SOUTH AFRICAN RESERVE BANK

‘Lessons from the crisis and the post-COVID-19 outlook for monetary policy’
Keynote address by Dr Rashad Cassim, Deputy Governor of the South African Reserve Bank, at the 3rd Annual HSBC Africa Conference
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1. Introduction

Good afternoon and thank you for inviting me to address you at your 3rd Annual HSBC Africa Conference on monetary policy as we, and the rest of the world, grapple with the devastating health and economic effects of the coronavirus disease 2019 (COVID-19) pandemic.

I will start by briefly recapping how and why the South African Reserve Bank (SARB) responded at the onset of the COVID-19 crisis, and move on to discuss what challenges we may face in the next two years, or to stretch it a bit and say what a possible post-COVID world means for the SARB and monetary policy, in particular. I use the word ‘possible’ because it may be ambitious or premature to talk about a post-COVID world at this stage, notwithstanding some encouraging recent successes in vaccine trials.

2. The SARB’s response to the COVID-19 crisis

South Africa entered the COVID-19 crisis on the back of a technical recession combined with mounting fiscal stress, growing public sector debt, and a downgrade to junk status in March 2020. Given this backdrop and the wide-ranging impact of the COVID-19 crisis on financial markets, commercial banks and economic activity, we, like many central banks, used the full arsenal of our tools to respond to the crisis. Our response was characterised by a simultaneous and swift implementation of policies consistent with our mandates of price and financial stability, and our responsibility for prudential regulation of the banking and insurance sector.

I will not spend too much time on the details of these interventions, as much has been written about them,[1] other than emphasise that our liquidity operations consisted of providing additional liquidity to commercial banks, and purchasing government bonds in the secondary market across the maturity spectrum of the yield curve to address stresses or dysfunction in this market.

The aim of our liquidity operations was to ensure that our monetary policy transmission mechanism was not compromised by ensuring that the financial sector remained stable, and banks continued to have an ample and stable source of refinancing. As a prudential regulator of the banking sector, we went further by relaxing capital and liquidity requirements for banks so that their financial intermediation role, so critical to everyday economic activity, was not impaired. Lastly, we assisted National Treasury in setting up and administering government's Loan Guarantee Scheme, aimed at providing lending support to qualifying businesses.

As we reflect on South Africa's response to the crisis, we should remember that we have an important conventional monetary policy tool, the overnight interest rate, at our disposal. This is in contrast to most advanced and a few emerging economies that operate largely at the zero lower bound of their policy interest rates and had to rely on large-scale quantitative easing (QE) – defined as central bank purchases of longer-term financial assets – as their main monetary policy tool to ease financial conditions and provide economic stimulus.[2] However, QE is a second-best alternative to stimulating the economy, and less relevant for a country such as South Africa.

We entered the COVID-19 crisis with our policy rate at 6.25% and were, as such, able to reduce it significantly by 275 basis points to 3.5% in a short pace of time. Even with this large reduction, we are still far from the zero lower bound and can still rely on interest rates before having to consider QE-type measures, should economic conditions

[1] SARB media release, 'Changes to the money market liquidity management strategy of the South African Reserve Bank', 20 March 2020, available here
SARB media release, 'Further amendments to the money market liquidity management strategy of the South African Reserve Bank and additions to the Monetary Policy Portfolio', 25 March 2020, available here
Prudential Authority media release, 'Regulatory relief measures and guidance to the banking sector in response to COVID-19', 6 April 2020, available here
South African Reserve Bank, 'Note on South Africa's liquidity measures in response to the COVID-19 pandemic', *Quarterly Bulletin*, June 2020, available here
[2] See B S Bernanke, 'The new tools of monetary policy', American Economic Association Presidential Address, Brookings Institution, 4 January 2020, available here

deteriorate and inflation moderate further down towards the lower end of the inflation target.

3. Medium-term outlook for monetary policy

While our policy response to the COVID-19 crisis has helped in stabilising financial markets and containing risks of a financial crisis, the near-term outlook for the economy remains very uncertain, even though we predict a strong recovery in third-quarter gross domestic product (GDP) from the second quarter’s low base. There is still some risk of resurgence in volatility and risk-aversion in global financial markets, depending on sentiments around the evolution of the pandemic and perceptions around the efficacy of policy interventions. This would have significant implications for capital flows to emerging markets, and in turn their currencies and inflation outlook.

In our November Monetary Policy Committee (MPC) meeting, we assessed the overall risks to the growth outlook as balanced, but acknowledge this as a tentative assessment, which is open to adjustment given the wide range of shocks hitting the economy, uncertainties involving the effectiveness of policy, and the sensitivity of sentiment to news flow. We revised our 2020 growth forecast marginally upwards from a contraction of 8.2% projected at our September meeting to a contraction of 8% on the assumption of a stronger recovery in the third quarter of this year. We further expect the economy to grow by 3.5% and 2.4% in 2021 and 2022 respectively.

Our Quarterly Projection Model (QPM) also points to a large output gap that will only narrow over the remainder of the forecast period but still remain negative in 2022. The main drag on medium-term growth is that we expect negative growth in investment this year and next year in both the public and the private sector. Admittedly, this is only a forecast, but if it holds, it will have profound implications for the future productive potential of our economy. Structural issues, such as electricity supply challenges and a constrained fiscal environment, also remain key obstacles to the economic recovery in the medium term.

The overall risks to the inflation outlook at this time appear to be to the downside in the near term and balanced over the medium term. One of the key factors explaining the projected downward movement in core inflation is the lower increase in medical insurance prices in 2021. However, we noted that evidence points to this reduction as temporary and likely to reverse in 2022. Some internal work done by our Economic Research Department shows that medical schemes built up significant cash surpluses under lockdown, as members were avoiding hospitals and other medical facilities except for emergency treatments. To reduce these surpluses, most medical schemes are implementing smaller price increases for 2021. Our engagements with medical schemes suggest larger increases will resume in 2022, once the excess reserves from the lockdown are depleted.

Rentals and owner-occupied rentals have also been on a downward trend, although this has been factored into our forecast. Furthermore, our projections of unit labour costs, which in the past were an important contributory factor to why inflation was persistently at the upper end of our inflation target, are likely to remain below the midpoint of the inflation target. This means that underlying inflation will remain moderate, unless there are unforeseen supply shocks that spill over into core inflation. We also noted in our November meeting that electricity and other administered prices remain a concern. Moreover, while risks to inflation from currency depreciation are expected to stay muted as pass-through remains low, additional exchange rate pressures in the medium term, as a result of heightened fiscal risks, continue to be on our radar.

This is perhaps an appropriate time to make one or two comments about how the MPC incorporates fiscal concerns into its reaction function. Having read various analysts' reports over the past two years, most rightly point out that the risks from the fiscus put some constraints on monetary easing. Many of you continue to ask for more clarity on how we incorporate fiscal concerns into our thinking. Fiscal developments matter for monetary policy in different ways.

The most obvious channel through which fiscal policy affects monetary policy is the exchange rate. To what extent do growing fiscal deficits and public debt generate more uncertainty for foreign investors, and in the process create more volatility in the exchange rate? This is a question that preoccupies us all the time, bearing in mind that we do not target the exchange rate but monitor its impact on prices as well as second-round effects. What also concerns us is that, while pass-through is relatively low, there may well be non-linearities in pass-through coefficients. In other words, if we were to see significant downward movements in the exchange rate, the effects on inflation could be a bit more serious. This is, however, a low probability scenario, but it could have a high impact. And if anything, COVID-19 has taught us to take low probability, high impact shocks seriously.

Lastly, and linked to the above, is the impact of fiscal policy on the country's risk premium. For a small open economy such as South Africa, with a strong dependence on external funding, the deterioration in fiscal metrics, such as a strong rise in the debt-to-GDP ratio, raises sustainability concerns and, in turn, the premium which investors require on government bonds. This is currently the case, as we are seeing elevated long-term government bond yields even after short-term rates were reduced. The result of this is that the natural rate of interest will rise, and this is something we cannot ignore when we set monetary policy.

4. Post-COVID-19 outlook for monetary policy

Let me now move on to a final discussion of the post-COVID-19 outlook for monetary policy. Once again, I would like to remind you that I am using the word 'post' with great caution as we are all acutely aware of the long-lasting health and economic effects of the pandemic.

Over the past few years, the SARB has repeatedly reminded the public about how the blurring of what is considered cyclical and structural growth factors has made it more difficult to pin down precisely how effective monetary policy can be. This problem of the disentanglement of cyclical and structural factors may even become more serious in the next few years, given the effect of COVID-19 on the economy, particularly its possible impact on productivity and potential growth.

Let me focus a bit on potential growth and output gaps. One of the main challenges the MPC will face now and in the next few years is whether we will have to reduce our potential growth estimates, as we were forced to do after the global financial crisis. Our revisions to both potential and output growth at the September 2020 MPC meeting were a surprise to several SARB watchers. From what I have gathered from our interactions with many of you, it was not the downward revisions that were a surprise, but the timing and approach that were of greater concern. In reaction to these concerns, the SARB's October 2020 *Monetary Policy Review* devoted a box to the detailed explanation of these revisions. The essence of our approach is characterised by significant movements in the output of the economy, and there is no predetermined date in deciding when to make these adjustments.

We, however, know that the methodological treatment of these concepts is always fraught with difficulties. As such, while potential output and output gaps have always been important in guiding our monetary policy stance, they have been used with great caution by most central bankers, owing to their measurement uncertainty. The large-scale disruptions to the economy as a result of COVID-19 have pushed this measurement uncertainty to a new level. The impact of the lockdown means that response rates to surveys have been lower than usual, and more uncertainty in data, from which potential output is derived, just adds a further layer of uncertainty. In addition, there are still businesses that are temporarily closed or operating at much lower capacity as a result of the crisis, and it is still unclear if and when they will return to their normal operations, for example those in the hospitality and tourism sectors. It will likely take some time before we are able to fully determine, with great certainty, how many permanent business closures will result from the crisis, which makes it difficult to accurately measure the supply-side of the economy.

Notwithstanding these uncertainties, several views are emerging globally that may be of relevance to South Africa. The nature of the pandemic is expected to bring about various changes to the economy, including much slower capital accumulation than in the past and a change in tastes and preferences that will lead to reallocation effects in the economy.[3] Some argue that, given the nature of the crisis, some capital will become obsolete very quickly and this has significant implications for the long-term productivity of the economy.[4]

Expectations of the potential long-term impact of the COVID-19 crisis on economic growth, along with rising levels of public debt, are also particularly concerning for a country such as South Africa, given our large dependence on external financing as a result of our structural current account deficit. These unfavourable growth/debt dynamics could result in a change in global investor sentiment towards South Africa,

[3] See, International Monetary Fund, *World Economic Outlook,* October 2020; Bank of Canada, *Monetary Policy Report*, October 2020; and Bank of England, *Monetary Policy Report*, November 2020.
[4] See J Kozlowski, L Veldkamp and V Venkateswaran, 'Scarring body and mind: the long-term belief-scarring effects of COVID-19', 2 September 2020.

even as investors turn towards riskier assets such as emerging markets in search of higher returns. This may, in turn, affect capital flows to South Africa and/or increase the risk premium investors require, particularly given that they already held an overweight investment position in South Africa going into the crisis. A key consideration in this regard is whether we will see investor differentiation between emerging markets, with preference for those with strong growth and fiscal metrics.

4. Conclusion and key lessons from the COVID-19 crisis

Let me end with a few concluding remarks and some key lessons from the crisis. Many central banks, particularly in advanced economies, had to largely resort to QE with speed and vigour to stimulate their economies. At this stage, we are able to rely on conventional monetary policy, which implies that we still have room to provide further accommodation before having to consider QE-type measures, should economic conditions deteriorate and inflation moderate further down towards the lower end of the inflation target. The SARB, like many central banks that are not at the zero lower bound of their policy interest rates, used its balance sheet not to stimulate the economy but as a crisis management tool, in line with its financial stability mandate. We will continue to use these tools in the future in the same spirit if need be.

Another lesson from the COVID-19 crisis is that, unlike the great financial crisis in 2008 where inflation was high, which required interest rate hikes even as the crisis was unfolding, we entered the COVID-19 crisis with stable and low inflation rates, and moderate inflation expectations. This allowed us room to respond to the crisis quickly with significant interest rate cuts. Despite our cuts, inflation still seems to be moderating further below the midpoint of the target.

Needless to say, the most important post-COVID challenge is that when the economy starts recovering and inflation begins to drift upwards, we have to make sure that we are able to find the right balance in our monetary stance that, at one level, would not result in a premature tightening of monetary policy while also guarding against a delayed response that would reverse a sustained downward trend in inflation expectations.

An additional challenge is to ensure that we are able to come to grips with the role of monetary policy relative to what we think potential growth is. This will serve as an important backdrop to opportunities or constraints that will exist for monetary policy in the future. However, as noted earlier, our medium-term projection for real potential and real GDP growth suggests that the output gap will remain negative throughout our forecast period. This should allow us to keep interest rates relatively accommodative over our forecast horizon and only normalise rates as the output gap closes. I should, however, emphasise that, given the high uncertainties about the current crisis, the SARB will continue to remain data-dependent in its policy decision-making.

Thank you.