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Labour market and monetary policy in South Africa

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Unemployment is the defining characteristic of the South African economy. The dimension of the problem has generated a large academic and political literature studying its determinants and characteristics. This literature sees the rise of unemployment in South Africa as a combination of structural changes in labour demand with an increase in capital intensity and skills-based technical progress, and institutional constraints on the labour-supply side, especially downward rigidities of wages due to bargaining institutions and relatively high reservation wages.

What has been missing from the debate is an analysis of the consequences of these structural characteristics of the labour market at the business cycle frequencies. The South African economy's dramatic response to the 2007 international financial crisis has given the strongest evidence yet of the relevance of the labour market in determining the response of the economy to external shocks.

This paper analyses the influence of the South African labour market on the conduct of monetary policy. First we illustrate the low sensitivity of wages to employment conditions using a reduced form estimation of a wage Phillips curve for South Africa.

After we show, estimating a small New Keynesian DSGE model with unemployment, that because of this weak response of wages to changes in employment, the South African Reserve Bank is confronted by an unfavourable short-run unemployment–inflation tradeoff that complicates the implementation of the inflation-targeting framework. Our estimation implies that for any percentage point desired reduction in inflation the Bank should be prepared to accept an increase in unemployment of 2.5 per cent.

Finally, we interpret these results in a strategic framework. Inflation targeting works differently if the Central Bank is the leader or the follower in the economic policy game. If the Bank is the leader, other economic agents internalize in their decision the inflation targeting, de-facto coordinating around the Bank preference. If instead the bank is the follower, it is the Bank that is constrained in its decision making by the preferences of the other economic agents.