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Seeing like a central bank: the SARB, supply shocks, and the logic of higher interest rates in a world of low economic growth

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Introduction

Good evening, ladies and gentlemen.

The South African Reserve Bank (SARB) has increased the repurchase (repo) rate at each Monetary Policy Committee (MPC) meeting since November of last year; our most recent move was 75 basis points, to 5.5%. We are raising rates in the context of higher inflation, with headline inflation currently at 7.8% − well above the 6% upper bound of our target range. I hear many questions about why we are raising rates, seeing that inflation is driven primarily by supply shocks in the form of higher global food and oil prices, while demand pressures in the economy are limited. I hope to explain today how central bankers think about what tools they have at their disposal in these circumstances. In so doing, I would like to make two points.

First, we are aware of the role of supply shocks in driving inflation, and we understand that monetary policy cannot cancel out something like a sudden food price shock. The task we set ourselves on the MPC is different. Our objective is to look past the immediate supply shock, focus on the period after it has subsided, and ensure inflation stabilises at that point. I will discuss what factors we consider in pursuit of that goal.

Second, we are starting from a point of very low interest rates. During the onset of the COVID-19 pandemic, we cut the repo rate to a record low of 3.5%. This was the right thing to do at the time, but rates could not stay that low forever. Economic conditions have changed since 2020. We therefore need to think about the appropriate level of interest rates, given how inflation and growth risks have evolved, particularly in the past few months. One issue that I hope gets clarified by the end of my talk is that one cannot just look at the change in our interest rates from one MPC meeting to another, in isolation. The level of the interest rate is also important in our thinking – and more specifically, the level relative to what economists call the 'neutral rate'.

Supply shocks and demand shocks in monetary theory

Let me start with some theory about how monetary policy should respond to different sources of inflation.

It is well known, by central bankers and academics alike, that monetary policy works best when managing demand-side inflation pressures. For instance, higher interest rates can cool off an overheating economy, aligning demand for goods and services with supply. However, we rarely find ourselves in this position in South Africa. Apart from the boom of the late 2000s, and arguably the period around the 2013 taper tantrum, the inflation-targeting era has not featured many episodes of overheating. Instead, we often have to think about managing sticky inflation as we confront multiple supply-side shocks in the context of subdued economic growth or slack in the economy.

Very few countries, to my knowledge, currently face pure demand-side inflation. But there are, across the world, variations among different economies that have different implications for their monetary policy response. I would distinguish two sets of countries.

In the first category, inflationary pressures reflect both demand and supply factors. I would say that the United States (US) and the United Kingdom (UK) currently fall in this category. In other words, one source of inflation is supply chain-related shortages, aggravated by increases in oil and food prices because of the Russian war against Ukraine. But, given the scale of monetary easing and significant fiscal stimulus in response to the COVID-19 pandemic, these economies have not only recovered from the pandemic but have seen

demand-side pressures, particularly in the goods market, relative to services. Demand-side pressures mean that monetary policy can play an important role in constraining demand, in interest rate-sensitive sectors, to bring inflation back to policy targets.

In the second category, some countries are currently subject to supply-side shocks similar to those of the US and UK but with no significant demand-side pressures, other than a modest recovery from the pandemic. There is typically some evidence of higher inflation, frequently from a low base, but by and large there is still slack in the economy. This, I would argue, aptly describes a country like South Africa as well as a few other emerging markets.

In these circumstances, the textbook says you should try to look through the first-round effects of the supply shock and focus on the second-round effects. The fundamental question is whether the effects of the shock will be temporary or persistent. Central banks should ignore temporary effects, but if they ignore persistent effects, that would be a policy mistake, creating substantially more inflation than can be explained by the supply shock itself. This point cannot be emphasised enough. The goal of ensuring that inflation does not go well beyond the inevitable price rise called for by the supply shock, through second-round effects, largely explains why the MPC has to respond despite low demand pressures.

To take a simple example, imagine an economy where there is a small supply shock, such as a modest increase in world oil prices. The central bank observes inflation somewhat above target in the near term. However, other items in the inflation basket remain stable, so the price increase is confined to fuel and immediately related items such as transport. Firms, households and workers do not change their views of inflation, except for the near term. Wage settlement rates do not pick up and firms do not seem to be raising mark-ups. Financial markets do not start to price more inflation compensation into instruments such as government bonds. In these circumstances, it is an easy choice for the central bank to rely on its credibility and make no policy changes. Inflation will very likely return to target after a year without further action.

Of course, not all policy decisions are so easy. They become harder when the shocks are large and persistent, or when there are multiple overlapping shocks. It is also not always straightforward to determine, given data lags, if inflationary pressures are broadening. There are no definitive sources you can trust for early warning. At the same time, it can be dangerous to wait too long for perfect information because delays can make the problem

worse. Furthermore, it is never clear how much credibility one has until you have lost it. These situations pose some of the most challenging balancing acts for monetary policy.

What are the data telling us?

Let me now put aside the textbook and talk about our real-world decisions.

As we went into the July MPC, we were confronted with tighter global financial conditions or higher global funding costs for countries like South Africa. In addition, we faced lower global economic growth projections due to factors that included slower growth in China, the continuing war in Ukraine, necessary monetary policy tightening synchronised across the world, and the tapering of commodity prices. While growth globally has been revised downwards, inflation has been revised upwards in most countries and has turned out to be more persistent. Inflation is expected to be above targets in most advanced and emerging market economies, both this year and next year.

South Africa has not escaped these trends. At our recent MPC meeting, apart from a marginal upward revision of growth for 2022, there was a downward revision for 2023 and 2024. At the same time, domestic inflation moved higher, primarily as a result of oil and food inflation. Headline inflation is now well above our 4.5% midpoint objective, and also outside the upper limit of our full 3−6% inflation target range. Our forecast indicates that we will be back below 6% around mid-2023, and we will reach the midpoint of our target only late in 2024.

Core inflation, a measure which excludes food and energy, is just above the midpoint of our target range at 4.6%. However, it has been trending higher recently, and is expected to average well over 5% next year. This points to a broadening of inflationary pressures. Decomposing core inflation reveals a wide gap between core goods and services inflation, with the former sharply higher, largely reflecting imported inflation, while services price increases have remained relatively well contained.

The trajectory of inflation expectations also provides evidence of potential second-round effects. When we look at different measures of inflation expectations, respondents – rationally – expect higher inflation this year. Unfortunately, respondents also expect inflation to stay higher in subsequent years than they did previously. For example, between the first

and second quarter of this year, the Bureau for Economic Research (BER) survey expectations for 2023 inflation have gone from 5.0% to 5.6%, and the 2024 expectations have gone from 5.0% to 5.4%. Less than a year ago, 2023 expectations were at 4.5%.[1]

Given this evidence, it is not implausible to conclude that supply shock pressures are unlikely to go away by themselves. The difficult question, however, is just how persistent inflation will be. If expectations do not come back to our target, that means price setters will build in higher prices in their contracts. Similarly, demand for wages will go up, at least to maintain real living standards. What is critical for the MPC is to avoid this spiral, where prices go higher and higher just because everyone believes, for example, that the rand will be worth less and less in future. We need to assess how serious this spiral risk is, and then deliver a policy response strong enough to deal with this risk.

There are two variables in this analysis − wages and the exchange rate − which are especially important, and I'd like to unpack these further.

I will start with wages, or more generally, labour costs. These are important determinants of inflation as they are one of the biggest inputs to firms' costs. That said, wages and inflation need not have a one-to-one relationship. If a firm has to pay more in wages, it can do several different things. In addition to raising prices, a firm can also reduce the number of workers it employs, perhaps buying more machinery so the remaining labour force is more productive, and the firms' total wage bill is unchanged. This increases unemployment rather than inflation. A firm can also accept smaller profit margins, if it is profitable enough and if market conditions make it difficult to raise prices instead. But in difficult conditions, this jeopardises the survival of the firm.

It is not the role of the MPC to dictate what wage earners should take home. This is a complex and firm-specific process, affected by factors such as productivity gains and firm profitability. But we do need to assess how broad labour income helps determine whether supply shocks, like the ones we are experiencing today, generate more inflation in the economy.

[1] The 4.5% expectation is from the 2021Q3 survey. All these numbers represent the BER average of firms, analysts and unions.

One measure I consult closely, to help make this judgement, is unit labour costs (ULC), which is basically the total wage bill divided by gross domestic product (GDP). The growth rate of this measure shows how much nominal wages are rising for each unit of real economic output. This is a useful measure because it incorporates productivity effects and labour-shedding effects, unlike raw wage measures. The downside is that these statistics, like all labour market statistics, contain a lot of noise and are only available with a lag. These challenges are compounded by base effects from the COVID-19 shutdowns, which make the data more difficult to interpret. Nonetheless, the most recent annual numbers show that nominal ULCs came down from 2.8% in 2020 to 1.6% 2021 for the formal sector, excluding agriculture. Looking at the most recent quarterly numbers, this measure of ULC growth decreased to 3.6% for the first quarter of this year, down from 4.6% in the fourth quarter of last year. Alternative ULC measures show analogous trends. This suggests that wage pressure on inflation has been quite benign, to date, with ULC growth below the inflation rate.

However, as we said in the MPC statement, there are still risks here that keep us alert. For instance, nominal wages are forecast to rise from 5.6% in 2022 to 7.3% in 2023. Furthermore, the latest Andrew Levy survey shows an acceleration in increases for collective bargaining agreements, and also a pick-up in wage-related strike action. Therefore, while we do not observe an actual wage-price spiral underway, to date, these recent developments warrant vigilance.

Another variable of special interest for us is the exchange rate.

The two big forces driving a weaker exchange rate for South Africa at the moment are weaker terms of trade as export commodity prices moderate, and higher policy rates in major economies – essentially a higher global risk-free rate. We have had very favourable commodity prices recently, and exceptionally low global rates. This helped us set very low interest rates. But now things are changing in the world, and South Africa, as a small open economy, has also had to adjust. Part of that adjustment has been a weaker exchange rate, which is why we have seen the rand at around R17 to the dollar lately, rather than R14 or so to the dollar, where we were a year ago.

Another aspect of the problem, however, is a re-setting of global base rates. If we tried to make policy in a way that ignored higher global rates, we would see unpleasant

consequences, including through a weak rand, which would drive the costs of imported goods even higher. It would be a mistake to say we have to adopt tight policy to keep the rand strong. My point is more subtle: what counts as tight or loose policy is changing, as global rates rise. If we do not recalibrate our policy settings accordingly, we could wind up with destabilising policy, which would be bad for inflation and also bad for domestic demand. In a changing financial climate, as with other forms of climate change, adaptation is healthier than denial.

Pulling all these factors together, I hope you will appreciate that there is more to our analysis than just assessing whether current inflation is driven by demand- or supply-side factors. We do not focus on current inflation; we focus on future inflation because monetary policy operates with a lag. And while we don't see today's elevated inflation going away next year, we also don't yet see inflation running out of control. With that said, the supply shocks that are driving inflation are significant, and we are seeing increasing risks of potential second-round effects. This justifies a policy response, rather than no response.

Calibrating the policy response

Why hike in response to supply shocks, given the low growth environment?

As I have explained, our assessment of inflation is quite nuanced. In matching this nuance, we do not perceive our choices as 'hike' or 'don't hike'. When we make repo decisions, rather than just deciding to go up or down, we think more about the level of the policy rate. More specifically, we consider the level of rates relative to a normal or neutral interest rate, defined as the rate which would neither slow down nor speed up the economy. We also think about these rates not just in nominal terms, but rather adjusted for inflation. Policymaking therefore centres on choosing a setting somewhere along a broad spectrum of real rates, with options ranging from very loose to very tight, and a wide range of choices between these extremes. This is the standard modern framework for monetary policy, as distilled, for instance, by scholars like Michael Woodford.[2]

As with the inflation analysis, using this framework is not simple and easy. We must estimate where neutral rates are, and there is no single best practice for adjusting the nominal rate for inflation. However, with a repo rate of 5.5% currently, and an inflation rate starting just

[2] The classic reference is Michael Woodford, *Interest and prices,* Princeton University Press: Princeton & Oxford, 2003.

over 7% and declining to just under 6% next year, we still clearly have a negative real policy rate. This rate was significantly more negative before the rate hike in July.

Meanwhile, our estimated real neutral rate is in the region of 2%, so actual rates are still well below neutral. They would also be below neutral even with different, lower estimates of neutral. This means the policy stance is still supportive of growth.

I've realised that most people do not use this model, so a 75 basis point hike reads as tight policy. But this is not a good description of actual policy. The fact that we have a gap between the standard practice of monetary economists and everyone else suggests we have a lot of work to do to improve our monetary policy communication.

Conclusion

To conclude, let me summarise the messages the MPC would like people to hear about monetary policy. We are not slamming the brakes on this economy, but we are easing off the accelerator, moving towards a more balanced or neutral interest rate setting.

We do not want to slow the economy down too much, and we are cognisant of the many challenges facing domestic producers and consumers. At the same time, we also do not want to join the large group of countries in the world today which took low inflation for granted, kept policy too loose for too long and ended up way above their targets, to the great unhappiness of almost all citizens. It is a delicate balancing act, and as an independent central bank operating an inflation-targeting framework, we aim to deliver moderate interest rates and low and stable inflation over time in our policymaking decisions.

Thank you.