# GAPS IN THE SOUTH AFRICAN INFLATION TARGETING DEBATE

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CODERA ANALYTICS

# Overview

- To help advance the debate about South Africa's inflation target, the paper discusses five unresolved questions around South Africa's inflation targeting framework:

    - What should the inflation target be?
    - Which inflation measure should be targeted?
    - How to better anchor inflation expectations?
    - How should the transition to a lower target be managed?
    - What are the implications of a target review for central bank communication?

Please read the paper for more detail and references.

# Summary

- A lower inflation target is desirable
- But there are important measurement issues to consider in selecting appropriate target
- SA has high structural inflation requiring government action to address
- We argue that sustained disinflation at low adjustment cost requires:

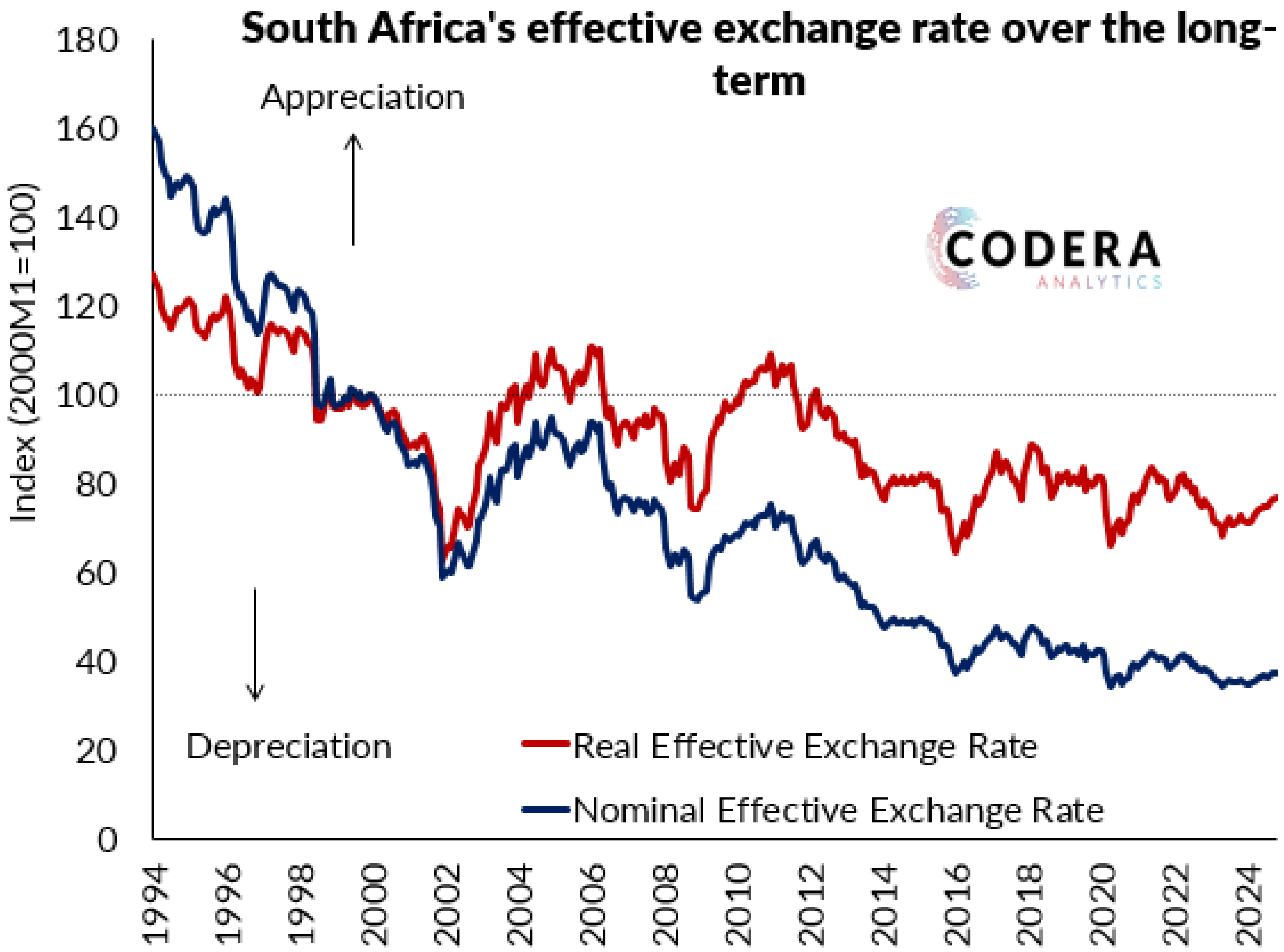
  → Complementary government policies to reduce structural inflation (e.g., SOE and municipal reform, competition policy)

  → A social compact tying wage increases tied to productivity

  → Supportive fiscal policy aimed at reducing the debt burden

  → Clear SARB communication around the planned transition

# Lower inflation would slow the slide in competitiveness




Source: BIS and Codera Analytics. Real (CPI-based), Broad Indices. These are the weighted value of a country's currency relative to an index or basket of other major currencies, deflated by inflation differences across countries.

- South Africa's high inflation is one reason why the exchange rate has tended to depreciate over time.
- We show that higher inflation has been associated with lower growth in SA at all levels of inflation (see [Fig 1]()).
- SA's inflation target is high compared to peer economies and trading partners.

# Which inflation measure should be targeted?

There are several considerations that matter for how the inflation target should be defined:

- selecting a price index that is relevant to the experience of firms and households
- types of shocks the economy is exposed to
- how much flexibility should be afforded to the central bank in achieving the target

We show:

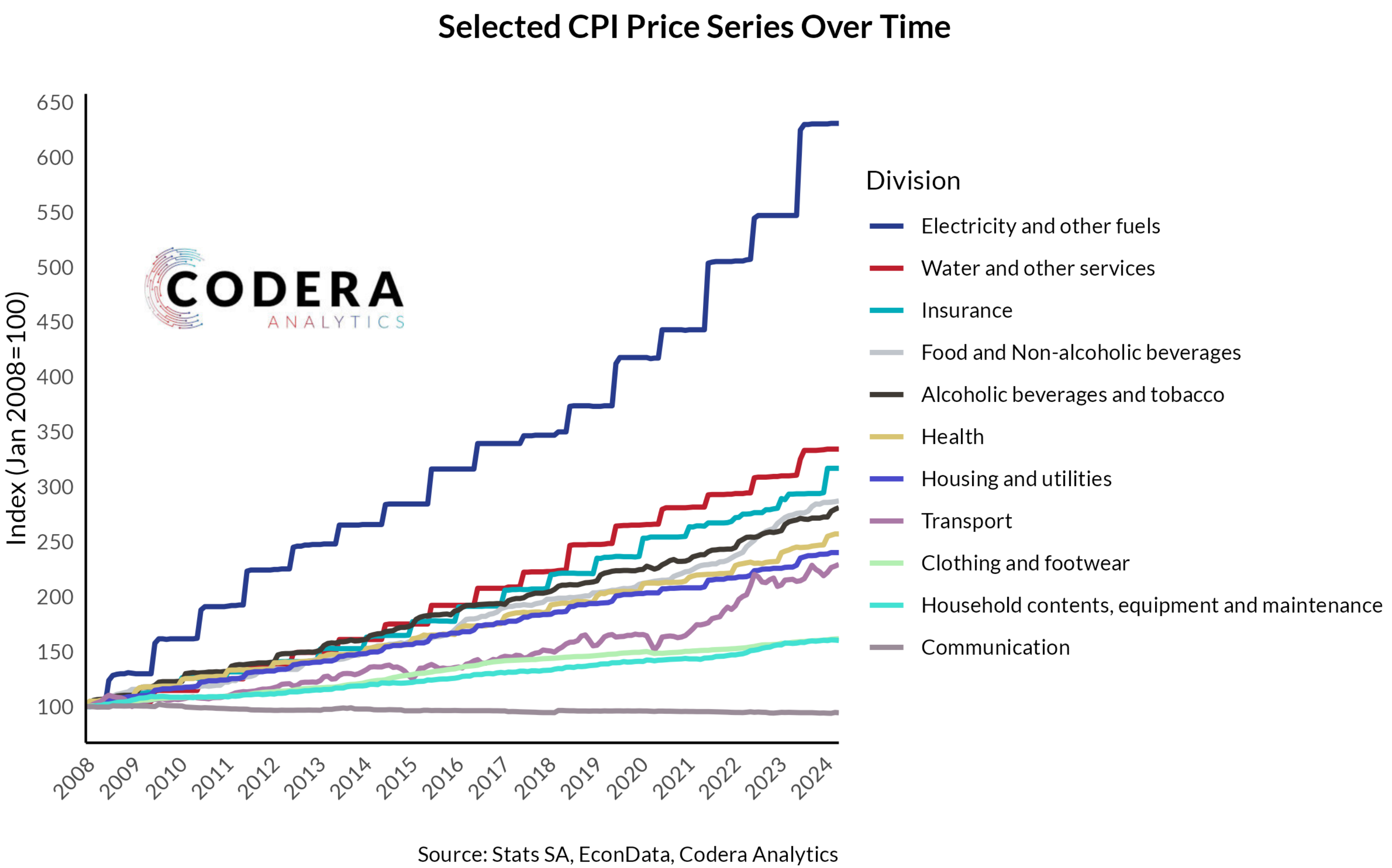
- SA has a high structural inflation with a high degree of dispersion and asymmetry
- Driven by govt-determined components, imported inflation, supply-side shocks and concentrated markets
- SA has backward-looking inflation expectations

Read the paper for more detail on implications for optimal target and conduct of monetary policy.

# SA has high structural inflation

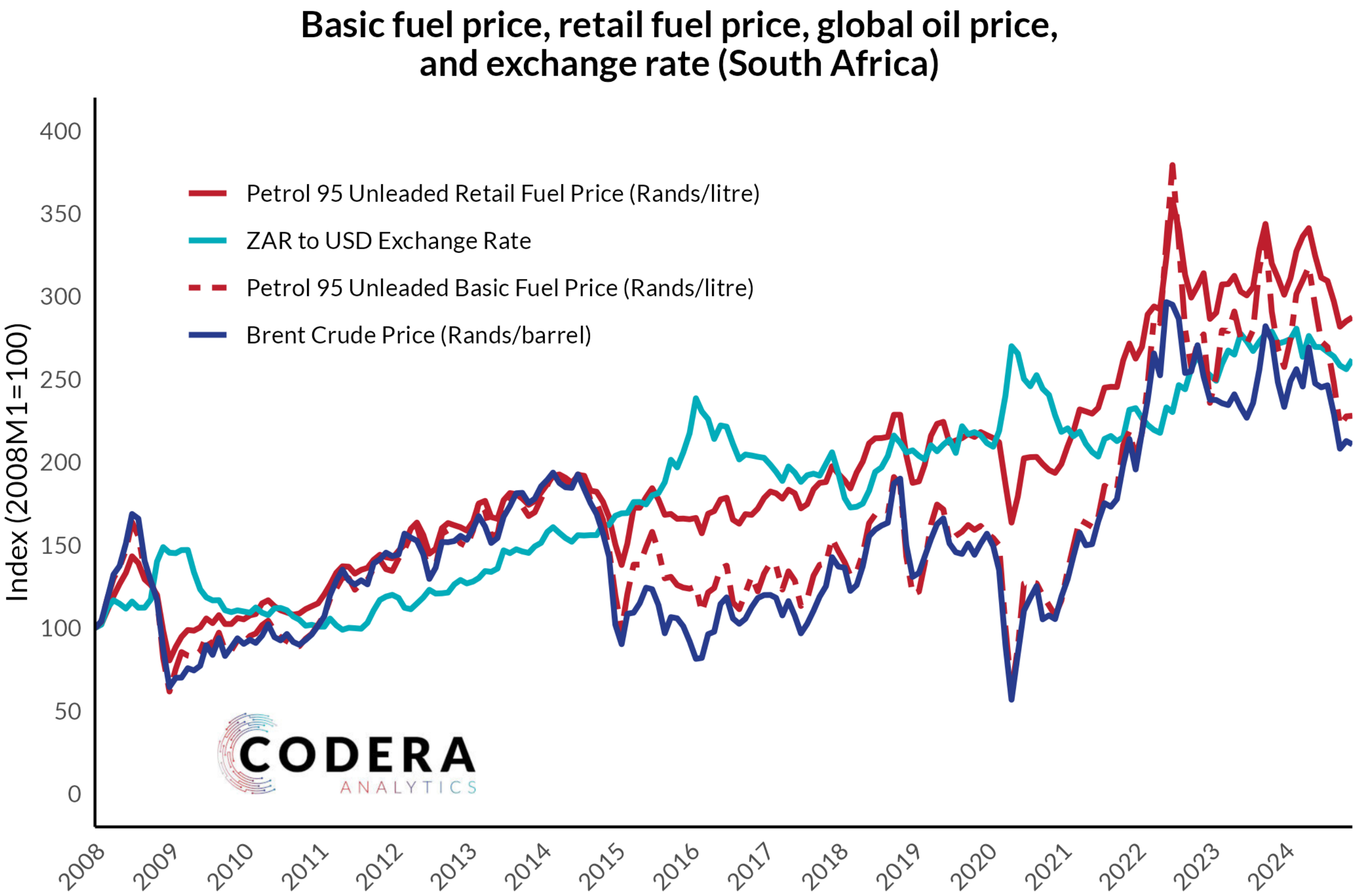
- High structural inflation has not just reflected high food, utilities and other administered inflation (e.g. fuel).

- Many categories of domestically-determined prices have increased much higher than the target, (e.g. education costs and insurance).



# Exchange rate depreciation has contributed

- Persistent exchange rate depreciation has played a key role in the continuous rise in domestic currency fuel prices, for example.



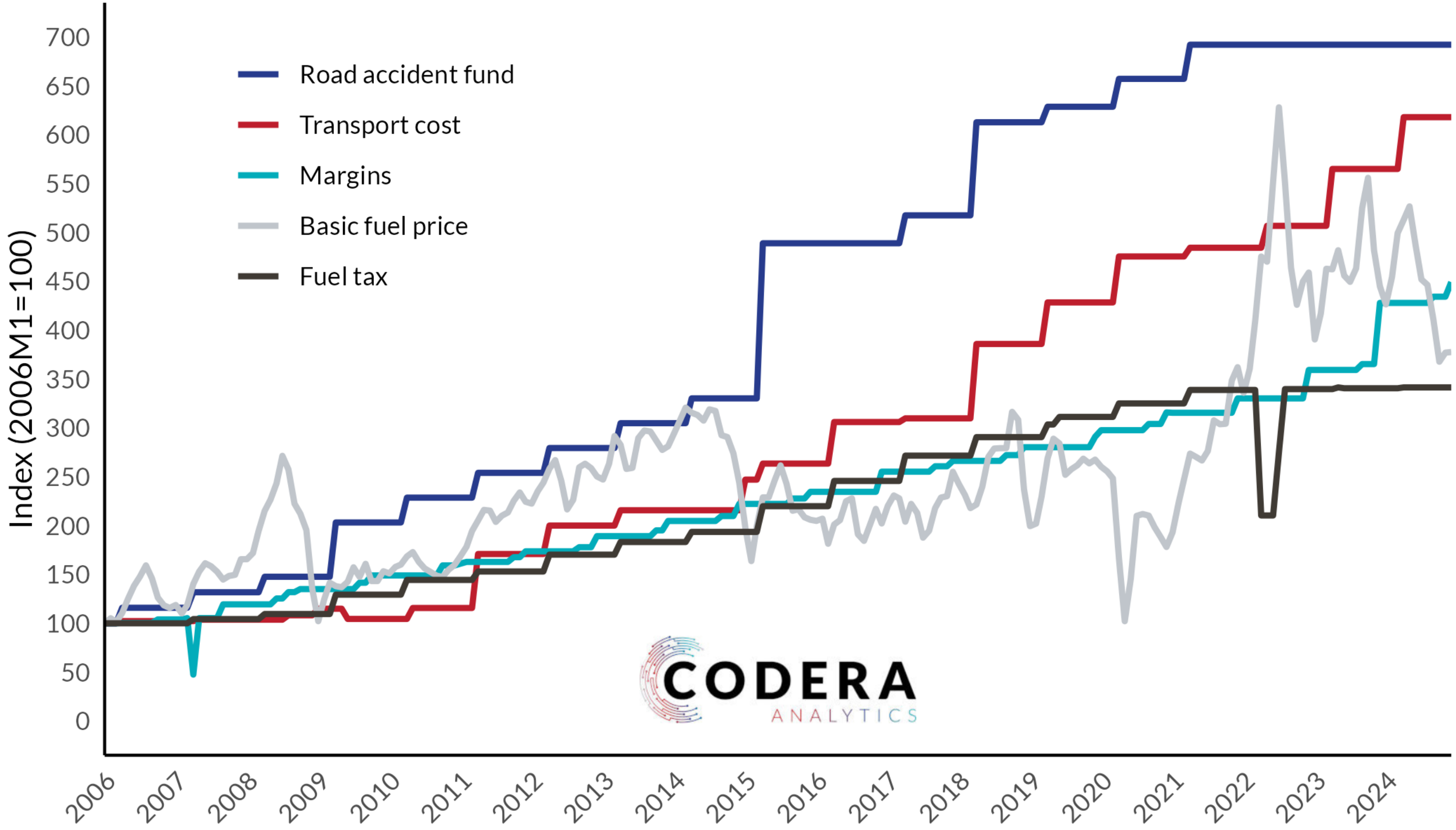

Source: Department of Mineral Resources and Energy, EconData, Codera Analytics.

# But domestic factors drive many CPI components

- But there is a meaningful wedge between the retail petrol price and the globally determined portion of its price.

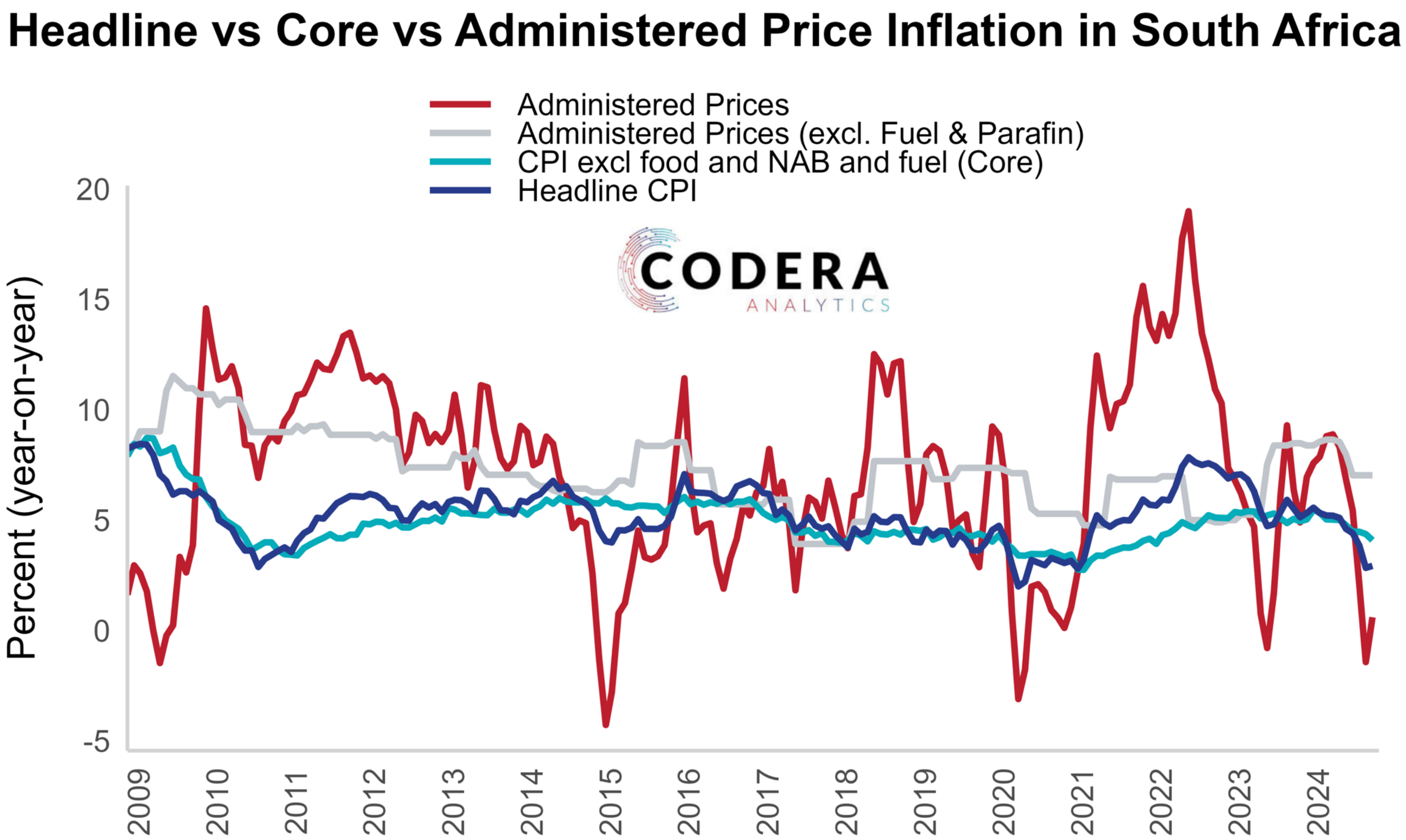
- Reflecting much larger cumulative increase in domestic taxes (the road accident fund levy), transport costs and margins and represent a large % of retail prices.

**Growth in components of petrol price in South Africa (95 Octane unleaded)**




Source: Department of Mineral Resources and Energy, EconData, Codera Analytics. Margins include retail and wholesale.

# Administered prices have risen > Headline CPI

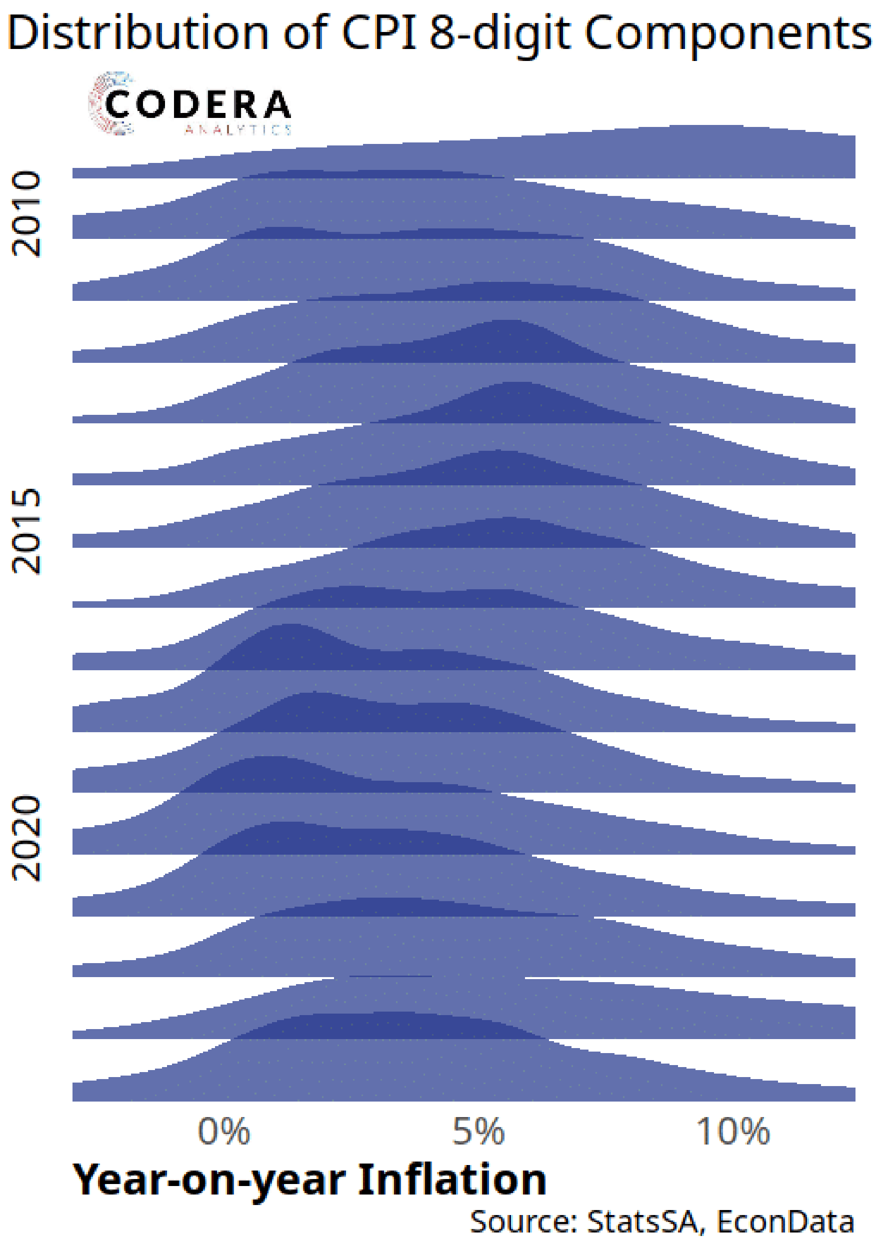



Source: Statistics SA, EconData.

- Administered price inflation averaged 7.1% (or 7.3% excluding fuel) since 2009.
- Direct government-related categories make up over 30% of the total CPI basket, so excluding such components would reduce the representativeness of such a measure against the underlying economic reality for consumers and firms.

# Wide (and time varying) dispersion of price components

- Many consumer price categories persistently exceed the upper bound of the target.
- High dispersion is most evident in tradables (e.g. petrol), administered prices (e.g. electricity), and some food items.
- This affects appropriate policy conduct
- The implication is that SARB needs to understand price setting behaviour for inflation forecasts and interpreting drivers and pass-through.

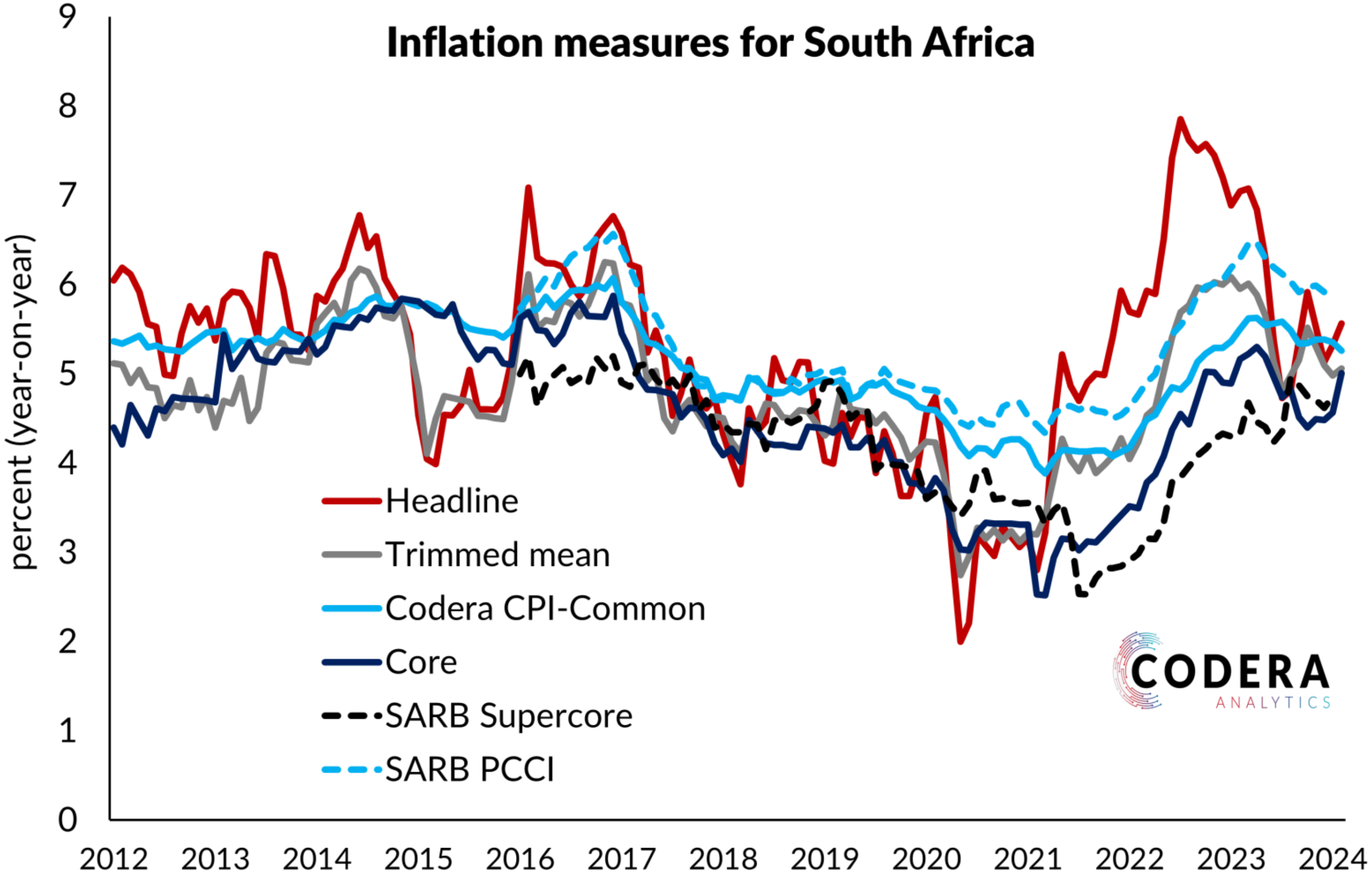


# Better measures of underlying inflation needed

- Various core measures (incl. CPI-common, supercore, PCCI) poorly predict headline inflation; all missed post-COVID spike.

- Sectoral heterogeneity in inflation / persistence requires more weight on controlling domestically-determined component.

- Broaden core inflation toolkit to include economically meaningful measures like cyclically sensitive prices, trend inflation, cross-sectional inflation pressures, measures of domestically-driven inflation.




Source: Statistics South Africa, EconData, Codera Analytics. CPI-Common measure is based on a factor model drawing on CPI data at five-digit level of disaggregation. PCCI is SARB's persistent and common component of inflation measure based on a factor model of four-digit CPI components, and 'Supercore' is constructed from the core inflation basket by isolating, via a Phillips curve, those components that are sensitive to the output gap.

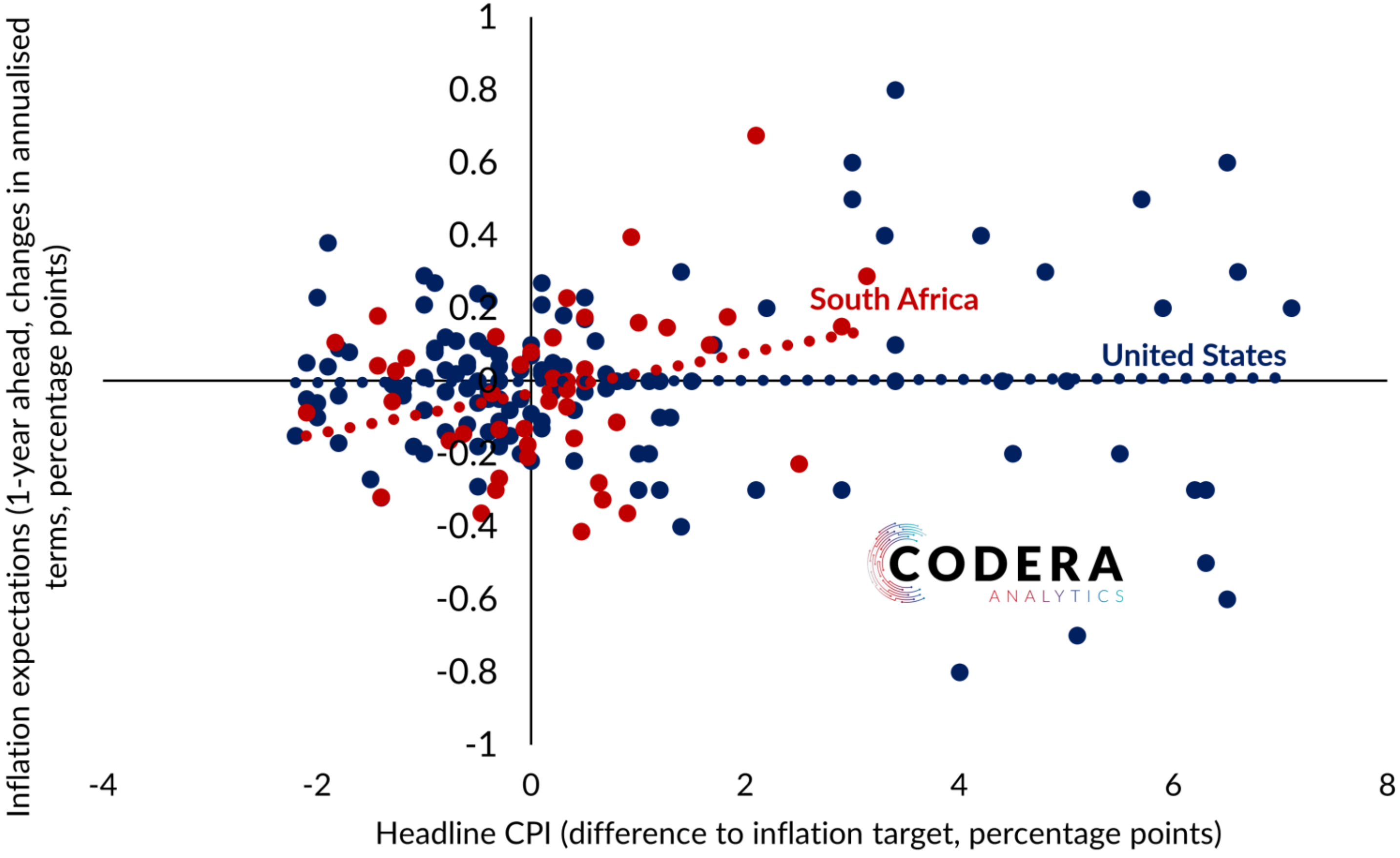
# Inflation expectations are not fully anchored

- Inflation expectations are crucial in determining costs of disinflation. They are partly backward-looking in SA and tend to lag actual inflation changes.

- Compared to advanced economies, SA's inflation expectations respond more strongly to deviations from the target, indicating weaker anchoring than commonly assumed.

- Strengthening anchoring requires sustained period of inflation below current target and enhanced communication.

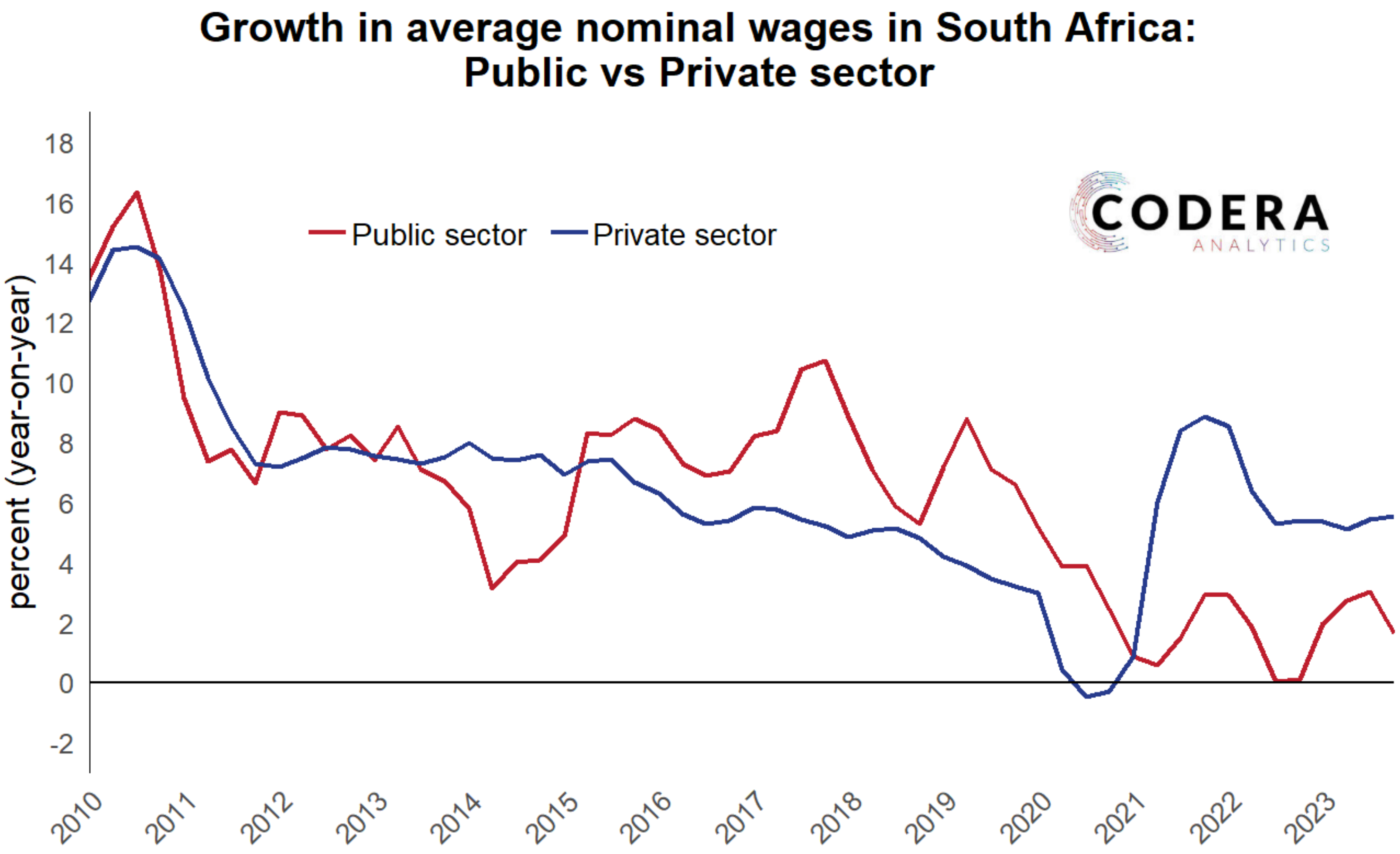
**Responsiveness of inflation expectations to CPI outturns in SA and US (since 2013)**




Source: Statistics South Africa, BER, EconData. Trading Economics. SA Headline is quarterly (year-on-year) and US is monthly (year-on-year).

Please see the paper for sub-sample analysis, alternative definitions and cross-country comparisons

# We see unanchored expectations in wage outcomes



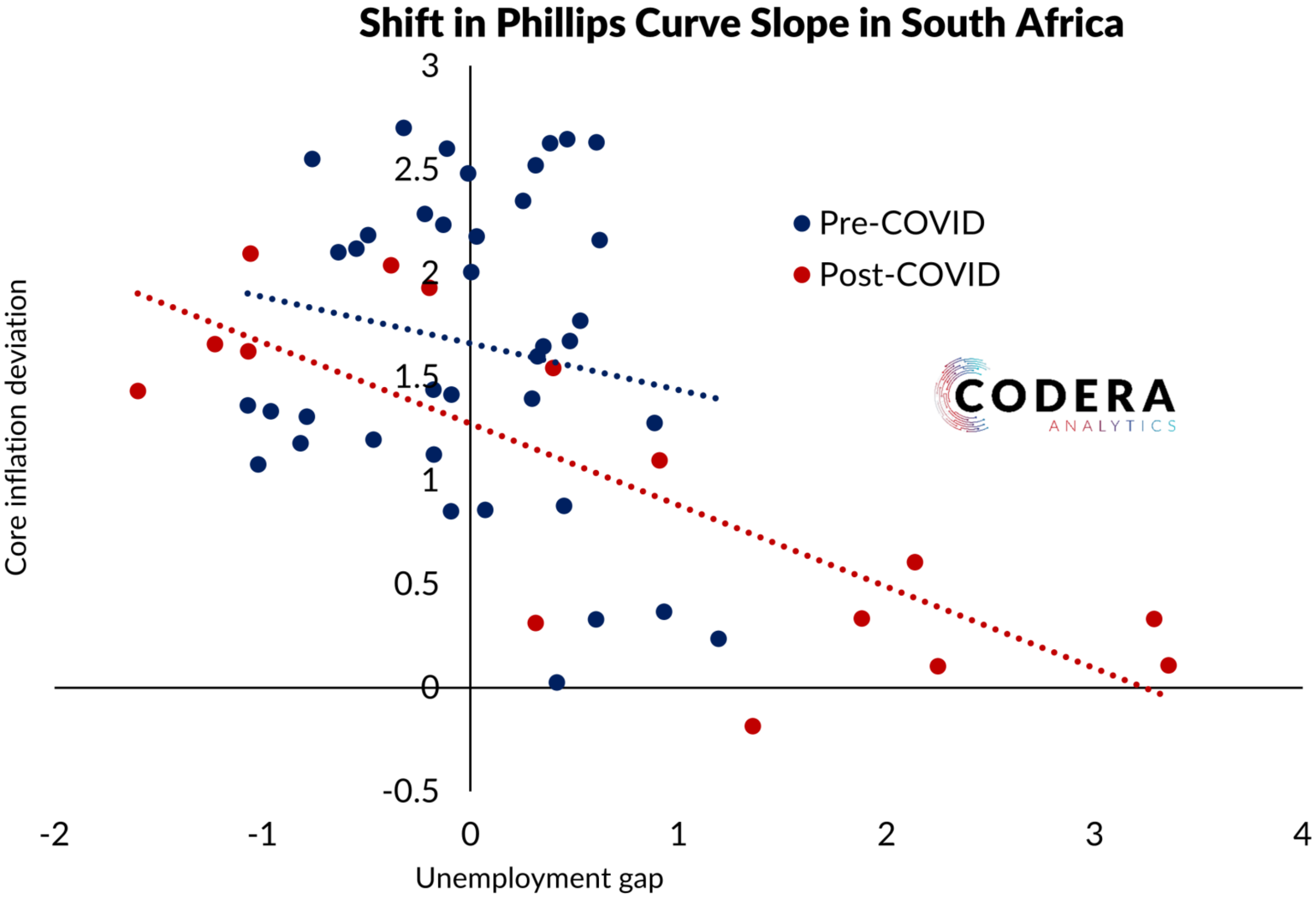

Source: SARB, Econdata.
Four-quarter moving averages of year-on-year rates.

- Backward-looking expectations observable in wage outcomes which have been above target, particularly for the public sector.
- Expectations remained above inflation, contributing to cost-push pressures.
- Wages > target pre-pandemic, since mid-2021, public wage growth slowed, private sector wages have been growing faster the mid-point.

# Transition costs are not likely to be zero

- Transition costs depend on how anchored inflation expectations are and how steep the Phillips curve is.

- Our estimates and those from IMF points to a steeper post-COVID Phillips curve, implying higher disinflation costs than SARB assumes.

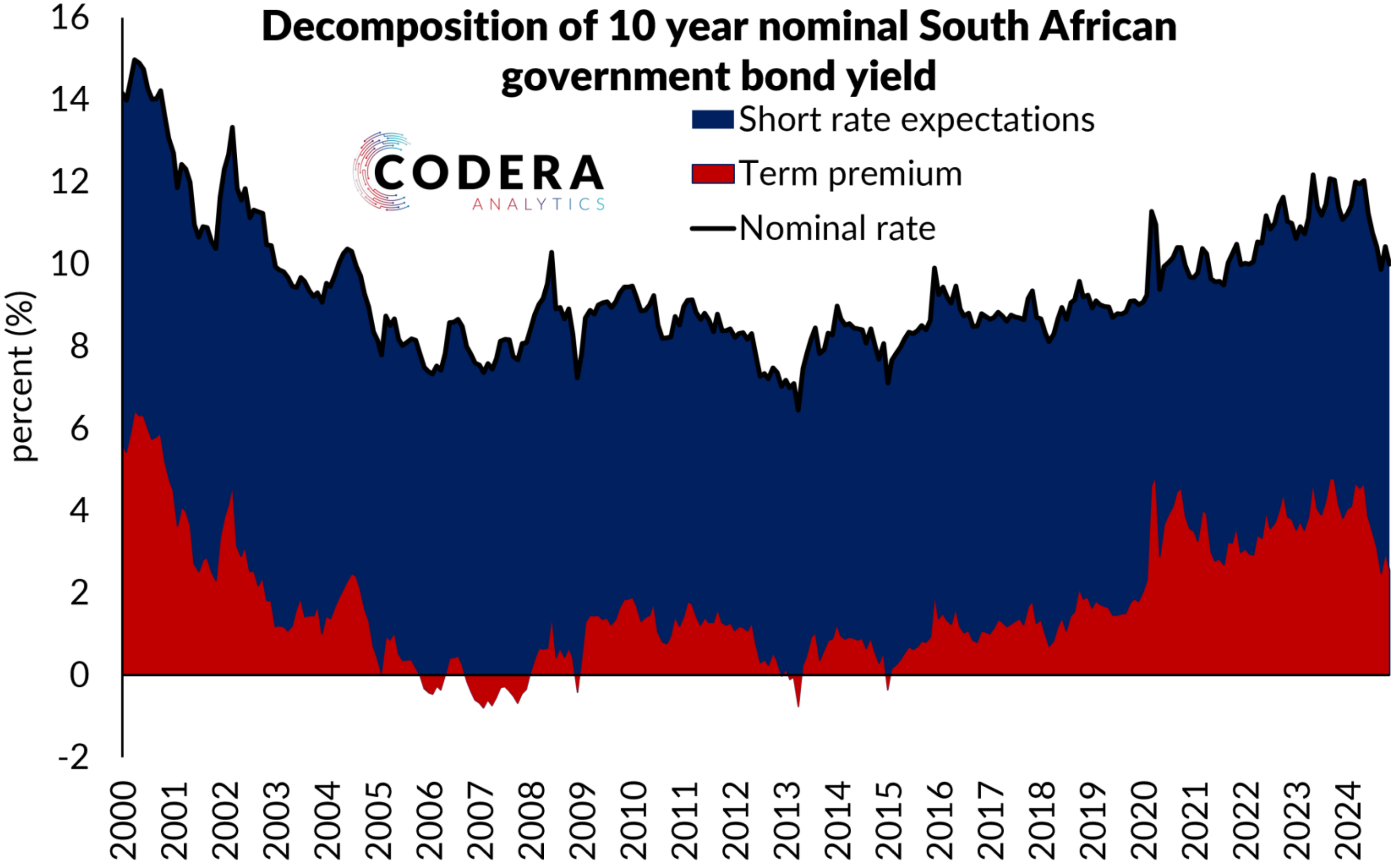


Source: IMF WEO October 2024

Please see the paper and this blog post for our estimates

# With benefits dependent on fiscal outlook

- The benefits of a lower target from lower borrowing costs partly hinge on whether term premia fall.
- Liquidity, credit and inflation risk premia, are important contributors to South Africa’s high long-term borrowing costs.
- Fiscal risks could offset gains from a lower target if government debt does not stabilise.



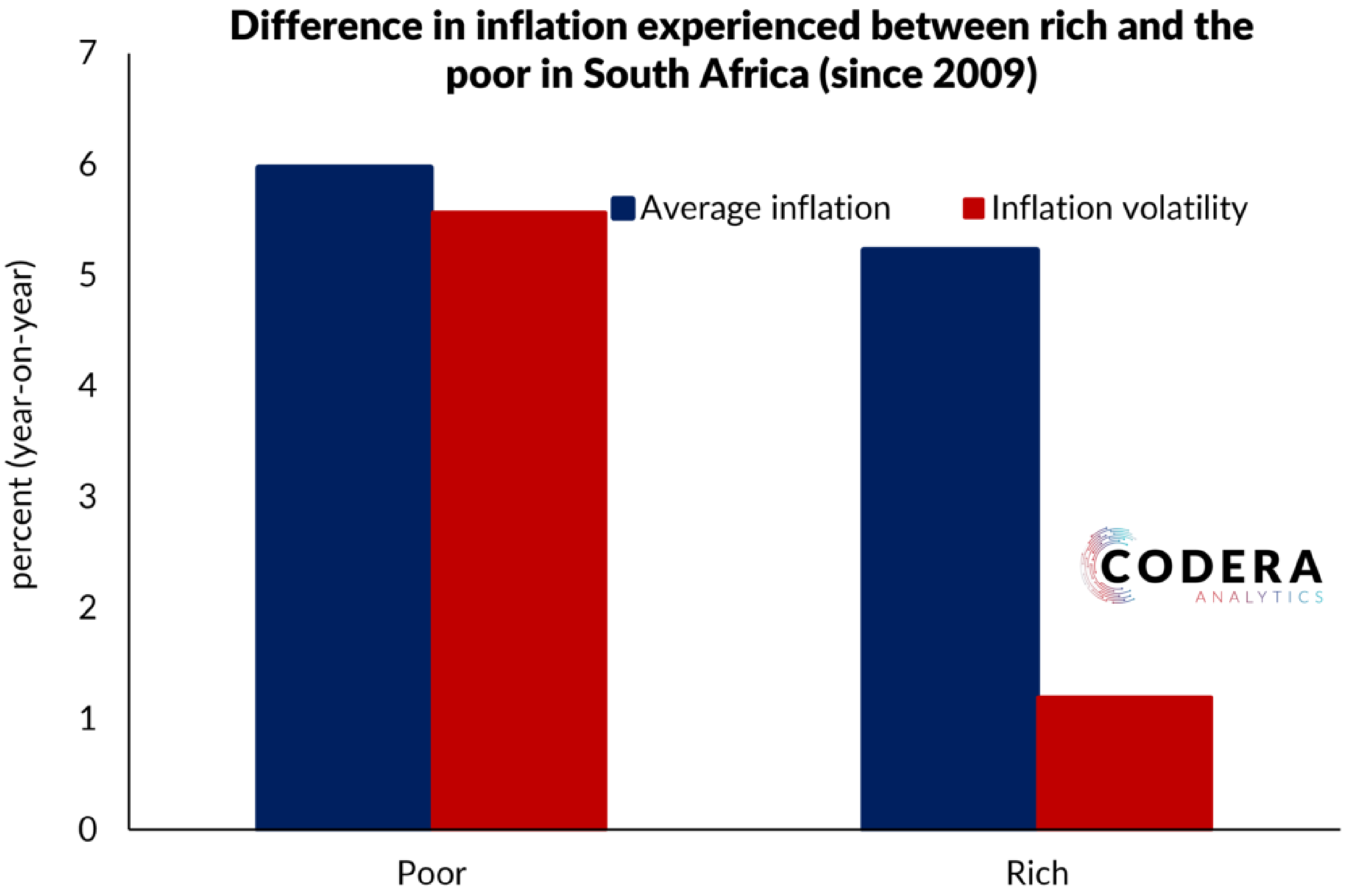

Note: Our approach for estimating the other term premia is described in Erasmus, R., Steenkamp, D. 2022. Term Premium Estimation for South Africa. Journal of Applied Economic Sciences, Volume XVII, 4(78): 347 – 350. The term premium is the difference between the nominal 10-year sovereign bond yield and average expected short rates over that horizon and captures sovereign bond market liquidity risk, sovereign credit risk and inflation uncertainty.

# Implications of target review for CB communication

- Poor households (decile 1) face higher average inflation and nearly 5x more inflation volatility than the rich (decile 10), given differences in inflation drivers (e.g. larger weight on food for decile 1).

- This creates a communication challenge for the SARB, given differences in the inflation experienced by different households and firms.

- Alignment of target to inflation experiences and importance of interpreting economic drivers of underlying inflation pressures to support policy credibility.




Source: Stats SA, EconData, Codera Analytics. Expenditure decile 10 is the richest 10% of households and decile 1 the poorest 10% of households.

# Policy implications

- Given high structural inflation and backward-looking inflation expectations, promising a lower target could backfire without government and stakeholder buy-in.
- Without structural reforms, inflation in parts of the economy where prices are flexible (e.g. the tradeable sector) would need to undershoot whatever a new target might be.
- Without co-ordination and reforms, this could imply higher costs for the private sector.
- Need a team-SA approach to a lower target:
    - Clear SARB communication of the approach to the transition and co-ordination with stakeholders
    - Social compact between government, SARB, SOEs, relevant regulators, and labour unions
    - Government commitment to structural reform
    - Supportive fiscal policy

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