



SOUTH AFRICAN RESERVE BANK

Globalised stagflation and the emerging market response

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Introduction

Ladies and gentlemen, it is a great pleasure to be invited back to the Peterson Institute.

While advanced economies dominate the newsprint, I want to speak today about how the global inflation problem impacts emerging economies, and South Africa specifically.

A broad spectrum of emerging economies are experiencing inflation rates that are persistent and well above target. And yet, five years ago, many emerging and developing countries seemed on a steady path towards lower, and more stable inflation. Are emerging economies able to get back onto that path, given the challenges presented by the current global environment?

The short answer to this must be 'yes', but we need to recognise that doing so will not be easy. Certainly, the headwinds to constructive policymaking have increased and global conditions are far from benign. The surge in global inflation and the many accompanying structural changes risk pushing emerging economies away from better policies.

I believe there are some grounds for optimism, despite the headwinds. In particular, we can build on the experience we have gained in emerging market central banking and monetary policy in addressing stagflation. A key lesson from our collective

experience has to do with how central banks can use transparency to improve the effectiveness of monetary policy. For advanced economies, arguably, the stagflation challenge demands better communications and clarity of policy. For emerging economies, many of which moved faster to tighten policy, central bank transparency can play a role in setting the tone for public policy more broadly, helping to ease or resolve our particular non-monetary constraints to better inflation outcomes.

The South African approach has been to speak clearly to the monetary policy challenges we face and to highlight the constraints to better results, even if these lie outside the immediate span of monetary policy. This has not won us many friends, but it has helped to foster a better public discussion about the challenges holding back our economy.

I want to spend some time today discussing the shift in global inflation from one paradigm to another, and then discuss how these challenges impact policymaking in emerging economies, with particular reference of course to South Africa.

Genesis of a global inflation shock

In late 2019, before the COVID-19 pandemic, inflation was expected to remain low, or even fall further. In October 2019, the International Monetary Fund (IMF) forecast inflation of 2.0% for advanced economies and 4.3% for emerging and developing economies. For the latter countries, this was more than 2 percentage points below the average of the previous decade. The COVID-19 shock reinforced expectations of more disinflation, and short-term inflation projections duly fell, alongside market-based measures of inflation expectations.

Within two years, advanced economies experienced their highest inflation rates in decades, and very few emerging countries (with the notable exception of China) were left unscathed. Inflation has become both more persistent and broader-based, whether you look at the common component of individual price patterns or at diffusion indices.¹ So, what happened?

¹ “Drivers of Post-pandemic Inflation in Selected Advanced Economies and Implications for the Outlook”, FedsNotes, Board of Governors of the Federal Reserve System, January 13, 2023

With hindsight, we know that the world-wide lockdowns and staggered reopenings that followed generated multiple supply-demand mismatches. Complex supply chains only proved as resilient as their weakest link, resulting in bottlenecks and rising delivery lags. Disruptions to global trade were global and dramatic.² Restrictions on activity persisted and demand rotated towards consumer goods, a surprise that quickly depleted industrial and retail inventories. The reopening was long and drawn out. Firms struggled to re-hire employees laid off months earlier and labour force participation plummeted, eventually causing widespread labour shortages.

Given this turmoil in the global economy, the Russian invasion of Ukraine was sure to roil markets and supply chains further, as unhelpful and tragic as it was incomprehensible.

Not all these developments were outside the purview of policymakers. As the consensus saw risks skewed towards disinflation at the start of the pandemic, so policymakers responded forcefully to the shock. Policy rates were slashed, often to zero.³ Central banks, including in some emerging countries, purchased fixed-income securities. Governments boosted cash transfers to households and firms.

Policymakers also drew lessons from the period following the Global Financial Crisis (GFC) and kept stimuli in place, well after economies had reopened.⁴ The impact on demand was massive and with supply still constrained, it compounded the growing inflation problem. With hindsight, this was a policy error.⁵

These policy responses also exacerbated the demand-supply imbalances in labour markets, adding another channel for inflation pressures. Ample cash transfers allowed

² “Growing challenge of empty container returns adds to US supply chain disruption”, Journal of Commerce, August 18, 2022

³ By March 2020, the US Fed Funds rate had been lowered to a range of 0–0.25% (a cumulative 150 basis points reduction since the start of that year). The Bank of England similarly lowered its policy rate by 65 basis points to 0.1% over the same period. Meanwhile, the European Central Bank and Bank of Japan maintained their policy rates at their long-standing levels of 0% and -10% respectively. Interest rate adjustments were also accompanied by large asset purchases.

⁴ Economies implemented additional supplementary relief measures throughout 2021: The EU adopted a EUR672.5 bn Recovery and Resilience Facility (RRF) in February 2021; and the US, a USD 1.9 tr COVID relief bill in March 2021. Japan approved a USD490 bn stimulus package in November 2021.

⁵ The GFC did not constrain supply in the same way as the pandemic, or for so long, so production could efficiently respond to sustained demand where it was offered.

many workers to 'pick and choose' from offers, while hybrid work changed the geographical distribution of labour supply. At a time when shifting spending patterns altered the demand for labour, mismatches grew, putting upward pressure on wages.

Perhaps the biggest single problem had to do with how all this stimulus was positioned as a 'new' policy that would be kept in place for an extended time. I would characterise this as an adverse, unintended consequence of policy commitment and credibility. Providing more certainty to markets than was possible, we central bankers positioned shifts in stance too often and fully as policy change, at the wrong time. When we overdraw these changes, our ability to change direction is compromised. When the data further puts our commitment into question, we get sharply higher uncertainty and volatility.

Imbalances persist

As we stand now, some of the supply/demand mismatches I just described have abated. Natural gas prices are back near pre-war levels. Global prices of food commodities have declined and shipping costs normalised. Supply bottlenecks have eased, and delivery lags are again in line with historical norms.

Yet not all imbalances have been resolved. Three years since the pandemic started, labour markets remain tight, with unusually high levels of vacancies relative to (low) unemployment levels.⁶ Furthermore, while year-on-year rates of inflation have peaked in most economies, the latest readings in major countries have shown stronger short-term momentum in consumer prices. Services prices and core goods prices are either sticky or have re-accelerated, and with wages continuing to rise, the inflation environment is much more complex today.

This places existing forecasting and macroeconomic models at serious risk of underperforming. Outdated data in advanced economies is one challenge. Another is simply the sharp rise in uncertainty and how it impacts on important model variables, like inflation expectations. As Lord Mervyn King observed, given the uncertainty, the

⁶ This suggests persistent shifts in the supply of labour, with many workers either 'opting out' of employment, or taking early retirement, or waiting for better pay or working conditions – all factors putting upward pressure on wage inflation.

model assumption that inflation expectations remain anchored to target is too strong.⁷ To complicate matters, our ability to derive useful conclusions from short-term data also requires humility. Short-term elasticities can be assumed to be in flux, but in what way? Is, for example, the pass-through of energy costs to final consumer prices stronger, faster, or more or less symmetric today than yesterday?⁸ Will falling energy prices have a measurable effect on wages that are rising for structural reasons?

Our models tell us that declining real incomes significantly counters a surge in inflation. But the labour market behaviour causing that outcome has very likely changed. Economic policies and structural factors suggest stronger responses of nominal wages to inflation. Are the implied changes to our Phillips curves permanent or do we need to adjust to non-linearities and more microeconomic ways of analysing labour supply?⁹

Companies' profit margins have also increased, suggesting greater capacity of firms to pass through costs to consumers.¹⁰ Various explanations for this have been posited, some less influenced by economics. Before we can get to firm conclusions about this, it seems useful to sort through the interactions between the many short-term demand and supply forces, simultaneously affected by lockdowns, supply constraints and technological change.¹¹

It may also be the case that a switch has been flipped – the price-formation process has become dynamically less benign, as the Bank for International Settlements last year pointed out in its paper on regime shifts. Rather than understanding consumer prices as a fading reflection of relative price shocks, they may co-move in self-

⁷ See for example “Central banks have ‘King Canute’ theory of inflation, says former Governor”, The Guardian, 23 November 2021.

⁸ See “Monetary policy after the energy shock”, Fabio Panetta, Member of the Executive Board of the ECB, 16 February 2023, and Bloomberg Interview with Isabel Schnabel, Member of the Executive Board of the ECB, 15 February 2023.

⁹ Recent experience of large positive employment gaps (negative unemployment gaps) raising inflation significantly provides strong evidence for a non-linear Phillips curve. Central banks should therefore consider incorporating downward wage and price rigidity and non-linear Phillips curves into their macroeconomic models. See “25 Years of Excess Unemployment in Advanced Economies: Lessons for Monetary Policy”, Joseph E. Gagnon and Madi Sarsenbayev, Peterson Institute for International Economics, Working Paper 22-17, October 2022

¹⁰ See Schnabel, 2023 (op. cit.)

¹¹ To give one example from South Africa, core goods prices are sharply higher on the back of imported automobile prices. Is this a permanent shift in pricing power on the part of manufacturers?

reinforcing ways – less a wave in a pond and more a tsunami building up as it gathers energy.¹²

I am also not sure that we can simply say that labour market cost pressures are primarily a result of labour force participation rates that fell with the pandemic and will now rise again, easing wages. A case could be made that the drawing in of elderly workers in the pre-pandemic period reflected high demand and a shift away from a preference for leisure because, for various reasons, returns to work had risen and returns to savings had fallen, alongside other kinds of factors.¹³

As I turn to central bank policy more directly, our inflation dynamics discussion also suggests that we may need to unlearn some lessons about cyclical policy from the GFC period. Rising debt with inflation and interest rates weakens the utility of fiscal and monetary expansion to address any source of slowing growth. This idea of policy inefficiency is a mainstay of emerging market policy thinking, but less commonly articulated in advanced economies.¹⁴

This is not to say that central banks could have or should have stepped back from action in the pandemic, but it does prompt consideration of challenges to central bank policy in the wake of the pandemic.

Inefficiencies in policy transmission and new trade-offs

As inflation increased, central banks withdrew the stimulative policies put in place during the pandemic. However, it is less clear that we are now in unambiguously tight policy territory. Real rate levels are barely positive and still negative in much of the world, and easing inflation acts as less of a drag on economic activity.

When we turn to nominal rates, we see they are acting on credit demand, in particular in important markets like housing. But their effects are less obvious in other areas, in part because of structural developments and more persistent relative price shocks stemming from climate change, technology and now geopolitics. Policy clarity is further

¹² “Inflation: A look under the Hood”, Bank for International Settlements, Annual Economic Report, 25 June 2022

¹³ Such as early retirement ages and preferences for work to provide meaning and belonging.

¹⁴ “When is debt odious? A theory of repression and growth traps”, Viral Acharya, Raghuram Rajan and Jack Shim, NBER Working Paper Series, May 2020

undermined by the high degree of forecast uncertainty and the role of the unobservables. With so many structural changes occurring, potential GDP and neutral real interest rates are moving around.

Such shocks will tend to muddy our sense of policy effectiveness and how we react in this environment. The possibility of over-tightening is clearly real, but central banks can also rectify their stance more quickly than in the event where they ‘under-tighten’.

At this point in my story, it becomes hard to dodge the problems associated with financial institutions and financial stability more broadly. While most central banks will move quickly to cordon off financial stability concerns from monetary policy where a trade-off emerges, the neatness of this will always be suspect. There will always be a more or less constant second-guessing of the monetary stance where tightening needs to happen, leading to market volatility.

More fundamentally, does the existence of such a trade-off undermine price stability? If our financial regulatory requirements imply savers’ deposits and investments at banks are at risk from market repricing, then do central banks have to permanently socialise losses just to keep the financial sector turning over? And with what long-term implications with respect to central bank finance, relationships with national treasuries and ultimately independence?

South Africa in the emerging market universe

Let me now turn to the situation of emerging countries. In a globalised world with long value chains, factors such as energy prices and shipping costs, shortages of semi-conductors or storage capacity will affect a broad set of prices in many countries. Integration in global food markets impacts local food prices. Common global factors, such as food and energy, also increasingly determine services prices.¹⁵ As the dollar has strengthened, the inflationary impact of currency depreciation has resurfaced, a result of the reduced appetite for risk and the relative attractiveness of EM assets.¹⁶

¹⁵ Using principal component analysis, economists at UBS research recently identified that the share of price variance across countries explained by a global factor was at its strongest since 2007, not just for core goods (ex food and energy) but also for services. See “Global inflation is turning in all major subsectors”, Global Economic Perspectives, UBS, 17 February 2023

¹⁶ “Dollar invoicing and the heterogeneity of exchange rate pass-through”, Emine Boz, Gita Gopinath and Mikkel Plagborg-Møller, American Economic Association, May 2019

As global price pressures rose, inflation expectations also increased, reflecting our local propensity to stagflation.

However, not every EM central bank faced the same price pressures, nor needed to respond in the same fashion. If we compare the response of monetary policy in South Africa to that of its emerging market peers, we see that it falls “somewhere in the middle”. Our repurchase (repo) rate currently stands at 7.75%, representing a cumulative increase of 425 basis points since we began raising rates in November 2021, compared to the policy easing of 300 basis points in 2020 in response to the pandemic.

Our inflation rate is 7.0% at present, or 5.2% when excluding food, petrol and energy. While both rates are still above the midpoint of our 3–6% target range, headline inflation is off its highs of a few months ago and compares favourably to our emerging market peers.

Several factors probably explain why South Africa did not experience the same acceleration in prices as many other countries.

First, budgetary stimulus in 2020 was relatively guarded, and successive budgets have strived for a primary surplus.

Second, South Africa’s inflation target credibility helped to dampen the initial waves of global inflation, keeping inflation expectations muted for some time.¹⁷

Third, the depth of our domestic capital markets has limited exposure to swings in hard currency interest rates, while South Africa’s net international investment position has remained positive in rand terms, suggesting little needed change in what is a beneficial level of international financial integration. Alongside a current account surplus from a robust terms of trade, relatively low levels of external and foreign currency-denominated debt, the currency played its role as an ‘automatic stabiliser’ without triggering financial concerns.

¹⁷ Over the ten-year period running up to May 2022, when inflation breached the upper end of the target, 83% of the time monthly inflation was within the target band.

Implications for policy going forward

With negative real policy rates and the accompanying commodity price boom, a large part of our recovery was demand driven. The terms of trade, fiscal expansion and the lower borrowing costs were, nonetheless, offset in part by higher household and corporate saving.¹⁸ Alongside very low potential growth, a function of energy constraints primarily, the output gap has been much smaller than expected and measured to be zero in recent quarters.

The weak growth performance entails further risks in a world where globalisation is retreating, with real yields propped up by high borrowing demands and insufficient efforts to get growth moving. South Africa and other emerging economies need to work harder to attract capital.

This is even more true in a world in which neutral real rates in advanced economies shift higher, a prospect that looks increasingly likely. In such conditions, emerging economies run a serious risk of becoming permanently more prone to currency depreciation and higher inflation. On its own, this prospect pulls up our neutral rates, and can only be combatted with more orthodox policy measures.

Clearly, in South Africa, structural reforms and key deregulations of transport and electricity are critical. But so too is a shift in fiscal policy back to predictable, transparent rules. With the rise in debt created by our efforts to confront weakening growth and failures of state enterprises, there is little chance of improving credit quality without new rules and more strategic use of macroeconomic policy. A major benefit to fiscal policy and to stronger growth would be the implementation of a revised inflation target in South Africa. A lower target, sitting at 3%, would help dampen exchange rate volatility and sovereign risk, reduce the potential for upward drift in the real exchange rate, and materially lower debt service costs, primarily for the now over-indebted public sector.¹⁹

¹⁸ Offsetting effects occurred in respect to volumes of exports and imports, even as price effects were strongly positive.

¹⁹ "Monetary Policy in South Africa: 2007–21", Patrick Honohan and Athanasios Orphanides, World Institute for Development Economic Research (UNU-WIDER), Working Paper 2022–29

Concluding remarks

In conclusion, we look forward to further easing in global inflation and falling inflation expectations, in particular in emerging economies where they have ratcheted higher over the past year.

Compared to the high inflation era of the 1970s, central bankers are probably better equipped to deal with the problem. We have a better understanding of the role of expectations in shaping price patterns, and of the relative importance of supply versus demand factors as well as better statistical tools to measure them. The inflation targeting framework now used by most central banks has provided a more solid anchor than the more 'ad hoc' approaches of those earlier high-inflation decades.

However, complacency is a subtle enemy in this particular policy effort. It is true that central bankers are better able to address inflation should it stay high, but doing so effectively requires much greater fiscal complementarity and for good communications to play a critical role in keeping expectations in check. From the side of central banks, the policy challenge in communications should be achievable, even though credibility in the markets has deteriorated. I am less sanguine about policy coordination, particularly with fiscal authorities, when demands on the public purse are so high and some long-term costs, such as from financial bailouts, remain hidden from view. Should coordination take place, the institutional setup should be such that the remit of each of the authorities is clearly spelt out and accountability maintained.

Perhaps the weakest link in our analytical and policy frameworks remains our ability to identify, measure and adjust to structural changes, such as climate change, demographics and labour markets, technology and trade. These drive relative price adjustments and create persistence in inflation but defy easy analysis. Central banks globally need to have more respect for these determinants of inflation, and advanced economies should consider taking greater comfort from minor recessions, instead of prolonged periods of weak growth that bedevil larger emerging economies like mine.

Together, cyclical and ongoing structural forces will present a rich and varied set of topics for central banks to focus on in coming years. Let's ensure we remain up for the challenge.

Thank you.