Lesetja Kganyago: South Africa – "Fit for the Future"

Address by Mr Lesetja Kganyago, Governor of the South African Reserve Bank, at the Agricultural Business Chamber Congress 2016, Cape Town, 1 June 2016.

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Introduction

Good morning, Ladies and Gentlemen.

I am honoured to be here with you today, on this 70th anniversary of the Agriculture Business Chamber. Congratulations on this milestone, Agbiz!

The theme of this Congress is "Fit for the Future", and to my mind, this is an excellent encapsulation of South Africa's monetary policy framework. Inflation targeting, the cornerstone of this framework, is fundamentally medium- to long-term orientated.

As you all know, economic activity in South Africa is currently weak. Drought has contributed much to this weakness, but it has considerably deeper roots.

Structural reforms are urgently needed to improve capital and labour use, which will boost productivity in the medium term. We have also seen rising inflationary pressures for some time, which prompted the current monetary tightening cycle. Headline inflation is above the upper end of the target range of 3 to 6 per cent, and this breach is expected to persist until late next year, driven especially by food price increases.[1]

The South African Reserve Bank is certain that an environment of consistently low and stable inflation is the best contribution it can make to balanced and sustainable growth in South Africa. However, inflation shocks such as the current food price spike can compromise the credibility of the Bank and thereby permanently accelerate inflation.

I will focus my remarks today on explaining how the Bank views these shocks and when it deems a monetary policy response necessary.

Economic conditions and the drought

South Africa's short-term prospects do not look encouraging. While growth has declined since 2011, underlying inflation1 has increased. At the same time, the economy continues to suffer spillovers from low global growth as well as idiosyncratic shocks, of which drought is the most recent.

Rainfall in 2015 was 20 per cent below its long-run average.[2] Parliament recently adopted a motion that drought should be declared a national disaster.[3]

After a particularly large maize harvest in the 2014/15 season, of 14,3 million tonnes, commercial maize production dropped last season and is estimated even lower for 2016/17, at just 7,2 million tonnes. We are thus likely to need up to 4 million tonnes of imported maize this year.

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[1] As measured by headline inflation excluding food, non-alcoholic beverages, petrol and energy prices.

[2] Annual rainfall measured 380mm in 2015, in contrast to the 1990–2015 average of 477mm.

[3] As of end 2015, five provinces had been declared disaster areas (those are latest available figures). However on 26 May 2016, Parliament adopted a motion to declare the drought a national disaster.

The agriculture, forestry and fisheries sector contracted in every quarter of last year, losing 8,4 per cent of its total value over the course of 2015.[4] Associated sectors such as manufacturing (via agro-processing) as well as banks and insurance companies that are heavily invested in the agricultural sector have felt the impact of this contraction – as everyone here will know.

In addition to the issue of access to food, we continue to see enormous human suffering from water shortages affecting people's quality of life. These shortages also endanger businesses; this, in turn, threatens the livelihood of the communities dependent on those businesses for employment.

More specifically, we in the Bank have been revising our estimates of potential growth downwards. In other words, the estimated rate at which the economy can sustainably grow before inflation rises has declined. As a result, South Africa today faces a high-inflation, low-growth situation similar to many other commodity-exporting emerging markets. The response to this problem is to push potential growth back up while ensuring that inflation does not rise.

Currency depreciation, while uncomfortable, is an important part of the adjustment to broader economic weaknesses, in particular coming from falling commodity prices. But it also tends to lift inflation as firms increase producer prices in response to higher imported input costs and as consumers demand higher wages to re-establish living standards relative to the cost of imported goods.

With a drought and a weaker currency, food prices are playing an unusually strong role in complicating the inflation outlook. I will turn to this relationship in more detail shortly. For now, from a policy vantage point, preventing an inflation response is critical to keeping our overall cost of borrowing low for investment and to maintaining the competitive advantage we have gained with depreciation.

In the past two years, National Treasury has embarked on a fiscal consolidation programme and the South African Reserve Bank has entered a monetary policy tightening cycle. These actions help to reduce inflation and will foster economic stability, consistent with our respective policy frameworks. In the long run, this is good for everyone. In the short run, however, we are providing less economic stimulus while the economy remains far from the hoped-for recovery.

Structural reforms to improve opportunities for small businesses and job seekers would increase investment and productivity, and should therefore complement the current macroeconomic policy stance of the Bank.

Food price inflation and the exchange rate

In 2015, due to favourable oil price shocks, inflation averaged 4,6 per cent. In contrast, inflation outcomes have exceeded 6 per cent this year because of food and petrol prices. The Bank expects headline inflation to average 6,7 per cent in 2016 and 6,2 per cent next year. Food prices are increasing due to the drought, whereas petrol prices are increasing because oil prices have risen off the extremely low levels prevailing at the start of 2015 and a weaker exchange rate. The drought, like oil price movements, is a supply-side shock to inflation.

Domestic price increases in maize, South Africa's staple food, have been extreme. Since 1 January 2015, yellow maize prices have increased by almost 70 per cent while white maize prices have increased by more than 130 per cent over the same period.[5] In total, food prices make up 14 per cent of the consumer price index, and this measure increased by 11,3 per cent

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4 Calculated as change in real gross value added at basic prices.

5 As traded up to 20 May 2016 on the South African Futures Exchange (SAFEX).

in April 2016, up from 4,3 per cent ten months earlier. Food inflation is forecast to peak at 12 per cent in the final quarter of this year.

Dry conditions since 2015 have caused a long period of herd culling, which increased the short-term supply of meat and temporarily suppressed meat price inflation – thus, although grains inflation has accelerated since June 2015, meat price inflation accelerated this year.

Meat price dynamics were an important reason why food inflation rose at a slower-than-expected pace last year. However, this trend has reversed in 2016, as food inflation rose faster than we had anticipated in the first four months of the year. Furthermore, the rising cost of meat inputs and the lower supply of animals to the market are likely to push meat prices significantly higher over the course of 2016.

Food prices are not solely determined by domestic supply and demand; they are increasingly influenced by international food prices and therefore by the exchange rate.[6] This is not necessarily negative. Although South Africa is a net food exporter, we do not have a comparative advantage in all food production. Thus we rely on international prices, which are predominantly US dollar-denominated, in markets where we are price takers. During a drought, international food prices and the currency play a greater role, as food imports are larger than in "normal" years and more food commodities trade at import parity prices. Exchange rate depreciation is thus often discussed as a disadvantage as it drives up food costs.

Yet there are advantages to depreciation that are easy to overlook. For South African commodity producers, rand depreciation has mitigated the impact of international price changes: food price indices from the UN's Food and Agriculture Organization, measured in US dollars, show international food prices deflating for the past three years. When calculated in rand terms, these prices have continued to rise. Thus, domestic producers (or at least those who have harvested during the drought) have been protected from global agricultural price deflation.

In general, currency movements assist the domestic economy in adjusting to changing international conditions by signalling an appropriate allocation of resources for production. I have been talking about food prices in particular, but broader commodity prices have been declining since 2011. This has resulted in rand depreciation, making our manufacturing and services exports more competitive at a time when mining exports have become less profitable. For the agri-sectors, this implies scope for agro-processing expansion, as we have a relative advantage while the currency is depreciating. Of course, this can only happen once harvests recover from the drought. The extent to which we can lock in these benefits will depend on ensuring that future price increases are contained so as not to erode competitiveness.

The rationale for inflation targeting in South Africa

Before discussing the way in which the South African Reserve Bank thinks about food prices and its framework, let me briefly reiterate the inflation-targeting rationale.

Inflation targeting is global best practice in monetary policy because it is transparent while also recognising that there is no long-run, or even medium-run, trade-off between inflation and growth. Instead, in the long run, price stability is a precondition for significant sustainable growth. This is also true of financial stability, which has been added to the mandate of the Bank in the aftermath of the global financial crisis.

Inflation targeting is a framework that helps to create the conditions for a stable and investment-friendly business environment. Volatile or higher inflation outcomes increase business costs in several ways. They can push employees into demanding above-inflation

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[6] The exchange rate also influences food production costs, as inputs such as fertiliser are usually imported.

wage increases, which pressure business margins. More variable inflation also increases uncertainty about the costs of business operation, which can delay investment decisions. Finally, investors require higher returns for increased uncertainty, which means elevated long-term real interest rates.

In addition, higher inflation can negatively impact on competitiveness. If inflation in South Africa is above that of our trading partners or export rivals, then the production costs of our exports will be relatively greater, and as a result we will be less competitive in global markets. This can be corrected by rand depreciation but the rand is especially volatile and, furthermore, domestic inflation can easily erode these gains. Inflation targeting helps to address these problems by guiding policymakers to respond to temporary supply shocks when they may permanently accelerate inflation, as well as by ensuring that demand-side inflation is controlled.

These advantages are generic; they apply to everyone. Yet inflation targeting is also particularly suited to the structure of the South African economy. The recent increase in the unemployment rate is a reminder of the large number of people locked out of the real economy. Fundamentally, inflation targeting is a policy framework that protects the vulnerable groups in society, such as the unemployed, the poor and the elderly – basically those with a fixed or no income. Higher headline inflation affects these groups most severely as they are not able to negotiate income increases commensurate with inflation, nor are they able to access financial markets to acquire assets to protect themselves against inflation.

The South African economy is characterised by strong pricing rigidities and resilient barriers to entry in many industries. Because of the high concentration of the economy as well as the shortage of skilled employees, "insiders" – meaning price and wage setters – are in a position to mark prices and wages in line with their expectations. When these price and wage setters expect higher inflation in the future, their actions make the expectations self-fulfilling: inflation duly rises and the risk of a wage-price spiral increases.

Inflation targeting, once credible, has the capacity to break this cycle as it provides an external anchor for the "insiders." They focus instead on the Bank's inflation forecast and its communication and on how and when it will achieve the inflation target. This then protects those groups that do not have the same market power as price and wage setters, such as the unemployed, non-unionised employees and small firms. Greater certainty and lower inflation rates remove a significant constraint that these groups face in accessing the real economy. Of course, this is only the case as long as the Bank can convince price and wage setters of its commitment to the inflation target range –as long as the Bank keeps their inflation expectations anchored.

Food prices and second-round effects

Food prices hold a particular interest for the Bank. In part, this is because we are aware of the regressive nature of food price increases. More crucially, from an inflation-targeting perspective, if those who do have negotiating power use it in response to food price shocks, this can lead to second-round effects. By second-round effects I mean a reaction in inflation expectations or wages to higher headline inflation, which would cause a further increase in headline inflation after the initial effect of the shock would have dissipated. This occurred after the previous peak in food prices; in 2008, food price inflation averaged 15,8 per cent. In four of the five subsequent years, wage inflation exceeded both food and headline inflation.

The current tightening cycle began in January 2014. Since then the Bank has hiked the repo rate by a cumulative 200 basis points to 7 per cent currently. This year, the Bank has hiked the repo rate by 75 basis points. From a historical perspective, the 7 real interest rate remains low, following a prolonged period of monetary accommodation. Furthermore, this is one of the most gradual hiking cycles on record.

Let me emphasise that interest rate increases are not aimed at decreasing food inflation; the Bank understands that the food inflation we are seeing is a market-based response to a temporary shock. Typically, a flexible inflation-targeting regime will look through supply shocks that shift headline inflation away from the target range, provided that the shift is clearly temporary and will not create second-round effects. The Bank applied this approach for a number of shocks occurring between 2009 and 2013. Headline inflation spent 18 months above the upper end of the target range over that period. Yet the Bank could afford to look through those shocks; underlying inflationary pressure, as measured by core inflation, was contained, and this, alongside anchored inflation expectations, meant that there was space for temporary breaches.

However, the Bank is of the view that, since January 2014, it has not been appropriate for it to look through supply shocks that drive inflation above 6 per cent. At that time, the Bank forecasted an extended breach of the target if it did not act. The risks around its forecast implied that second-round effects would manifest if it did not act to prevent them. In the run-up to the hiking cycle, the Bank noted with concern persistently above-inflation wage settlements despite weak growth and the clustering of inflation expectations around the upper end of the target range. These were signals that inflation could permanently accelerate if further shocks occurred.

The problem is not that inflation may exceed 6 per cent; the problem is that people may come to believe that the South African Reserve Bank does not target 3 to 6 per cent but instead targets 6 per cent plus a "supply shock premium". Such a perception would compromise the credibility that the Bank has earned since inflation targeting was introduced in 2000. As I've mentioned, price and wage setters have enormous discretion if they believe that the true target is above the set range. The Bank wants to avoid such a situation.

"Fit for the Future" and the agribusiness and agro-processing sectors

The environment that I have described today may feel discouraging to you. I would not want that to be my overarching message. I think that the actions South Africa takes now, to reinforce our framework, will protect economic competitiveness in the global arena and encourage future growth.

The National Development Plan has highlighted the potential of the agriculture and agro-processing sectors, particularly for increasing employment but also growth. Although South Africa is a leading exporter of certain food commodities – including maize, sugar and fruit – there is great scope for expansion of the agro-processing sector. Even a cursory glance at the manufacturing production statistics makes them look encouraging, as the weight of the food and beverages category has increased from 11 per cent in 2000 to 24 per cent currently. However, the contribution from manufacturing production to GDP has been shrinking over this period, so agro-processing volumes have merely grown in line with real GDP. I am sure that this observation will be a key focus of your conference over the next two days, so I will not say more on the subject.

There are multiple advantages to expansion. Agriculture is relatively labour-intensive, and it is a crucial source of employment for rural communities. Increasing agricultural output would also strengthen food security, not just in South Africa but in sub-Saharan Africa. Furthermore, expanding manufacturing production is key to creating stable jobs suitable for our underemployed workforce. The International Monetary Fund has recommended expansion of agro-processing in sub-Saharan Africa as the region has a comparative advantage in agriculture and countries such as Ethiopia have enhanced their integration into global value chains through agro-processing.[7] Research has shown that this value chain integration is key to productivity growth for small open economies in particular, as they learn from countries

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[7] See the International Monetary Fund, "Regional economic outlook – sub-Saharan Africa: navigating headwinds", April 2015, p. 59. Available at http://www.imf.org/external/pubs/ft/reo/2015/afr/eng/pdf/sreo0415.pdf.

further along in the value chain. Overall, then, expansion would assist in South Africa's great need for export growth and give it a productivity boost and additional employment.

Conclusion

This Chamber is well suited to tackling challenges related to expansion. As a forum of stakeholders from different stages of the agricultural process, Agbiz is in a unique position to facilitate communication and action. It is encouraging that your strategy and objectives highlight competitive performance, transformation, inclusivity and technology – all necessary for a thriving and sustainable agriculture sector, and for managing the challenges of globalisation and climate change.

Although periods of underperformance are often the most difficult times to make changes, they also provide valuable time to evaluate and strengthen frameworks with a view to sustainable growth. The many recent shocks to growth and inflation have created a great deal of uncertainty. In this context, you can at least be certain that the South African Reserve Bank is committed to containing inflation. This preserves your competitive advantage for exporting and contains long-run investment costs, creating the foundation for your expansion. You can count on the Bank to do its part. In turn, I look forward to watching you build a productive and integrated sector that is able to contribute ever more meaningfully to domestic growth and employment.

Thank you