A keynote address by Daniel Mminele,
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Understanding the core drivers of inflation in South Africa

Introduction

Ladies and gentlemen, good morning, and thank you to S&P Dow Jones Indices for inviting me to deliver the keynote address at this conference, which brings together a broad spectrum of investment management and other financial market professionals to discuss, among others, key drivers of South Africa's reinvention of itself to stimulate economic growth.

The topic chosen for this address, 'Understanding the core drivers of inflation in South Africa', is of high relevance today – not just because of the key influence that price developments have on the economy in general, and on corporate investment decisions in particular, but also because of the growing debate, both at home and globally, about the mandate of central banks and what exactly they should be responsible for.

Within the context of today's theme, I thought it might be useful to first provide some insight into how inflation has ended up relatively high in South Africa, the challenges in bringing it lower, and how the South African Reserve Bank (SARB) sees the recent encouraging developments, and its outlook for consumer prices over the near to medium term. I will conclude my address by highlighting the SARB's policy response to this inflation outlook and the risks thereto.

A brief history of inflation challenges in South Africa

In recent years, South African consumer price inflation has regularly exceeded the median levels for both the world and large emerging markets. But this was not always the case. In the three decades or so that followed the Second World War, South African inflation was largely in line with that of its main trading partners. The decoupling occurred mostly from the 1980s onwards, when central banks – in the advanced world at first, though later also in emerging markets – took effective steps to root out high inflation. By contrast, the 1980s saw South Africa experience high and volatile inflation in an environment of growing supply constraints, disinvestment and sanctions, and a loosening of the fiscal stance by a government facing increasing pressure for political reform.

The advent of democracy in 1994 saw increased focus on price stability as a necessary condition for growth and development, which is why the drafters of the Constitution enshrined, in the country's fundamental law, the SARB's mandate of achieving and maintaining price stability in the interest of balanced and sustainable economic growth, and its independence. For the remainder of the 1990s, in contrast to the previous two decades, the SARB's policy of positive real interest rates brought inflation sustainably within single-digit territory. In 2000, the introduction of inflation targeting helped to clarify the mandate of the SARB, providing a policy anchor and introducing greater transparency in policy decisions.

This policy has brought clear results. Since inflation targeting began, annual consumer price inflation has averaged 5.7% (and 5.3% so far in the present decade), compared to 10% in the 1990s and as high as 15% in the 1980s. As the inflation-targeting regime has gradually grown in credibility, South African inflation has also become less volatile. The standard deviation of monthly year-on-year inflation readings has fallen to 0.9 percentage points so far in this decade, from 3.1 percentage points in the 2000s. Yet, as I mentioned earlier, South African inflation is still relatively high by global standards: its 2018 average of 4.6% placed it around the 80th percentile of a sample of 58 large advanced and emerging economies.

This brief recap of the recent history of inflation in South Africa reminds us of how the level and volatility of inflation can have a crucial impact on the decisions of both real economy and financial investors. The high and volatile inflation in the 1980s and early 1990s, resulting in high-amplitude interest rate cycles, coincided with a large decline in fixed investment as a share of gross domestic product (GDP), especially in the private sector. That decline only started reversing in the 2000s, after inflation targeting was adopted. Still, investment levels remain insufficient to trigger the kind of sustained acceleration in economic growth that is necessary to meaningfully reduce unemployment and poverty. It is true that low and stable interest rates provide a conducive opportunity for investment, but the issue lies in where these funds are channelled.

While other factors contributed to the low investment rates of earlier decades, it is not difficult to understand why high and volatile inflation can cripple capital formation. Uncertainty about future nominal returns makes a business more reluctant to commit capital, except for the more profitable projects. At the same time, high inflation discourages domestic savings, thus increasing reliance on foreign investors who are more likely to prove risk-sensitive and demand a premium because of inflation volatility. High uncertainty premiums can, in turn, result in misallocation of capital, with small and medium enterprises (SMEs) in particular struggling to access funding.

Why has South Africa's inflation struggled to decline?

What are the drivers of this still relatively high rate of inflation? And why has it not declined more after so many years of sub-par growth?

There are several factors, but the role of inflation expectations cannot be neglected. As often happens in countries with a long history of relatively high inflation, these expectations are in part adaptive – that is, private economic agents are often sceptical about the authorities' ability (and, possibly, willingness) to keep inflation low, because their experience indicates otherwise. The rand's long-term depreciating trend, caused by positive inflation differentials with trading partners as well as a structural current account imbalance, has fuelled such expectations: it has directly impacted on the prices of consumer goods, as a large fraction of them is either imported or subject to import parity pricing.

The relatively rigid wage- and price-setting process has also resulted in upward shocks to prices proving relatively persistent, for instance after a large-scale exchange rate depreciation. In South Africa, the coexistence (especially during recessions) of large-scale job losses and high real salary increases bears witness to the fairly high degree of rigidity in wage demands. It has been argued that high wage gains are a key tool to redress past income inequalities; and also that there is a trade-off between inflation and employment gains. While there is no denying the large levels of inequality in South Africa, it is doubtful that high wage gains can do much to reduce income disparities when they get absorbed by inflation or come at the expense of large job losses. Equally, experience suggests that tolerance of higher inflation only has a short-term boost to employment at best, with negative consequences in the long run.

Other supply-side rigidities have probably also contributed to the persistence of relatively high inflation in South Africa. High mark-ups in several segments of the South African economy, barriers to entry for small businesses, and the relatively slow response of domestic producers to depreciation in the exchange rate, all suggest limits to competition in the private sector. In turn, this prompts rigidity in upward price adjustments. At the same time, tariff hikes by municipalities and state-owned enterprises (for example, electricity tariffs, which are receiving particular attention at the moment) have often exceeded the headline rate of inflation and have added to the upside cost pressures for private businesses. It also does not help that many of these increases affect the regular, high-frequency expenses of households, and therefore contribute to perceptions of high inflation among the general public.

The recent encouraging signs in price trends

This is not to say, however, that price-formation patterns in South Africa are completely static. In fact, the last two years or so have seen some encouraging developments. From 5.3% so far this decade, average headline inflation fell to 5.0% in the last two years and further to 4.6% in 2018, showing some gradual easing towards the midpoint of the 3-6% target range.

Core consumer price inflation has followed similar patterns. After remaining stuck above 5% for four whole years to February 2017, it has now been in the 4.0-4.5%

range for more than a year. True, the 2016 rand recovery did favour the decline in both headline and core inflation, yet the trend persisted even as the rand experienced volatility in 2017-18. Indeed, of the last 24 monthly consumer price index (CPI) releases, 14 came out below the consensus expectation of economists polled by Bloomberg, versus only 3 that came out higher.

Why did market economists – and indeed, the SARB's own econometric models – fail to anticipate the extent of this inflation slowdown?

Some particular factors stand out, which were highlighted in the last issue of the SARB's *Monetary Policy Review*.

First, the decline in food inflation that began in early 2017, as crops recovered from a drought-induced plunge a year earlier, lasted longer than most projections had anticipated. Part of this positive surprise reflected a continued decline in global food commodity prices.

Second, the impact of the 1 percentage point value-added tax (VAT) hike implemented in April 2018 proved lower than expected. Possibly, retailers and service providers trimmed their margins to avoid too negative an impact on sales volumes.

Third, housing costs, incorporated into the CPI through actual and owners' equivalent rents, slowed markedly in 2018. In many regions, rents had been slowing for several years already, amid a lacklustre property market and downbeat building activity. However, the national average was long distorted by an acceleration in the Western Cape, which only reversed in the past year, in line with other regional trends.

However, the jury is still out on several of the potential causes of this latest disinflationary trends, and whether they will last.

I will first mention the pass-through of foreign exchange movements to domestic goods prices. In several components of the CPI, it has been less pronounced of late than in earlier cycles. Yet economists are still assessing the full range of causes of this lower pass-through. It is conceivable that the long persistence of a negative output gap has made price-setters more sensitive to the weakness of demand than was the case in

the past. But will this pattern persist or will it fade once demand finally picks up again and the output gap starts to close? More observations may be needed before we conclude that the pass-through is now structurally lower or simply 'slower' because of unusually weak demand conditions.

Equally, the signs of a moderation in private-sector wage inflation over the past year or so are not yet fully understood. Remuneration per worker in the private sector slowed to an average of 5.0% year on year in 2017 and the first half of 2018, compared with 6.7% in the previous five years. As a consequence, unit labour cost growth slowed to as low as 3.6% year on year in the second quarter of 2018 – the lowest reading since early 2007 and a far cry from the double-digit readings seen at the start of the decade. Yet it is hard to establish whether this moderation is a consequence of prolonged cyclical demand weakness, whether the labour market has become structurally more responsive to the business cycle, or whether wage-setters' inflation expectations have inched permanently downwards.

The inflation outlook improved since the November 2018 Monetary Policy Committee meeting

In light of these uncertainties, how does the SARB see the outlook for inflation over the next two to three years?

Encouragingly, at the time of our Monetary Policy Committee (MPC) meeting last month, our econometric models indicated a significant improvement from the earlier projection exercise in November last year. The SARB now expects inflation to average 4.8% in 2019 (down from 5.5% in the November projection) and 5.3% in 2020 (slightly below the previous forecast of 5.4%). Arguably, the lower assumptions for the dollar price of oil explain a large part of the lower inflation profile for 2019. The real effective exchange rate of the rand has also recovered somewhat, while world agricultural prices are expected to provide more of a drag on domestic food inflation.

Importantly, core inflation forecasts have been revised downwards too. Projections for 2021, published for the first time in January, show both headline and core inflation falling back below 5% in this end-part of the forecast. Furthermore, the SARB's Quarterly Projection Model (QPM) shows a continued convergence of inflation

expectations, which are already off their near-6% ‘perch’ of the earlier part of the decade, and seem to be steadily moving towards the midpoint of the target range. In addition, the gap between nominal unit labour cost growth and CPI inflation is expected to gradually fade over the forecasting period, reducing one lasting source of upside pressure on inflation.

Risks to the inflation outlook that may still be skewed to the upside

Still, when we met in January to assess the risks to this downwardly revised inflation outlook, the MPC found that, on balance, they were still skewed to the upside. This is not to say that further downside surprises may not occur, of course. After all, demand remains weak and credit creation is sluggish, and in many countries these would be sufficient conditions for inflation to fall further. Equally, many risks, both external and internal, could result in higher inflation should they materialise.

Among the former, exchange rate volatility remains a key factor of uncertainty in light of South Africa’s reliance on portfolio flows to fund what is, by emerging market standards, and its current level of growth, a relatively large current account deficit. The rand has been quite stable over the past few months, thanks in part to reduced expectations of interest rate hikes in the United States (US) and the subsequent moderate retreat of the US dollar. But such a situation can change if market expectations of the future US rate path need to be revised upwards again or, conversely, if the world economy slows faster than expected, triggering a new wave of investor aversion towards ‘riskier’ assets. The implications for capital flows towards emerging markets of global central banks’ balance sheets, some of which are currently contracting after nearly a decade of expansion, are also not clear yet. Equally, the oil price outlook remains uncertain amid persistent geopolitical tensions.

On the domestic front, the MPC is cognisant of the upside risks to administered prices, especially electricity and water, in light of the challenges that utilities have faced for years to contain costs, and in light of the pressing maintenance needs if supply safety and quality are to be secured. The MPC also sees risks of a pickup in food prices in the outer years of the forecasting period. In addition, any unresolved domestic policy uncertainties could trigger exchange rate volatility even in the absence of external shocks.

The South African Reserve Bank’s reaction and policy mandate

Following its decision to hike the policy rate by 25 basis points at the November 2018 meeting, the MPC felt that the inflation backdrop and outlook had improved sufficiently enough to warrant keeping the policy rate unchanged at the January meeting. While the MPC still judged the policy stance as broadly accommodative, the endogenous rate path generated by the QPM now only entails one hike of 25 basis points in the policy rate, to 7.0% by the end of 2021. As previously indicated, this does not represent policy guidance nor commitment. The MPC will remain alert to any possible second-round price effects of potential shocks and stands ready to act accordingly should data indicate a shift in the inflation outlook and the risks thereto in either direction.

It has at times been suggested that the SARB should place greater emphasis on growth and employment objectives, or even that its mandate should be modified to make such objectives clearer. These suggestions may miss the key channels through which monetary policy best serves the goal of long-term economic development. South Africa’s monetary policy framework is not one of rigid inflation targeting, but a flexible one, which takes full account of the outlook for real economic growth and how it is likely to affect inflation over the forecasting period. For instance, when demand is weak and exerts downward pressure on prices, the SARB has far more latitude to ‘see through’ external price shocks than in an environment of domestic ‘overheating’.

However, as I mentioned earlier, trying to ‘kick-start’ economic growth and employment through a larger dose of monetary stimulus would probably have only a short-lived impact on activity. By contrast, its implications for the current account, policy uncertainty and inflation expectations would most likely be negative. Over time, therefore, the consequence would probably be higher, rather than lower, interest rates.

International and local experience does suggest that it is a stability-oriented monetary policy framework, focused on reducing price volatility and risk premiums on financial assets, that has the best chances of delivering lower interest rates and stronger economic growth, amid sustainable investment, over the longer term.

Conclusion

Allow me to end my address by reiterating that in line with its constitutional mandate, the SARB will continue to seek to ensure that the purchasing power of our currency is protected. Monetary policy cannot contribute directly to stronger economic growth and employment creation in the long run, but by ensuring a stable financial environment, monetary policy fulfils an important precondition for the attainment of growth and development. Monetary policy in South Africa considers all factors driving inflation, including output growth and the external environment. Monetary policy has an important role to play, but it needs to be part of a carefully defined overall macro-economic policy mix.

Thank you.