SOUTH AFRICAN RESERVE BANK

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Challenges facing the global economy: a South African perspective

Ladies and gentlemen, it is with great pleasure to be invited to address you today.

The past few years have been a rollercoaster – evidenced by the numerous shocks that we have been faced with in a space of just three years. While the global economy at large continues to recover from the COVID-19 shock, and as we navigate what one could consider a new normal, there are important challenges that we continue to face as policymakers across the world. As such, the topic chosen for my address today – challenges facing the global economy from a South African perspective – could not be more fitting. This topic is particularly important for South Africa which, alongside other emerging market economies, has had its own idiosyncratic challenges being exacerbated by these global shocks.

In light of this background, my speech today will focus on how inflation, growth and the monetary policy outlook have impacted our domestic economy. Before doing so, it is probably important that we do a quick recap of where we have come from.

Global developments since the outbreak of the COVID-19 pandemic

The major disruptions since the onset of the COVID-19 pandemic have been an important learning exercise for global economic policy. With no precedent in recent history to learn from, it has highlighted the importance of finding appropriate policy responses required to address the shock. The unusually large supply and demand imbalances we witnessed during and post the pandemic were a result of the sudden restrictions (and consequent relaxation) of economic activity as authorities around the world sought to contain the spread of the pandemic.

You will remember that prior to the COVID-19 pandemic, global inflation was quite low, with many major central banks struggling to get inflation up to the 2% target. Soon after the pandemic hit, broad-based declines in inflation followed, which then, in response, induced a wave of fiscal and monetary stimulus. The South African Reserve Bank (SARB) itself reduced its repurchase – or repo – rate to an all-time low of 3.5% in July 2020. This stimulus provided by policymakers to mitigate the impacts of the pandemic, together with pent-up demand from the COVID-19 restrictions and the much slower reopening of the services sectors, boosted the demand for goods while supply remained constrained. This, in turn, fuelled what would eventually be the highest rates of global inflation in a generation.[1]

As the global economy was gradually recovering from the COVID-19 shock, another unexpected shock came early last year: Russia's invasion of Ukraine which triggered a war that still rages on today. The war in Ukraine compounded the shock to the prices of oil, gas and some inputs into food production, such as fertilisers – further fuelling the global inflation problem.

With the benefit of hindsight, we now know that the various stimulus efforts by policymakers contributed to the inflation problem we are currently sitting with. Nonetheless, the stimulus was much needed and supported demand conditions at a time when consumer confidence had been crushed by the lockdowns and furloughs. However, it is now clear that fiscal and monetary policy remained too loose for far too long. The ultra-low interest rates and generous transfers to

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[1] World inflation calculated by Haver rose to a peak of 9.4% in September 2022 and was still in excess of 7% in March this year.

households and businesses created excess demand – in an environment where supply constraints have lowered potential output in most economies – which, in turn, ignited the inflation problem we currently face. Subsequently, global inflation pressures have resulted in many central banks around the world embarking on unusually fast and synchronised monetary policy normalisation. The SARB itself implemented a series of 75 basis point hikes over the past year – faster than in prior tightening cycles. Since November 2021 to date, we have raised the repo rate by a cumulative 425 basis points. However, for context, the cumulative repo rate increases by the SARB have been below those implemented by some of our emerging market peers and, more importantly, the real repo rate is still below its estimated neutral level of 2.5%.

Where are we now?

It is encouraging to see that some of the shocks that drove the surge in global inflation have begun to ease. After peaking around the middle of 2022, global inflation moderated somewhat in the fourth quarter of 2022 and into the first quarter of 2023. However, although these developments have, overall, been positive, for many economies inflation still remains elevated and well above central bank targets. Importantly, inflation is showing signs of persistence in several sectors.

The latest International Monetary Fund (IMF) *World Economic Outlook* projects global inflation at 7.0% this year, down from the 2022 average of 8.7%. Inflation is expected to further moderate to 4.9% in 2024. This decelerating trend is reflective of lower food and commodity prices, particularly oil, coupled with the gradual unwinding of supply constraints. Although demand pressures have begun easing somewhat in response to global monetary and fiscal policy normalisation, core inflation remains high and persistent, risking prolonged target breaches in most economies, which could lead to some de-anchoring of inflation expectations.

Furthermore, the global growth outlook remains weak. Following the steady recovery in trading-partner growth in 2021 of 7.0%, growth slowed to an estimated 3.5% last year. Looking ahead, and in line with higher prevailing interest rates, the

SARB expects trading-partner growth to average 2.0% this year, before rising gradually to 2.6% in 2024 and 3.1% in 2025.[2]

In addition to slow global growth, rising interest rates have also triggered banking sector stresses in the United States (US) and Europe – leading to tighter global credit conditions as markets and financial institutions readjust their portfolios. Consequently, uncertainty around the path for the US Federal Reserve's (Fed) federal funds rate has increased over the near term. This has added to financial market volatility and the resulting 'risk-off sentiment' is impacting small open economies such as South Africa. These bank stresses have also added to global policy uncertainty as the size and duration of these effects are still playing out, as can be seen in the recent failure of First Republic Bank at the beginning of May 2023.

The domestic inflation landscape

When I mentioned earlier some of the positive global developments over recent months, one of them has been a reduction in delivery lags and supply bottlenecks, which has contributed favourably to the inflation dynamics of some countries. Unfortunately, this has yet to have a material impact on our domestic inflation, mainly due to idiosyncratic domestic factors. In fact, it is expected that our own domestic infrastructural bottlenecks will continue to exert upside pressure on the inflation outlook.

In addition to the initial studies on the impact of load-shedding on growth, there is recognition and growing evidence that the country's ongoing energy supply challenges are impacting on prices as well. The SARB now estimates that load-shedding will add 0.5 percentage points to headline inflation in 2023.[3] This calculation has taken into account the cost of alternative energy sources such as solar or back-up power generators – costs which are assumed will likely be passed on to consumers.

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[2] The SARB's global growth forecasts are based on real GDP growth in South Africa's major trading-partner countries.
[3] See Box 1 in the April 2023 *Monetary Policy Review*.

Overall, South Africa is no different from most countries that have experienced a surge in price pressures. With our economy being an open economy, global price pressures were bound to, sooner or later, reach our shores. Higher global food and oil prices and, more generally, elevated global goods inflation, translated to inflationary pressures in the domestic economy – partly transmitted via the weaker rand – a point I will revisit later. This pushed domestic headline inflation to a high of 7.8% in July 2022 – a rate that was last reached almost 14 years ago.

Parallel to the somewhat easing global price pressures, domestic headline inflation has gradually slowed and came in at 7.1% in March 2023. However, despite this moderation – primarily driven by a decline in fuel prices from the peaks observed in mid-2022 – inflation remains well above the SARB's preferred midpoint of the 3–6% target range. Inflation edged slightly higher in February and March 2023, after recording 6.9% in January, underpinned by rising food and core inflation. Nonetheless, we expect a return to the 4.5% midpoint – though only by the third quarter of 2025.

In South Africa, food inflation has continued to surprise to the upside, despite the decelerating trend observed in global agricultural commodities. Domestic meat inflation remains elevated, reflective of lingering domestic supply constraints in the beef market after the outbreak of foot and mouth disease last year. The expectation is for market conditions to improve gradually over the near term. However, the ongoing electricity supply challenge is likely to have more of an impact on energy-sensitive markets, such as poultry and dairy farming.

Another important factor that has impacted inflation in South African has been exchange rate weakness. The rand has been one of the worst-performing emerging market currencies this year and over the past 12 months.[4] Idiosyncratic factors such as persistent load-shedding and the recent greylisting of the country by the Financial Action Task Force have kept investors wary. And, by extension,

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[4] The rand has depreciated around 6.8% in the year to date and by 17.6% over the past year against the US dollar.

the rand depreciation has negated the impact of lower global energy and food costs on domestic inflation.

Of concern is that core inflation, which excludes the more volatile food and energy components from the consumer price index (CPI) basket, remains sticky. The pressure on core inflation has been mainly driven by repriced imported goods costs. But apart from higher imported goods costs, one needs to keep an eye on core services inflation. To date, services inflation has remained relatively subdued – averaging around 3.9% in 2022. However, upside risks seem clear, especially in medical insurance as premiums move closer towards their longer-term average rates. In addition to this, the tightening rental housing market and high inflation expectations are expected to exert upside pressure on core inflation over the near term. Risks to services inflation also emanate from spillover effects from higher food and fuel inflation as well as possible higher wage increases given the adaptive nature of wage settlements in our economy. (We have already seen sharply higher wage settlements in the public sector.) We predict that core inflation will only decline to the target midpoint in the second quarter of 2025.

Inflation has important distributional consequences, with the poor and those living on fixed incomes the most adversely impacted. The current inflation surge has been underpinned by high food and fuel price increases that more adversely affect the consumption baskets of poorer households. Statistics South Africa (Stats SA) data show inflation for the lowest expenditure deciles (deciles 1 and 2) at about 11% in March 2023, while that for expenditure deciles 9 and 10 is around 6.5%. Unlike high-income South Africans, low-income earners and the poor more generally cannot protect their incomes from erosion due to inflation, and this results in rising income inequality in our country. This is a critical reason for the SARB's constitutional mandate to protect the purchasing power of the rand, as this mandate ensures that we can continue to work towards improving and advancing the economic well-being of all South Africans.

Looking ahead, domestic headline inflation is projected to remain elevated, returning to the target range in the third quarter of this year and averaging 6.0% for the year. A more pronounced moderation in inflationary pressures is only expected in the latter years of the forecast horizon, with headline inflation projected to average 4.9% in 2024, before reaching the midpoint of the target range only in 2025.

What this means for growth

The SARB, like many other central banks elsewhere in the world, has to deal with the task of maintaining price stability. In South Africa we protect the value of the currency in the interest of balanced and sustainable growth, as stated in our constitutionally enshrined mandate. The challenging part now is that we must do this in a context where many of the drivers of both inflation and growth are outside of our control. Central banks have a very constrained policy toolkit to steer growth and can only effectively smooth business cycle fluctuations. By design, central banks are not capacitated to influence the long-run growth trajectory for the economy, as the decisions needed require governments to make policy trade-offs that entail winners and losers.[5] Good decisions, of course, generate growth, making it possible for governments to compensate losers both as the economy itself gets much larger but also through direct transfers where required.

Fighting inflation is much harder when the economy is already underperforming, as tighter financial conditions have the effect of cooling economic activity more broadly. Yet, if allowed to persist, high inflation will either fatally undermine the economy's growth potential or raise the nearer-term costs of eventually bringing inflation back to target. As we have often said, the prevailing conditions, more than ever before, have brought the monetary policy conundrum to the fore.

For instance, world growth is expected to be lower this year as the lagged impact of policy tightening weighs on real incomes and dampens demand.[6] Demand for South African exports is likely to be weaker and this could be exacerbated by a decreasing trend in commodity prices, which had previously helped mitigate what otherwise would have been a much more dire fiscal situation over the past two or

[5] Even for central banks with a dual mandate (inflation and employment), government policy dictates the full employment level (trend growth) while the central bank sets policy to keep inflation and output consistent with the given inflation target and trend growth rate.

[6] The IMF's April 2023 *World Economic Outlook* forecasts world output at 2.8% this year, down from 3.4% in 2022. It forecasts South Africa's growth at 0.1% this year (compared with 2.0% in 2022 and a projection of 1.8% for 2024).

so years.[7] Together with increased alternative energy imports, this means that our terms of trade will deteriorate further.

Following the robust growth rate of 4.9% recorded in 2021, the domestic economy slowed sharply to 2.0% in 2022. The SARB now forecasts growth of 0.2% this year, and to average 1.0% in the following two years – this is barely an expansion. In fact, this is a reflection of the headwinds that the domestic economy continues to face. The ongoing infrastructure challenges, especially for electricity, continue to impose a hard constraint on growth. The SARB estimates that load-shedding alone will reduce GDP growth by 2% this year, after knocking off 0.7 percentage from growth in the previous year.

We trust that the government will remain committed to implementing structural reform measures, especially with regard to logistics and electricity. We believe that the implementation of much-needed structural reforms will unlock South Africa's growth potential and, in turn, address the long-standing unemployment challenges of the country.

Concluding remarks

In conclusion, it is safe to say that the past few years have presented a new set of challenges for macroeconomic policymakers across the globe. Although the demand and supply mismatches we witnessed at the peak of the pandemic and when the Russia-Ukraine war broke out last year have eased significantly, imbalances continue to linger, and risks remain elevated. Despite the decelerating inflation trend over recent months, inflation remains above target in many jurisdictions, with core inflation showing signs of persistence – this is despite sharp policy tightening by monetary policy authorities across the globe.

South Africa's experience has paralleled that of the global economy, with high inflation and slowing growth. However, domestic idiosyncrasies have played an

[7] Elevated commodity prices had also supported the rand which helped to keep imported inflation at bay through the early stages of the domestic economic recovery.

outsized role in these developments over the past year, suggesting that we could have had somewhat lower inflation and stronger growth had structural policy settings been more favourable. Put differently, we are suffering from largely self-inflicted wounds.

With headline inflation having remained above the target midpoint for an extended period, the SARB's Monetary Policy Committee has had to act decisively to prevent inflation expectations from de-anchoring more permanently. Over the past 18 months, the repo rate has been raised by a cumulative 425 basis points, and now sits at 7.75%. Still, the real policy rate remains somewhat accommodative, being slightly below its estimated neutral rate of 2.5%.

As we have reiterated before, we are constantly monitoring price developments and stand ready to act as necessary to fulfil our mandate. As an independent central bank operating a flexible inflation-targeting framework, the SARB's primary goal is to guide inflation and inflation expectations closer to the midpoint of the target band. I believe that many of us here understand that low and stable inflation is a prerequisite for a conducive business environment and, in turn, for inclusive and sustainable economic growth. We remain committed to ensuring price stability.

Thank you.