Interest rates: MPC stays in the hole it has dug for itself

The Monetary Policy Committee (MPC) kept rates unchanged, as expected. We would suggest that this reveals a more dovish, growth sensitive tone with a further strong emphasis on the cost push nature of inflation (to which the Reserve Bank should not be expected to react). Growth forecasts were revised significantly lower while inflation was forecast to be higher in recognition of exchange rate influences on inflation. This was an acknowledgement not previously made as strongly (as far as we can remember) but it was an appropriate and welcome recognition of the key role played by unpredictable exchange rate moves – over which the Reserve Bank has no influence (though this impotence was not noted by the Governor or her interlocutors). The usual bromide about the role of inflationary expectations was administered. Very little change in surveyed inflation expected was recorded. Welcome criticism of administered prices for their impact on growth was heard: some moral suasion in this regard is to be encouraged.

The MPC may well be underestimating spending growth – most of the high frequency data cited, for example retail sales, employment data, construction activity and monetary statistics, are months out of date. So are third quarter and employment numbers to which reference was made. A clear divergence between better employment numbers and weaker GDP numbers was indicated. This is a contradiction that will be resolved in due course but better employment numbers do help explain the buoyancy of retail sales in December 2011.

The Reserve Bank acknowledges that the supply gap (demand less expected supplies) will widen over the next two years. Inflation is of the cost push variety and not influenced by demand pressures. The global economic outlook remains as uncertain as ever for the Bank and therefore is unlikely to help the domestic economy to grow. Yet the Bank is not at all inclined to lower interest rates and actively defends its decision not to raise interest rates – rather than having to explain why it is not given to lowering them to help close the expected output gap. Inflation targeting and a belief (not supported by any evidence) that higher inflation can be self fulfilling through more inflation expected keeps the Bank in the hole it has dug for itself. Or to put it another way: it tolerates persistent negative output gaps for fear of an inflation rate over which it has no influence.

In conversation the Governor expressed her frustration with the inability of inflation in SA to fall towards zero, as it has in the US. She should know the answer to this structural problem and therefore why inflation targeting is not helpful for the SA economy. This is especially so in the absence of exchange rate predictability. ***Brian Kantor***