Daniel Mminele: A delicate balancing act – how to reconcile upside medium term inflation risks with near term growth concerns

Keynote address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Bank of America Merrill Lynch 10th Annual Investor-to-Corporate Conference 2011, Cape Town, 18 October 2011.

*   *   *

1. Introduction

Good morning ladies and gentlemen.

The topic I have been asked to speak on is quite an appropriate one at this juncture, but also a very difficult one, consuming the minds of many central bankers around the world, particularly in emerging market countries. The world has never fully come out of the crisis that started in 2008; we have just seen the form of the crisis evolving over time. Now, four years later, the global economy appears to be once again on the precipice and could tilt in either direction, depending on the resolve of policy makers to finally put in place comprehensive and credible plans to fully address sovereign debt and banking sector risks, in order to deal with current near-term downside risks to the global economy. This should then open the way for undertaking the necessary structural reforms required to tackle underlying root causes, and thus put the global economy on a stronger, sustainable and more balanced footing in the medium term.

My comments this morning will focus more generally on the dilemma facing many emerging market economies today, notably, elevated inflation and slowing growth. This is in stark contrast to the situation one year ago, when emerging markets were faced with rising inflation and stronger growth. Thereafter, I will delve a little deeper into the inflation and growth dynamics in South Africa.

2. Reconciling inflation and growth

Real economic activity in advanced economies has slowed considerably, confidence has fallen sharply and financial sector risks have intensified. This has added to an already complicated environment, characterised by high levels of public debt. Growth dynamics in emerging market economies are in much better shape than advanced economies, but interlinkages in the global economy render emerging markets vulnerable and they may not be in a position, as they were in the past, to carry the global economy. Ultimately, emerging market growth is highly dependent on growth in advanced economies, as we saw recently after China recorded a sharp slowdown in exports, due to softer growth in the US and Europe. Emerging market central banks have also had to contend with strong capital inflows over the past few years owing to a search for yield, and resulting in appreciating currencies. We were, however, provided with a stark reminder a few weeks ago about the inherent risks associated with volatile capital flows, when we saw abrupt and sizeable outflows in the wake of sudden changes in investor sentiment, and the associated impact on currencies and emerging market assets in general.

Signs have emerged of a slowdown in emerging market economies, while inflationary pressures continue to be somewhat elevated. South Africa's situation has been a little different, as growth has been somewhat more subdued as compared to other emerging market economies and demand driven inflationary pressures largely absent. The Monetary Policy Committee statement after our most recent meeting in September highlighted the challenges facing monetary policy presently and going forward. These challenges are driven by recent data which have confirmed that while the domestic economic activity has slowed down considerably in the second quarter, at the same time, there is upward pressure on domestic inflation driven by a number of exogenous factors. The worst case scenario for monetary policy of course, is a combination of slow growth and higher inflationary pressures, a real double whammy scenario.

Different shocks, depending on whether they be demand or supply driven, require different policy responses. What is important is to understand the source of the shocks, their magnitude and possible duration, as well as the associated inflationary consequences, and only once we understand this, judge what the suitable policy response will be. Sounds much easier than it is in practice! In the case of a demand driven shock or demand-pull inflation, monetary policy would generally be tightened sufficiently in an effort to bring inflation back towards any stipulated target.

Cost push inflation on the other hand is caused by rising costs of production, such as a rise in oil prices, which will tend to drive up petrol prices and in turn, the prices of other goods as transportation costs increase. This type of inflation causes a certain level of inflation across the economy, but also tends to have a dampening effect on growth, as consumers will tend to adjust their spending habits to take into account increased spending on these items. The policy response in this case is not quite as straightforward. A tightening of policy may bring down inflation, but will not have any impact on the root of the problem being rising oil prices, and in fact would most likely exacerbate the fall in output and worsen the impact of the shock for households and businesses. Having said that, however, discarding a supply side shock, such as a spike in oil prices, may not always be advisable. What needs to be carefully assessed are the reasons for any supply shocks, whether such shocks are viewed to be transitory or permanent, and most importantly, whether or not they carry with them the risk of feeding through to underlying inflation or core prices. A feed through to core inflation and evidence of second round effects would most likely occur when there is very little slack in the economy and prices in general are under pressure, or if inflation expectations rise alongside the rise in inflation, and translate into higher nominal wage demands, which in turn would feed through to higher core prices. In this event, the supply shock will result in general price levels going up, generating inflation. Depending on the extent of this, policy makers at some point have to make a choice to either accommodate these pressures or seek to counter them.

The manner in which the South African Reserve Bank has approached such supply side shocks, is to allow the initial price level effects to flow through to final prices, but to look out for second round effects that would push inflation above the target on a sustained basis. In the longer-run, the impact of the supply shock on prices of other goods will depend largely on how inflation expectations respond to the shock. The best case scenario would be if inflation expectations signal that the rise in inflation will only be temporary. However, if expectations show a more permanent rise in inflation, in response to the supply shock, then it is likely that wages and salaries will also rise across the economy and prices throughout the economy could be affected and adjusted higher. In this case, core inflation will generally tend to rise and converge with the higher measure of headline inflation. In this instance, monetary policy would need to ensure that relative price changes do not alter inflation expectations to the extent that it becomes difficult to achieve a moderate and acceptable inflation rate over the medium term[1].

3. South Africa's inflation/growth profile

South Africa's year-on-year consumer price index has remained within the 3 – 6 per cent target range since February 2010. A combination of supply side shocks, administered price

[1] Eric S Rosengren, "A look inside a key economic debate – how should monetary policy respond to price increases driven by supply shocks?", 4 May 2011.

increases and wage settlements well in excess of inflation, resulted in the targeted CPI measure increasing from a low of 3.2 per cent in September 2010 to 5.3 per cent in August 2011. Administered prices increased well above the upper end of the target range for more than 20 months, accelerating from 7.1 per cent in September 2010 to around 12.0 per cent in August 2011. Rising prices for food, petrol and electricity contributed 1.1 percentage points, 1.6 percentage points and 1.0 percentage point respectively to the August reading, and greatly influenced what otherwise would have been a somewhat more benign inflation environment. Core inflation has also edged up in recent months, although the overall underlying inflation trend appears relatively well contained for now.

Alongside the increase in inflation, inflation expectations, as measured by both the Reuters survey of financial analysts, and the Bureau for Economic Research, have adjusted higher towards the upper end of the inflation target range. Whereas inflation expectations remain on average within the target range for the forecast period ending 2013 and as such appear to be relatively well anchored at present, future developments in this regard will require careful monitoring. Nominal wage settlements, although well above the upper end of the inflation target range, have moderated. The average wage settlement rate in the first half of 2011 amounted to 7.5 per cent, compared to 8.2 per cent in 2010. Nominal unit labour costs decelerated from 10.7 per cent in the second quarter of 2010 to 5.3 per cent in the first quarter of 2011, despite a marked decline in productivity.

Demand-side pressures are currently relatively subdued and not expected to exacerbate inflationary pressures in the short term. Economic activity in South Africa decelerated from 4,5 per cent real GDP growth in the first quarter of this year to 1.3 per cent in the second quarter. South Africa is currently growing at below its potential growth rate, which we estimate to be around 3.5%, with an output gap of around 3% in the second quarter of 2011. During this quarter the deceleration in economic activity was recorded across the agriculture, mining and manufacturing sectors, with only a marginally stronger performance recorded in the services sector. The combination of adverse weather conditions, industrial action and safety-related stoppages at certain mines contributed to this disappointing performance. High frequency data points to continued weak conditions in the mining, manufacturing and construction sectors and this is also reflected by declining business confidence, to well below the neutral level of 50.

The manufacturing sector, which contributes about 15 per cent to GDP, contracted by 7 per cent year-on-year during the second quarter. The monthly manufacturing data and the Kagiso Purchasing Managers' Index (PMI) indicate that the manufacturing sector will likely record another disappointing performance in the third quarter. The PMI remained below the 50 threshold for two consecutive months, before recovering to a level of 50,7 index points in September 2011, while the employment index has remained below the 50 index level. According to Kagiso, the PMI leading indicator, measured as the ratio between new sales orders and inventories, remained at an early-2009 low of 0.85 in September. This is reflective of high inventory levels, well above the demand for factory goods. Furthermore, the PMI average for the third quarter was 47.2 index points (55.1 recorded in the second quarter), which does not bode well for actual factory output and growth in the third quarter.

Weak conditions on the production side reflect both the poor state of the global economy, as well as the deceleration in domestic demand conditions. Domestic expenditure grew by 1.3 per cent in the second quarter of 2011, from an annualised rate of 7.9 per cent in the first quarter. Household consumption expenditure decelerated significantly and government expenditure contracted. The combined impact of rising inflationary pressures that affect households' disposable income, falling consumer confidence, the still relatively weak housing market, declines in the value of assets, high debt burdens and reduced access to credit further adds to households cautiousness in their spending decisions. Strong wage inflation during 2010 is also starting to take its toll on employment creation and the unemployment rate increased to 25.7 per cent in the second quarter of this year (although even through the boom periods, unemployment still remained high around 22 per cent). Continued labour shedding is expected to weigh on consumer spending going forward, while the lower growth trajectory, in turn, does not bode well for employment creation. Other indicators pointing to a slowdown in economic growth, include the weaker growth and/or in some instances a decline in retail sales, vehicle sales and house prices.

Against this background, policy makers and economists have downgraded their growth forecasts for the year. The Bank has lowered its growth forecast, due to the lower-than-expected GDP outcome in the second quarter, the impact of industrial action on key sectors such as manufacturing, as well as a downward adjustment to the global growth assumptions. The Bank's latest projections show growth to average 3.2 per cent in 2011, lower than the previous forecast of 3.7 per cent, while the forecast for 2012 has been reduced from 3.9 per cent to 3.6 per cent. The risks to this outlook are seen to be on the downside, mainly on account of risk to the global economy.

The Bank's inflation forecast has been adjusted higher on a few occasions this year to take into account higher oil and food prices. At the last sitting of the MPC in September, the inflation forecast was left largely unchanged. It is expected that inflation could breach the upper end of the target range in the final quarter of 2011 and to peak in the first quarter of 2012 at around 6.2 per cent, but then to return within the target range in the second quarter. In the final quarter of 2012, inflation is expected to ease to around 5.5 per cent. The Bank's measure of core inflation shows a rising trend, peaking at around 5.1 per cent in the second and third quarters of 2013. What is important for the Bank is the trajectory of inflation and to what extent any breach of the target is sustained. Our assumptions at this stage point to a temporary breach of the inflation target.

However, there are a number of upside risks to the inflation outlook which require careful monitoring. The main upside risks continue to emanate from exogenous factors, as well as administered prices, and despite the easing in wage pressures this year, this could become a factor going forward. The stronger currency to some extent helped to contain inflationary pressures domestically, but more recently, the depreciation of the rand brought to the fore the potential upside risk emanating from a sharply weaker currency. To what extent one should be concerned about the recent depreciation in the rand exchange rate is a function of many factors, including whether it is short-term or longer-term in nature, the eventual magnitude of the depreciation, the pricing power of firms, the stickiness of prices, the history of inflation and the domestic content of traded goods.

Clearly, the MPC is having to deal with a delicate balance at present between the upside risks to inflation and the downside risks to growth. Much is dependent on the unfolding global environment, in particular growth prospects in the US, and the sovereign debt crisis in the euro zone, whether or not this turns into a banking crisis and spills over to other areas of the world. Should European leaders manage to avert a full-blown crisis, this will go a long way to restoring the health of the financial system and injecting confidence into financial markets, business and consumers. The MPC will keep a close watch on underlying inflationary pressures, and to what extent these are reflected in inflation expectations and wage settlements, in addition to which, we will pay close attention to global economic and financial market events as they unfold.

4. Conclusion

Monetary policy makers across the world have to make difficult decisions in a highly uncertain and volatile economic and financial market environment, and have to be careful and ensure that higher inflation expectations do not become entrenched, but also ensure that actions taken to contain inflation are not premature and risk a further slowing in growth. However, it is also important to also accept that while monetary policy has to contribute its fair share, shifting a disproportionate amount of the responsibility to resolve current challenges to monetary authorities can only result in sowing the seeds of future problems.

In South Africa recent supply shocks have placed upward pressure on inflation, but there is no evidence this far to suggest that these pressures are becoming entrenched and that inflation expectations are becoming less anchored. Nonetheless, it is important to monitor these dynamics to ensure that second round effects do not take hold, that there any pass through to other prices is carefully assessed, and that inflation expectations do not diverge significantly from the recent past. As indicated, the key challenge will be to strike a delicate balance between a monetary policy stance which is appropriate to support the hesitant economic recovery, while ensuring that incipient inflationary pressures are managed, and that there is no doubt about the Bank's commitment to its mandate.

Thank you.