Lesetja Kganyago: Policy choices in a low growth, high inflation environment

Address by Mr Lesetja Kganyago, Deputy Governor of the South African Reserve Bank, at the University of Limpopo, Faculty of Commerce, Sovenga, Limpopo, 6 June 2014.

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1. Introduction

Last week in the *Financial Times*, columnist Wolfgang Münchau reported a conversation he had with a central banker in the 1990s, at a time when inflation targeting was first being adopted. What would you do, Münchau asked then, if you faced stagflation – low growth and high inflation? Would you raise rates and risk a recession? The banker replied that such a situation would never occur. Münchau now accepts he was right – it never happened.

He shouldn't give up so easily.

South Africa finds itself at precisely this unpleasant juncture. Growth was negative in the first quarter of the year, the worst performance since the 2009 recession. Meanwhile, inflation has crept above the target, reaching 6.1% in April, and the Reserve Bank has since January forecast an extended breach of the target lasting until the second quarter of 2015. This morning, I would like to speak to you about how we got into this difficult situation, and what policy can do about it. I will mostly talk about monetary policy, because that is my responsibility, but let me say upfront that monetary policy cannot fix these problems alone. Monetary policy can help staunch the bleeding, but it cannot heal the patient.

2. Inflation

Starting with inflation, a central banker, like Münchau's nameless interlocutor, might consider high inflation and low growth to be an impossible combination because weak demand alleviates price pressures. If firms lack for customers, they are unlikely to raise prices and scare off buyers. There is substantial evidence that demand has moderated in South Africa. Credit growth has been subdued. Mortgages, the largest category of credit extension, have grown slower than inflation for several years. Unsecured lending, which expanded very briskly in recent years, is now dropping fast. Installments, which mostly fund the purchase of motor vehicles, are also slowing markedly; new vehicles sales appear to have peaked last year. Retail sales have also been sluggish, falling in March 2014 on a month-on-month basis, and retailers are expecting a poor second quarter. These indicators do not point to an overheating economy and demand-driven inflation.

Why, then, do we have above-target inflation? I would like to draw your attention to two main causes, cost-push pressures and exchange rate depreciation.

2.1 Cost-push inflation

Cost-push pressures impart a structural upward bias to prices. The logic is that many firms and employees enjoy limited competition, so they make high wage and price demands without risking losing jobs or customers. However, the two influence each other. When firms raise prices, costs go up for workers, who then demand higher wages. Higher wages raise costs for firms, who then raise prices, and so forth. The result is consistent inflationary pressure. There is abundant evidence for this dynamic in South Africa, but let me illustrate my point using one particular example: inflation expectations. On behalf of the Reserve Bank, the Bureau for Economic Research at Stellenbosch University measures inflation expectations by surveying three groups: businesses, unions and financial analysts. Generally, the focus is on the aggregate of their expectations. However, businesses and unions have systematically higher expectations than analysts, which is especially

problematic given these actors actually determine prices and wages. In a recent paper, Alain Kabundi, Eric Schaling and Modeste Some estimated that businesses and unions have implicit inflation targets of 6.8% and 6.2% respectively, above the Reserve Bank's 3–6% target. With expectations like these, price setters will keep inflation high despite weak economic conditions.

2.2 Inflation and the exchange rate

The exchange rate affects inflation both in how it moves and in how that movement gets passed-through to consumer prices. South Africa faces inflation from both these sources, and I'll discuss them in that order.

The rand has been on a depreciating trend since the start of 2011, which accelerated markedly after May 2013 and again in January 2014. In both cases, faster depreciation was driven by international developments. In May it was "taper talk", which surprised markets with news that the Federal Reserve might start tapering its asset-purchase programme sooner than expected. In January, it was the actual implementation of tapering. Since then, the rand has appreciated somewhat, for reasons that remain mostly international. In the United States, the Federal Reserve has settled into a predictable pattern of tapering by US$10 billion per meeting. Market sentiment now holds that rate increases remain quite distant and will be gentle when they do come, thanks to low inflation and moderate growth. Meanwhile, the European Central Bank is still moving towards looser monetary policy, rather than away from it, as is the Bank of Japan. The result has been renewed global appetite for risk, leading to currency appreciation for most of the emerging markets which had previously experienced weakening exchange rates.

Domestic factors seem to have played only a supporting role in driving emerging market currency movements over this period. In South Africa, markets appear to have welcomed the responsiveness of monetary policy to rising inflation; the current account deficit also narrowed somewhat in the last quarter of 2013. But South Africa's economic fundamentals have on the whole not changed substantially, nor have markets assessed them differently: the current account deficit remains over 5% of GDP and growth has deteriorated. It would be very rash indeed to assume that the rand's long depreciation trend is now concluded, and that henceforth a strengthening rand will mitigate inflation. Instead, South Africa remains vulnerable to further changes in global sentiment, which could be sudden.

The other aspect of exchange-rate linked inflation is pass-through. With certain prices, pass-through is quick and complete. The obvious example is petrol prices, which have exerted substantial inflationary pressure despite relatively flat international prices thanks to exchange rate depreciation. But many prices behave differently. In a weak economy, firms may choose to absorb higher import costs rather than pass them on to consumers, leading to a divergence between headline consumer prices and the exchange rate. This seems to have been the pattern from the start of 2011 until early 2014. However, at some point firms will judge that their profit margins have been eroded to an unacceptable degree, and they will start passing on these costs to consumers.

We see evidence that firms are being squeezed in producer price inflation, which reached 8.8% in April, its highest level in two years. And we see evidence for higher pass-through in rising core inflation, which has picked up again after a period of stability in 2013. Our conclusion is that pass-through has risen, pushing inflation above the target. This effect cannot be expected to abate just because the rand has recovered some lost ground. If the currency begins to trade in a stable band well above its old levels, stability will not necessarily moderate pass-through; rather, it could convince firms to price in the new normal level. We should not assume that inflation will simply track the most recent movement of the exchange rate.

3. The role of monetary policy

South Africa has a flexible inflation targeting framework for monetary policy. Flexibility means that inflation does not have to be within the target at all times; instead, policymakers will look through passing shocks – for example, during the temporary departure from the target in August 2013, which was driven by petrol prices. Flexibility also means avoiding abrupt interest rate movements which might destabilise the economy. But flexibility does not mean ignoring sustained breaches of the target. With inflation expected to be above 6% for about a year, and given that that the exceptional period of ultra-low world rates is ineluctably drawing to a close, the Reserve Bank has commenced a monetary policy tightening cycle, starting with a 50-basis point increase in January.

In describing the revised monetary policy stance, we have been at pains to emphasise that this tightening cycle will not necessarily move rates as far or as fast as in previous cycles. There are good reasons for this. Subdued economic growth reduces demand-driven inflation. Fiscal policy has moved in the direction of consolidating deficits, which should ease pressure on capital markets. World rates are very low, and may not return to pre-crisis norms. Global inflation is subdued.

We have also emphasised that monetary policy remains accommodative, despite the January hike. It is easy but wrong to confuse the change in monetary policy with its level. In real terms, the repo rate is still negative. Furthermore, since 2009, the MPC has accepted inflation closer to the upper end of the target than it might in different circumstances, so as to support the recovery. In other words, monetary policy has done a great deal to assist growth.

But this is not the only message to bear in mind when thinking about the monetary policy stance. The other message is that monetary policy is not the long-run solution to South Africa's growth problems. Over the long-run, monetary policy is effective at achieving price stability, but it can generate additional growth only at the cost of rising inflation. This is why the Bank's core mandate is for price stability. To address high inflation and low growth, what South Africa really needs are structural reforms. And it needs them even more urgently given the paucity of alternatives:

- The two growth engines which powered the economy in the late 2000s are running down. Commodity prices remain high, in comparative perspective, but South Africa's terms of trade peaked in 2011, and will probably continue to decline as China slows and rebalances. Credit extension has also been growing quite feebly in South Africa, and although household balance sheets have improved, they are not robust enough to sustain another round of credit-driven growth.
- Furthermore, the policy stimuli which have bolstered growth since the crisis now need to be slowly withdrawn. Responsible fiscal and monetary policies in the pre-crisis period left South Africa with considerable policy space to run fiscal deficits and enjoy record-low interest rates. But now debt levels are once again approaching uncomfortable levels, and as I have already said, the inflation outlook requires an interest rate hiking cycle.

4. The need for reform

The above notwithstanding, South Africa does have attractive prospects for policy reform. The National Development Plan (NDP) outlines ten critical actions which we should focus on to take the country to the next level, that of a higher, labour absorbing growth path. These critical actions include:

1. A social compact to reduce poverty and inequality, and raise employment and investment, founded on partnerships with all sectors of society.

2. A multipronged strategy to address poverty and its impacts through broadening access to employment, strengthening the social wage, providing public transport and raising rural incomes.
3. Steps by the state to professionalise the public service, strengthen accountability, improve coordination and prosecute corruption.
4. Boost private investment in labour-intensive areas, competitiveness and exports, with adjustments to lower the risk of hiring younger workers.
5. An education account-ability chain, with lines of responsibility from state to classroom.
6. Phase in national health insurance, with a focus on upgrading public health facilities, producing more health professionals and reducing the relative cost of private health care.
7. Public infrastructure investment at 10 percent of gross domestic product, financed through tariffs, public-private partnerships, taxes and loans and focused on transport, energy, water and freight.
8. Interventions to ensure environmental sustainability and resilience to future shocks.
9. New spatial norms and standards – densifying cities, improving transport, locating jobs where people live, upgrading informal settlements and fixing housing market gaps.
10. Reduce crime by strengthening criminal justice and improving community environments.

5. Conclusion

Looking around the world, this is something of a springtime for reform. In Mexico, for example, the government has adopted a bold structural reform package, known as the Pact for Mexico, which includes major changes in telecommunications and education policy. More recently, in India, a development platform with the promise to reverse several years of sub-par growth and high inflation is being pursued.

The lesson to take from this is that we are not helpless in the face of economic disappointment, of high inflation and low growth. For monetary policymakers, with limited tools, this situation provides no attractive choices. But there are many appealing options available for other aspects of policy. For South Africa, our present predicament should be read as an invitation to embrace reform. The National Development Plan provides a compelling basis upon which to build our reform agenda.

Let us begin to do the work. The contribution of the South African Reserve Bank to the National Development Plan is captured in the constitution of the Republic of SA and I would like to end by quoting "*Section 224.The primary object of the South African Reserve Bank is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic.*"

Thank you.