



South African Reserve Bank

**Public Lecture by Lesetja Kganyago,
Governor of the South African Reserve Bank,
At the University of South Africa, Pretoria**

24 July 2019

**Delivering on our mandate:
Monetary policy, inflation, and balanced and sustainable growth**

Good morning, ladies and gentlemen.

Today, I would like to talk about the South African Reserve Bank's (SARB) mandate: what it is, how we interpret it, and where we are in our national conversation about the SARB.

Although central banking has a global reputation for being boring, in South Africa it has been getting a lot of attention. Much of this is welcome: it is largely a useful opportunity for improving public understanding of what the SARB does, while we at the SARB also learn and benefit from our interactions with people all over South Africa.

However, some parts of the discussion are problematic because they distract us from more pressing priorities. As Mr Tito Mboweni, the Finance Minister, has pointed out: this 'obsession', to use his phrase, is getting in the way of a more fundamental discussion about economic growth, job

creation and dealing with inequality.¹ This economy used to grow at 3% or 4% a year, but now it grows at about 1%.

As we in the SARB have tried to communicate: the growth problem in South Africa is mainly structural in nature, beyond the reach of monetary policy alone. Perhaps part of the problem is that whenever we get a new gross domestic product (GDP) statistic, the news bulletins and the newspaper articles end up talking about what it means for the next Monetary Policy Committee (MPC) meeting.

Given this pattern, you might well assume that interest rates have large growth consequences. But we need some perspective. If we reduce rates by 25 basis points, and there are no other reforms in the economy, our modelling tells us that growth will be about 0.1 percentage points higher, one year later. That's all.

Remember that when we cut rates, borrowers have more spending power but lenders have less. Exporters may do better from a weaker rand, but firms that use imports do worse. Investment may pick up, but that depends on long-term rates, not just the repurchase rate (repo rate) – in addition to many non-monetary factors.

So the growth effects of a rate cut are small. And if we as a country obsess about the SARB and monetary policy as the only answer to our growth problems, we will fail to discuss the difficult but vital reforms that might actually rescue us from our growth malaise.

¹ Lindeque, M. 10 June 2019. *Eyewitness News (EWN)*. Retrieved from *EWN*: <https://ewn.co.za/2019/06/05/what-is-this-obsession-with-the-reserve-bank-mboweni-sets-record-straight-again>.

Failing to get that conversation about growth going has further repercussions, because it feeds the notion that the SARB's private shareholding matters to the policy framework we have and the decisions made on policy. And again, this shareholding debate is more damaging to our economy than it should be. It sends a signal to investors, both here and abroad, that our macroeconomic framework is at risk, making the cost of debt higher than otherwise and undermining confidence. Who loses from all this? One of the biggest hits is to indebted households and the beneficiaries of public spending, who pay the price for skyrocketing interest costs on our public debt as the resources to spend are squeezed.

These very serious problems aside, the fact that South Africans want to engage with the SARB and its mandate is welcome, and we applaud it. Of course, not everyone agrees with us 100% of the time. A certain amount of disagreement is normal, in central banking, as in so many other things. Indeed, not only is public engagement and discussion of monetary policy appropriate. When it is based on evidence, it is something we encourage.

In the old days, central bankers did everything in secret, and any public statements were deliberately complicated. Nowadays, we try to be open and transparent. We have learned that monetary policy works better with communication. An economy is populated with people. If these people understand what the central bank is trying to do, they adjust their behaviour, which in turn helps the central bank to achieve its policy goals. Furthermore, we appreciate that having independence creates a duty to be transparent and accountable; we are not, and do not want to be, exempt from democratic principles.²

² Kganyago, L. 2019. 'Principled agents: reflections on central bank independence.' *19th annual Stavros Niarchos Foundation lecture*. Washington D.C.: Peterson Institute for International

This talk is a contribution to the discussion on our mandate.

So let us talk about the SARB's mandate.

The Constitution, in section 224, instructs the SARB to protect the value of the currency in the interest of balanced and sustainable growth. This mandate reflects an understanding that protecting the value of the currency is a critical foundation for achieving lasting growth.

Clearly, the mothers and fathers of our Constitution did not want us to let inflation run. We might have got more growth but it would have been unsustainable. As many countries have discovered, after a temporary boom, we would end up in stagflation, with weak growth and high inflation.

The framers of our Constitution also cared about macroeconomic imbalances, which might, for example, result from a debt boom, or if we spend well in excess of what we produce, with imports running too far ahead of exports.

The Constitution tells us what to do, but it is not explicit about how we do it. We had to figure out a monetary policy framework for ourselves. In fact, it took us a few years to arrive at the approach we use now: the Constitution was passed in 1996, but we only started inflation targeting in 2000 – after a false start using the so-called 'eclectic approach' that included a failed attempt to control the exchange rate.

Economics. Retrieved from the SARB:

<http://www.resbank.co.za/Lists/Speeches/Attachments/550/Principled%20agents%20Reflections%20on%20central%20bank%20independence.pdf>. For a scholarly treatment: Tucker, P. 2018. *Unelected power: the quest for legitimacy in central banking and the regulatory state*. Princeton University Press.

The inflation target, agreed between the SARB and National Treasury, was initially set at 3-6% before being shifted to 3-5%. The emerging market crisis of 2001 led to the reinstatement of the 3--6% target, and it has remained since then. More importantly, the target created a clearer framework for decision making and enhanced public understanding of the SARB's monetary policy objectives.

But this choice of target also left important questions open. In particular, because the 3-6% we ended up using is a wide range, it created uncertainty about the SARB's true objective. I recall that a consultant helped us with some educational materials, including for our website, who wrote that with a 3-6% target the SARB would cut rates when inflation was under 3% and hike rates when it was over 6%. That was a logical interpretation, but it was completely wrong. The fact is that during the inflation-targeting era, the SARB has not seen targeted inflation below 3%. We have nonetheless cut rates on many occasions. In fact, these rate cuts have typically happened with inflation over 5%, already in the top end of the target range. Various analysts and academics have spent a lot of time trying to estimate the SARB's de facto target, and they have tended to conclude it has been close to 6%.³

Four years ago, we took a critical look at our monetary policy and reflected on our shortcomings. We realised we had let underlying inflation, and inflation expectations, drift to the very top of our target range. This wasn't a problem of supply shocks or demand shocks; it was a problem of the

³ Examples include: Klein, N. July 2012. 'Estimating the implicit inflation target of the South African Reserve Bank'. *International Monetary Fund (IMF) Working Paper 12/177* and Miyajima, K. and Yetman, J. 2018. 'Inflation expectations anchoring across different types of agents: the case of South Africa'. *IMF Working Paper 18/177*.

trend inflation rate. The analysts and academics were right: we had ended up with a 6% target. This meant we had a high inflation rate relative to other countries. We found that about three-quarters of other countries had lower inflation. In addition, with 'normal' inflation already near 6%, every new adverse price shock would push us outside of the target range. This would force us to act, rather than be flexible, or would cost us credibility, ensuring a higher inflation rate. To make matters worse: because everyone was used to inflation around 6%, indexation had set in – prices and wages across the economy were locked in to grow at this pace.

This left us in a trap: nominal interest rates had to be high because inflation expectations were anchored at around 6% but high interest rates meant there was always pressure to cut. Meanwhile, the indexation bias meant that inflation never fell much, and so in turn interest rates stayed *structurally* high.

The paradox is that we have often been accused of being hawkish and keeping interest rates too high, when in reality we have often tolerated as much inflation as we can, ignoring the bottom half of our target range. This is the main reason why our interest rates haven't fallen further. We tend to spend a lot of time comparing ourselves to low inflation and low interest rate economies, when we really are not in that particular picture frame.⁴

Given this analysis, we decided to make some changes. We could better achieve permanently lower interest rates if we were clearer about where exactly we want inflation to be, within our range.

⁴ See also Mnyanda, L. 22 July 2019. 'Reserve Bank should clarify inflation target'. *Business Day*.

The simplest and most honest option would be to emphasise the middle of our target range, 4.5%, as our goal. By analogy, we began to think of the 3-6% target range as the lines on a road. When you're driving down the road, you try to steer between the lines. You don't drive along the yellow line or the centre line, unless you're a bad driver. Of course, you can't keep the car dead-centre in the middle of the road all the time, but every time you start to drift towards the lines, you correct, aiming back for the middle of the lane. For monetary policy, the 4.5% midpoint is the middle of the lane in this metaphorical road, and 3-6% are the lines.

When we decided on this adjustment, we were aware that using interest rates to move inflation expectations from the top of the target to 4.5% could be costly. For this reason, we started with some communication, expressing our preference for inflation expectations moving towards 4.5% over time. We also began more detailed work on 'sacrifice ratios', which is the term economists use for how much growth it costs to lower inflation. These exercises generated a range of estimates, but, broadly speaking, they suggested we would have to do a series of rate increases, lifting the repo rate to 8% or higher, to get inflation to 4.5% – assuming everything else in the economy was normal. The estimated output sacrifice ratio was in the range of 1-1.5% of GDP.

However, while we were studying this problem, a fortunate thing happened. Inflation began to slow, falling to around the middle of the target range by the middle of 2017. This occurred mainly because of positive supply shocks. In particular, food price inflation declined to unusually low levels, around 3%, compared with a long-term average nearer 7%. The exchange rate also stabilised: after depreciating every year from 2011 to 2016, it began trending sideways, which helped to moderate inflation for imported goods. We also like to think our communication made a difference. People were seeing inflation around

4.5%, and they were hearing the SARB say that's where we planned to keep it, so they used that information in setting prices and wages. All of this happened without us having to adopt a tight policy stance – we started with the repo rate at 7%, and we never had to go above that. Put simply, we got a good opportunity to get inflation lower, and we used it.

Did we do the right thing? Again, I appreciate that informed people disagree, and these are good-faith disagreements. People who understand economics and genuinely want what is best for South Africa, take different views. But let me make two points about our decision.

First, what we are doing is completely consistent with our target and our mandate. Some people tell a story that in February 2010 there was a letter from the Minister of Finance changing the SARB's target and how the SARB is now ignoring that letter.⁵ It is strange for me to be told what that letter was about, because at the time I was Director-General in the Treasury, under Minister Pravin Gordhan, so I should know the content of that letter. It did not establish a new target close to 6%. Rather, it reaffirmed the 3-6% target range, and it reaffirmed the SARB's practice of pursuing this target in a flexible way.

Flexibility means the SARB should avoid excessive volatility in growth and interest rates. In other words: if an inflation shock moves inflation outside of the target range temporarily, the SARB doesn't have to hike interest rates to return inflation to target immediately. The SARB just needs to do enough to get inflation to return to target over time. The Minister's letter specifically recognised that inflation expectations need to be anchored,

⁵ Gordhan, P. 16 February 2010. National Treasury. Retrieved from National Treasury: http://www.treasury.gov.za/comm_media/press/2010/2010021701.pdf.

and that well-anchored inflation expectations under credible monetary policy are good for growth.

The approach we are taking now, emphasising the 4.5% midpoint, is our best attempt at implementing the 3-6% target framework optimally. As I have noted earlier, the SARB and National Treasury had originally agreed to lower the target range to 3-5%. With hindsight, by postponing it to some unannounced future date, we made a mistake. We should have announced we would get to 3-5% more slowly, instead of reverting to 3-6%.

If we reformed the target now, in consultation with National Treasury, we would likely go to either 3% or 4%, with a tolerance band of maybe 1 percentage point on either side. This is where most of our peer emerging markets are already, or where they are heading. For instance, this is where inflation targets are for Brazil, Chile, China, Colombia, India, Indonesia, Mexico, Russia and various other peer countries.⁶ But we never reformed our target, so we are still using 3-6% and we are making policy target that range as best we can.

The second question I would like to tackle is whether emphasising 4.5% is an optimal monetary policy for South Africa? My view is that this is a key macroeconomic accomplishment. We have positioned South Africa to have permanently lower inflation. This is valuable progress.

Critics will say we could have cut rates to get higher growth. But, as I have noted earlier, South Africa's growth problem is caused mainly by structural

⁶ Unlike the other countries mentioned, China's monetary policy approach is not always classified as pure inflation targeting. Nonetheless, the authorities have specified an inflation target of around 3%.

factors, like a constrained electricity system as well as policy uncertainty. Given these constraints, a monetary policy that tolerated higher inflation for the sake of more demand would have yielded, at most, relatively small and temporary benefits, at the price of long-term costs.

As an exercise, we have modelled what would happen if the MPC started aiming for a 6% target again. If we cut rates by about 100 basis points, growth would be half a percentage point higher, at its peak, and about a third of a percentage point higher the year after that. That isn't much growth, and certainly not a game-changing growth recovery. The exchange rate would depreciate, the output gap would close, and inflation expectations would start shifting higher. Core inflation would hit 6% after about two years. By around this point, growth would slow once again; there would be no permanent increase in output. Interest rates, however, would be permanently higher, given the implicit 6% target. Higher inflation begets higher interest rates. If the country needs long-lasting low interest rates, then we must have lower inflation.

This last point is something you should bear in mind whenever you hear someone arguing for a higher inflation target. Many of you are students, so it matters for you as much as for anyone else. A higher inflation target would mean higher interest rates. Over the short term, one or two years, tolerating more inflation can allow a looser stance. But this effect is temporary. If we decide to tolerate more inflation now, by the time you graduate and go to work, you are going to face higher interest rates. Your student loan repayments will be higher. A car payment will be more difficult. A mortgage will be costlier. All this will have real implications for your incomes.

This does not mean the SARB should avoid all rate cuts. Rather, we should avoid cutting if the price of doing so is *permanently* higher inflation. We can cut rates if we feel confident we can keep inflation under control over time.

Our modelling framework balances growth and inflation over the medium term using a Taylor rule. If the model sees growth underperforming the economy's potential, the rule suggests a looser policy stance. If inflation is simultaneously higher than the target, it compromises, aiming both to hit the inflation target and to move growth back to potential over the forecast period, of two to three years. Given this process, the MPC decided to reduce rates at its July meeting, because growth is underperforming and inflation appears to be under control. So this is one responsible way to do rate cuts.

You may wonder why we say 'growth' instead of 'employment'. Of course, the two are linked. Better growth generally means more jobs. But we don't refer to employment because of technical issues with our employment data, making them difficult to interpret. For example, despite the negative GDP growth in the first quarter of the year, the Quarterly Employment Survey told us that the economy had created an extra 49 000 jobs. That was probably not a signal the economy was picking up. Unfortunately, the data throw up these kinds of puzzles all the time, making it hard to rely on them as guides for monetary policy. At a more fundamental level, it doesn't make much difference if we use growth or employment in our Taylor rule, a point made by academics assessing our policy decisions.

They find that the SARB cares about jobs as well as growth, and does not behave as if it cared about inflation and nothing else.⁷

We can also measure our policy stance with reference to something called a 'neutral real interest rate', which in recent years has increased. This makes it more difficult to cut rates without inducing inflation. A part of the rise in our neutral rate has come from higher global rates, which affect us because we have to borrow from foreigners to finance our current account deficit. A larger part of the rise comes from an increasing risk premium. The risk premium is the price that lenders demand for putting their money here in South Africa instead of somewhere else they perceive as safer. Our risk premium has increased by about three-quarters of a percentage point over the past five years. If risk subsides again, perhaps because we borrow less or invest more to grow faster, we will have more monetary space and might cut rates responsibly.

Ladies and gentlemen, to conclude, let me make a point frankly. We don't have balanced and sustainable growth in South Africa. With annual GDP growth rates under 1%, we barely have any growth. Indeed, adjusting for the increase in our population, we have been getting poorer for half a decade. We also don't have balance or sustainability. Government's debt-to-GDP ratio is moving steadily higher, and with bailouts for state-owned enterprises, there are real risks we will soon have one of the highest debt levels amongst our emerging market peers. Because we have borrowed so much from abroad, we pay a rapidly rising amount of interest to non-South African creditors, and this is contributing to a large current account deficit – again, one of the biggest in our peer group.

⁷ Bold, S. and Harris, L. April 2018. 'Identifying monetary policy rules in South Africa with inflation expectations and unemployment'. *SA-TIED Working Paper 7*. Available at: <http://sa-tied.wider.unu.edu/sites/default/files/pdf/WP-7-2018-Bold.pdf>.

There are real limits on what monetary policy can do to help. By anchoring inflation expectations at lower levels, we lower long-term interest rates, supporting investment and helping government to finance a growing debt burden. By maintaining a credible monetary policy and a short-term interest rate that compensates investors for risk, we help to maintain capital flows into South Africa. Our repo rate setting is accommodative relative to our estimate of neutral, and it is low compared with historical averages. Rate cuts, like the one we've just decided on, provide some help on the margin, but inflation shows few signs yet of further moderation.

There is a healthy debate about where exactly we need to go with the repo rate. But we see no monetary policy stance that would single-handedly transform South Africa's prospects. And as our economic circumstances get more difficult, I worry that more people will choose to avoid making hard choices and pretend they do not need to be made, as if the SARB could just cut rates enough and all will be well.

The facts are, central bankers care about growth and employment, and the SARB is no exception. But we do not face a permanent trade-off between inflation and growth. There are short-term trade-offs involving growth, but after a while, inflation and interest rates are the things that permanently increase.

The SARB can deliver low and stable inflation. But balanced and sustainable growth also requires contributions from many other parts of government and society. As a country, we need to maintain prudent macroeconomic policies and we have to make further progress on a range of structural issues. Ultimately, prosperity cannot be created by an MPC

setting interest rates. We are but one part of the orchestra; we are not soloists. We are doing our best but we can't put on a show alone.

Thank you.