SOUTH AFRICAN RESERVE BANK

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Central banking in an era of stagflation risk: a view from the MPC

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Introduction

Good afternoon and thank you for the invitation to address you today. Nowadays it feels very strange to be in front of a live audience, instead of a screen. Three years ago, when I spoke at this conference, the world was a different place. When the COVID-19 crisis started, we all said that everything was different. Two years later, everything is different again. Trying to figure out these 'new differents' *certainly feels like I'm lost in the multiverse or my daughter's version of the 'upside-down world'.*

In October 2021, Wordle took the world by storm as people tried to guess the letters that made up the 5-letter word of the day. The most popular game back in 2020 was also about letters… specifically which letter shape would describe the economic recovery.

- Would it be a V-shape, with a quick downturn and equally quick rebound?
- An L-shape, with a collapse to a persistently lower level of output?
- Or a K-shape, with a recovery for the rich and an ongoing recession for the poor?

Everyone had their favourite letter. Despite all the imagination that went into crafting these scenarios, I don't recall anyone warning of global stagflation. But nowadays, everyone is worried about that toxic mix of high inflation and weak growth. I'm not sure what letter could have denoted this outcome.

The journey since 2020

So how did we get here? And where are we going? Advanced economies went into the COVID-19 crisis on the back of a decade of subdued growth and below-target inflation.

Central bankers invested heavily in strategies to deal with the zero lower bound on interest rates to avoid getting stuck in Japan-style 'lowflation'. Worries about high inflation were often considered as dated and alarmist. This was particularly the case in the United States. New fiscal thinking also emphasised taking advantage of interest rates that were low relative to growth rates. All of this suggested that macroeconomic stability was secure and there was ample scope for aggressive policy action to manage the COVID-19 crisis.

In emerging markets, the situation looked very different.

Few of us had to worry about too low inflation. We read the new fiscal literature with interest. For emerging market countries, including South Africa, interest rates were clearly above our growth rates. But none of us were complacent about macroeconomic stability.

Many emerging markets also confronted low-trend growth rates, well below those achieved a decade before. As a result, we had started diverging from advanced-economy-living standards, after a prolonged period of convergence. These circumstances called for stability-oriented macroeconomic policies, coupled with growth-boosting structural reforms.

The South African perspective

Let's move closer to home. At first sight, the COVID shock changed everything. It was often said it would be better to do too much rather than too little. Indeed, South Africa joined in the global response with aggressive fiscal and monetary policy action.

Given strong monetary policy credibility, our policy rate cuts were particularly large relative to peer countries. Despite our large monetary response, the SARB fielded many questions about the possibility of much lower inflation, or even deflation.

We also heard various calls for more extreme SARB action, extending beyond rate cuts to policies such as Quantitative Easing. As policymakers, we agreed that there was high uncertainty, but as the SARB, we also explained that much lower inflation was unlikely. We further communicated that South Africa probably would not need unconventional tools such as QE, given both minimal deflation risk and the fact that we still had ample firepower with our regular repo rate tool, which was nowhere near the zero lower bound. While we agreed on the need for strong policy support to manage the impact of COVID-19, we saw the distinction between boldness and recklessness.

Well, were we on the right track? Inflation for 2020 ended up averaging 3.3%, vindicating the SARB's assessment about a prolonged target undershoot or even deflation. The actual outcome was close to our April 2020 emergency MPC meeting forecast, where we projected 3.4% inflation for the year. From that point, inflation largely played out as expected. Inflation also normalised at a fast pace in the next year, averaging 4.5% for 2021 as a whole, precisely in the middle of our target range.

As for growth, South Africa's recovery was slow relative to our peers', with progress repeatedly interrupted by shocks such as flooding, riots and load-shedding. That said, growth outcomes in 2021 and early 2022 generally surpassed expectations.

Revisions to our MPC growth forecasts were therefore consistently to the upside – in contrast with the pre-COVID period, where we were generally revising growth downward. For instance, at that unscheduled April 2020 MPC meeting, we envisioned growth of 2.2% in 2021, a number we eventually marked up to 4.9%. Our estimates of slack in the economy also narrowed over time, mainly because of better-than-expected growth.

In these circumstances, the view of the MPC was that we had provided about the right amount of policy support. Our assessment was also that it would be appropriate to start moving away from emergency-level interest rates during the course of 2021.

By the fourth quarter of 2021, we had a whole new different. Fortunately, unlike some of the advanced economy central banks, we had not committed to forward guidance on interest rates. Nor had we changed our framework in ways that made it more backward looking, for instance through average inflation targeting. We also did not have to worry about the sequencing of balance sheet policies, a factor which appears to have complicated timely policy adjustments elsewhere.

The path to policy normalisation

We started the normalisation cycle with a relatively modest 25 basis point increase at the November 2021 MPC. This was, incidentally, only a few days before Fed Chair Powell said he was retiring the term ‘transitory’ for inflation.

The SARB’s gradual pace of normalisation continued with interest rate increases in January and March of this year. From May, we started seeing evidence of inflation persistence. Thus, we accelerated the pace of tightening, to 50 basis points, and then stepped it up further in July, hiking by 75 basis points. Those decisions were shaped by a deteriorating inflation forecast, with a strong likelihood of a sustained target breach, starting with the unexpectedly high May print, at 6.5%, as well as the June outcome of 7.4%. The rand had also begun weakening after a period of resilience. Furthermore, inflation expectations were clearly rising, both in survey results and as implied in financial market variables.

Now that we have got rates back up from 2020’s record lows, the question we face is how quickly we need to get to positive real rates, and ultimately a more neutral stance. In turn, this depends on just how persistent higher inflation will be. Here’s how I assess the main factors. Upside risk from higher price passthroughs, higher wage settlements, currency corrections driven by interest rate differentials. But also moderating such as lower oil prices, moderating food prices and the large gap between headline and core inflation. We don’t see much demand pressure in this economy. At the same time, it seems firms can put through price increases and have

them accepted. This is consistent with a small or zero output gap – an economy that does not have a lot of slack but also isn't overheating. We appear to have moved past the phase when we were getting disinflationary pressure from spare capacity in the economy, to a space where this factor is broadly neutral.

On the labour market, South Africa's high unemployment rate is clearly not an important determinant of inflation. If it was, we would've been in deflation by now, given the massive downward pressure on wages from labour market slack. Instead, what we have seen between the first quarter of 2021 and the first quarter of 2022 is average compensation growth in the region of 5%. This is reasonable given the underlying inflation rate and productivity growth. The risk, however, is that this number could accelerate.

The structure of our labour market is such that some parts of the workforce are privileged. They are protected either by labour laws that favour insiders, or by skills shortages that confer market power. These segments of the workforce tend to demand full cost-of-living adjustments, over and above any productivity growth they achieve. This tends to drive up inflation for everyone else. We are alert to this threat.

On the exchange rate, the rand had been resilient through much of the first half of this year, despite the stronger dollar. We saw a range of advanced economy currencies depreciate, including the Japanese yen and the euro, but a group of emerging market currencies, including the South African rand, seemed to be immune to the strong dollar. However, this trend suffered a breakdown in June. We are no longer in the space where we can have low policy rates without currency weakness. There are too many other countries offering higher policy rates, and we are getting less support from export commodity prices than we did previously. Although exchange rate dynamics are always unpredictable, the SARB's baseline forecast is that we are seeing some exchange rate pressure to inflation, but timely rate increases keep this from being a major source of pressure.

Set against these considerations, the good news is that oil prices seem to be easing again, and there is also some tentative progress on the food price front. We have a large gap currently between our headline and core inflation measures – 3

percentage points, with core at 4.4% and headline at 7.4%. If headline starts to move back towards core, we won't have low inflation, but we will at least be closer to the midpoint of our target. Even taking into account these moderating factors, we would still want to get back to 'normal' interest rates, but there would be less urgency to get there fast.

On the whole, our policy stance remains accommodative. The 75 basis-point hike in July might have been the largest hike since 2002, but our starting point was very low, and the repo is still below the inflation rate. Indeed, if you apply a simple Taylor rule to the data, where the policy rate is a function of normal or neutral rates adjusted for deviations from the inflation target and full output, you will certainly get an outcome above 5.5%. This applies even when you are looking at next year's inflation, past the 12-month impact of the Ukraine war price shock.

Let me conclude, by stepping back a bit to see the bigger picture. I'd like to offer two comparisons.

The first has to do with South Africa's performance relative to other countries. It is still early days, and I don't want to signal complacency, but given the size of the global shock underway, it is fortunate that South Africa has a good chance of getting through this without particularly high inflation or high interest rates.

Our July QPM projection, which is a reasonable baseline, shows inflation peaking during the current quarter and then moving back towards our midpoint target during the rest of the forecast period. Meanwhile, the QPM's endogenous policy rate moves moderately higher, but the stance is never tight. For instance, the average repo rate is about the same as it was in the pre-COVID period, when it was between 6% and 7%; the QPM has repo averaging 6.5% next year and 6.75% in 2024. This compares well with what has happened in many other countries.

I hope you have all taken time to appreciate the fact that South Africa's inflation has been below the inflation rates of the United States, the United Kingdom and even Germany, in recent months. Perhaps more relevant, we have not seen target misses of the scale experienced by many of our peers, and unlike those countries, we have

not had to raise rates well into restrictive territory. The SARB is not happy about our target breach, but given what is happening to the world, neither our inflation rate nor our interest rates look especially onerous. It's actually a reasonable outlook, given the worst global inflation shock in a generation.

My second observation is an historical comparison. A decade ago, during the global taper tantrum, South Africa was one of the most-affected countries. For instance, we were included in the grouping known as the 'Fragile Five'. In 2020, during the onset of the COVID-19 shock, South Africa was once again identified as a vulnerable country. For example, Adam Tooze published a widely read essay in *Foreign Policy* describing the coronavirus as the 'biggest emerging market crisis ever', which included the claim that, and I quote, "At the head of the list of vulnerable countries is South Africa". This year's financial market storm has hurt a wide range of countries. The experiences of the worst hit, like Sri Lanka, have reminded us once again that macroeconomic stability is precious. It's striking, however, that of the Fragile Five from 2013, only one country, Turkey, is in danger of an acute macroeconomic dislocation today.

Yes, South Africa remains vulnerable to external shocks, and this keeps us awake at night. But South Africa's resilience during this stress episode is very welcome. We have benefitted from some good luck, mainly from higher commodity prices. In large part, the macroeconomic choices of the past few years have also reduced fragility. This reflects necessary fiscal policy decisions, especially around the public sector wage bill, as well as a prudent monetary policy.

There are many accounts being written now of what central banks got wrong, that made the ongoing inflation surge possible. Reading them, I realise that despite the criticisms – we at the SARB are sometimes attacked for not being adventurous – it is clear that when central banks do become adventurous the consequences can be even more unpopular.

Conclusion

To conclude, looking back over the past – very exciting – three years, the SARB probably did about the right amount of stimulus in 2020, and we probably started withdrawing stimulus at about the right time, in late 2021. Obviously, the war in Ukraine was an unexpected shock. But South Africa's inflation profile was not too problematic prior to that shock.

Looking ahead, and all else being equal, we have a reasonable chance of getting through this current 'different' without high interest rates. But life is never straightforward in central banking. Conditions remain highly uncertain, so we cannot be precise about where interest rates are going. Before this crisis, there was a strong preference, globally, for forward guidance, but recent events are really testing central bank communication. We've all been reminded that forecasts are flawed and that circumstances change fast. Plans that looked measured and reasonable at one point can look wholly inappropriate at another.

As the MPC, we've not made any promises about future policy rates. Our approach remains risk-based and data-dependent. Our objective is to get inflation back to target over the medium term, and we will continue to do what it takes to achieve that, adjusting our plans as we get new information.

We have been urging structural reforms for many years, but this year it feels like we may finally be nearing a tipping point. We need to lift our potential growth. Fortunately, we have the base of macroeconomic resilience and the private-sector balance sheet strength, and with the right reforms, we really could have balanced and sustainable growth again.

Thank you.