Lesetja Kganyago: Monetary policy amidst high inflation

Address by Mr Lesetja Kganyago, Governor of the South African Reserve Bank, at the American Chamber of Commerce, Pretoria, 5 April 2023.

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Introduction

Ladies and gentlemen, thank you for inviting me to address you today. As you know, South Africa and the United States (US) have a long history of economic cooperation, and American businesses have played an important role in the development of our economy. South Africa is the US's largest African trading partner and has the most diversified and industrialised economy on the continent. Last year alone, the US accounted for close to 9% of total exports and 7% came from imports.

In 2021, US exports to South Africa totalled US$5.5 billion a 25.8% increase from 2020, while US imports from South Africa totalled US$15.7 billion a 38.5% increase. There are approximately 600 US businesses operating in South Africa and many use South Africa as their regional headquarters,[1] and a springboard for greater opportunity on the African continent.

Today I want to talk about monetary policy in the context of high inflation and an environment of low growth - conditions which are, unfortunately, normal for South Africa but now also feature globally. The challenge currently being faced by all central banks is how to steer monetary policy to get inflation down without plunging the economy into a recession, and doing so in a context in which key determinants of inflation and growth are outside our control.

Getting policy correct in turn depends on how well we handle the analytical challenge of distinguishing between the supply and demand sources of our inflation and growth problems.

Are the price pressures we see today related to specific shocks that will gradually fade, or are they more permanent? How are global shocks impacting a country like South Africa and how should policy respond to them?

These are the questions I will try to unpack today.

Where we stand now

Higher energy and other commodity prices, supply bottlenecks as well as insufficient inventories are some of the factors that drove inflation sharply higher in 2021 and early 2022. In recent months, headline inflation has started to come down in most jurisdictions, largely reflecting lower energy prices. By contrast, core inflation rates remain sticky. The lagged effects of energy, food and other cost increases are still feeding through to wages, services prices and many final prices.

Furthermore, in many countries, labour markets remain very tight, even as economic momentum has slowed. This has forced businesses to offer higher wage increases to attract or retain workers. Furthermore, indications of still-solid profit margins suggest that firms continue to have significant latitude to pass through costs to their customers.

So, while inflation forecasts show a decline in inflation, both for headline and core inflation, the uncertainty about the trajectory is very high. Forecasters are unsure about the terminal level of inflation and how fast it will get there. For example, members of the Federal Open Market Committee (FOMC) foresee, on average, personal consumption expenditure inflation of 3.3% this year and 2.5% in 2024.

Consequently, the world may, for a relatively long period, have interest rates that are high by the standards of the past 20 years.

Banking strains and policy

While it is clear that central banks prefer to address higher-than-desired inflation with interest rates, there is a possibility for financial stability concerns to cloud policymaking. Financial markets have adjusted their forecasts for rates in recent weeks as strains in financial institutions emerged. However, it is important to remember that while pockets of vulnerability exist in the global financial system and can be exposed by the recent quick shift to more elevated funding costs, global banks are by and large much better capitalised and more resilient to shocks than they were before the global financial crisis.

This explains why, at least so far, central banks have been able to 'ring-fence' problem institutions and maintain confidence through targeted interventions, without compromising on the necessary steps required to bring inflation back to target. This separation of financial stability concerns and the policy steps needed to address inflation is a critical benchmark for policy effectiveness. Central banks need to emphasise how the determinants of the two problems differ, how policy in each domain can and should respond, and to maintain the trust of the markets and the public so that the correct steps are taken.

How the world affects South Africa

There are several channels through which the global developments I have just described influence South Africa's economy and markets and, in turn, the policy response of the South African Reserve Bank (SARB). First, higher global interest rates weigh on world growth, and hence the demand for South Africa's exports. The impact on our balance of payments and, in turn, the rand, can be compounded as slower global growth reduces the prices of our commodity exports.

Second, global banking strains can also result in reduced lending to South Africa, as such pressures often prompt major financial institutions to pull back loans from 'riskier' destinations, especially emerging market countries. However, South African banks do not have large external liabilities, while the corporate sector is not heavily dependent on foreign bank financing. Hence, we are confident that this channel of contagion should remain relatively limited.

Lasty, financial markets are probably a stronger channel through which global conditions affect South Africa. Portfolio flows have historically been a key source of funding for our current account, which is in a deficit most of the time, and these flows are highly sensitive to global financial conditions. South Africa's current rating status as well as the recent greylisting of the country by the Financial Action Task Force will continue to exert downside risks to the rand, which has already underperformed most of its emerging market peers in recent months.

Domestic inflationary pressures

As described earlier, the exchange rate remains under pressure due to idiosyncratic domestic factors as well as the evolving global situation, thus exerting upward inflationary pressures. This limits the benefits of slowing global inflation to domestic inflation. In fact, the SARB has revised its inflation projections upwards – headline inflation is now forecast to decelerate at a slower rate, averaging 6.0% in 2023 (5.4% previously) from 6.9% in 2022. This is, in the main, due to higher fuel and food price inflation – a direct consequence of a more depreciated exchange rate. Domestic food price inflation continues to rise despite normalising global agricultural commodity prices. Inflation pressures on food price inflation appear to be broad-based, with most components still at double-digit inflation rates. While these pressures are expected to ease over the forecast period, food price inflation usually spills over into wage costs and other constraints, such as electricity and logistics, which will continue to put upward pressure on prices and business input costs.

Fuel inflation continues to decline, benefitting from the correction in oil prices on the back of slowing global demand. However, here again, the depreciation in the currency is limiting the extent of this benefit, and it is thus likely to keep headline inflation elevated.

In addition to this, while core inflation surprised on the downside recently, the exchange rate-sensitive core goods continued to accelerate. Second-round effects are also starting to show up in services inflation, with categories such as restaurants and hotels as well as public transport rising significantly. Other key services components such as insurance and housing inflation are starting to normalise from their recent lows, with insurance inflation averaging 6.4% in the recent outcome (February) compared to 3.1% at the same time in the previous year. Inflation expectations, which have increased and remained above the target midpoint, are also key to the overall evolution of services inflation. They largely characterise wage negotiations and ultimately inform price formation in the economy.

Monetary policy going forward

In light of all this, the SARB has often been asked: What is your view on economic growth and what is your forecast for inflation? These are important questions for any central bank and we find ourselves faced with an important conundrum, that is, juggling high inflation against low growth.

Like many of our global peers, we are cognisant of weak growth prospects. Our gross domestic product (GDP) projection for 2023 is 0.2%, on the back of the electricity supply deficit. By contrast, inflation remains elevated. Our primary goal as a central bank is to anchor inflation expectations and to reduce the extent to which higher inflation does spill over into pricing behaviour in the following year. Our role as central banks is to keep inflation expectations anchored to prevent wage spirals from generating permanently higher inflation.

As discussed at our Monetary Policy Committee (MPC) meeting held at the end of March, the balance of risks to the inflation outlook are assessed to be on the upside. As we have conveyed on several platforms, we believe that we have taken the right decisions over the past few MPC cycles to ensure that we get inflation back to the midpoint of the target range, but this cannot preclude further steps if inflation and inflation expectations continue to surprise higher. At this stage, we do not know what the terminal interest rate level will be, but we hope that the way in which we explain our policy creates confidence that future inflation will come back to target. We continue to monitor data and developments and we stand ready to act, as and when warranted.

Concluding remarks

In conclusion, I think many of us will agree that the emerging financial vulnerabilities are introducing new headwinds for global financial markets. As such, global conditions are likely to remain volatile in the near term, with tightening financial conditions in the US as new weaknesses in financial institutions emerge and concerns of contagion intensify.

On the upside, the banking sector, globally, is much better capitalised than it was in 2008 and has become more resilient to shocks. However, central banks have to guard against continued volatility in financial markets while ensuring that they keep to their mandate of price stability.

Thank you.

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[1] Details are available at https://www.state.gov/u-s-relations-with-south-africa/