SOUTH AFRICAN RESERVE BANK

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Dealing with the high cost of living: South Africa's experience

Introduction

Ladies and gentlemen, it gives me great pleasure to be here in Limpopo and to address you today. This province is home to the baobab tree – a symbol of growth amid adversity, which bears a stark resemblance to the domestic economy's resilience, despite its challenges. The province's contribution to commodity exports has also helped South Africa withstand the headwinds to growth in recent years.

Over the past three years, the global economy has endured multiple large and overlapping adverse supply shocks. This was at a time when the COVID-19-induced expansionary fiscal and monetary policies were firmly in place. This confluence of factors pushed global inflation to multi-decade highs, eroding real incomes and forcing consumers to make some difficult choices.

Today, I want to talk about how the high cost of living has impacted households globally and relate it more specifically to how the typical South African consumer has fared. In doing so, I will discuss how the resilience of global demand has perpetuated high inflation; how global inflation has propagated into the domestic economy; and how we, as the South African Reserve Bank (SARB), have responded to this inflation scourge.

Global backdrop

To provide context, I will begin by providing the global backdrop.

Global inflation averaged 8.7% in 2022 – its highest level in four decades. The genesis of this inflation was a confluence of factors, including supply chain pressures occasioned by the COVID-19-induced lockdowns and higher international food and energy prices brought about by Russia's war in Ukraine. Expansionary fiscal and monetary policies meant to cushion economies from the ravages of the COVID-19 pandemic inadvertently became accelerants to inflation as demand recovered faster amid constrained supply.

Early in the recovery, consumption shifted to the less contact-intensive goods as mobility restrictions held back services consumption across the world. Goods consumption benefitted from pent-up demand due to lockdowns as well as from the savings accumulated during the pandemic. Unfortunately, constrained supply chains could not cope with the sudden pick-up in demand, and shortages of goods became the order of the day, which resulted in soaring goods prices globally. You may recall the shortage of microchips in 2021 which impacted the production of vehicles in our own economy.

Initially, inflation was thought to be transitory, but it soon became clear it was anything but transitory. The sharply higher and more persistent inflation prompted global central banks to begin normalising policy rates, with institutions such as the United States (US) Federal Reserve at times hiking rates in successive steps of 75 basis points. With a synchronised global hiking cycle, and monetary policy moving to restrictive territory, expectations were for global growth to slow sharply in 2023, weighed down by high interest rates. In fact, many forecasters assessed a high likelihood of a recession in the major advanced economies this year. Ordinarily, sharply rising interest rates squeeze household and corporate incomes and thus reduce demand and investment, and hence quickly extinguish inflationary pressures. This is what many commentators, policymakers and analysts had expected early in the hiking cycle.

Global growth, however, has proved resilient. Growth prospects have continued to improve, leading to an overall upgrade in the 2023 growth forecasts. The global economy is now forecast to expand by 3.0% this year, from 2.8% projected in April

2023.[1] China's strong rebound at the start of the year, following the country's reversal of its zero-COVID policy, together with the easing global supply chain disruptions, provided a boost to global economic momentum. Demand, which had earlier shifted to the less contact-intensive goods consumption at the height of the pandemic, has rebalanced by rotating back to services as the COVID-19 pandemic has faded. Consequently, services-intensive economies, such as the US, have shown strong growth so far in 2023.

One unexpected challenge brought about by the resilience in household spending is inflation persistence. The pass-through of high energy costs into broader prices in the economy – the so-called second-round effects – have also added to inflation persistence, particularly across Europe.[2] Although global inflation peaked last year, its pace of decline has been much slower than expected, especially given the rapid pace of monetary policy normalisation by the major global central banks. Global headline inflation has fallen from a peak of 9.4% in the third quarter of 2022 to 5.7% in the second quarter of 2023.

Much of the decline in headline inflation has been due to lower international food and oil prices, which have fallen considerably as the uncertainty occasioned by Russia's war in Ukraine has abated, as well as the normalisation of supply chain pressures. Headline inflation is projected to average 6.8% in 2023 from 8.7% in 2022. Measures of underlying inflation have, however, remained persistently high in major advanced economies, with core inflation[3] declining more slowly. The rotation of demand from goods back to services that I alluded to earlier has also seen goods inflation slow markedly, while pushing services inflation higher, meaning that the stickiness in core inflation is largely a services inflation story.[4]

Several factors, including still elevated excess savings and unusually tight labour markets, especially in advanced economies, have also continued to support consumer demand and have possibly delayed the impact of rate hikes on aggregate demand.

[1] International Monetary Fund, *World Economic Outlook*, July 2023.
[2] Consumers and businesses across major advanced economies have been grappling with rising costs, which saw headline inflation measures rising to historic highs last year. See World Bank, *World Economic Prospects,* July 2023.
[3] Core inflation strips out the volatile components (food and energy) from headline inflation.
[4] Among the services components, rental inflation in major advanced economies has perhaps contributed the most to the stickiness in core inflation. (Fortunately, we do not seem to have that problem here in South Africa, at least not for now.)

Complicating the disinflation efforts is that labour markets in advanced economies have remained unusually tight, which is likely to strengthen workers' bargaining power and drive real wage growth above productivity gains.[5]

Although longer-term inflation expectations have remained anchored, headline inflation is expected to remain above the 2.0% target beyond 2024 in most advanced economies. Inflation also remains elevated in most emerging market economies, including here at home, and is expected to decline only gradually towards central banks' targets by 2025.

Despite the recent moderation in headline inflation, risks to global inflation are assessed to be on the upside. Geopolitical tensions show no signs of abating, which will likely keep global food and energy markets tight, while the probability of El Niño weather conditions this year has risen sharply. Monetary policy is likely to remain focused on ensuring that inflation continues to retreat, implying that global policy rates could remain higher for longer.

Now, let me turn my attention to developments in the domestic economy.

How has the domestic economy fared?

Like the rest of the world, South Africa has been grappling with persistently high inflation. South Africa has experienced a sustained inflation target breach, with headline inflation having remained above the midpoint of the target range for 27 consecutive months since May 2021. High inflation erodes the purchasing power of the rand and thus makes South Africans poorer. Over the past 18 months, South Africans, alongside their global counterparts, have endured a rise in the cost of living. This came at a time when South Africans had become accustomed to low and stable inflation.

After hovering in the upper half of the target range for a year, South Africa's inflation breached the upper limit of the SARB's 3–6% inflation target range in May 2022, and reaching a high of 7.8% in July 2022 before beginning its retreat. The trajectory of domestic headline inflation has been shaped primarily by fuel, food and electricity

[5] This presents risks of wage-price spirals, particularly given demand resilience.

prices. The first two have largely reflected global developments, beginning with the sharp rebound in the demand for goods amid supply bottlenecks, and later exacerbated by the Russia–Ukraine war, which further strained global energy and food markets.

Sharply rising food and fuel prices raise fundamental concerns from a distributional standpoint. To provide some perspective, fuel inflation in South Africa soared to 56.2% in July 2022, and pushed pump prices well above R25 per litre, with immediate knock-on effects on transport and production costs for goods and services.[6] Meanwhile, high electricity tariffs have further raised the cost of living for many South Africans.

Food and transport inflation impact the poor the most, as their consumption baskets are weighted heavily by these items. Recent inflation data by Statistics South Africa shows inflation for the lowest income deciles (deciles 1 and 2) averaging 9.0% in July 2023, while that for income deciles 9 and 10 averaged at 4.3%.[7] Low-income earners and the poor more generally are less able to protect their incomes from being eroded by inflation, and this contributes to rising inequality in our society. The authors of our Constitution understood the need to protect those who cannot protect themselves. The Constitution tasks the SARB with protecting the purchasing power of the rand, and we are committed to executing on this mandate.

In light of the deteriorating domestic inflation environment, the SARB's Monetary Policy Committee (MPC) raised the repurchase (repo) rate by a cumulative 475 basis points since the hiking cycle began in November 2021. At the current level of 8.25%, monetary policy in South Africa is now considered restrictive. While the MPC paused the hiking cycle in July, the committee will continue to assess inflation developments, and will act appropriately to steer inflation to the midpoint of the 3–6% target band (4.5%) to create an environment conducive to balanced and sustainable economic growth in the interest of all South Africans.

Inflation outlook

As food and fuel inflation have eased, mostly reflecting base effects, so has headline inflation, which recorded a low of 4.7% in July 2023. Going forward, we expect to see

[6] Diesel is used in many production processes, including agriculture.
[7] The Limpopo Province has not been spared. Inflation in the province rose sharply and peaked at 8.9% in July 2022, but unlike the rest of the country, inflation in the province declined markedly to 4.4% in July this year.

further moderation in headline inflation on the back of further declines in fuel and food inflation as well as the cumulative effects of the repo rate increases to date. This should help ease the burden of high costs for both consumers and businesses.

However, core inflation has exhibited signs of stickiness, much like we have seen at the global level. Core inflation was initially pushed up by markedly higher global goods inflation and exacerbated by the depreciation of the rand. Inflationary pressures have, however, broadened within the core basket, in part reflecting spillover and second-round effects from the high fuel and food price increases over the past year.

Within the core basket, inflation has been driven mostly by core goods, and to a lesser extent, services.[8] Housing – the largest services component – has experienced subdued inflation since the pandemic. This has helped to keep services inflation more muted and slowed the rise in core inflation. Core inflation is expected to average 4.9% this year.

Risks to the domestic inflation outlook are on the upside. Although some food price components have eased over the past few months, domestic food price inflation is still elevated (10% in July 2023), while the risk of drier weather conditions in coming months has increased. Domestic food prices also remain at risk from exchange rate volatility as well as the impact of geopolitical developments, particularly following Russia's decision to withdraw from the Black Sea Grain Initiative agreement. Similarly, global oil markets remain tight and sensitive to geopolitical tensions. Risks also emanate from the still elevated inflation expectations, which could feed into prices and wages, providing impetus to core inflation.

Before I conclude, let me briefly touch on the recent performance of the South African economy.

GDP performance

Much like the global economy, the resilience of the domestic economy has surprised policymakers. After contracting by 6.0% in 2020, the domestic economy rebounded

[8] The weaker rand exchange rate has had an impact on big-ticket imported goods such as vehicles, and alcoholic beverages and tobacco, which has kept inflation in exchange rate-sensitive core goods above 6.0% in the year to date.

sharply, growing by 4.7% in 2021 and 1.9% in 2022. These growth rates were much stronger than we had expected and meant that the recovery to the pre-pandemic output level was achieved sooner than we had forecast.

South Africa experienced large terms of trade gains as the global economy re-opened following the COVID-19 lockdowns, underpinned by buoyant global commodities demand while imports remained subdued. The strong domestic recovery also reflected a very supportive domestic macroeconomic environment, with massive fiscal support and multi-decade low interest rates.[9]

With output now back to its pre-pandemic level, South Africa's medium-term economic outlook has weakened sharply again, this time on the back of extensive load-shedding. Expectations were broadly for the domestic economy to experience no growth in 2023 and only modest growth (1.0%) over the medium term. The domestic economy, however, is again likely to surprise to the upside this year with projected positive, albeit subdued, growth of 0.4%, following a better-than-expected growth outturn in the first quarter of 2023.

Load-shedding continues to place increasing pressure on economic activity and will remain a drag on domestic growth in the near term. The SARB estimates that load-shedding will shave up to 2 percentage points off real gross domestic product (GDP) growth in 2023. This means our economy could have grown by at least 2.4% this year.

Let me put the challenges of load-shedding into perspective. We have seen more load-shedding in the first six months of 2023 than for the whole of 2022.[10] Load-shedding is having broader effects on the cost of doing business and ultimately the cost of living for all South Africans.[11]

Encouragingly, we are beginning to see some traction on reforms, particularly in the energy sector. While some strides have been made in removing structural barriers to entry for independent energy producers, the full benefits of these interventions will mostly materialise in the medium to long term. The SARB sees both potential growth

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[9] The budget deficit rose to 10% of GDP in 2020/21 – one of the highest in emerging markets. The SARB lowered the repo rate to 3.50% during the pandemic – its lowest level in over 50 years.
[10] The cumulative electricity shed from the grid in the first six months of 2023 amounted to just over 15 000 GWh, which is significantly higher than the 11 770 GWh shed in the whole of 2022.
[11] Load-shedding is estimated to have contributed 0.5 percentage points to domestic inflation this year.

and output growth slightly higher over the medium term.[12] Meanwhile, private sector investment in alternative energy is providing a welcome boost to fixed capital formation and is supporting domestic economic activity, particularly in the construction industry. Investments in back-up energy solutions have cushioned business operations from the impacts of load-shedding and partly explain the resilience we see in the economy.

Despite high inflation eroding real incomes, household spending has grown over the past year, although its contribution to overall economic growth has been declining. High inflation and rising interest rates, alongside slower employment recovery and declining real disposable income, continue to weigh on consumer confidence, raising the prospect of further slowdowns in household consumption growth.[13, 14]

Slower domestic growth ultimately reflects in weaker fiscal numbers, especially so given the reversal in revenue windfalls. The current trajectory of the fiscus is characterised by elevated budget deficits and rising public debt levels. This has contributed to a higher risk premium, driving up the cost of borrowing, and depreciating the rand exchange rate, thereby raising exchange rate pass-through inflation. Fiscal consolidation can significantly lower fiscal risk, and this should support macroeconomic stability and ultimately economic growth.

Conclusion

Finally, let me conclude by recommitting the SARB to the challenge posed by our Constitution. Our job is to contain inflation in the interests of balanced and sustainable growth. The SARB will continue to exercise its mandate to guide inflation and inflation expectations closer to the midpoint of the target band which, in turn, keeps demand and supply in the economy in balance. By so doing, we play our part in creating an environment conducive to inclusive and sustainable economic growth for the benefit of our people. It is important, however, to realise that economic growth and development really is a team sport, and as such, needs all the players to pull together

[12] Potential (real GDP) growth has been raised from -0.1% in 2023 to -0.8% and 1.0% in 2024 and 2025 respectively.
[13] Consumer confidence declined sharply to -25 points in 2023Q2 from -8 points in 2023Q1.
[14] According to the 2023Q2 Quarterly Labour Force Survey, an additional 784 000 (5.0%) people were employed during the quarter, when compared with the same period in 2022. This brings employment back to 2019 levels. Meanwhile, the official unemployment rate has declined from 33.9% in 2022Q2 to 32.6% in 2023Q2. The Limpopo Province is also facing the challenge of job creation, with unemployment in the province currently at 31.6%, slightly below the national average.

and do their jobs well. So, while we work hard to lower inflation and interest rates to support a healthy balance of saving and investment, it is critical that the broader public sector identifies constraints to growth and job creation and focuses on relieving them.

Thank you.