The Asynchronous Monetary Stances of Advanced Economies and South Africa's Policy Options

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1. Introduction

The 'Great Recession' that manifested from the financial crises of 2008 necessitated unconventional monetary policy decisions in the form of quantitative easing (QE) from the US Federal Reserve Bank (FED). The US economy has begun to show signs of recovery and the FED is expected to normalise interest rates in the years ahead. In the midst of sluggish growth, prospects of deflation, and near zero policy rates, the European Central Bank (ECB) has embarked on a QE quest of its own in order to stimulate the Eurozone economy.

This essay will dissect the implications of the FED and ECB monetary policy decisions on South Africa, and also paying attention to domestic factors, the essay will discuss an optimal policy response.

2. Global Factors

Information and Communication Technologies have made the world much smaller than it was a few centuries ago. Financial instruments are much more varied and exotic, financial markets have deepened and broadened, and trade in financial markets now exceeds trade in goods markets. Hence financial developments in one region spillover to other regions with much more pace and penetration.

South Africa, though an emerging market economy (EME), has financial markets that resemble those of the advanced economies of the world and the rand is a convenient currency that allows speculative traders and investors' entry into emerging markets. Hence South Africa is particularly vulnerable to spillovers from financial developments in the global economy.

Normalisation in US

The FED monetary policy decisions affect the global economy primarily through three channels; (a) trade and exchange rates, (b) capital flows and (c) global stability (Subramanian, 2014).

The International Monetary Fund (IMF, 2014a) reported that the tightening cycle from the US is likely to exert upward pressures on the global interest rates. EMEs are likely to experience more stress on their sovereign bonds and stock markets and significant currency depreciations (IMF, 2014a).

Similarly, Bowman, Londono and Sapriza (2014) argued that the FED monetary policy decisions had a significant impact on the yields of EMEs' sovereign bonds.[1] Individual specific variables at country level determined how vulnerable asset prices of EMEs where to changes in US interest rates. Nations

[1] Their sample included Brazil, China, the Czech Republic, Hong Kong, Hungary, India, Indonesia, Korea, Malaysia, Mexico, the Philippines, Poland, Singapore, South Africa, Taiwan, Thailand, and Turkey.

such as South Africa which have relatively high inflation rates, large current account deficits, and more vulnerable banking systems are affected more severely by changes in U.S. interest rates.

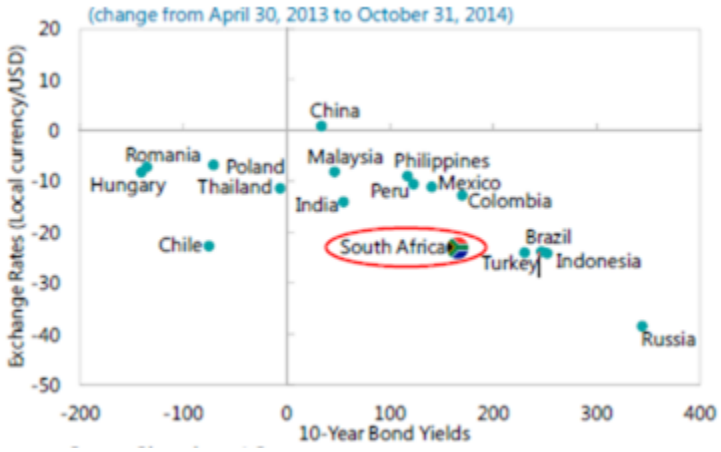
The FED tapering of May 2013 offers some insight into how US normalisation might transmit to the South African economy. IMF (2014a) reported that the announcement of tapering triggered volatility and re-pricing of risk and capital flow reversals in some EMEs. The yield in 10-year instruments rose by approximately 100 basis points in the United States and around the world (IMF, 2014a). This volatility was likely associated with the unexpected policy move (IMF, 2014a). This time around, the normalisation is anticipated and so even if markets might experience increased volatility and EME's might see reversal of capital flows, it will likely be less severe than in the case of FED policy move coming as a shock. IMF (2014a) reported that the tapering also sparked some uncertainty about the FED road map going forward.

Furthermore, empirical evidence of the FED tapering of May 2013 showed that nations with large current account deficits and high inflation rates such as South Africa experienced a stronger increase in yields and larger exchange rate depreciations (IMF, 2014a).

Subramanian (2014) explored the impact of tapering of May 2013 on EMEs and observed capital outflows and sharp currency adjustments. The so-called 'Fragile Five' economies, Brazil, Indonesia, South Africa, India and Turkey, were most heavily affected by the tapering since large current account deficits renders them vulnerable to reversals of foreign flows (Subramanian, 2014).

Similarly, the IMF (2014b) reported that South Africa was among the EMEs most heavily impacted by market volatility that manifested from the FED tapering (See figure 1). Portfolio inflows decreased from May 2013 and reversed to outflows in the second and fourth quarter of 2013 (IMF, 2014b). These outcomes were likely caused by large twin deficits, a sizable share of foreign holdings in government in rand government debt, and deep financial markets combined with accommodative monetary policy and absence of foreign exchange market intervention (IMF, 2014b). The rand depreciated by 23% against the dollar compared to its 2012 end of year value, and local bond yields were approximately 110 basis points higher than they were in 2012 (IMF, 2014).

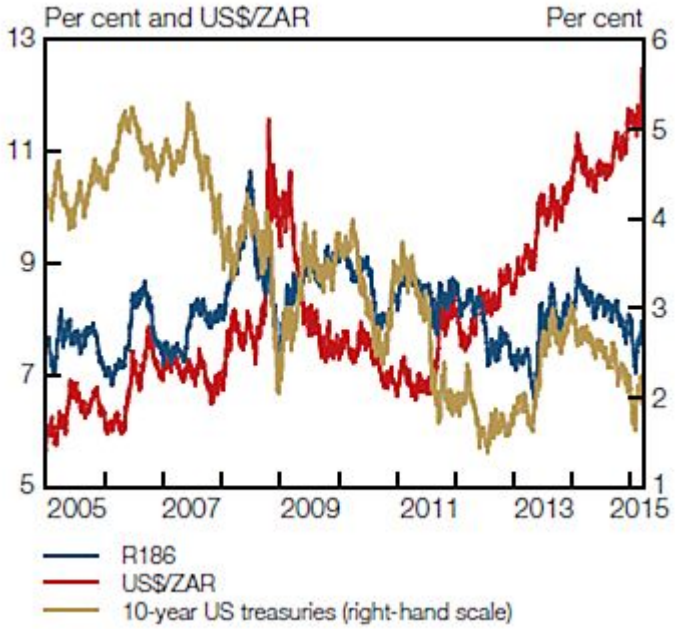
Figure 1: South Africa among the EMEs most affected by market volatility



Source: Bloomberg as quoted by IMF

The South African Reserve Bank, (SARB, 2015) reported that US normalisation is likely to steepen the US yield curve and exert upward pressure on South Africa's yield curve since there is high correlation between South African long-term yields and yields on US Treasuries (See figure 2).

Figure 2: Domestic and US yields and the South African rand



Source: Bloomberg as quoted by SARB

The SARB (2015) further reported that if US interest rates are hiked more aggressively than anticipated the spillover effects for EMEs could be more damaging. Long-term US Treasury bonds will be more attractive to investors at the expense of EMEs bonds (SARB, 2015). Improving confidence in the US economy might create market expectations of quicker interest rate hikes (SARB, 2015). And so even if normalisation path is approached with sound management by the FED, it may still lead to increased volatility in financial markets and eventually spark capital outflows from vulnerable EMEs as investors revise their risk perceptions (SARB, 2015). South Africa's large fiscal and current account deficits make it particularly vulnerable to capital outflows and currency weakness (SARB, 2015).

ECB Quantitative Easing

The ECB has begun its bond purchasing programme which will increase its balance sheets by around €1.1 trillion (SARB, 2015). The quantitative easing from ECB will increase global liquidity (SARB, 2015). Increased global liquidity could give some temporary cushion to the exchange-rate risk of EME bonds such as South Africa, whose currencies have been depreciating over recent years (SARB, 2015).

If European investors begin to diversify and balance their portfolios by purchasing more foreign assets to find a balance given low returns in European assets, EMEs such as South Africa could benefit from these flows. (IMF, 2014a)

Europe is one of South Africa's major trading partners. The impacts of ECB's QE on South Africa's current account balance in the short term will depend on how much the rand will appreciate against the Euro throughout the bond purchasing process. A stronger domestic currency means stronger terms of trade however export volumes might suffer on the back of decreased price competitiveness. But in the long term successful QE that boosts the Eurozone economy might benefit South African exports through stronger external demand.

The ECB's QE announcement and implementation saw ten year yields on government bonds fall to zero in many Eurozone nations. The benchmark government bond yields were also somewhat pressed downwards in the US, the UK and South Africa (SARB, 2015).[2]

The overall impact on South Africa

The ECB monetary decisions mean that tightening cycle is not well-synchronised and this will counteract some of the effects of US normalisation. This presents a new risk in that it might lead to greater volatility of major currencies and this poses a potential problem for economies like South Africa which have balance sheet vulnerabilities and exchange rate exposure (IMF, 2014a).

The changes in expectations of interest rates in AEs have also manifested in EMEs through a widespread increase in yields on short-dated EME government bonds (SARB, 2014). South Africa's yields on short-dated government increased while yields on longer-dated bonds fell. This is due to the fact short-term rates are more sensitive to changes in policy rates while long-term rates are more sensitive to structural factors (SARB, 2014). However, the FED normalisation is likely to reverse the relatively low yield at the longer end of the curve (SARB, 2014).

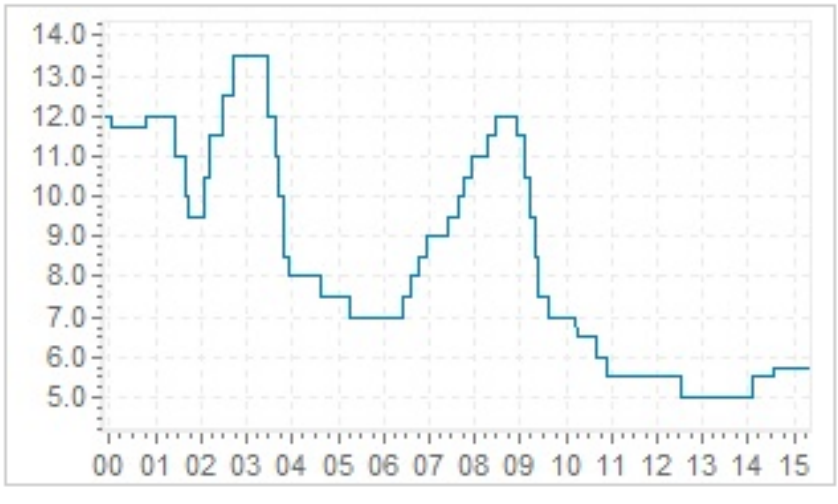
Ultimately, the asynchronous monetary decisions of the FED and the ECB will have contrasting impacts on capital flows to South Africa, the rand and domestic yields. The appropriate policy response requires an understanding of which effects will be dominant.

The US is the world's largest economy, making up around 20% of the global GDP. The US dollar is the primary reserve currency of the many of the world's central banks and US markets are the financial hub of the world. For these reasons, the FED normalisation is likely to carry the dominant spillover effects. De Cadenas-Santiago et al (2014) argued that FED normalisation will contract portfolio flows to EMEs and ECB QE will offset the flows only partially. ECB monetary decisions have strong regional impacts on Europe and small impacts elsewhere while FED monetary decisions have strong impacts on the entire global economy (de Cadenas-Santiago et al, 2014).

3. Impacts of repo rate increase

South Africa's Monetary Policy Committee (MPC) cut interest to help the economy recover from the aftermath of the financial crises of 2008 and in recent years interest rates have been lower than historical levels (See figure 3).

Figure 3: South African Repo Rate 2000-2015



Source: SARB

[2] This was also a result of lower oil prices.

The MPC has recently embarked on a patient tightening cycle to normalise interest rates. In light of the upward pressure that recently announced FED normalisation will exert on global interest rates, increasing domestic interest rates seems to be an appropriate policy decision, however there are domestic ramifications that need to be considered.

3.1 The Downside

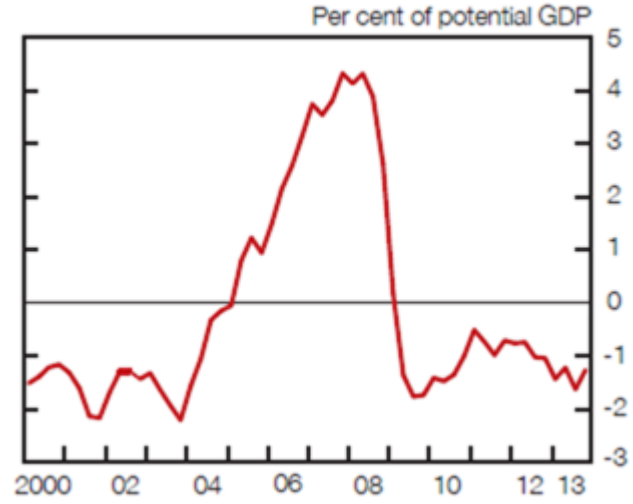
Sluggish Growth and High Unemployment

Post 2008, growth in many EMEs has improved but South Africa has not shown the same resilience. The SARB (2015) forecasted growth to remain sluggish at 2.2 and 2.3 percent for 2015 and 2016 respectively. Over and above that, structural constraints have decreased South Africa's potential growth over the past few years. The IMF (2014b) estimates potential growth be around 2.25-2.5% which implies negative output gaps in 2014 and 2015 (See figure 4(a) and 4(b)). Interest rate hike during periods of stagnation would be pro-cyclical. Furthermore, hiking interest rates during periods of stagnation and rising inflation might lead to stagflation.

Figure 4 (a): South Africa's estimated potential output growth, 2000–2014

Source: IMF

Figure 4 (b): South Africa's estimated output gap, 2000–2014



Source: IMF

South Africa's sluggish growth has been mirrored in high unemployment. Interest rate hikes adversely impact aggregate demand and might compound the unemployment conundrum. In 2014, unemployment increased by 143 000 and continues to hover around 25% (SARB, 2014). High unemployment might spark social unrest and also presents risks of spill over into banking sector through more defaults on loans (SARB, 2014).

Furthermore, contractionary shocks in the short run that result in higher unemployment may impact the long-term unemployment rate through hysteresis. In physics hysteresis refers to the inability of an object to return to its original position even after an external force is removed. A form of hysteresis is present in labour markets (Ball and Mankiw, 2002). Contractionary shocks that lead to loss of employment and unemployment being higher that structural rate for too long might damage the workforce and lead to a higher natural rate of unemployment.

Lending conditions and household financial positions

The IMF (2014b) reported that in addition to the MPC repo rate increase of 75 basis points in 2014, Basel III stringent capital and reserve requirements, curatorship of African Bank in August 2014, and credit rating downgrades have contributed to tighter financial conditions. Higher interest rates will tighten lending conditions further and this might supress consumer spending, especially since many South Africans are already highly indebted.

3.2 The Upside

Public Saving

South African households saving as a percentage of disposable income remained negative in 2014 (SARB, 2015). Low interest rates and relatively high inflation over recent years has resulted in negative real interest rates. Higher interest rates could help stimulate private saving.

Inflation

The IMF (2014b) reported that over the past few years, large depreciation had been the main driver of headline and core inflation despite negative output gap mitigating exchange rate pass-through to some extent. The rand is vulnerable to Fed normalisation and many financial assets[3] have started to track the rand exchange rate expecting some pass-through to inflation. (SARB, 2014). Higher interest rate might mitigate the inflation expected from exchange rate pass-through.

4. The inflation targeting framework

An important question is whether a floating exchange rate and explicit inflation targeting framework allows South Africa to respond optimally to global shocks and domestic challenges.

Bonga-Bonga and Kabundi (2011) argued that monetary policy tools need to be complemented by other tools if monetary policy is to be effective in influencing the level of inflation. Malikane and Mokoka (2012) argue that an explicit inflation targeting framework did not exhibit credibility effects[4]. Malikane and Semmler (2008) argued that for a small open economy with high unemployment, inflation targeting framework could trap the economy at a high unemployment unless real exchange rate fluctuations were incorporated in the Taylor rule.

Other studies had contrasting views. Arona and Muellbauer (2007) argued that the inflation targeting framework lead to increased credibility and reasonable predictability. Their paper demonstrated that monetary policy decisions taken in response to external and domestic shocks under inflation targeting improved in comparison to preceding frameworks (Arona and Meullbauer, 2007). Kumo (2015)

[3] Including bonds, forward rate agreements, forward swaps and break-even inflation rates
[4] Credibility in monetary policy makes disinflation less costly

argued that the pre-inflation targeting monetary policy regime were characterised by high inflation rates and inflation volatility. Inflation volatility and high inflation rates of pre-inflation frameworks had negative impacts on the economy but such negative impacts were not observed during the inflation targeting framework (Kumo, 2015).

On the other hand, Ostry, Ghosh and Chamon (2012) argued that using two policy instruments- interest rates and forex market interventions- could allow EMEs to achieve both price stability and exchange rate objectives. They added that the absence of intervention in the foreign exchange market when exchange rate strayed too far from the level consistent with sound fundamentals could undermine macroeconomic stability (Ostry, Gosh and Chamon, 2012).

A monetary policy framework that involved forex intervention could enable South Africa to respond to external shocks that fluctuate the rand, however as is the case in many developing countries, South Africa's limited reserves would constraint its ability to protect the rand during extreme depreciations.

In any case, inflation targeting framework does allow monetary policy to affect external stability. Mallick and Sousa (2012) argued monetary tightening lead to exchange rate appreciation and hence allowed monetary policy to respond to external shocks that fluctuate the rand.

5. Recommendation

The financing of the current account deficit is dependent on foreign capital inflows. Weak external demand, labour market unrest, competitive problems and soft terms of trade saw the current account deficit reaching 5.4% of GDP in 2014. (IMF, 2014b). According to the SARB (2014), South Africa has sufficient reserves to cover imports however the risk associated with financing the current account deficit is intensifying. As flows to EMEs are becoming more and more moderated, financing the current-account deficit could become more expensive (SARB, 2014). Higher domestic interest rates would mitigate some of the risks of capital outflows and help ensure that financial surplus that finance the current account deficit are sustained.

Macroeconomic reforms such as strengthening our manufacturing sector to increase the variety and value of our exports, addressing electricity challenges and resolving labour market rigidities have the potential to reduce the current account balance. An improving current account balance will make South Africa less vulnerable to foreign capital flows. Other sound fundamentals such as low and stable inflation, will make South Africa less fragile to spillovers from the global economy and allow policy makers greater space to respond to domestic challenges.

In the meantime, South Africa's MPC has announced that interest rates in the future will increase in order to balance monetary policy. However the hiking cycle needs to be gradual and patient. The impact of US normalisation is likely to have more impact on the medium term to long term than in the short term. An increase in repo rate should be postponed since domestic factors require monetary policy to stay accommodative for a little longer.

However, it is also important for inflation to remain within target so that the economy can sustain price competitiveness with trading partners. Stable inflation is also important for macroeconomic stability. Milton Friedman (1968) made this observation. He writes,

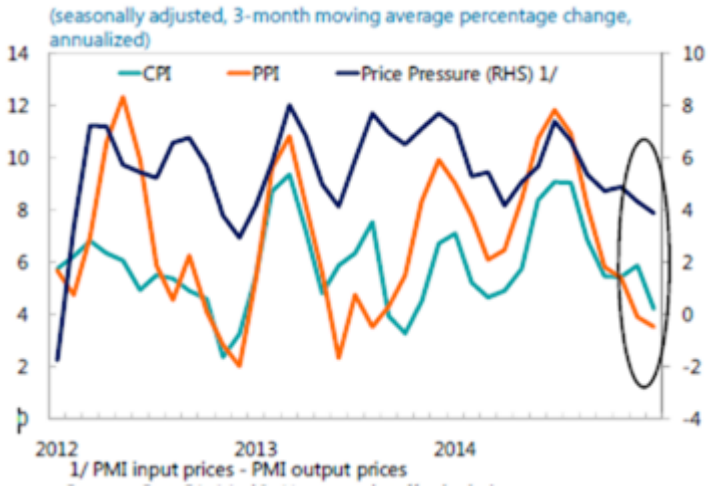
> A second thing monetary policy can do is provide a stable back-ground for the economy... Our economic system will work best when producers and consumers, employers and employees, can proceed with full confidence that the average level of prices will behave in a known way in the future-preferably that it will be highly stable.[5]

[5] Friedman, M. (1968), "The Role of Monetary Policy" *The American Economic Review*, Vol 58, p.13

The IMF (2014b) argued that on the basis of a simple Taylor rule, the MPC would have to hike interest rates in order to stay within inflation target over the medium term but large drop in oil prices and intended fiscal consolidation allowed the MPC to stay accommodative in the short term.

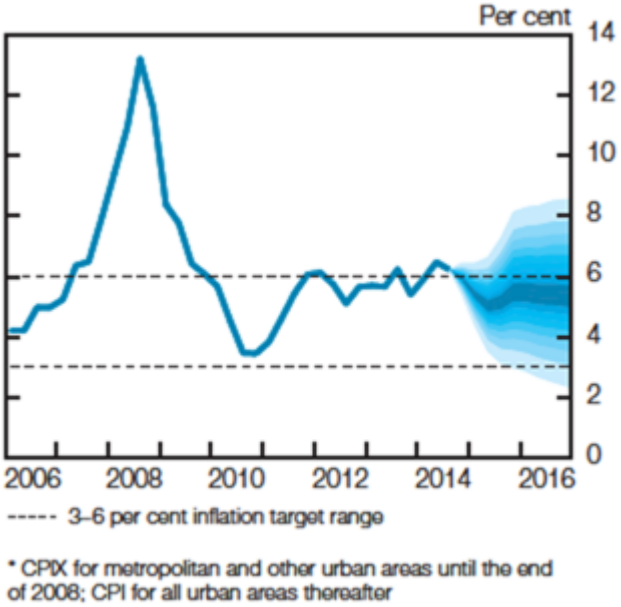
Inflation momentum is declining and the expectations are that inflation will be within the upper bound of target in the short term (IMF, 2014b) (See figures 5(a) and 5(b)). Hence MPC has room to approach the tightening cycle with patience.

Figure 5 (a): Inflation momentum is declining



Source: IMF

Figure 5 (b): Targeted inflation* forecast



Source: SARB as qouted by IMF

Higher interest rates might mitigate some of the inflation that is expected to pass through from rand depreciation, however Liu (2013) explored the cost channel of monetary policy in South Africa and argued that whether contractionary policy should be used to combat inflation depends critically on the nature of the disturbance. If increase in expected future inflation is due to a supply shock, a contractionary policy could lead to a persistent increase in inflation (Liu, 2013). And so when inflation is due to external supply shock, as in the case of exchange rate pass-through, intervention should only happen when there are second round effects through wage channels.

The fiscus is also an important consideration. South Africa reacted to the financial crises of 2008 through discretionary counter-cyclical fiscal policies. The budget deficit widened following increased government spending and low tax revenue (Nene, 2015). Widening budget deficit poses risks of macroeconomic vulnerabilities. Persistent deficits limit the role of fiscal policy in stabilising the economy and unsustainable government debt levels undermine investor confidence and constraint growth (Swanepoel, 2004).

And so for these reasons, National Treasury has recently embarked on a path of fiscal consolidation to reduce the budget deficit to 2.5% of GDP by the 2017/18 fiscal year (Nene, 2015). Improved fiscal position will reduce the default risk associated with government bonds and reduce government's interest rate payments. Spending less on interest rate payments will widen the scope for more growth enhancing expenditure such as infrastructure investment and education (Nene, 2015).

Fiscal consolidation is likely to put more strain on South African consumers but an important implication for monetary policy is that it is likely to reduce upward risks on inflation and this gives monetary policy room to stay accommodative in the short term.

Furthermore, rapid FED normalisation amidst ECB QE is likely to strengthen the US Dollar against the Euro. This will impact negatively on the US price competitiveness and might lead to falling US exports and a deteriorating current account balance. This risk is likely to compel the FED to be patient in their normalisation path and this widens the MPC's room of remaining accommodative in the short term.

6. Conclusion

The FED normalisation and ECB QE will have contrasting impacts on South Africa, however the FED normalisation is likely to be the dominant external shock. The risks for South Africa will depend on the kind of normalisation path that the FED will adopt in terms of timing and pace.

South African monetary policy can afford to stay accommodative in the short term, over the year 2014 or so, but in the medium term monetary tightening will be required to ensure that risks of capital flow is mitigated, the exchange rate is protected from extreme depreciation, and inflation remains within target. Fiscal policy should continue on a path of consolidation to ensure sustainable public finances and restore investor confidence.

The NDP sets out the necessary framework for how South Africa can achieve economic growth in the long term. Policy makers should ensure macroeconomic stability so that structural reforms that can drive growth would not be constrained by unstable macroeconomic conditions. In this regard, continued fiscal consolidation and gradual normalisation are the appropriate policy responses.

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