South African Reserve Bank

An address by Daniel Mminele,
Deputy Governor of the South African Reserve Bank (SARB),
to the Rand Business Club dinner

Johannesburg
28 May 2019

The role of the SARB in the context of growth and development in South Africa

Introduction

Ladies and gentlemen, good evening, and thank you for allowing me the honour to address this dinner hosted by the Rand Business Club.

Our country has gone through general elections in the past month. With it came and went the usual debates about what the results would mean for South Africa over the next five years. What is unlikely to go away, however, is the debate over the policy priorities for the years ahead, and what authorities should focus on to lift the country from what increasingly looks like a 'slow growth trap'. Monetary policy is already part of that debate, and is likely to remain there. Hence the relevance of the topic chosen for tonight's address: The role of the South African Reserve Bank (SARB) in the context of growth and development in South Africa.

I thought it might be useful to first address the SARB's mandate, its independence in fulfilling that mandate, and why it often seems misunderstood. I will then look at how our institution has performed over the years in the fulfilment of that mandate, and what tasks still lie ahead, before tuning into the current debates on whether central banks in general, and the SARB in particular, should reassess or broaden their mandates and strategy, looking specifically at the context of South Africa's development needs.

On the SARB's mandate, independence and ownership

The issue of the SARB's mandate, as I have said earlier, is a topic that often raises emotions, partly because some people do not fully appreciate what the central bank can and cannot do, what the role of its private shareholders is, and how its accountability is ensured.

When South Africa's Constitution was adopted in 1996, the drafters of our fundamental law insisted that the primary objective of the SARB was to 'protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic'. They further said that the SARB, in pursuit of that goal, had to 'perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the [SARB] and the Cabinet member responsible for national financial matters'.

It is not by chance that these words were inscribed in our Constitution. Such wording was in line with international best practice at the time. Following the failure of many countries to deal with stagflation problems in the 1970s, the global trend was to give central banks increased independence from political authorities in their search for price stability.

But the South African context also played a key part. By the time of the 1994 democratic elections, South Africa had experienced two decades of high and very volatile inflation – even as economic growth gradually came to a halt. Monetary policy, in the absence of both a clear framework and a political pledge of non-interference, had struggled to contain these price gyrations.

But central bank independence never meant that the SARB would have completely free reign; neither did it mean lack of accountability. As indicated in Article 224 of the Constitution, which I have just quoted, there has to be (and there is) regular consultation between the SARB and National Treasury.

It is also this consultation that produced the SARB inflation targeting range – the 'yardstick' against which we would measure the achievement of price stability.

The SARB has operational independence in how to best achieve its policy goals, but does not unilaterally shift these goalposts. Put differently, the SARB is independent within the overall system of economic governance, but not independent of it. Furthermore, accountability extends beyond consultations with National Treasury. The Governor and senior staff meet periodically with members of parliamentary committees, and the SARB also submits an Annual Report to Parliament. Consultations with the general public, in the form of publications as well as Monetary Policy Forums, have also become the norm, as the SARB seeks transparency in explaining the rationale for its policy decisions.

The SARB's ownership structure has also raised concerns, albeit misplaced ones, about control and accountability. Admittedly, the SARB is one of only a handful of central banks in the world with private shareholders. Yet these shareholders do not have the power to amend the SARB Act[1], which can only be done by Parliament. Neither can they appoint the Governor and Deputy Governors, who are responsible for monetary policy, because that is a presidential prerogative. Through their representatives on the Board of Directors, these private shareholders merely exercise oversight over the SARB's governance. There is no way in which they can interfere with monetary policy or financial stability policy decisions, prudential supervision, or the SARB's other day-to-day responsibilities.

The SARB's performance: price and financial stability?

But how well has the SARB delivered on this mandate set by the Constitution?

Let us first recall how the technical modalities of the mandate evolved over the years. From the more eclectic approach that was in place in the 1990s, including a framework for monetary aggregates, the yardstick for the measurement of price stability moved to an inflation target in 2000.

[1] SARB Act 94 of 1989

South Africa's situation at the time, including the sensitivity of inflation to swings in energy and food prices as well as the structural changes the economy was undergoing (such as the effects of an earlier reduction in tariffs and capital controls), led authorities to select a 3-6% inflation target range. It was always understood, however, that this target was not cast in stone and could be reviewed if justified.

The 2008-09 global financial crisis then taught us that achieving price stability was not enough. Many countries had witnessed a significant growth in financial imbalances even as inflation remained muted. These countries faced major economic adjustments as these imbalances unwound. While South Africa's banks and its financial system had remained sound during the crisis, and domestic financial markets had kept functioning properly, the SARB felt that it would be wise to follow international best practice and place greater emphasis on monitoring the stability of the financial system while developing tools against the potential build-up of severe imbalances.

The inflation-targeting approach has yielded gradual yet significant results over the years. So far in this decade, targeted consumer price inflation has averaged 5.2%, down from 6.8% in the previous decade (the first of the inflation-targeting regime). Inflation volatility has declined too. The standard deviation of year-on-year consumer price changes since 2010 stands at 0.9 percentage points, compared with 2.4 percentage points between 2000 and 2009.

Importantly, in the present decade, inflation has exceeded the 6% upper end of the target range for only 26 months, compared to 70 months in the previous decade. Inflation expectations, as measured by the quarterly survey of the Bureau for Economic Research, have also become more stable over the years, and while they remained stuck at around 6% from 2012 to 2017, they are now showing an encouraging decline towards the midpoint of the target range.

Meanwhile, our financial system continues to enjoy stability. South Africa's banks remain sound and appropriately capitalised. Growth in credit to the private sector has not deviated significantly from nominal GDP[2] growth in the past few years.

[2] gross domestic product

In fact, expressed as a deviation from its trend, the credit-to-GDP gap currently stands at a negative 3.9%. In contrast to many other emerging markets, inflows of non-resident capital (be they portfolio flows or bank loans) have not spilled over into excessive domestic credit growth. Equally, residential property prices have been subdued since the global financial crisis.

Where does South Africa stand at present?

Improved policy performance towards the goals of price and financial stability has resulted in lesser volatility of interest rates, which in itself is good for long-term economic growth as it helps to smooth economic cycles and reduces the uncertainty that investors face when they assess capital spending opportunities. Between 2014 and 2016, the policy rate increased by 200 basis points over a period of 26 months. By contrast, the previous tightening cycle, which began in 2006, saw the repo rate rise by 500 basis points over a period of equal duration.

Nevertheless, because of the nature of South Africa's economy – which is a relatively small and open one, vulnerable to external shocks, yet one where the domestic price and wage formation process is fairly rigid – the fight to stabilise inflation is far from over. Throughout 2018, the SARB was concerned that the depreciation of the rand, together with higher oil prices, was skewing inflation risks to the upside and raising the odds of an overshoot of the target. This balance of risks informed the decision of the SARB's Monetary Policy Committee (MPC) to raise the policy rate by 25 basis points in November 2018, reversing a cut of a similar magnitude in March of the same year.

In subsequent months, though, the combination of downside inflation surprises, continued softness in global food prices, and the stabilisation in the exchange rate led the SARB to revise downwards its inflation projections. As of the MPC meeting in May 2019, the SARB projects headline inflation to average 4.5% in 2019, 5.1% and 2020 and 4.5% in the fourth quarter of 2021. Inflation should thus remain within target over the forecasting period.

Meanwhile, core inflation is expected to average 4.8% in 2020 (compared with a forecast of 5.5% six months ago) and 4.5% in 2021. The MPC assessed the overall risks to the inflation outlook to be more or less evenly balanced. The recent downward trend in inflation outcomes were welcomed. As previously indicated, the MPC prefers inflation to inflation to stabilise at around the midpoint of the target range. Future adjustment the monetary policy stance will be informed by a careful assessment of the balance of risks to the inflation outlook.

While oil prices, electricity prices and the rand continue to pose upside risks to the inflation outlook, these are offset by the downside risks emanating from the weakness in demand and the projected inability of sluggish economic growth to close the output gap even by the end of the forecasting horizon. Beyond the volatility of GDP from one quarter to the next, economic activity has disappointed over the past year. From 1.9% six months ago, our model's projection for GDP growth in 2019 has now been revised to just 1.0%. And while an acceleration is expected over the next two years, the projections for 2020 and 2021 (1.8% and 2.0% respectively) only indicate, at best, a sluggish recovery in the absence of implementing reforms to restore confidence, attract investment, support growth, and rebuild buffers.

Should the policy framework be reviewed?

As economic growth continues to disappoint, some observers might feel that the SARB is not doing enough to help kick-start economic activity – or, in a word, that the inflation-targeting framework may be less appropriate now than it was in the previous decade, when growth was dynamic and inflation cycles were more demand-driven than is currently the case.

This debate does not occur in isolation. In many countries, economists and policymakers are questioning the surprising lack of sensitivity of inflation to shifts in demand and unemployment, the trend decline in neutral real interest rates, and the efficacy of monetary policies as central banks get closer to the effective lower bound on interest rates.

The mix of subdued demand growth, low inflation and low interest rates is keeping alive talk of ‘secular stagnation’, although economists disagree on whether this is a temporary phenomenon linked to post-crisis adjustments or a more permanent one.

It is, however, important to take into account the differences between countries and be wary of ‘one size fits all’ recommendations. Some people, for example, look at the rigidity of expected and actual inflation in the advanced economies, and question whether monetary policy should more formally incorporate real economic targets in its framework. In South Africa, however, the period of relative stability in inflation expectations has been much shorter than in economies like the United States, Germany or Japan. There have been, admittedly, some encouraging developments of late, like the lower pass-through of exchange rate variations to prices and the moderation in unit labour costs. But these dynamics are not yet fully understood, and the SARB cannot therefore be sure whether they indeed represent a structural, permanent shift towards lower and more stable inflation.

Consequently, alterations to the monetary policy framework at this stage would create the risk of confusion among economic agents and market participants. At worst, it could mean de-anchoring inflation expectations and reversing the gains of the past few years.

For now, it appears to us that a strategy of limiting inflation volatility and hence the risk premium embedded in the cost of capital in South Africa is the best approach to support medium-term economic growth. Our internal research, for example, suggests that the country could benefit from somewhat lower borrowing costs if inflation expectations were credibly anchored at around 4.5%. But because of its structural current account deficit, South Africa has to compete with peers to attract international capital. Such gains, therefore, cannot be neglected.

Some people might also wonder whether our current inflation target range of 3-6% is too high or not wide enough, and whether it consequently imposes unnecessary constraints on the economy. However, as I have alluded to earlier, the standard deviation of inflation since 2010 has been 0.9 percentage points.

This suggests that the current band is wide enough to allow for normal cyclical fluctuations in inflation while limiting target misses to the minimum, provided that expectations are anchored close to the target's midpoint. It is also important to note that many of South Africa's emerging market peers have lower or narrower inflation target bands than our country, yet their trend economic performance has been better over the past few years, with no evidence of undue constraints from the monetary policy framework.

Equally, alternative anchors to the inflation target would be difficult to implement in South Africa. Prior to inflation targeting, the SARB, like many other central banks at the time, used monetary aggregates as a key guideline. However, the relationship between money growth and inflation became too erratic to validate the role of the former as a reliable lead guide to the latter. Private credit growth, which is the main counterpart of money supply, does at times play a role in driving inflation, yet economic and financial cycles do not always coincide, and the latter generally has a longer duration. Excess focus on credit growth in a monetary policy framework would therefore risk missing key cyclical influences on inflation. Finally, using a currency anchor in an open economy like South Africa, with its large commodity share of exports resulting in strong terms-of-trade variations, would bring unnecessary real economic costs in the pursuit of exchange rate stability.

The SARB's role in South Africa, a developing state

But does all of this mean that, under the current framework, there is little that monetary policy can do to assist in the build-up of stronger, sustainable and more inclusive growth? We do not think so. Admittedly, the poor economic performance of the past few years highlights the urgency for South Africa to boost its growth rate and deal with the problems of high unemployment, poverty and inequality. Investment needs, both in public infrastructure and in the private sector, are large, and the need for capital to be adequately channelled to fund these needs is obvious. But in South Africa, like on the rest of the continent, many capital spending requirements can probably be met by a more efficient use of existing capital, stricter procurement processes, and the reduction in wasteful expenditure. Many of these policies fall outside of the remit of a central bank.

Politicians may sometimes query why central banks (like the SARB) do not play a greater role in funding development needs, especially in those sectors where the level of risk and the duration of projects make it a highly risky investment for private lenders. But public development finance institutions already exist in South Africa, and their role can be leveraged through more efficient partnerships with the private sector. Involvement of the central bank, by contrast, would risk creating conflicts with its other mandates and eroding its trust with the public.

What a central bank like the SARB is best placed to do, however, is to create the appropriate conditions for the flow of savings to investment in the economy. Price and financial stability are indeed crucial to building the confidence of households, especially lower-income households, for them to accumulate savings, as they are less likely to fear future capital losses. At the same time, properly functioning financial markets and a sound banking system would ensure that risk is fairly rewarded and, as such, this would reduce the risk of capital misallocation.

Whereas the SARB fully comprehends that it should carry out its mandate in the interest of sustainable growth for our economy, it also understands that inclusive growth and financial inclusion are prerequisites for sustainable growth. While the SARB does not currently have an explicit financial inclusion mandate (although the Financial Sector Regulation Act of 2017 (FSR Act) mandates the Prudential Authority (PA) to 'support' financial inclusion), as stated in the SARB's National Payment System (NPS) *Vision 2025*,[3] financial inclusion is viewed as a 'cross-industry public policy initiative'. Collaboration is therefore imperative as it helps to drive the interoperability and ubiquity of payment services. It also enables payment services to meaningfully leverage new channels (such as mobile phones), new functionality (such as instant payments), and new technologies (such as application programming interfaces (APIs) and distributed ledger technology (DLT)).

[3] Available at https://www.resbank.co.za/RegulationAndSupervision/NationalPaymentSystem(NPS)/Documents/Overview/Vision%202025.pdf.

From a payments perspective, measures such as (a) promoting competition, (b) enhancing access to payment systems, (c) making the regulatory environment more enabling, and (d) promoting collaboration are therefore identified as being the most helpful in advancing financial inclusion.

In line with this, one of the recommendations in the policy paper on the Review of the National Payments System (Act 78 of 1998) also advocates for the enablement of non-bank institutions to provide payment services that involve the pooling of funds (e.g. e-money, remittances, transactional accounts and others) independently and without the need to partner with banks. This is with a view to establish a level playing field for both banks and companies that offer money transfer services and/or transactional services while also establishing a regulatory framework that will address the pooling of funds by non-banks when they provide such payment services.

While central banks need to remain alive to changes in their operating environment and stay relevant to their context, the German Development Institute made some interesting observation that can serve as guiding principles when considering challenges that may come with mandating central banks with developmental objectives:

- Trade-offs between developmental and stabilisation objectives: central banks are likely to struggle if they are mandated to achieve too many objectives but have too few policy instruments to pursue these objectives.
- A wider mandate may give too much power to institutions that have limited accountability: often when central banks seek to play a promotional role, the performance of relevant developmental policies is not systematically evaluated and regularly reported on.
- Central banks with a wider developmental mandate may face significant political pressure to pursue developmental policies at the expense of stability.

Conclusion

To conclude, allow me to reiterate a few important issues: The South African Reserve Bank certainly has a role to play in the context of growth and development in South

Africa, and I would submit that it is indeed playing its appropriate role, in line with its assigned mandate. The SARB's mandate forms an integral part of economic and development policy, and this is what our founding fathers and mothers envisaged when they drafted the Constitution.

It is important to not conflate issues of mandate, ownership and independence.

The current monetary policy framework has served the SARB and South Africa well, and while continuous improvements and refinements should be welcomed, any fundamental changes to the policy framework would need to be underpinned by a convincing problem statement.

The SARB serves development best by doing what it knows it can do well, and that is what forms part of our mandate. At a time when central banks, somehow against their will, became 'the only game in town', in Mohamed El-Erian's words, trying to reach beyond their mandate would probably trigger too big a risk of a loss of legitimacy. Not well-considered broadening central mandates will likely complicate the trade-off between independence and accountability, whilst also complicating the conduct of monetary and financial stability policies given likely tension that may arise with developmental policies.

Thank you.