SOUTH AFRICAN RESERVE BANK

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Higher for longer

Good morning

Thank you for the invitation to speak at your annual Year Ahead conference.

We live in very interesting and uncertain times. These past four years, we have learnt that what we may think the year ahead could look like, often does not hold true, often in the most surprising ways.

The nature of the shocks we have experienced in recent years has resulted in an unusually high degree of convergence of global monetary policies in recent years.

In other words, central banks have been running together in a pack.

During the onset of the COVID-19 pandemic, most of us lowered rates sharply. Then, as inflation took off afterwards, we all raised them again. Nowadays, one could argue on the back of our communication, that central banks are in a third phase, which everyone is calling ‘higher for longer’.

I thought it would be useful today to discuss this concept of higher for longer – what it means, why so many central banks are using it, and how it applies to South Africa.

There are two main reasons 'higher for longer' have been getting so much airtime, globally.

The first is that markets, especially in the United States (US), placed increased focus on interest rate cuts. Even as the US Federal Reserve (Fed) raised rates steeply, starting in 2022, markets kept anticipating that this would trigger a recession and that the Fed would start cutting rates again.

This was contrary to the Fed's own expectations for rates, as demonstrated, for instance, in the famous dot plot.

And it was a problem because it meant financial conditions did not tighten as much as the Fed wanted: very short-term rates, which the Fed largely controls, were going up, but long-term rates were not rising nearly as much.

This was weakening monetary policy transmission.

Only in early 2023, did markets start accepting that rates would be higher for longer.

The collapse of Silicon Valley Bank (SVB) triggered a last round of hopes for large, near-term cuts. But the financial stress from that episode was contained, and the US economy kept on growing.

By mid-2023, the market had converged to the Fed's messaging, and 'higher for longer' became the new consensus. In these circumstances, we have seen the two-year Treasury bill rate rise to around 5% – it was just 3.8% after SVB collapsed, and 3% at the start of 2022.

Similarly, the 10-year US Treasury rate, which is a crucial benchmark for the US economy and the world, briefly hit 5% in late October, and is now around 4.6%, up from just 3% at the start of 2022.

Of course, long-term rates are not just determined by monetary policy expectations. Many explanations have been offered for the rise in the 10-year rate, but there is no expert consensus yet.

However, for monetary policy, it is clear that there has been a broad tightening of financial conditions. And this has given the Fed space to leave rates unchanged at its past two meetings, after previously hiking for 11 meetings in a row.

This brings us to the second reason central bankers have been emphasising 'higher for longer'.

I should at this point highlight that although 'higher for longer' might sound like bad news, this is meant to be a reassuring message about why central banks could pause their hiking cycles.

At the South African Reserve Bank's (SARB) 2023 Biennial Conference, held in late August, the Bank of England's Chief Economist, Huw Pill, captured this with a brilliant metaphor. He distinguished two monetary policy strategies – one that looks like the Matterhorn and one that looks like Table Mountain.

The Matterhorn is a very steep mountain in the Alps, nearly 4.5 km high, and it looks like a pyramid. A Matterhorn monetary policy is one where you raise rates sky high, then quickly start cutting again.

Table Mountain, of course, is not as high. It has an elevation of just over 1 km. But it stays that high for about 3 km. For monetary policy, a Table Mountain strategy means you do not hike as far, but rates remain elevated for an extended period.

At our conference, Pill made three arguments in favour of the Table Mountain option. Let us see if you agree with him:

Firstly, he suggested a less volatile rate cycle could mitigate financial stability risks.

Secondly, he argued ‘higher for longer’ could also control underlying inflation pressures more effectively, for instance by better influencing slow-moving prices like wages.

Thirdly, he also pointed out that in the United Kingdom (UK), many borrowing costs, such as mortgage rates, reset after a couple of years. This would put a lag on monetary policy transmission, meaning the Bank of England’s Monetary Policy Committee would be able to pause rates and still expect the effects of past monetary tightening to intensify in the economy.

Of course, different countries have different conditions. Accordingly, it is not clear that Matterhorn strategies are always better or worse than Table Mountain strategies.

For example, there are several Latin American central banks that have been praised for their proactive responses to the recent global inflation surge. Their interest rate paths resemble the Matterhorn much more than Table Mountain.

In Brazil, for instance, the policy rate went from 2% in 2021 to a peak of 13.75% by August 2022. It has since fallen by 150 basis points to 12.25%.

Similarly, in Chile the policy rate was just half a percent in 2021. It peaked at 11.25% by mid-2022. It has so far fallen back by 225 basis points to 9%.

But these are countries with worse inflation experiences, historically.

They also experienced very severe inflation surges, with double-digit price growth during 2022. You can make a strong argument that Matterhorn strategies were appropriate in these contexts.

South African conditions are different.

Our policy stance has so far looked much more like Table Mountain: we climbed from 3.5% to 8.25%, and policy rates have been unchanged at 8.25% since May this year.

Rates have clearly risen significantly, but much less than we saw in the Latin American cases.

Relatedly, while we have seen cuts already in those countries, markets and analysts only anticipate shallow cuts in our repurchase (repo) rate, sometime around the second half of 2024.

Barring any upside surprises, this has the appearance of a Table Mountain path.

Is this the right strategy for South Africa?

Firstly, it is important to note that we have not had the experience of the US or the UK where financial conditions have been slow to tighten.

The South African private sector, especially households, mostly carries floating rate debt.

When the SARB adjusts the repo rate, borrowing costs reset rapidly, typically within one month.

We therefore see quick and clear monetary policy transmission, which carries over as expected to variables such as credit extension and core inflation.

Therefore, the 'higher for longer' story for South Africa is not about delayed transmission or markets misreading our intentions.

Secondly, the financial stability consideration has not played a big part in our thinking.

No doubt, if there was a way to achieve our target that involves less stress on the system – households, firms and government – we would prefer that.

But we have a resilient financial sector. Liquidations and insolvencies have been limited.

There are some pockets of stress, and households are certainly feeling the squeeze, but we are not like advanced economies where rates are suddenly radically higher than they used to be.

We are 200 basis point above where we were before COVID-19 struck – by contrast, both the US and the euro area have seen changes that are double that, about 400 basis points.

Furthermore, having not had zero interest rates in South Africa, no one got used to treating debt like it was nearly free.

Importantly, we also have a range of tools, beyond interest rates, to look after financial stability.

Overall, we feel we can be resolute in using interest rates to stabilise inflation, without feeling hobbled by trade-offs between our mandates.

Nonetheless, even if you cannot copy and paste the rationales from other economies to South Africa, there still seems to be a good case for keeping rates 'higher for longer' domestically.

To anchor that claim with a number, in the 2010s, the repo rate averaged just over 6%. It seems unlikely we will be going back to those kinds of average rates over the next few years.

Let me address the why.

The starting point is the global story.

As discussed, the era of ultra-low inflation rates and ultra-loose monetary policies in the advanced economies seems to be over. Where once global financial conditions were loose and it was relatively easy to attract foreign money, nowadays even the very safe and liquid assets generate attractive real returns.

This means investors are no longer searching the world for a bit of extra yield; instead, it is the borrowers who must put in extra effort.

South Africa is one of those borrowers.

On top of that, our domestic policy settings are also calibrated to push up rates. This is not a statement about monetary policy; it is a statement about the environment in which we make monetary policy.

Consider the following.

Firstly, fundamentally, interest rates reconcile saving and investment.

South African savings, as a share of gross domestic product (GDP), are at historic lows, under 14% of GDP.

We have the lowest saving rate in the BRICS countries, and also the BRICS+, which includes the six new members joining next year.

If you posed an exam question that asked: what would happen to interest rates in a country where savings decline while everything else stayed unchanged, the answer would be clear. Interest rates would be higher.

Well, here we are, competing for a shrinking pool of resources.

Where does this come from?

As a country, we have long had a culture of low saving. What is new is the scale of our fiscal deficits. The average fiscal deficit from 2000 to 2020 was 2.5% of GDP.

By contrast, Nation Treasury expects 4.9% for this financial year and 4.6% for the year after that.

The International Monetary Fund (IMF) numbers suggest that we could do a lot worse, reaching a fiscal deficit of over 6% of GDP.

What this tells us is that the biggest economic actor in the country decided to save less, or more precisely, to dissave more heavily – which means to borrow more. That reduced the pool of saving available for the rest of the economy. The result is upward pressure on interest rates.

Of course, in a global economy you can draw on foreign savings to supplement local stocks. But as noted, global rates are higher and we are now perceived as a riskier borrower.

The sovereign lost its last investment-grade credit rating in 2020. That affected the creditworthiness of all South African borrowers.

We have a bigger risk premium to deal with than we used to, and we deal with it by paying up.

In other words, the underlying drivers of interest rates are going up. To maintain the value of the currency – that is, to stabilise inflation – actual rates must rise too.

The SARB is the messenger that conveys this information. It is the way of the world that the carriers of bad news get shot at. It is therefore no surprise that our rate increases have drawn some fire.

Questions are often asked whether the SARB is helping this economy or not – with the emphasis on not.

Our answer is clearly yes, we are helping.

In the counterfactual where we tried to lower rates significantly in the face of these headwinds, the outcomes would be unsustainable and inflationary.

This is not some hypothetical speculation; there are very visible examples of countries that did not get monetary policy tight enough and are paying a high price.

Our mandate is clear: we have a duty to step in and ensure price stability.

This equates to protecting the purchasing power of households, preserving the value of savings and the global competitiveness of South African businesses.

And where this requires higher interest rates, plainly we need to deliver them – as we have done.

But the more material question to ask is, does this economy not need lower rates? And the answer to that is, yes.

We are in a suboptimal macroeconomic space, and if we could coordinate our way to a better set of macro settings, we could be better off.

I would love to see rates being lower for longer, not higher for longer. And there are things we can do, as a country, to make that possible.

It is not hard to imagine reforms that bring down the country risk premium. It is also not hard to imagine reforms that lower inflation.

Reduced country risk would help the exchange rate. Lower administered price increases would directly reduce inflation.

It is also helpful to think about a lower inflation target, like those of other well-run emerging markets. But I will leave this topic for another day.

All these changes would give the SARB space for lower rates. And to the extent that some of these reforms temporarily weakened demand, that would bolster the case for lower rates.

So, that is one problem with ‘higher for longer’ – it is the second-best outcome, not the first. It is what we must do in a situation where the SARB carries more of the burden of stabilising the macroeconomy. The first-best solution entails broader burden-sharing and therefore lower interest rates.

The other problem with ‘higher for longer’ is that it sounds too much like a commitment.

Over the past few years, central banks have experimented more widely with what is called ‘forward guidance’, and the results have not been pretty.

The problem is, when you say something about the outlook for interest rates and then add all your caveats, people just hear the first part. They then get hurt when they act on the projections and do something else.

Worse still, central banks can feel obliged to stick with their initial commitments, even in situations where the world changes for which different tactics are required.

If we have learnt anything from the past four years, it is to expect surprises. We therefore need to retain optionality.

The only hard promise we can make is that we will do what is needed to deliver on our mandate; we cannot pre-commit to a specific policy path.

I therefore hope, when I say ‘higher for longer’, that I’m heard correctly.

It is not a SARB promise.

It is not even our preferred outcome.

Instead, it is a useful way of describing the stresses in this economy – some of them from outside and some of them from within.

It also conveys a viable strategy for controlling inflation despite those stresses.

But higher for longer is not inevitable. We have to control inflation, but if we have different macro arrangements, that could be done more cheaply.

Lower for longer is also possible, and I hope we get there.

Thank you.