FASTEN YOUR SEATBELTS !

Monetary Policy Challenges in Turbulent Times

Remarks by Mr T.T. Mboweni, Governor of the South African Reserve Bank

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Governor Reddy,
Deputy Governors of the Reserve Bank of India
Honoured Guests
The Consul General of the Republic of South Africa
Members of the India-South Africa Business Forum
Ladies and Gentleman

1. Introduction

Thank you for your kind invitation. I am delighted to be in India for the first time at this juncture as you celebrate the 60th anniversary of your independence and enjoy the international spotlight as the result of your splendid economic performance.

It is a great pleasure and privilege to deliver this address today for two main reasons. Firstly, this lecture is in honour of a truly great person, Mr Chintaman Deshmukh. The contribution of Mr Deshmukh to the Indian economy cannot be exaggerated as is borne out by his long service to this country as Governor of the Reserve Bank of India, Member of the Planning Commission of the Government of India, Minister of Finance, Vice-Chancellor of the University of Delhi and as President of the Indian Statistical Institute from 1945 to 1964, amongst others. Secondly, I understand that this lecture series has been graced with the presence of some truly remarkable speakers. I am indeed very grateful to be accorded the privilege to deliver this the 13th lecture in this series.

The relationship between South Africa and India is a very strong one today. This relationship, however, goes back a long way in history. President Nelson Mandela, the former President of the Republic of South Africa encapsulated this quite well when he said that “India and South Africa are two countries held so closely by bonds of sentiment, common values and shared experience, by affinity of cultures and traditions and by geography”[1]. The contribution of one of your and our favourite sons, Mohandas Karamchand (Mahatma) Gandhi, and the support received from the Indian authorities during the liberation struggle went a long way towards assisting South Africa to achieve democracy in 1994. The important role that India played in South Africa’s transition to democracy is without question and highly appreciated back home.

Currently, strategic relationships on the bilateral and multilateral fronts hold promising opportunities of mutual benefit for both our countries. Already, bilateral trade between India and South Africa has increased by well over

[1] India Digest, vol 4, 1996.

100 per cent in the past four years and a Preferential Trade Agreement between South Africa and India aims to treble trade by 2010. In addition, South Africa has been benefiting from India's rich entrepreneurial and educational skills base, with many teachers and other skilled personnel being employed in various institutions in our country.

South Africa is currently India's biggest investment partner in sub-Saharan Africa, serving as an important entry point into the rest of Africa. Indian investments in our country have grown significantly over the years, and have become more diverse, ranging from vehicles (Tata, Mahindra), steel (Arcelor Mittal), telecommunications (Neotel) and pharmaceutical companies such as Ranbaxy. Investments from South Africa to India are also growing. South African Breweries acquired stakes in various Indian breweries. Other areas in which South African companies have invested include insurance, diamond exploration and infrastructure. In February 2006, the Airports Company of South Africa (ACSA) won the contract for upgrading the Mumbai Airport. I also gather that SASOL is interested in a coal-to-synthetic automotive fuel project in India and many other South African companies have signed up marketing contracts with Indian companies in the pharmaceutical sector.

On the multilateral front, initiatives such as that involving India, Brazil and South Africa (IBSA) and Brazil, Russia, India, China and South Africa (BRICSA) provide useful platforms for the strengthening of ties between our two countries and the South-South economic relations in general. In addition, over the last few years India, South Africa, Brazil and China have been recognised as systematically important countries to the extent that they have been regularly invited to the G-7 meetings in order to contribute to the discussion on global economic and financial matters. On the one hand, this participation has taken place usually on the fringes of the main G-7 meetings, thus raising the question about the seriousness with which the G-7 countries give to these meetings. On the other hand, these four countries have started to meet on a regular basis in order to strengthen co-operation on issues of common interest.

As you may well be aware, one of the burning issues at the moment relates to increasing the "voice" or representation of emerging-market economies in international financial institutions such as the IMF and World Bank. This issue, together with other matters relating to the reform of the Bretton Woods Institutions have also been key agenda items addressed this year during the preparatory meetings for the G-20 meeting of Ministers of Finance and Central Bank Governors. As we know, South Africa currently chairs the G-20 Forum and it will be our pleasure and privilege to welcome the Indian G-20 delegation in South Africa during November. There are many issues which are the centre of focus to the G-20 this year, but most prominently are the fiscal elements of growth and development and the impact of commodity prices on member countries. South Africa and India do not only share common policy positions on many of these issues, but have also been very active in advocating the interests of emerging-market economies in this new world order.

Both countries have benefited from the economic reforms implemented over the last decade or so. However, both countries have similar economic challenges which in the main relate to, inequality, poverty alleviation and the reduction of unemployment. As a central banker, I wish to dwell on some issues and challenges facing monetary policy in emerging markets.

2. The "Great Moderation"

One of the defining characteristics of global economic developments over the last three decades has been termed the "Great Moderation" –the sustained decline in the volatility of output and inflation. This development has been due to the structural changes that many economies have undergone. Some have attributed these changes to the implementation of better policy options and others to simply good luck. Professor Kenneth Rogoff of Harvard University has argued on many occasions that improved competitiveness as a result of increased globalisation coupled with better policies has had a major positive impact on inflationary trends in many countries. The declining trend in inflation since 1990 is clearly evident in India and South Africa. Inflation in India has declined steadily from an average of 10,3 per cent between 1990–1994, to 8,9 per cent between 1995–1999 and to 4,3 per cent in this decade. Similarly in South Africa, inflation has declined from an average of 12,5 per cent, to 7,3 per cent and to 5,1 per cent over the same time periods.

The economic growth performance of both countries has also been quite impressive. Since 1990, India has experienced average growth rates of around 6 per cent per annum, increasing to an impressive 9 per cent in the last two years. It is now widely expected that the Indian economic growth rate trajectory would be very close to, if not, in double digit territory in the short to medium term. South Africa has not been performing badly either, with an average economic growth rate of about 3,4 per cent per year since the advent of democracy in 1994, compared to an average of below 1 per cent in the previous decade. Over the last three years, however, growth has averaged about 5 per cent and the current trend in the economic growth rate is the longest experienced in the country's recorded history.

3. Improved macroeconomic performance: some side-effects

A side-effect of strong economic growth in many emerging market countries is the growing middle class. This has been particularly true for both India and South Africa. The rapid emergence of this middle class brings opportunities that will have a significant impact on future prosperity, but also poses a rather unique set of challenges for policymakers. With increasing affluence, there is bound to be a change in consumption levels and patterns. Related policy concerns centre on the implication of these changes on the demand for credit, the level of imports and the effect on asset markets.

Then, there is the added concern that the unequal distribution of wealth brings with it a tension between the haves and the have-nots. Under these circumstances, the broadening of access to financial services becomes an important policy objective. It is well recognised that the financial inclusion of the lower echelons of society into the financial sector is a powerful contributory factor to poverty alleviation through, for example, the provision of micro-finance. As the demand for consumer finance increases, a greater range of financial instruments are needed and the financial sector will need to adapt.

Over the past few decades, alongside financial deepening, household debt levels have been on the rise across a number of countries, both in developing and advanced countries. Rapid increases in household indebtedness have been associated with increases in asset prices, mainly house prices. These developments have indeed increased the probability of defaults, stemming in the main from adverse external shocks and rising interest rates.

Whilst household debt ratios in emerging-market countries like South Africa are low in comparison to developed countries, the rapid rise in household debt and credit levels has raised some concerns. In addition, high levels of inequality could mean that some groups are more affected than others. Hence, the close monitoring of lending practices and detailed reviews of credit standards can contribute towards the integrity and stability of the financial system. In the case of South Africa, an Act of Parliament (the National Credit Act) was introduced to address this issue. It is still too early to ascertain the impact that this Act has had on borrowing and lending practices in South Africa. There is little doubt that positive outcomes may be realised.

4. The role of monetary policy

Central bankers have more often than not found that the role of monetary policy in the economic growth process is not fully understood or appreciated by all stakeholders. Let me use the South African case to illustrate this difficulty. Monetary policy in South Africa is implemented within an inflation targeting framework – the target range being an inflation rate, namely CPIX (headline inflation less mortgage interest costs) of between 3 and 6 per cent. CPIX inflation in South Africa has been outside the upper end of the target range for the past six months. In addition, there has been a deterioration in the inflation outlook. This has mainly been (initially) as a result of higher international food and fuel prices as well as robust consumer spending. However, underlying pressures have also become more broad-based. Although credit growth has slowed somewhat in response to previous monetary policy tightening, persistently high food and fuel costs have meant that the risks to the outlook are on the upside. Inflation expectations have consequently risen to the top end of the target range, with possible adverse implications for wage and price-setting decisions.

These risks to the outlook have necessitated the tightening of monetary policy from 7 per cent in May 2006 to 10,5 per cent currently. The tightening of monetary policy has not gone down well in all parts of society. Not everyone appreciates that sacrifices – albeit short term sacrifices – are sometimes needed to secure medium to long term benefits. In general, due recognition is not always accorded to the role that price stability plays in securing sustainable economic activity. In our modern world where remote controls and microwave ovens are the order of the day, not everyone – market participants included – always comprehend or appreciate that monetary policy operates with a relatively long lag. So in essence, one of our primary challenges as central bankers relates to the issue of regular and consistent communication.

Communicating monetary policy has become complicated because the transmission channels have become somewhat clouded. Structural changes in the economy have had an impact on functional relationships, with the result that the transmission mechanism of monetary policy has become more complex. Advances in econometrics and economic theory have facilitated the construction of sophisticated structural models incorporating complex behavioural relationships. However, as Professor David Hendry argues, forecast errors are very often the result of unanticipated large changes or shocks within the forecast period[2]. Hence, anecdotal evidence that provides a better understanding of the risks to the inflation outlook is essential to monetary policy-making. As the Chairman of the Federal Reserve Board, Mr Ben Bernanke recently remarked, good economic forecasts “involve art as well as science”[3].

The recent South African experience has shown that some of the conventional observations do not always hold

[2] Clements, M. P. and Hendry, D. F. (2002). Explaining forecast failure in macroeconomics. In Clements, M. P. and Hendry, D. F. (eds.), A Companion to Economic Forecasting, pp. 539–571. Oxford: Blackwells.

[3] Bernanke, B.S (2007). “Inflation expectations and inflation forecasting”. Monetary Economics Workshop of the National Bureau of Economic Research Summer Institute, Cambridge, Massachusetts.

in practice. For example, the South African currency (the Rand) has on more than one occasion weakened when interest rates were increased or appreciated when interest rates were lowered or when they remained unchanged.

Furthermore, emerging-market currencies in general are subject to extreme volatility resulting from shifts such as was the case with the USD recently, having an impact on domestic monetary conditions. An added challenge relates to the fact that many emerging-market countries have a relatively short track record of credible monetary policy. Credibility is earned over time and yet it is central to the anchoring of inflation expectations.

Communication is further complicated by the global context in which inflationary pressures occur. On the one hand, there are downward inflationary pressures as a result of lower-priced goods due to globalisation. On the other hand, increased trade protectionism, coupled with rising commodity prices due to robust world growth, pose risks to price stability.

China and India play a significant role in the global economy today. This assertion to many is without question. The disinflationary benefits of globalisation have been manifested in China's contribution to lower global inflation over the last decade, through lower import prices of manufactured goods, more specifically clothing and footwear. India has also played an important role through the supply of low-cost knowledge based services such as in the field of information and communications technology (ICT). However, the utopia of strong economic growth with low inflation may be reversed as China and India, because of their appetite for commodities, contribute to the surge in commodity prices, notably in base metals and minerals, especially oil prices. China and India have been the world's fastest growing energy markets with oil demand currently increasing at around 6 per cent for China and 5 per cent for India. As is not foreign to this gathering, oil prices have reached nominal record high levels recently, thus placing upward pressure on inflation and complicating the task of monetary policy, specifically in the anchoring of inflation expectations.

Regarding the commodity boom, South Africa is faced with a double-edged sword. Whilst the demand for commodities boosts export revenues, surging energy price increases have had a significant upward pressure on import costs and inflation in South Africa.

5. Global financial market integration

Global financial market integration has increased significantly in recent years, posing further challenges to the conduct of monetary policy. There are divided opinions on the advantages and disadvantages of global financial market integration, but to a large extent most would agree that globalisation has been positive insofar as it has imposed market discipline on policymakers. There are many who think that globalisation increases economic growth prospects and reduces volatility. In some respects, globalisation and financial market integration also make policymakers aware of the importance of independent central banks. Market participants are more comfortable in situations where central banks are seen (and actually are) going about their primary objectives without fear, favour or interference from not only the political executive, but all other stakeholders.

One of the main challenges of this new global environment relates to the so-called "contagion effect". The 1997/1998 global financial crisis is one example. Another more recent example relates to developments in the US sub-prime market. To begin with the 1997/1998 crisis, economies with relatively weak macroeconomic fundamentals were punished the most. South Africa, in particular, at the time suffered from capital outflows, a depreciation of the currency and subsequently inflationary pressures. As a result, monetary policy had to flow with the tide, and interest rates were increased by a full 7 percentage points between April and September 1998.

However, as painful as the process was, not only for South Africa, but for most other emerging markets, lessons have been learnt and major reform of existing financial structures and adjustment in macroeconomic policies emerged.

The 1997/1998 crisis highlighted concerns surrounding debt sustainability. As a consequence, many emerging-market countries reduced their domestic and external debt, and in the process, reduced currency mismatches which in some respects rendered these emerging markets less vulnerable to currency depreciation. There have also been efforts to reduce the external vulnerability through debt buybacks, while reserves accumulation has also been gathering pace over the past few years. India's reserves are the world's seventh largest at over USD250 billion. While South Africa's are but a fraction of this, one needs to bear in mind that we have moved from a position of a negative net open forward position of almost USD26 billion at the end of 1998, to positive net reserves of US$28 billion currently, the result of which means that today the country boasts an investment grade rating.

Furthermore, central banks have shifted towards market-based instruments which enhance their ability to respond to shocks. India is one such example, with the increased use of repo and reverse repo operations since the early 2000s, increasing the role of interest rates in the transmission mechanism of monetary policy. In South Africa's case, we have come a long way in terms of the development of our own bond market, a process in which the South African Reserve Bank played a major role for a very long time. Today, we have a very deep and liquid bond market, if not the most liquid bond market in the emerging-market economies.

The positive impact of these financial market and macroeconomic developments have been put to the test on numerous occasions since the 1997/1998 crisis. The most recent event has been that of the US sub-prime mortgage market. This episode has been well documented and I shall therefore not spend time on its detail. As you are aware, it was a liquidity and credit crisis, emanating from financial institutions having exposure to the sub-prime market and thereby incurring huge losses as delinquencies and foreclosures increased in the wake of tighter monetary policy. Although the sub-prime mortgage market was an issue related to the US, the adverse developments were transmitted to other developed and emerging markets without much relation to domestic developments.

At the height of the crisis, developed and emerging-market equities were sold. Foreign exchange markets witnessed a significant increase in volatility as carry trades were rapidly unwound and emerging-market spreads rose significantly between late July and mid-August. However, the rise in emerging-market debt spreads was not quite as pronounced as that of credit markets in developed economies. Spread movements also reflected higher risk credits moving the market in either direction.

Although South African financial markets were affected by the events surrounding the sub-prime crisis, our money markets were relatively unaffected. Our banking system had very little exposure to the sub-prime market and liquidity conditions domestically remained healthy. As such, there was no need for the South African Reserve Bank to provide extra liquidity to markets. Throughout this turmoil, the principal challenge for the Monetary Policy Committee has been to address inflation concerns. Inflation developments in South Africa have been such that at a time when global monetary policy seems generally to have turned from a tightening bias to an easier or neutral stance, our MPC has had to tighten monetary policy.

Since the recent turmoil experienced in financial markets, money market conditions have eased considerably, most notably in the US, following the Fed's decision to cut interest rates by a cumulative 75 basis points. Money market conditions in Europe, however, remain a little more strained, probably partly due to the fact that a significant amount of the structured investment products were in fact purchased by European and other overseas investors. Up until the end of October, financial markets recovered, with equity markets in particular bouncing back to levels higher than at the time of the turmoil. However, experience has taught us that financial market gains could easily be reversed in times of uncertainty.

Emerging markets could still feel the impact of an abrupt and sustained change in global financial conditions and international investor appetite for risk. Such a scenario could play out in the event of a significant slowing in global growth and rapid reversal of capital inflows in spite of better macroeconomic fundamentals. In a more globalised world, emerging-market economies may be more vulnerable to shocks originating in developed economies than was the case previously. Under these circumstances, extreme vigilance on the part of policymakers remains the order of the day. The current uncertainties in global financial markets will remain fixed on the radar screens of policymakers for some time to come.

6. Conclusion

In an interdependent world, the effects of uncertainties will not only be exaggerated, but could also affect innocent third parties. We have to remain vigilant to global and domestic developments in order to ensure that prosperous outcomes are not unduly threatened. Under these circumstances, policymakers have to ensure that strong economic fundamentals are maintained. The role of monetary policy in this process should not be underestimated. For emerging economies, like India and South Africa, the challenge remains to reinforce and build on the achievements of the last decade or so.

Thank you very much, once again dear colleagues and Governor Reddy for inviting me to deliver this address. I will leave this remarkable country truly inspired and I am certain that this is not my last visit to this beautiful country.

Thank you for your attention.