An address by Lesetja Kganyago,
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How the new global environment is influencing the state of South Africa's economy

Introduction

Ladies and gentlemen, it is my pleasure to address you today at this event hosted by the Southern African Lebanese Chamber of Commerce. I commend the efforts of the Chamber to deepen economic ties between Lebanon and Southern Africa, especially the long-established and thriving Lebanese community in South Africa. Last year, trade between South Africa and Lebanon amounted to over R170 million. As we look into the future, I believe there is room to strengthen ties even more.

The topic chosen for my address – how the global environment is influencing the state of South Africa's economy – could not be more topical. Since the spread of the COVID-19 pandemic across the globe three years ago, the world economy has faced numerous shocks, which have compounded the domestic challenges faced by South Africa and complicated the task of central bankers, both here and in the rest of the world.

COVID-19 and other macroeconomic shocks

The major disruptions since the onset of the pandemic in early 2020 challenged the belief of many that the world had entered a long phase of low and stable inflation. We

now know that the ‘closing and reopening’ of economies due to the pandemic would not occur without major supply and demand mismatches in most markets. Supply chains, stretched by the staggered reopening of economies, only proved as resilient as their weakest link, resulting in major delivery lags and higher costs in key industries. Labour supply did not adjust automatically when firms began to hire again, resulting in tight labour markets and, in some jurisdictions such as the United States or the United Kingdom, an unusually high level of unfilled vacancies relative to unemployment.

There was no precedent in recent history that we could learn from relating to the policy responses required to manage the pandemic shock. Even after economies had re-opened, fears of long-term scarring, including bankruptcies and permanent job losses, prompted coordinated responses from governments and central banks to uphold highly stimulative policies. In retrospect, we now know that such stimulus provided excess support to demand at a time when supply was struggling to adjust, which compounded inflation.

The war in Ukraine, which exacerbated the shock to prices of oil, gas and some inputs into food production, such as fertilisers, added to the global inflation problem. Even a country like South Africa, where supply constraints did not originate, faced price pressures from more expensive imports, shortages of key inputs, elevated shipping costs and the depreciation of the rand as financial markets repriced the outlook for global interest rates. Worldwide inflation pressures have forced broad-based and, in many cases, unusually fast monetary policy normalisation.

Where do we stand now?

Thankfully, some of the shocks that caused the global inflation surge have begun to abate, albeit at a slow pace. Energy and agricultural commodity prices have fallen. Shipping costs have largely normalised; other input prices have slowed significantly too. Yet, in many countries, inflation remains far above target and is showing signs of persistence in several sectors. This is particularly the case in non-housing services, where prices are highly dependent on wage growth, but also in some consumer goods.

In South Africa, headline inflation also remains above the upper end of the target band, though it has been gradually moderating since the latter part of 2022 – primarily driven

by a decline in fuel prices from the peaks observed mid-2022. However, we are not completely out of the woods yet. Domestic fuel prices have been rising, albeit moderately, and there is a risk that we could see further increases in the coming months, largely as a result of exchange rate volatility. This shows that the domestic inflation outlook is still susceptible to global factors, exacerbated by domestic conditions, of course.

In South Africa, food price inflation has yet to peak, despite the decelerating trend observed in global agricultural commodities. Domestic meat prices are still accelerating, reflective of lingering supply constraints in the beef market following last year's outbreak of foot and mouth disease. While these constraints are expected to gradually unwind over the near term, persisting electricity supply issues – and the need for costly energy alternatives – will keep raising input costs for food producers in industries such as poultry and dairy farming. These may be passed through to consumers.

Although core inflation has come in lower than our expectations over the past two months, we still caution that it remains above the midpoint of the South African Reserve Bank's (SARB) target of 3–6%. In fact, our baseline view is that core inflation – particularly core goods – is likely to remain sticky over the next few months, before starting to ease over the medium term. For now though, prices of exchange rate-sensitive goods continue to accelerate. In the services sector, while some components have surprised on the downside over recent months, we may start to see the margins in some of these sectors, such as insurance and housing, also starting to pick up pace and, as such, exert upside pressure on overall inflation.

As we have communicated before, the SARB will continue to monitor price developments and act to guide inflation back to the midpoint of the target band over the medium term. Elsewhere in the world, major central banks have repeatedly indicated that they have not yet completed their policy normalisation. They may need to keep policy in restrictive territory for an extended period until clear signs emerge that inflation is returning sustainably to target.

Implications for growth

The number and pace of rate hikes needed to fight global inflation suggests we are likely to see weaker world growth in 2023, even ashousehold cash buffers and corporate profitability have limited the downside risk, so far. The International Monetary Fund (IMF) forecasts global growth of 2.9% this year, after growth of 3.4% in 2022, and this means weaker demand for the exports of small, open economies such as South Africa.

Implications for the domestic economy are twofold: first, directly through weaker growth, and second, through a possible deterioration in our external accounts. Amid weaker exports volumes, combined with South Africa's persistent and more intensive load-shedding as well as a deterioration of its ports and railway infrastructure, the SARB's gross domestic product (GDP) growth forecast for this year currently sits at 0.3%. Stats SA published the Q4 GDP report this morning and the outcome was much weaker than what we thought it would be. It seems like the adverse impact of these factors has already started materialising, placing further downside risk to our current forecast. 2022Q4 GDP came in at -1.3%, bringing growth for the year 2022 to 2.0% – below our estimate of 2.5% at the January MPC meeting. A deep dive into these numbers shows that the decline was broad-based over the quarter, with 7 out of the 10 sectors detracting from GDP growth.

From the expenditure side, we note the pressures faced by households, where elevated inflation has necessitated higher interest rates. While the domestic labour market also continues to recover gradually, an environment of weak growth implies that we may start seeing renewed job losses. Furthermore, while nominal wages have shown a recovery, real incomes, however, remain constrained. Nonetheless, we do expect household spending to remain supportive of the little growth that is projected for the year. This view is also corroborated by today's GDP report, which continued to show positive growth in household consumption. Furthermore, although having moderated over recent quarters, growth in fixed investment showed some recovery in Q4 and is also expected to contribute positively going into 2023.

From this it is clear that the outlook for even the relatively low growth rates we project over the medium term, remains highly uncertain – in light of our own domestic constraints. The outlook also hinges on how quickly South Africa's structural constraints can be addressed over the medium term.

From an external accounts' perspective, South Africa has benefitted from the generally high commodity prices that have prevailed over the past two years. These, however, have been moderating since the second half of 2022, in line with the slowdown in global growth, with further declines in South Africa's commodity export prices expected in 2023. While the reopening of the Chinese economy led to renewed strength for key commodities such as iron ore, platinum, copper and steel at the beginning of the year, this may not be sustained. The recovery in China's economy should mostly be led by services, while the commodity-intensive construction sector is unlikely to rebound at a fast pace.

At the same time, the persistence of domestic electricity supply constraints implies that more businesses and households may be investing in alternative energy solutions, thereby driving up imports. This, balanced against projections of lower export volumes, equates to a deteriorated current account balance over the short to medium term.

The role of the financial channel

Financial markets are another channel through which global conditions affect South Africa. Global growth, inflation and the pace of policy normalisation in advanced economies affect investor risk appetite, cross-border capital flows and, hence, the availability and cost of external funding. So far, considering the pace of policy normalisation in major economies and the extent to which 'safe assets' have re-priced, the shock has not been strong by historical standards. Capital outflows from emerging markets were moderate for most of 2022 and recovered in the fourth quarter as global conditions improved. Throughout 2022, the rand weakened by a mere 6.5% against the US dollar, initially helped by supportive terms of trade and South Africa's current account surplus.

But 2023 may still hold challenges on the financial front. If, as developments in February suggest, investors become more worried about global rates having to stay

higher for longer, they may again shun riskier assets, and that includes South African bonds and equities. A similar outcome may occur if the consequence of policy normalisation is a deeper economic contraction than what markets currently discount. In both cases, South Africa may face renewed capital outflows, and the deterioration in the current account over the past year means this could trigger new volatility in our asset prices.

Furthermore, if global investors become more selective in their choice of assets, South Africa may suffer from its own idiosyncratic issues and various fiscal risks such as rising public sector wage costs and an increasing need for fiscal support for some of our state-owned companies. Following the outbreak of COVID-19, unprecedented fiscal support in many economies has once again put sovereign debt sustainability at the forefront of investors' concerns. Many emerging countries face a mix of elevated public debt from the pandemic as well as low growth. This, combined with the higher borrowing costs that currently prevail, means that attracting foreign capital can become more challenging.

Concluding remarks

It has been quite a journey since the outbreak of the pandemic. Lockdowns were instituted almost universally to stem the spread of the virus, while fiscal and monetary authorities around the world implemented unprecedented policy support for their economies. And as we navigated through those risk shocks and their inflationary impacts, the start of the war in Ukraine in early 2022 presented a new set of challenges for economic policy around the globe.

The impacts of both these shocks continue to linger and present a conundrum, for monetary policy especially. The global economy appears to be experiencing stagflationary conditions – with high inflation and low growth. These conditions create some tension between anti-inflation policies and pro-growth policies. That notwithstanding, global central banks have communicated their resolve to bring inflation back to target, as low and stable inflation is a prerequisite for high and sustainable growth.

Similarly, in South Africa, we are also faced with high inflation and weak growth, and face similar policy challenges. However, weak growth in our domestic context is aggravated by structural constraints such as inadequate electricity supply, making this an even more challenging task. The encouraging news is that we have started to see a disinflationary trend. Inflation remains quite elevated, and like our peers around the world, as the SARB, we remain committed to seeing inflation sustainably returning to target.

Thank you.