to have lower exposure to floating interest rate debt. Therefore, a loose monetary policy is not likely to be pro-poor, nor would it be a net benefit to the economy over the longer term.

In fact, the loss of central bank credibility, especially in cases where their independence is questioned, comes with high social costs over the longer term. This

[4] International Monetary Fund. (2018). *South Africa Article 4 Consultation*.

is because very dramatic steps are required to contain inflation and stabilise the economy once market confidence in a central bank is lost. The recent steep tightening in the policy rates of Argentina and Turkey, to 73% and 24% respectively, serves as a stark reminder that the erosion of central bank credibility and independence comes at a steep cost.

Monetary policy is far better utilised as a tool to anchor inflation expectations and ensure that all South Africans are provided with a degree of certainty about prices in the future. Indeed, this is the only way in which it can positively contribute to long-run investment and growth, and thus fulfil its constitutional mandate of ‘protecting the value of the currency in the interest of balanced and sustainable economic growth in the Republic’.

**Concluding remarks**

The MPC faces a difficult balancing act. We do not want to unduly constrain an already weak economy, but we must also ensure that the average South African’s purchasing power remains intact. Hence, the repo rate may rise gradually over the medium term, in a manner consistent with keeping inflation inside the target range. However, we are not bound to any particular path of action. Rather, the MPC will continue to conduct policy commensurate with the forecast and the balance of risks as these stand at the time of each meeting.

Thank you.