THE REAL ECONOMY BULLETIN

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Briefing Note 1: Why inflation targeting does not work in a highly unequal country

Saul Levin

The inflation targeting approach by the South African Reserve Bank (SARB) and its recent increase of 0.5% has seen interest rates more than double when compared to the first quarter of 2022. The interest rate is now 8.25% and it was at 4% in March 2022. In a highly unequal country these increases disproportionately affect two groups: homeowners who are in the top 10% of income earners who owe over R1 trillion in home loans, and the working poor who often get by on payroll based loans.

Why should we worry about the incomes of the top 10%? They have decent formal work, with assets including homes, savings, and pensions. The TIPS report, *Inequality in South Africa: An Overview* (2020), showed that the richest 10% of households owned well over half of household assets and, as a group, these households held R8.5 trillion in financial assets. But they owed almost R1 trillion in mortgage bonds on housing. They may well be resilient in their response to high interest rates by reducing their discretionary spending. The problem comes in the disproportionate role the top 10% of income earners in South Africa play in driving economic growth and employment creation. This top decile earns approximately half of total household incomes. A squeeze on the disposable incomes of the top 10% may well see many in this group reducing spending on luxury goods, an intended effect of high interest rates. But as the high interest rates put further pressure on these households it would likely result in cuts in spending on activities that create employment throughout the economy – eating out, entertainment and non-luxury goods. Further pressure on the disposable income of this top decile may also reduce monthly remittances to poorer family members, with a knock-on effect for these poorer households.

Further, this top decile is 50% more likely to derive income from a business than those in the 70th to 90th percentile, and three times more likely than those in the bottom 50% of income earners. Between higher financing costs and lower demand, formal businesses will borrow less and generate less employment, which will likely put downward pressure on wages. This intended effect of inflation targeting assumes employment is high, however, as shown in this bulletin employment is still lower than before 2020.

The slowing economy is further exacerbated by the second group who in addition to struggles with declining economic opportunities (especially with single income households) they are now paying more interest on their salary based loans. Yes, they may benefit from lower inflation as it will keep their monthly costs down, but with less economic opportunities their immediate decline in income brought about by lower economic opportunities and high interest on loans poses a high risk to them. Unlike other countries, the comparably poor middle class in South Africa (from 40th to 90th percentile) are less likely to have assets to withstand the economic contraction brought about by high interest rates.

Not being able to access the labour market is a core driver of inequality in South Africa – this is further exacerbated by slow growth. As TIPS has noted elsewhere “addressing income inequality requires both job creation and measures to address South Africa’s unusually large wage gap amongst the employed” (TIPS 2020:5). Inflation targeting is not a redistributive measure and on its own does not create an ‘equilibrium’ that will result in job creation. Rather because high interest rates are designed to lower inflation by slowing down the economy, they only serve to exacerbate unemployment and inequality.

The focus on interest rates assumes that the problem is excess demand. A strong case can be made that South Africa is rather experiencing supply push inflation. For instance, this bulletin shows the increasing import prices of diesel and petrol. Further supply push inflation is due to highly speculative increases in some food products due to the ongoing Russian invasion of Ukraine. Lastly, the depreciation of the rand would be an important contributor to supply push inflation. If the cause of inflation is supply rather than demand factors, then the increase in interest rates is an inappropriate remedy. Shouldn’t we rather be seeking alternatives? For instance, government could do far more to promote local production of imported products, where viable. It could also shift away from petrol and diesel, including in electricity generation, as well as coming up with an electricity strategy that makes economic sense.

Including employment as part of the mandate of central banks is a common feature of central banks as it brings balance into their decisions and approach. Repeated calls for the SARB to include employment as measure should not be ignored, especially in a country with high levels of inequality and low employment.