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Page: 24 -- Part 1 of 2

INTEREST RATES

Focused on one enemy

Hiking rates into a downturn was never going to be a welcome decision, but the Bank is more worried about inflation risks than being popular

Many economists were surprised by the SA Reserve Bank's decision to raise the repo rate last week. Some went so far as to describe the Bank's reasoning as unpersuasive and inconsistent, while nearly all bemoaned the negative effect it would have on growth.

They wouldn't have been surprised if they had heard the illuminating speech that Bank governor Lesetja Kganyago made at the Bureau for Economic Research (BER) conference in Cape Town last month.

WHAT IT MEANS

6% INFLATION SEEN AS NORMAL IN SA

BANK MORE HAWKISH THAN REALISED

In it the governor came close to admitting that the Bank had made monetary policy errors in the aftermath of the global financial crisis. Its decision to start on the current hiking cycle stems from these events.

Kganyago described how the Bank looked through several temporary breaches of the inflation target around the end of 2011 and the start of 2012, and again in mid-2013.

Because each breach could be traced to specific supply shocks, from food or administered prices, and since core inflation remained within the target range and inflation expectations were elevated but reasonably stable, the Bank felt justified in cutting the repo rate to record lows.

"For a flexible-inflation-targeting central bank facing persistently sub-par growth, there was a robust case against responding to these price developments," Kganyago said. "But that did not make the choice free. The policy had costs. And the benefits disappointed."

There were two main costs. The first, he said, was shifting to a much higher level of core inflation (headline inflation minus food, nonalcoholic beverages and energy costs, including petrol).

When headline inflation first exceeded 6%, the top end of the target range, towards the end of 2011, core inflation was at 3,9%. It then tracked steadily upwards to peak at 5,8% in late 2014. It did so in line with repeated, if temporary, deviations of headline inflation from the target range.

The other cost was the consolidation of inflation expectations around the very top of the target range.

"Medium-term expectations have converged strongly over the past four years, revealing something near a consensus that SA inflation will be around 6% over the longer term," said Kganyago. "This is not because of shocks, which cannot be foreseen with any clarity several years out, this is because the 6% is perceived as the normal level."

What of the benefits?

The goal of cutting rates to historically low levels was to close the output gap and restore growth to its potential as inflation was easing, explained Kganyago. But growth did not accelerate, it slowed persistently: from just over 3% in 2010 and 2011 to slightly over 2% in 2012 and 2013, and a mere 1,5% in 2014.

In pursuing policies designed to restore growth to its potential, the Bank was slow to realise that SA's potential growth rate and hence the output gap (the gap between the actual and potential growth rate) had declined in the aftermath of the global financial crisis.

Before the crisis the Bank considered SA's potential growth rate to be 3,5%-4%. It was only recently that the Bank cut its estimate to about 2,25%. In the past few months it has lowered it even further to 1,8%.

Not only does this implicit narrowing of the output gap mean that the Bank must show less tolerance for mounting inflation, but in the process of trying to get SA's growth rate back up to its former potential, the Bank eroded valuable policy space.

So now, when the economy is flirting with a recession and the Bank is being urged to do more for growth, it finds it has run out of room to act.

"Were the [inflation] forecast more favourable or were inflation expectations anchored firmly within the target range, monetary policy would enjoy greater freedom of action," Kganyago said.

"If wage and price setting in the economy were more attuned to weak demand and the usefulness of lower inflation, we would have more policy space. But we do not have that space. It has been eroded trying to get growth back up to potential."

Freddy Mavunda

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>
> LESETJA KGANYAGO

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