SOUTH AFRICAN RESERVE BANK

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The state of the South African economy and the role of monetary policy

These are some of the most remarkable years in the history of the South African economy. Unfortunately, they are remarkable for the wrong reasons. Domestically, we are experiencing the lowest growth episode in modern South African history, marked most recently by the widespread failure of basic infrastructure, especially electricity. Externally, we have been buffeted by a series of extraordinary shocks: the COVID-19 pandemic, the war in Ukraine, and a global inflation surge. These circumstances have profoundly affected the lives of all South Africans. They have also confronted policymakers with difficult choices. Today, I want to outline how monetary policy has responded, and share with you the main uncertainties and debates we are grappling with today.

I will start with the changing external environment. In 2020, the COVID-19 shock prompted an unprecedented drop in economic activity worldwide. We saw a broad decline in inflation which led to a huge wave of stimulus from fiscal and monetary authorities. In South Africa, this included lowering the repurchase (repo) rate to 3.5% – its lowest level ever.

Fortunately, global pandemics are rare events, but this meant no one had much experience on which to base forecasts. While policymakers emphasised this uncertainty clearly, we can still say actual outcomes surprised most of us. For example, in 2020 it did not seem like the major advanced economies would soon be confronting the highest inflation rates in a generation.[1] Part of the challenge was that

[1] For instance, inflation rates in the United States and the United Kingdom reached their highest levels since 1981. In France, inflation is at its highest levels since 1984. In Germany, inflation has reached its highest levels in the post-war period.

the pandemic produced an unusual mix of supply and demand effects, which included supply chain disruptions and abrupt shifts in the composition of demand. On top of this came the Ukraine war, a further shock in none of our forecasts, which pushed up food and energy costs around the globe.

The result for macroeconomic policymakers was that we had to pivot fast. In South Africa's case, as inflation rebounded, economic output recovered to pre-COVID levels, and global rates soared. At a minimum we needed to have interest rates near their normal or longer-run levels, not at long-term lows. In this context, the South African Reserve Bank's (SARB) Monetary Policy Committee (MPC) implemented a series of 75 basis point hikes, larger than those used in the previous hiking cycle, to get back to safety.[2]

Given that the full impact of monetary policy on inflation is not immediate but has a lag effect, we could not immediately bring inflation back to target in 2022. Instead, what we aimed to do was set policy so that inflation would normalise after the initial, deep shock had played out.

As at the latest data, headline inflation is at 6.9%, with core or underlying inflation at 4.9%. The peak appears to have been in July last year when headline inflation hit 7.8%. To put that in context, we have been outside of our 3–6% target range since May 2022. The last time we were close to the midpoint of that range, which is where we aim to stabilise inflation, was about a year before that.[3]

On current forecasts, we anticipate inflation will be back at the midpoint of our target range towards the end of this year. Similarly, the International Monetary Fund's (IMF) forecasts, from the most recent *World Economic Outlook*, have end-of-period inflation for 2023 at 4.5%,[4] which is the midpoint of our target range. To put that in perspective, the IMF does not see major advanced economies hitting their 2% targets over this

[2] The hiking cycle began with 25 basis points in November 2021. There were further 25 basis point increases in January and March 2023, followed by 50 basis points in May. The July, September and November 2022 decisions were all for 75 basis points. In January 2023, the MPC raised rates by 25 basis points.
[3] Headline inflation was 4.4% in April 2021, 5.2% in May 2021, 4.9% in June 2021 and 4.6% in July 2021.
[4] The precise forecast is 4.526%.

horizon, with year-end projections at 2.3% for the United States (US), which is quite close to target, but 5.4% for Germany and 6.3% for the United Kingdom.

These projections are encouraging. After all, the key test of policy is not whether shocks happen, but whether inflation comes back to target after the initial effects of the shocks wear off. After that, the next test of policy is how difficult the adjustment process is for getting inflation back to target.

One problem is that we could get more shocks. Food inflation has been coming in higher than expected, and it surprised us once again in the latest consumer price index (CPI) release from Statistics South Africa. There is a global dynamic to elevated food price inflation, but now we are also worrying about load-shedding driving up food prices, as electricity shortages start to disrupt the production and storage of food.

The exchange rate outlook has also deteriorated recently. At the start of this year, markets were optimistic that US inflation was coming down, that the US dollar had peaked in late 2022, and that the US Federal Reserve (Fed) would be able to pause rate hikes soon and even think about cutting rates. Recent data have undermined this benign view.

The US economy still appears to be running hot, and markets have rapidly priced in an extra half a percentage point of Fed hikes, relative to where we were earlier in 2022. This has helped weaken the rand from around R17 per dollar in January 2023 to over R18 to the dollar recently. Domestic factors also have not helped. The local news flow has been mostly rand negative, for instance around load-shedding. Local interest rates are also well below those in some peer economies, adding to a weaker currency. For example, Brazil’s policy rate is at 13.75%, Mexico’s is at 11% and Hungary’s is 13%.

In a world where the dollar is weakening, the rand is likely to benefit along with other currencies. But February was not kind to the market consensus on a weaker dollar, and the rand outlook has correspondingly become more worrying, once again.

A second problem is that South Africans might start seeing a higher level of inflation as normal.

For a start, inflation expectations have risen. The fourth quarter survey of inflation expectations, published by the Bureau for Economic Research (BER), registered expectations of 6.1% inflation for 2023, up from 5.9%, and 5.6% for 2024, up from 5.3%. Over five years, expectations are at 5.5%, up from 5.4% previously.

Of course, respondents are rational to see higher inflation at the moment, given elevated food and fuel prices. A bigger concern is that expectations for longer-term expectations are well above our 4.5% target, which may indicate that the initial supply-side shocks are feeding through into longer-run price and wage-setting behaviour – a phenomenon referred to as ‘second-round effects’. We are therefore monitoring expectations closely, to see if people recover their faith in our target or if we need to do more to stabilise longer-term expectations close to 4.5%.

For a sense of underlying inflation pressure, another important area we look to is core inflation. This is a measure of inflation which excludes food and energy prices, which are often volatile. Core inflation has been lagging headline inflation, only moving above the midpoint of our target range during the second half of last year. We anticipate that the peak for core is still ahead of us, with the January MPC forecast projecting core inflation of 5.4% in the second quarter of this year.

So far, most of the pressure in core inflation has been coming from imported goods, which are being repriced to reflect the weaker rand and higher global goods prices. Our forecast takes the view that core goods inflation peaked at the end of last year.

A weaker rand could keep core goods inflation higher for longer. But the bigger concern may be that inflation pressure is shifting over to services. This category is around two-thirds of the core basket, and it contains many prices which are not adjusted frequently – for items such as housing rental or insurance contracts. This is the area where second-round effects, through wages[5] and inflation expectations, are most likely to manifest.

A year ago, services inflation was near the bottom of our target range, at 3.1%. The latest CPI release puts it at 4.3%.[6] In our forecast, the peak is just over 5%. The disinflation trends we see in headline inflation is therefore not the narrative for services.

That said, we have had a couple of better-than-expected outcomes for services inflation recently, and these allowed us to revise down our core forecast at the January 2023 MPC, even as we revised up headline inflation. Perhaps we can hope our core forecasts will be too high. Of course, if we do not see services coming down later this year, then we will have a problem. We are not going to be able to achieve our target over time if services inflation gets stuck in the top half of our target range.

After all this inflation analysis, you may well be thinking: but what about growth? Here the outlook is not good at all.

We are expecting growth rates of 0.3%, 0.7% and 1.0% over the next three years. These are disastrously low. Given population growth rates of around 1.2% annually, the implication is that living standards will continue to fall, as they have done on average since 2014. Our growth rate also compares very badly to the historical record. Since the 1960s,[7] South Africa has, on average, managed to grow by about 2.8% a year. This is around four times the average growth rate both for our forecast and for the past 10 years. This feeble growth outlook is also related to other social ills, including our 33% unemployment rate.[8]

What does South Africa's growth challenges mean for monetary policy?

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[5] For the November 2022 MPC forecast, average salaries were expected to be 5.3%, 6.7% and 5.4% for 2022, 2023 and 2024 respectively. For the January 2023 meeting, the respective figures were 5.2%, 6.9% and 5.5% for 2022, 2023 and 2024 respectively, and 4.7% for 2025 (with the additional year added to the forecast in January).

[6] See the January 2023 CPI report published by Statistics South Africa.

[7] This claim is based on data from the Penn World Tables, starting in 1961.

[8] The official unemployment rate for the third quarter of 2022 was 32.7%; for the second quarter of 2022 it was 33.6%.

When we at the SARB think about growth, we would of course like to have the highest growth rate possible. But there are many things that drive growth that central banks do not control – and do not have mandates to tackle – including technological innovation, education, natural resources, and yes, reliable electricity supply. In this sense, delivering growth is much more of a team sport than controlling inflation. Central banks can do much of the work of managing inflation by themselves, although as with any solo sport, such as golf or tennis, support teams make important contributions. Growth policy, however, is more like soccer or cricket, where individual heroes cannot do much if their team members are weak or absent.

When a central bank is playing for the growth team, what it can affect is demand, which can be applied to reduce the volatility of output. More technically, as long as prices are fairly stable, changing a nominal variable such as interest rates can temporarily affect real variables, including quantities of goods and services. This is useful when demand is too weak, during downswing phases of business cycles. Where a central bank aims for a growth rate which requires more output than an economy can produce, however, the results are troublesome. For a small open economy such as South Africa, this typically means that we experience unsustainable imports, currency depreciation and rising inflation.

In modern central banking practice, we formalise these intuitions using a concept called 'potential growth', which is an estimate of the amount an economy can produce at full capacity. To the extent an economy is not at potential, we say it has an output gap. If output is below potential, then the output gap is negative; if it is above potential, the gap is positive.

For every MPC meeting, the forecast team prepares estimates of South Africa's potential growth and the output gap. They are unobservable concepts and must be estimates using imperfect techniques, which makes them uncertain. So, when I look at these figures, and how they shape the forecast and the policy advice, I do not quibble about the exact numbers, but I think about what kind of problem these numbers describe, how this information squares with the other information available, and how policy should then respond.

As of the January 2023 MPC forecast round, those numbers told an extraordinary story. I have already mentioned that our growth projections are very low, but our potential growth estimates are even lower. The team estimates potential growth at 0% this year, then 0.6% in 2024 and 1% in 2025. Because the economy performed better than expected last year, and because expected growth is above potential, the forecast now sees a small positive output gap developing this year. In other words, in the interpretation of our Quarterly Projection Model (QPM), we have an economy operating modestly *above* its potential. And this, in turn, supports policy advice to raise rates not only because inflation is above target, but also because growth is too high.

In assessing this forecast story, I am struck by two plausible but competing interpretations.

The first interpretation is that potential growth must be 0%, or worse, given the scale of supply-side dysfunction in the economy. After all, isn't it hard enough for people just to achieve the output they delivered last year, let alone produce more? We know electricity shortages have intensified; we expect to have 250 days of load-shedding this year, from 157 days last year and 48 days in 2021. On top of that, the freight rail system has, for the most part, not been functioning optimally, removing another pillar of the economy's productive potential. There are many other constraints in the economy that also suppress potential growth.

For our forecast team, these are facts that must be faced squarely, and it's better to accept them up front than gradually mark down the projections as disappointing data come in. Of course, it is reasonable to expect that South Africans will find ways to cope with these challenges, and that there will be policy steps to address them with time. For this reason, potential growth rises over the forecast period, reaching 1% in 2025. But the narrative for this year is that the economy does not have the supply-side capacity to produce more than it did last year.

At the same time – and this is the second interpretation – is it possible for the economy to be at full potential when unemployment is over 30%? The Quarterly Employment Survey recorded 10.57 million formal jobs at the end of 2019, against 9.98 million now.[9] Were all those workers unproductive, so that recovering those roughly half-a-million jobs would add nothing to output? Are all sectors in the economy at full capacity? Can potential realistically be at zero?

These competing views are not wholly incompatible. They both capture important truths. The main point of the comparison is to illustrate how the economy is short of some inputs, like electricity, but there is slack in other areas, such as employment. In these conditions, what the MPC is trying to gauge is the space to satisfy additional demand and follow through on what that means for monetary policy. The difficult part, for the MPC, is judging how much we can do to help on the demand side when the supply side of the economy is in such a perilous state.

In common with many other central banks, we are flexible inflation targeters. We aim to achieve our inflation targets while also considering growth; if inflation is above target but there is a negative output gap, then we can tolerate a somewhat slower disinflation path for the sake of supporting demand. No one really targets inflation exclusively, ignoring growth and employment, as great policy thinkers like Stanley Fischer have pointed out.[10] There is always a balancing act.

As you know, a balance rests on a fulcrum, which is the central point around which balance can be achieved. In monetary policy, this fulcrum is another one of those unobserved concepts, like potential growth; it is called the neutral rate. The neutral rate is the interest rate that neither speeds up nor slows down the economy; it is the level at which the policy rate will settle when inflation is at target and output is at potential. This is a concept many of our close watchers have questions about.

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[9] These data are not seasonally adjusted. Regardless of the exact quarter used, this series shows a clear and sustained downward shift in formal, non-agricultural employment since the onset of COVID-19. The Quarterly Employment Survey (QES) is likely to be a more reliable indicator of changes in formal sector employment than the Quarterly Labour Force Survey (QLFS).

[10] Speech by Stanley Fischer, 'Central bank independence', 9 November 2015. https://www.bis.org/review/r151109c.htm: "In practice, I doubt that any central bank targets inflation to the exclusion of all other outcomes. For example, the Bundesbank was generally thought to have a very strict focus on inflation in the years in which it had an independent monetary policy before the founding of the European Central Bank. But researchers who have studied the Bundesbank's policies of that period have concluded that it likely responded to deviations from target of both expected inflation and output growth."

In South Africa, we estimate this neutral rate to be 7% over time,[11] of which 4.5% is compensation for inflation and 2.5% is the so-called neutral real interest rate – the rate excluding inflation – which economists abbreviate as r-star. In turn, that 2.5% is made up of half a percentage point which reflects the global real rate, which we derive from the longer-run real policy rate of the US, the euro area and Japan, plus 2 percentage points for the South African risk premium.

As with potential growth, we cannot be sure that the neutral rate is exactly 7%. It is an unobservable concept and our tools for measuring it are imperfect. Nonetheless, a rate of around 7% is a reasonable place to start conversations about the policy stance. It suggests that current rates, at 7.25%, are in the region of the neutral rate, and it also illustrates how loose policy was back when we were at 3.5%.

Of course, if the inflation-adjusted rate needs to be around 2.5%, then for policy to be neutral we need inflation to be around 4.5%. We aren't there yet; as I noted earlier, inflation is still close to 7%. For this reason, the extent to which the policy rate will change from the current 7.25% will depend on whether we feel confident that disinflation is proceeding and we will get to 4.5% this year.

If the disinflation story does not play out as expected, then we won't get real rates where we need them. I have discussed the risks that could produce that outcome. Because we cannot stabilise prices with persistently low or negative real rates, in this scenario there will be more work to do with rate changes, and the trade-offs between output and inflation will be more difficult. There are clear risks of adverse developments, which could require further monetary policy action to contain inflation. And so, to conclude, while we hope for the soft landing, we are also prepared for worse outcomes.

Thank you.

[11] Neutral rates can change over time. Although the QPM steady state is 2.5%, the neutral rate was estimated at 2% for both 2020 and 2021, and 2.3% for 2022. Over the forecast period, the neutral rate is currently projected at 2.4%, 2.4% and 2.5% for 2023, 2024 and 2025 respectively.