The Political Economy of Monetary Policy in South Africa: Real Economy Outcomes

Haroon Bhorat *Professor, Development Policy Research Unit, School of Economics, University of Cape Town*

Alan Hirsch *Professor and Director, Graduate School of Development Policy and Practice, University of Cape Town*

Introduction

South Africa has the highest level of unemployment in the G-20. This reflects the continued impact of apartheid policies pursued before 1994, not all of which have been effectively countered. While monetary policy can hardly take primary responsibility for restructuring a severely distorted economy, its impact on employment and growth is not negligible in this context and needs to be considered.

The practice and impact of monetary policy in the emerging market context are subject to a unique set of constraints, which differ considerably from those in advanced economies. These range from political economy constraints—in many cases still involving a lack of Central Bank independence, the need to maintain some broad exchange rate stability, debt servicing by the fiscus, and a weak transmission mechanism borne out of shallow financial markets.[1] While the South African economy does not contain all these constraints, each element is important in understanding the factors impacting monetary policy decisions in the economy.

The inflation target-based monetary policy regime introduced in the early 2000s marked a decisive break from the apartheid regime to an appropriate post-apartheid policy.[2] At the same time, there is a general consensus that South Africa's monetary policy did not make a smooth transition from international isolation to a post-apartheid full global integration, even though the appointment of Tito Mboweni as the Governor of the South African Reserve Bank (SARB) was an important step forward. We argue below that monetary and macroeconomic policies have some way to go before they can appropriately address the challenges of growth and employment creation in South Africa. It is important to note that, in recent decades, monetary policy has often shouldered the burden of sub-optimal fiscal policies. Nevertheless, there are some specific concerns about the impact of monetary policy on growth and employment that need to be considered.

This short note briefly considers three issues. First, it analyzes the extent to which monetary policy has an influence on labor market conditions in South Africa with a particular focus on cyclical unemployment. Second, it assesses whether the most appropriate price index is being targeted by the monetary authorities as the South African economy is characterized by high levels of income inequality and hence, highly skewed consumption bundles. The third point is a review of the impact that the current policy framework has on domestic consumer credit creation, and its consequences.

Monetary Policy, Cyclical Unemployment and Poor Household Inflation Rates

Economic growth is subject to a range of determining factors, wherein the role of interest rate movements is but one of these factors. While the short-run actions of the monetary authorities are important, it is crucial to consider how building a reputation for price and financial market stability over time impacts long-run economic growth.

We are interested in the extent to which short-run fluctuations in the interest rate, through their impact on business cycle movements, impact conditions in the labor market. It is generally accepted that the excess supply of labor in South Africa is driven by structural and institutional factors such as

a mismatch of skills, factor market regulation, institutional inefficiency, spatial segmentation and so on. However, it is also true that the unemployed who have worked before and who have made contributions to unemployment insurance must be subject to fluctuations consistent with movements in the business cycle. In this context, we explore the extent to which monetary policy may be able to affect dynamics within the labor market through an examination of the cyclical component of unemployment.

The significant monetary policy reaction following the financial crisis in the third quarter of 2008, evident in the steady downward adjustment in the repurchase rate as the SARB searched for real economy adjustments to the crisis, was an action common to developed and emerging market central bank responses around the world. Regardless, though, the cyclical unemployment rate increased steadily until the fourth quarter of 2009, briefly dropped, and then rose sharply again during this environment of declining interest rates. Interest rate adjustments have been a weak predictor of cyclical unemployment movements since the onset of the recession.

There are two reasons why this matters. First, it suggests that short-run labor market adjustments are not within reach of monetary policy in South Africa. For an economy with one of the highest unemployment rates in the world, it is a significant policy concern that monetary policy, within the inflation targeting framework and with the policy interest rate as its instrument, is ineffective in changing the level and rate of cyclical joblessness. Second, it suggests that a series of factors, well beyond the control of monetary policy, lie behind firm decisions to lay off workers. In addition to responding to weak demand, layoff decisions are influenced by factors such as regulatory considerations around the marginal wage and non-wage costs of labor, institutional inefficiency of the courts of law, the rise of temporary employment services, the share of the wage bill in total costs, and the perceived productivity-reducing effects of workplace practices induced by unionized workers.

Political economy concerns for monetary policy in the emerging market context, as Hammond *et al* (2009) note, arises when the authorities target headline inflation, but exclude the inflationary experiences of households in the bottom half of the income distribution. Targeting core inflation in an era of high food and fuel prices is often politically unpopular, but it can also have the unintended consequence of fuelling inflation through excessive wage demands. Hence, targeting an inappropriate or non-representative price index can result in unexpected or unpredictable inflationary outcomes.

In the case of South Africa, which remains an economy with one of the most unequal distributions of income in the world and certainly the most unequal in the G-20,[3] there are two important considerations. First, the standard construction of the price index based on a plutocratic weighting technique is inappropriate as a measurement tool for inflation because it often does not represent the consumption bundle of the average household. More often than not, it is representative of households in the upper percentiles of the income distribution.[4] Indeed, more unequal societies yield less representative core inflation indices.

Second, targeting the CPI or CPIX—as the South African monetary authorities do—means that domestic factors fuelling inflation in the economy, most notably wage demands, implicitly may not be well predicted in the decision framework of the Reserve Bank. Inflation cycles are notably different across the deciles of the income distribution in South Africa. For example, the inflation cycle following the global economic turmoil sparked by the attacks of September 11 in the U.S. yielded a rate of inflation across the income distribution at levels not seen since before January 1998. However, the highest price increases were found among the poorest deciles, while the top 10 percent of households saw the lowest increase in prices for their consumption bundles. Though prices since then declined steadily in the 2003-2006 period, the differential in household inflation rates across the deciles remains evident.

Ultimately though, monetary policy based on average inflation rates and, arguably, on an index construction weighted towards the top-end of the distribution runs the risk of basing decisions on incomplete or incorrect information. The gap between policies and perceptions leads to distrust and higher political risks. In an emerging market context, understanding the uneven patterns of price movements across the income distribution should be a key tenet of developing informed monetary policy decisions.

Monetary Policy and the Management of Cyclical Risks

South Africa's recession during the global financial crisis was more severe than in any other African country or in many of its developing country peers, with GDP shrinking by –1.8 percent in 2009. Employment fell by about one million people—8 percent of those employed—in just one year. Unemployment, narrowly defined, rose by 20 percent and remains extremely high at around 25 percent, narrowly defined.[5] The overall employment rate fell from about 45 percent to 40 percent. Growth has remained sluggish in absolute terms and relative to the rest of Africa and developing country peers since the crisis of 2009.

Several reasons can be offered to explain this unusually poor performance. One reason proffered for South Africa's slow growth in African terms is that it started from a higher level of per capita income. But a recent OECD Economic Survey of South Africa points out that South Africa's growth is low, even when corrected for its level of income.[6] Another reason is the electricity shortage that has hampered growth since 2008. To address the shortage, new power plants are being built, but the process remains behind schedule. Political uncertainty has also amplified due to conflicts in the gold and platinum mines between employers and unions, and among unions. But this is a relatively recent phenomenon. One point that is not frequently mentioned is that South Africa had a credit crunch, not entirely unlike those in the U.K. and the U.S. Even though asset prices were affected less than in the U.K. and the U.S., and the banks remained sound, the credit crunch was real and significant.

After damagingly high interest rates in 2002-2003, South Africa reduced interest rates to the lowest levels (nominal and real terms) in many decades. As a consequence, consumers went on a borrowing spree. Household debt as a percentage of household income had never exceeded 63 percent in any previous boom. This may seem low compared to advanced markets, but it reflects the distribution of credit-worthy consumers, as well as some shallowness in the financial system. Between 2004 and 2009, household debt rose from 56 percent to 83 percent of household income. The introduction of a consumer credit law to restrain credit encouraged banks (buoyed by capital inflows) to lend enthusiastically because the implementation of the regulations was delayed by one year (to mid-2008) "to allow adjustment". Household debt was 35 percent higher than ever before. Before a domestic correction could take place, world markets made it happen. The resulting damage was severe and long-lasting.

South Africa would most likely have had a minor recession, even without the global financial crisis. For policymakers, the global crisis was a fig leaf to hide their mistakes, although it is not undoubtedly true that the external trade and capital flow shocks compounded the homegrown crisis.[7]

The SARB thought that growth at 5.5 percent between 2004 and 2007 was above potential (then estimated at 4.5 percent). However, when capacity utilization bumped up against its historical maximum level in the pre-crisis years, credit expansion to consumers continued without abating. The SARB appeared to maintain the view that investments in new productive capacity needed to be encouraged and raising interest rates would inhibit this from occurring. When the government was faced with the suggestion that it would be possible to limit the growth of consumer credit without raising the interest rate, their response was that in a financial market as broad and deep as South

Africa's, credit was fungible and credit markets could not be separated.

Other countries have used a wide range of tools to insulate their economies against the most destabilizing effects of cyclical flows of goods and capital. These are now commonly called "macro prudential tools" and they include caps on loan to value ratios, caps on debt to income ratios, countercyclical capital requirements, caps on leverage, levies on non-core liabilities and varying reserve requirements.[8] Korea's success achieved by implementing macro prudential measures to protect their domestic economy from the excesses of global liquidity shocks is widely documented.[9] It is not clear why such measures have not been implemented by the SARB (in conjunction with the National Treasury), in light of their success elsewhere in protecting domestic stability without requiring an increase in interest rates or other economy-wide measures.

Conclusion

The appointment of Tito Mboweni as the Governor of SARB in 1999 marked a welcome transition to central bank leadership attuned to South Africa's reintegration to the global economy. However, the modernized monetary policy of the first decade of this century still failed to address some key challenges. Further policy reforms could reduce the negative impact of monetary policies on employment and of the living standards of the poor. As an emerging market country and a member of the G-20, South Africa's monetary policy formulation and its potential impact on real economy outcomes remains a key area for future debate and discussion.

References

Aron, Janine (2011). "Macroeconomic Policy and its Governance after Apartheid", in Shapiro, Ian and Kahreen Tebeau (Eds.) *After Apartheid: Reinvesting South Africa?* Charlottesville, VA: University of Virginia Press.

Bhorat, Haroon and Ravi Kanbur (2006). *Poverty and Policy in Post-Apartheid South Africa*. Cape Town: Human Sciences Research Council (HSRC) Press

Borio, Claudio (2011). "Rediscovering the macroeconomic roots of financial stability policy: journey, challenges and a way forward", *BIS Working Papers*, No 354. Basel, Switzerland: Bank for International Settlements.

Bruno, Valentina and Hyun Song Shin (2013). "Assessing Macroprudential Policies: Case of Korea", *NBER Working Papers*, No. 19084. Cambridge, MA: National Bureau of Economic Research.

International Monetary Fund (IMF) (2012). "The Interaction of Monetary and Macroprudential Policies: Background Paper", December. Washington, D.C.

Hammond, Gill, Ravi Kanbur, and Eswar.S. Prasad (2009). "Monetary Policy Challenges for Emerging Market Economies", *Global Economy and Development Working Papers*, No. 36. August. Washington D.C.: The Brookings Institution.

Ley, Eduardo (2005). "Whose Inflation? A Characterization of the CPI Plutocratic Gap", *Oxford Economic Papers*, 47(4): pp. 634-646.

Organisation for Economic Co-operation and Development (OECD) (2013). *OECD Economic Surveys: South Africa*. Paris:

Oosthuizen, Morne (2007). "Consumer Price Inflation across the Income Distribution in South Africa", *DPRU Working Papers*, WP 07/129. Cape Town: Development Policy Research Unit, University of Cape Town.

Prais, Sigbert J. (1959). "Whose Cost of Living?" T*he Review of Economic Studies*, 26(2): pp. 126-134.

Endnotes

[1] Hammond et al (2009).
[2] Jeanine Aron (2011) summarises this history.
[3] See also Bhorat and Kanbur (2006).
[4] See Ley(2005) and Prais (1959).
[5] The 'narrow' definition of unemployment includes only actively searching work-seekers, and is the standard definition of unemployment used by the International Labour Organisation (ILO). The 'broad' definition of unemployment would also include discouraged work-seekers.
[6] See OECD (2013).
[7] Alan Hirsch was a deputy head of policy in the South African Presidency until mid-2008.
[8] See Borio (2011) and IMF (2012).
[9] See Valetina and Shin (2013).