TT Mboweni: Inflation, growth and employment opportunities

Lecture by Mr TT Mboweni, Governor of the South African Reserve Bank, at the Department of Economics, University of Stellenbosch, Stellenbosch, 6 March 2003.

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1. Introduction

Members of the Portfolio and Select Committees on Finance, Deputy vice-chancellor,
Professors,
Staff,
Students,
Ladies and gentlemen

It is very pleasant to be on this side of the beautiful Hex River Mountains and to speak to you on a number of issues right at the core of central banking. The accusation is often heard that central bankers have narrowed the world down to inflation, and do not have an open mind on any other matters. Not true! The way in which these matters come together - the principles behind their interaction - will be central to my talk to you today.

2. The magnitude of the challenges facing our economy

Starting with a longer-term picture of inflation, it is a well-known fact that the double-digit inflation which reigned from 1974 to 1992 left considerable scars on our economy. Its redistributive impact was nasty, with the buying power of the most vulnerable groups in society, the poor and the elderly, in particular being undermined. The plight of a pensioner who retired twenty years ago using interest on a fixed deposit to provide for himself or herself is illustrated by the cost of a basket of consumer items which cost R100 in early 1983. The cost of that basket shot up to R380 in early 1993, and currently amounts to R815. Although inflation has receded to single-digit levels and has averaged around 7,8 per cent per annum over the last ten years, this is still enough to very significantly erode the living standard of the most vulnerable groups in our society over time. Some distortions therefore remain, leading to frictions and misallocation of resources.

High unemployment continues to characterise the South African labour market. Based on the responses of a representative sample of 30 000 households sampled in the February 2002 Labour Force Survey, Statistics South Africa puts the official unemployment rate at 29,4 per cent. The absolute number of the unemployed amounts to 4,7 million people. And these are people who are looking for jobs - it does not cover those who have given up. The opportunity cost to our economy is huge: even if each of them would only produce goods and services to the amount of R650 per month (the equivalent of the minimum wage in the lowest-paying areas), their combined output would amount to almost R40 billion per annum - almost as much as the value actually added in our entire agriculture, forestry and fishing sector.

Disillusionment and desperation often accompany unemployment. Unemployment insurance - soon to be expanded to more sectors - can help to relieve some of the symptoms, but what is of course needed is the creation of a sufficient number of sustainable job opportunities to absorb the unemployed.

To this end, most economists agree that sustained real GDP growth of around 5 to 6 per cent per annum is needed. Whereas South Africa barely managed to record an average growth rate of 1,5 per cent per annum during the 1980s, this has indeed accelerated to around 3 per cent per annum since 1994. Nevertheless, a significant and sustained further improvement is needed. The question is how? And in what way could monetary policy contribute towards such stronger growth?

3. Inflation and growth: is there a trade-off?

Can more growth (and the other side of the coin, less unemployment) be bought by allowing more inflation? This question has interested economists a lot since 1958 when A W Phillips and R G Lipsey published their analysis of the relation between unemployment and the rate of change of money wages in the United Kingdom from 1861 to 1957. Empirical evidence indicated the existence of an inverse relationship between wage inflation and unemployment. This implied that an inflation-accommodating monetary and fiscal policy stance - an easy-money policy - could be used to reduce unemployment.

However, this relationship turned out to be fragile at least and quite false at worst. Firstly, empirical evidence which accumulated in numerous countries increasingly undermined the Phillips curve theory as inflation accelerated but the hoped-for reduction in unemployment either failed to materialise or did not last for long. Secondly, economic theories were developed which explicitly incorporated learning behaviour. Assuming adaptive expectations it could be shown that "the" Phillips curve (with the unemployment rate on the horizontal axis and inflation on the vertical) would shift upward over time. The true picture would then consist of a short-term Phillips curve where the trade-off holds for a while, but a long-term Phillips curve which is vertical.

Some rational expectations models went further, and implied that stimulatory monetary and fiscal policies would be fully expected and reflected in prices without having quantity effects. This would mean that there would be no short-term Phillips curves, just a long-term vertical relationship.

Looking at South African empirical information in this regard, there are unfortunately severe data problems. The data on registered unemployment (people registering as unemployed in order to receive unemployment insurance payouts) is patchy and where available, not consistent over time. As far as the Labour Force Surveys are concerned, they only started in 2000 and have a six-monthly frequency.

But assuming growth in real GDP is the mirror image of unemployment, adequate data of high quality is available to investigate the proxy relationship - that between inflation and real GDP growth. This relationship turns out to be very loose. On a few occasions there are signs of the expected short-term relationship, with higher growth accompanying higher inflation, but most of the time it doesn't seem to persist. Over the long term, no trade-off seems to hold. In fact, it is noteworthy that from 1982 to 1992 average inflation amounted to 14,6 per cent against average real GDP growth of 0,7 per cent, while from 1992 to 2002 inflation averaged 7,6 per cent per annum and real growth 2,7 per cent. The lower inflation, the better economic growth. This runs against the logic of the Phillips curve, but makes perfect sense for central bankers who tend to stress the deadweight losses flowing from high inflation. An uncertain environment with high inflation is certainly not conducive to a true reading of price signals and relative scarcities, brisk fixed capital formation and sound resource allocation in general. (Some observers would of course argue that both the low growth and the high inflation of the 1970s and 1980s were caused by outside factors such as various supply side shocks. Correlation doesn't prove causality. And so the debate will continue…)

Pursuing this line of reasoning further, a number of studies covering a large number of countries have been done, inter alia by IMF officials, to estimate the rate of inflation above which the distortions introduced by inflation really start to drag the real growth rate of the economy down. Not surprisingly, these studies come up with different answers. Growth-destroying inflation starts at low single digits, high single digits or (at most) slightly above the ten per cent mark, depending on the methodology used. A little inflation may be good, for example making it easier to lower real prices and wages in industries experiencing more competition without having to lower nominal prices and wages.

However, it must be pointed out that low inflation should not solely be pursued because it is conducive to sustainable economic growth. It should also be pursued because equity, fairness and development in the broadest sense would be sacrificed if inflation were left to spiral upward.

4. What is currently happening to inflation, growth and employment?

It is by now well-known that the South African government has set a target of 3 to 6 per cent for CPIX inflation. In 2002, the actual outcome was 10 per cent. While disappointing, this outcome was not unexpected in the light of the 34 per cent depreciation of the nominal effective exchange rate of the rand during 2001. It fed higher rand prices for imported products into the inflation spiral. In order to brake these inflationary forces, the Reserve Bank therefore raised its repurchase rate on 4 occasions from January to September 2002, on each occasion by 100 basis points.

The 2001 depreciation of the rand was fairly soon reflected in production prices. Twelve-month production price inflation accelerated from a low point of 7,8 per cent in September 2001 to a double-digit rate of 11,5 per cent in January 2002 and eventually reached a maximum of 15,4 per cent in both August and September 2002. Consumer prices tend to lag a bit behind production prices, and this is indeed what happened again: Twelve-month CPIX inflation accelerated from a low point of 5,8 per cent in September 2001 to double-digit rates from August 2002 and recorded a recent highest level of 12,7 per cent in November 2002. Food prices played an important role in this process. At the production price level twelve-month food price inflation peaked at around 30 per cent, while at the consumer level it peaked at around 20 per cent. For key food items like maize, Southern African production fell below demand, driving prices towards import parity - which meant very high levels in rand terms during most of the past 18 months, given what had happened to the exchange rate.

But year-on-year inflation rates can be deceptive, making it worthwhile to also analyse shorter-term price movements. One way of doing so is to calculate the percentage change from quarter to quarter in the relevant price index, and then to annualise it. Calculated in this way, production price inflation shot up to 25,8 per cent in the first quarter of 2002, but receded during the course of the year to only 5,0 per cent in the fourth quarter. Consumer prices were much more sticky; annualised CPIX inflation on balance accelerated from 11,5 per cent in the first quarter of 2002 to 14,5 per cent in the final quarter. By January 2003, however, the month-to-month rate of CPIX inflation reflected some moderation flowing through from some of the slowdown in production prices; it receded to an annualised rate of 6,0 per cent. At that time the recent appreciation of the rand had swung the month-to-month rate of production price inflation around to an annualised rate of *decline* of 6,4 per cent. It is not only in Japan where prices can decline! But I should hasten to add that there is no comparison between Japan's long-term price deflation and South Africa's short-term decline in production prices which is so closely related to exchange rate movements.

How do inflation prospects look going forward? To some extent this has already been dealt with in the Reserve Bank's Monetary Policy Review of October 2002. It projected that CPIX inflation would peak towards the end of 2002 (which it did), and then would decline fairly dramatically during the course of 2003 (which also seems to be in progress). The disciplined monetary policy stance and continued sound control over the government finances were already set to reign in the inflation spiral, and are now receiving some additional help from the relatively strong exchange rate - stronger than had been incorporated in the central scenario of the October 2002 projections. New projections will of course be tabled at the forthcoming Monetary Policy Committee meeting, to be held on 19 and 20 March. Some downward rigidity in inflation should always be expected with various ratchet effects, sticky nontradeables' prices and the like, but the resolve of the MPC to steer inflation through difficult terrain to within the 6 to 3 per cent target range should not be underestimated.

Doing all the right things and the things right as far as macroeconomic policy is concerned, with enhanced stability, clear medium-term policy frameworks, and adequate transparency and accountability, confidence is growing and fixed investment expenditure is rising. Furthermore, the rising investment expenditure is spread over many industries. This bodes well for future growth. The transition from volatile real GDP growth that did not quite match population growth in the 1980s to more consistent growth of around 3 per cent per annum in recent years is very significant. As the consistent track record grows, the athlete is likely to graduate to the stage where 3 per cent is much too pedestrian.

Declining employment numbers have since 1989 been recorded in the core formal sectors of the South African economy. These numbers are not comprehensive; while it inter alia includes government, manufacturing and mining, it for instance doesn't include industries such as computer programming. But it is broad enough to make it worthwhile to note that core formal sector employment turned around in the second quarter of last year, growing at an annualised rate of 1,8 per cent, followed by 2,4 per cent in the third quarter. While two swallows do not make a summer, it nevertheless represents good news.

5. A note on lags in monetary policy

In monetary policy formulation we are acutely aware of the long and variable lags inherent in monetary policy. We have to assess the current economic situation and economic problems at hand as comprehensively and quickly as possible. And we cannot simply look out of the window like a rain forecaster to get an initial feel for the situation. A huge amount of statistical work, including large-scale surveys of economic agents in various sectors, has to be done to get the facts on the table.

Then we have to decide which policy instruments to use and to what extent. Utilising inputs from economic researchers, the Monetary Policy Committee deliberates on issues and after thorough debate takes a decision. Next we have to implement those instrument changes. With operational departments that are well-geared, this element of monetary policy is usually quick and clean. But then, of course, the economy has to respond to the new instrument settings.

Many things can only be speeded up to a certain point. Even with the utmost dedication and effort, a comprehensive picture of the economic situation can only be tabled about two months after the end of the quarter concerned, although many individual bits of information are available and are analysed earlier on. The MPC process itself is fairly quick, taking two days. Monetary policy changes can generally be implemented almost immediately. The really frustrating part is the "outside lag". This is generally held to be about 18 to 24 months. When the MPC senses an imminent acceleration in inflation and raises interest rates to counter it, private sector banks usually raise their own interest rates within days. However, with so many transactions already irrevocably in the pipeline and with many economic agents not very sensitive to interest rates, credit extension and expenditure are slow to react. Eventually they do, of course. It is usually only at that time, when expenditure slows down significantly, that price and wage setters start to discover real resistance to further increases. It could easily be 18 months or longer from when policy interest rates are raised to when it fully works through and moderates the inflation rate.

In this world of long lags, credible inflation targeting seems a useful mechanism to shorten the outside lag and perhaps moderate the magnitude of the interest rate changes required to achieve a particular outcome. If there is no doubt that the authorities are committed to the inflation target and will in the end prevail, economic agents are likely to set their prices and wages at levels readily reconcilable with the inflation target, and are likely to view deviations from the target as temporary. Less interest rate medicine is likely to be required with such a forward-looking expectations formation process. Less sacrifice would therefore be required to get to the inflation target range and to remain there. But this could only work if the central bank is fully committed to the inflation target, is independent and willing to use its policy instruments to the full extent needed, and if all economic agents know this.

In cricket, one-day games have risen in popularity as the tempo of life has accelerated. Most people simply do not have five days to watch the traditional kind of match. So things have been speeded up; without it, the Cricket World Cup tournament would have taken ages to complete. It seems preferable to also speed up the tempo at which inflation unwinds and returns to our 6 to 3 per cent target range, working along the lines of the forward-looking expectations process described previously. While I have no doubt at all regarding the Reserve Bank's independence and commitment to achieving the inflation target, the lag structure in economic agents' response will be most interesting. May we have a one-day match rather than a marathon!

6. Conclusion

Low inflation and financial stability support sustainable economic growth, development, equity and employment creation. They are not in opposition to it. While some short-term trade-offs cannot be denied, allowing inflation to take root has dire long-term consequences. CPIX inflation is already in deceleration mode, and the Reserve Bank will vigorously ensure that it ends up in the 6 to 3 per cent target range.

Thank you.