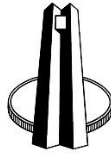

South African Reserve Bank

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at the Nelson Mandela University

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Inequality and monetary policy in South Africa

Introduction

Good afternoon, ladies and gentlemen.

Debates about inequality have kicked into a higher gear in recent years – in academia, in policy circles, and in the broader political space. For central banks, especially those in advanced economies, inequality has become an inescapable issue, and experimental policies like quantitative easing are being blamed for making it worse.

In South Africa, we have had very high inequality for a very long time, so for us, these debates are not new. Nonetheless, there are new ways of thinking and new data to help us understand the issue better.

Today, I would like to make a couple of points to clear up some misconceptions that people may have about inequality and, more specifically, about the interactions between inequality and monetary policy.

First: although everyone knows that inequality *within* countries has been rising, inequality *between* countries has actually been coming down. This is thanks to sustained growth in emerging markets, which are not as far behind the rich countries as they used to be.

Second: in South Africa, inequality has been persistently high – but the composition of inequality has changed. Inequality among black South Africans has increased since the end of apartheid, so that South Africa's inequality story is now about class as much as it is about race.

Third: people often don't know where their family fits in South Africa's income distribution, chiefly because people who are relatively better off often do not realise how much poorer most other South Africans are.

And that helps explain my fourth point, which is that the relationship between inequality and monetary policy does not work the way people usually think.

Lower interest rates typically worsen inequality.

I'm going to spend a large portion of my speech today explaining the four most important channels through which monetary policy affects inequality – namely inflation, borrowing costs, asset prices and employment coupled with growth – to show how this works.

Inequality at the global level

But let me start with the global environment.

Over the past few decades, global inequality has either risen sharply or begun to moderate, depending on how you look at it. Inequality has risen in the sense that inequality *within* countries is often higher than it used to be. As Thomas Pikkety and others have shown us, for example, inequality in the United States (US) has been rising since the 1970s, and is now at levels last seen nearly a hundred years ago, in the 1920s.[1] Similar trends are visible in many other countries.

This increase in inequality has captured many headlines, and has also been cited as an explanation for political developments like Brexit or the outcome of the last US presidential election. This rise in inequality is usually attributed to changes in technology, productivity and the skills of workers, where the return on higher and newer skills has accelerated faster than the returns to less-skilled workers.

However, inequality has also fallen since the 1970s – if we look at the gaps *between* countries. Fifty years ago, the gap between rich countries and poor countries was very clear. Nowadays, there are a lot more middle-income countries. There are also many more rich and middle-class people in countries that used to be almost universally poor. To take one example: fifty years ago, even rich people in China were typically worse off than poor people in the US.

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[1] See *Capital in the twenty-first century* by Thomas Piketty (2013).

That is no longer true: the rich in China are now rich from a global perspective, thanks in part to several decades of strong economic growth. The same thing is now happening in India, which is also catching up with richer countries because its economy is growing at around 8% a year (while advanced economies are growing at around 2%).

This decline in worldwide inequality is a big change, reversing a trend of steadily higher inequality between countries that has held since the Industrial Revolution.[2] The reduction in inequality is driven by some big trends: better economic policymaking, growth in world trade, the spread of technology and finance, and more education.

However, the fact that people in poorer countries have been catching up with those in richer countries doesn't mean that the world has become equal. In fact, the world as a whole is probably more unequal than almost any one country on its own. For instance, while there are now more middle-class Indians than ever before, the country has also become more unequal internally.

Estimates suggest that the Gini coefficient of the whole world is around 0.7. To put that in perspective, a relatively equal country like Sweden has a Gini coefficient a bit below 0.3; the coefficient for the US was around 0.35 in 1950 and is a little over 0.4 today; Brazil is at 0.6. South Africa is around 0.7, which makes it one of the most unequal countries in the world, and certainly the most unequal large country.

[2] See *Global inequality* by Branko Milanovic (2016), especially Chapter 3, titled 'Inequality among countries: from Karl Marx to Frantz Fanon, and then back to Marx?'.

Inequality in South Africa

South Africans know that theirs is an extremely unequal country. However, there are some aspects of this inequality which are not well understood. One is that inequality is no longer as completely determined by race as it used to be. Historically, of course, inequality in South Africa was fundamentally a racial story, with access to economic as well as political rights and opportunities based on skin colour. Since the end of apartheid, however, this has begun to change.[3]

Inequality within the African portion of society has risen, as some black people have moved into the middle and upper classes while others have stayed very poor. As a result, inequality among black people is higher than for the other racial categories in South Africa.[4] The Gini coefficient among Africans is above 0.6 – about the same as Botswana, and close to Lesotho and Swaziland – countries which are less racially diverse than we are but still very unequal.

Another aspect of inequality that people tend to get wrong is the contribution of monetary policy. I am often struck by the comment that higher inflation reduces inequality by benefiting poorer South Africans. The core of this argument is that higher inflation creates more jobs that go to poorer people.

[3] Leibrandt et al. (2010), *Employment and inequality outcomes in South Africa*, p. 21, available at https://www.oecd.org/employment/emp/45282868.pdf.
[4] As of 2016 data, the Gini coefficient for the black population in South Africa was 0.65. It was 0.58 for coloured South Africans, 0.56 for Indians / Asians, and 0.51 for whites. The number for South Africa as a whole was 0.68.

Another part of the argument is that – because most households are highly indebted, and because poorer households are the most indebted – interest rate cuts will disproportionately improve the welfare of those people.

I would like to assess those arguments, as well as a couple of other monetary policy channels that are less discussed, in an effort to get at a deeper understanding of how monetary policy affects inequality. I will discuss the four main channels through which monetary policy affects inequality: borrowing costs, asset prices, employment and growth, and finally inflation. I will demonstrate that a decision to go for a loose monetary policy is likely to worsen inequality and make it more extreme.

Interest rates and borrowing costs

What South African households borrow for, and at what rate of interest, depends mostly on their jobs and income. We can break these households down, very roughly, into two groups: the top 20% of the income distribution and the bottom 80%. A team at the University of Cape Town has built an online Income Comparison Tool which tells you where your household actually fits in, and which I suggest everyone should try.[5]

To give away the punchline, however: if your family income exceeds R173 000 a year, or about R14 400 a month, then you are in the top 20% of households. Getting into the top 10% of the income distribution requires

[5] See http://www.saldru.uct.ac.za/income-comparison-tool/.

just under R270 000 a year, or R22 500 a month.[6] The average government salary is R335 000 a year, which is within the top 10%.[7]

Compare those income levels to a household in the poorest 10% of South Africans, which is getting less than R17 721 per year. That is under R1 500 per month. That's roughly a tenth of what a family just within the top 20% is getting.

These income differences play out in the amount of debt households can take out and the interest rates they pay.

When the Monetary Policy Committee (MPC) moves the repurchase rate (or repo rate), households immediately see the difference in their mortgage payments or their car payments. But what does this do for inequality? The reflex answer is that, in South Africa, there are both rich and poor people, and the poor borrow from the rich, so higher interest rates increase inequality while lower rates, or looser policy, reduce it. But this is misleading.

South Africans in every income bracket tend to have a lot of debt. The National Credit Regulator reports that there were a bit more than 25 million 'credit active' people in South Africa at the end of last year, which compares with around 16 million people who have some sort of employment.

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[6] These decile figures are used by Statistics South Africa for the consumer price index. See http://www.statssa.gov.za/publications/P0141/P0141April2018.pdf, p. 10. The precise threshold for decile 10 is R296 903 and for decile 9 it is R173 023.

[7] See National Treasury (2017), *Medium Term Budget Policy Statement*, *Annexure B,* p. 62, available at http://www.treasury.gov.za/documents/MTBPS/2017/mtbps/Annexure%20B.pdf.

However, South Africans borrow for different things through different parts of the financial system. Most mortgages for homes, and vehicle loans, are taken out by that 20% of households earning the most income that we talked about earlier. Lower down the income ladder, the composition of debt changes. Mortgages and vehicle loans more or less disappear. In their place, we see more high-cost debt, like store cards or informal loans.

These kinds of debts carry much higher interest rates. Crucially, these higher-rate debts are also much *less* closely tied to monetary policy. When we move the repo rate, which is the rate at which commercial banks borrow from the central bank to fund their reserve requirements, the decision has a direct and strong effect on the prime rate, which is the rate at which commercial banks lend to their safest customers. This, in turn, changes the loans that are tied to prime, such as mortgage loans or vehicle loans. To put numbers on this, we currently have the repo at 6.5%. The prime rate is at 10%. The average interest rate on a new mortgage is also 10%, and the average rate on a vehicle loan is almost 12%.

As you can see if we reduce the repo rate by 25 or 50 basis points, people with mortgages and vehicle loans get a nice saving. But the same repo rate move has little or no effect on a microloan, which has an interest rate of roughly 30%, or an informal loan, at an even higher rate. As a result, there is almost no relationship between the repo rate and the interest rate on high-cost debt.

Put these two facts together, and we get an interesting implication: changes in monetary policy have a much stronger impact on the top 20% of households than they do on the rest of the population. That is not because poorer households don’t borrow. Rather, it is because they

borrow at interest rates that are shaped by factors other than monetary policy, including higher costs of offering loans, higher risk of default, and lack of information about income. When interest rates go down, therefore, the more highly indebted and wealthier households save much more on interest costs than the poorer households do borrowing at microloan rates. This, by itself, worsens inequality.

Interest rates and asset prices

Now consider asset prices – a channel which is often poorly understood. As with borrowing costs, people tend to think that higher interest rates reward rich people who have savings. Again, this intuition is misleading. In fact, much of the global debate about inequality and central banking rests on the exact opposite claim: that very *low* interest rates exacerbate inequality.[8] This is because lower interest rates raise asset prices, and an increase in asset prices benefits those people who already have assets.

We have seen this play out in advanced economies following the global financial crisis: as central banks cut interest rates as low as possible, house prices, equity markets and bond prices all soared. The winners were the people who had already invested in those assets. Those who lost out were younger people who couldn't afford expensive homes, as well as savers who had their money in interest-bearing accounts.

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[8] For example, see Bridges and Thomas (2012), 'The impact of QE on the UK economy – some supportive monetarist arithmetic', *Working Paper No. 442,* available at https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2012/the-impact-of-qe-on-the-uk-economy-some-supportive-monetarist-arithmetic.pdf?la=en&hash=81412E5177BCE802F2D37ECF42D20144EEB9513D.

As you can see, what really matters for the asset price / inequality channel is the distribution of wealth. Who has assets? In many advanced economies, the middle classes tend to have substantial stocks of housing wealth, even if most stocks and bonds are owned by richer people. This means that higher asset prices don't necessarily raise inequality, because enough people have assets to start with.[9]

In South Africa, the situation is different: most assets are owned by people at the top of the income ladder. As one researcher has commented, '10% of the population owns more than 90% of all wealth while 80% have no wealth to speak of; a propertied middle class does not exist'.[10] For this reason, a low interest rate policy that pushes up asset prices will only magnify inequality. This may also explain why some asset managers are opposed to interest rate increases and publish angry articles in newspapers when we decide to raise rates.

Interest rates, employment and growth

In fairness, asset managers aside, most people who argue for lower interest rates do not really take these effects into consideration. Instead, they are focused on employment. As they rightly observe, reducing South Africa's extraordinarily high unemployment rate is crucial to fighting poverty and moderating inequality.

[9] As argued, for instance, by Josh Bivens (2015) in *Gauging the impact of the Fed on inequality during the Great Recession*, available at https://www.brookings.edu/wp-content/uploads/2016/06/Josh_Bivens_Inequality_FINAL.pdf.
[10] Available at http://www.redi3x3.org/sites/default/files/Orthofer%202016%20REDI3x3%20Working%20Paper%2015%20-%20Wealth%20inequality.pdf, pp. 3-4.

The problem for us at the central bank, however, is that interest rates are not the right tool for addressing South Africa's unemployment problem, and especially not the joblessness among the poorest households.

In undergraduate economics classes, students are usually taught simple models in which there is a short-term trade-off between inflation and employment – the so-called 'Phillips curve'. One explanation of the Phillips curve relationship is that lower interest rates create more demand, which in turn creates more jobs but also more inflation, hence the trade-off. Another explanation is that higher inflation destroys the value of people's wages, so they become cheaper to hire and employment rises.[11]

The empirical evidence for the Phillips curve, however, is just not there – as researchers have repeatedly reminded us.[12] In fact, South Africa tends to get stronger economic growth and more job creation when inflation is low, in part because of demand effects but mostly from stronger productivity growth and investment. It is the wisdom of the inflation-targeting framework: that we focus on something within our control, something which is important for balanced and sustainable growth over the long term.

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[11] As discussed in Banerjee et al. (2006), *Why has unemployment risen in the new South Africa?*, p. 6, available at https://www.hks.harvard.edu/sites/default/files/centers/cid/files/publications/faculty-working-papers/134.pdf.

[12] Fedderke and Liu (2016), 'Inflation in South Africa: an assessment of alternative inflation models', *South African Reserve Bank Working Paper 16/03*, available at http://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/7275/WP603.pdf. As these authors observe: "A core feature of the South African empirical studies has been a resolute search for a Phillips curve type of trade-off between prices and demand-side inflationary pressure associated with real economic activity. A second constant that emerges from the empirical literature is the consistent failure to successfully support the Phillips curve trade-off." See also Vermeulen (2017), 'Inflation and unemployment in South Africa: is the Phillips curve still dead?', *Southern African Business Review*, Vol. 21, available at https://www.ajol.info/index.php/sabr/article/viewFile/154882/144463.

Targeting employment and not inflation could worsen inequality even more, especially if we were specifically trying to target employment for the poorest South Africans. This is because poorer households are more disconnected from labour markets. In fact, as data from Statistics South Africa tell us, jobs are not even the primary source of income for the poorest 30% of households in South Africa. Instead, these households rely heavily on grants. For the poorest 10%, which is around 1.3 million households, 60.9% of income is from grants and just 13.9% from work.[13]

People tend to use the term 'working class' to mean poor people, but the poorest third of South Africans mostly are not working. Joblessness is fundamentally a structural problem, explained by factors such as quality of education, skills shortages and settlement patterns – people aren't living near jobs. These are not problems that monetary policy can solve.

If we did have the ability to create jobs generally, that would be a powerful tool for reducing inequality. But in fact, as a central bank, our ability to create jobs for anyone is weak in the short run and non-existent in the long run. If we were in a skills-rich country like the US, with flexible labour markets, there would be a respectable argument that low interest rates could help ease inequality by bringing down unemployment caused by a recession.[14] But that's not the economy we've got, and that's not the labour market we've got, so this isn't an option for monetary policy here.

[13] See table 3.7 of the 2014/15 Living Conditions Survey, p. 18, available at http://www.statssa.gov.za/publications/P0310/P03102014.pdf.
[14] See, for instance, Ben Bernanke (2015), *Monetary policy and inequality*, available at https://www.brookings.edu/blog/ben-bernanke/2015/06/01/monetary-policy-and-inequality/.
[14] As discussed in Banerjee et al. (2006), *Why has unemployment risen in the new South Africa?*, p. 6, available at https://www.hks.harvard.edu/sites/default/files/centers/cid/files/publications/faculty-working-papers/134.pdf.

Interest rates and inflation

The final channel I'd like to discuss is inflation. Inflation is a problem from an inequality perspective because it tends to hurt poor people more. One reason for this is that poorer people have less choice over spending. Poor people's consumption baskets are mostly taken up with a few basic items, especially staple foodstuffs and shelter. Richer people buy many more *kinds* of things, so they have more room to adjust away from items that get too expensive.[15]

A second reason why inflation exacerbates inequality is that it is harder for poorer people to protect their wages and savings against inflation. If you have a job where you get a cost-of-living increase every year, or if you have some assets which keep their real value despite inflation, like Krugerrands or a house, then you can avoid much of the pain of inflation. But if you are not in a position to negotiate with your boss, or if your savings are in cash, inflation can hurt you badly.

Given these factors, a monetary policy stance that lowers inflation can actually increase the expenditure of the poorest South Africans – even as it reduces the buying power of richer South Africans. The conventional wisdom about a short-term growth-inflation trade-off therefore needs to be supplemented with the knowledge that this also poses a growth-inequality trade-off. Or, to put the point more simply, any decision to tolerate a bit

[15] Bhorat and Oosthuizen (2005), *The relative inflation experience of poor urban South African households*, available at https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/346/Relative%20inflation%20experience%20of%20poor%20urban%20SA%20households.pdf.

more inflation for the sake of a little extra growth is also a decision to make inequality a bit worse.[16]

Unfortunately, South African inflation has tended to be quite high, and it has been even higher for the poorest South Africans. Our inflation target is a range of 3-6% for headline inflation. Since 2010, inflation has been above 6% for 28 months, just over a quarter of the time. Meanwhile, the inflation rate for the poorest 10% of households has been above 6% for 51 months, which is about half the time. With an inflation rate of close to 6%, on average, South Africa has become a relatively high-inflation country – almost three quarters of the world's countries have lower inflation rates than we do.

This suggests that we haven't taken the battle against inflation seriously enough. We hope to remedy this by anchoring inflation nearer 4.5% – the midpoint of our target range – as we have repeatedly said in MPC statements and in speeches. The poorest South Africans should be among the biggest beneficiaries of that policy.

Inequality and macroeconomic policy

To conclude, monetary policy affects inequality through several channels. Low interest rates tend to push up asset prices, helping those who have assets already. Low interest rates also reduce borrowing costs, but mainly for borrowers at the high end of the income spectrum. Interest rates have weak and limited effects on employment, especially for the third of

[16] International Monetary Fund (2018), 'Annex VIII. The distributional impact of inflation', *South Africa 2018 Article IV Consultation*, available at https://www.imf.org/~/media/Files/Publications/CR/2018/cr18246.ashx.

households which are not closely connected to labour markets or which are disadvantaged by having less education. Where monetary policy tolerates higher inflation, this tends to reduce spending power, especially for the poor. Put together, all this suggests that a more inflationary monetary policy is likely to make inequality worse.

As the guardians of the value of the currency in South Africa, it is important that we at the South African Reserve Bank bear all this in mind when we make monetary policy decisions. The richest 20% of South Africans can make themselves heard quite easily. They let us know when our raising of rates pushes up their bond repayments. They do a good job of getting a cost-of-living adjustment every year. They often don't realise how many poorer people there are out there, because they assume they are roughly in the middle of the income distribution, not close to the top. But we as the central bank have to think about everyone in South Africa, including the other 80% of households.

I hope that today I have left you with a clearer sense of what monetary policy does, and what it cannot do. At the simplest level, we know that low inflation has many benefits, so that's what we aim to deliver. But there are also many other policies and agencies that affect South Africa's worst problems, including poverty, unemployment and inequality. Our contribution as the central bank is just one part of the fight against these evils.

Thank you.