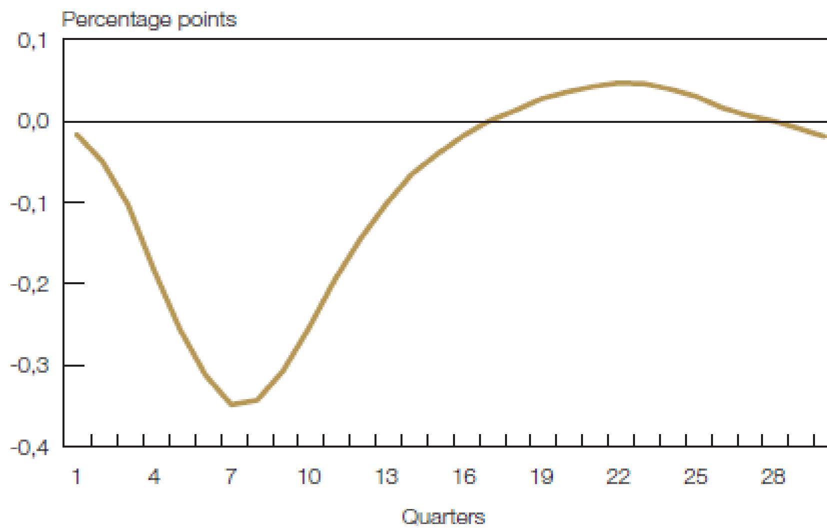
Monetary Policy- a very different mandate is called for and urgently

The national income accounts for Q2 2014 that now include the aggregate expenditure estimates for Q2 2014 make for very uncomfortable reading. The Reserve Bank confirmed that growth in spending by households, firms and also the government has slowed down sharply and may well shrink further even go into reverse in the quarters to come. These estimates of expenditure make it clear that SA has a serious demand side as well as a structural supply side problem that mean slow growth. Without a recovery in household and business spending and hiring- that will take its cue from household spending - spending the economy cannot hope to achieve anything like its potential growth. That optimists might say is a maximum 4% p.a rate of GDP growth. The economy as measured either by output or spending growth is now growing at less than half this rate. While the supply side of the economy will take structural reforms, particularly of the labour market, that will take time- the urgency is to deal with a lack of demand

The danger is that government and Reserve Bank actions will reduce spending growth further and compound the problems that slow growth cause. Higher interest and tax rates will do this and prove highly counterproductive. They can be avoided – indeed both interest rates and tax rates should and could come down – but would take an economic reality check that the Reserve Bank and government seem to find so difficult to make.

Firstly the Reserve Bank must give up its notion that inflation is under its control and that higher interest rates are helpful in containing inflation. It's own econometric model upon which it appears to rely so heavily predicts that higher interest rates have a minimal effect on inflation outcomes even as they have a significant impact on household spending. Developments over the past six months will have confirmed these dismal predictions. The figure below shows how inflation is predicted to respond to an increase in the Repo rate of 100bp. It predicts that the inflation rate will decline at most seven to eight quarters later by about 0.35% p.a. The model however also predicts that household spending growth will have declined by 0.26% over the same period and by 0.52% over the longer run. In todays conditions this is a half a per cent of what is now a very low growth number of less than 2% p.a.- In other words the model predicts a marginally slower increase in the CPI because domestic spending will come under further quite severe pressure as interest rates rise. That is if all the other forces acting on inflation remain as they were.



Source; The core forecasting model of the South African Reserve Bank, Working Paper WP/07/02 June 2007

But they are very unlikely to do so and will be little influenced by interest rates. That is to say the exchange rate may well follow a course quite independently of these interest rate settings dominated as it will be by independent and very difficult to anticipate changes in by global risk appetite. The more risk tolerance the more capital will flow to SA supporting the rand and vice versa. In other words the higher short term rates of interest, given past reactions, will not have any predictable influence on the exchange rate. They are as are as likely to be accompanied by rand weakness as rand strength making the CPI outcomes largely unpredictable. Other possible influences on the CPI over the next 12 to 24 months will be unpredictable trends in global food and commodity prices as well as tax rates and administrative prices about which only assumptions can be made when the forecasting model runs.

The Reserve Bank may well be and should be aware of all this. After all it is their forecasting model. But they reassure themselves by arguing that if they did nothing in the face of rising inflation rates- even if beyond their control- this would ignite inflationary expectations that are a self fulfilling process. The evidence for this notion of self perpetuating inflation is however very weak. The statistical evidence is that inflation in SA leads inflation expected. And inflation expected is one of the great constants of the SA economy- it is very sticky between six and seven per cent- as revealed by the yield gap between a long dated vanilla RSA bond and its inflation protected alternative. The Bank may even accept this and yet remain convinced that if it was seen to do nothing in the face of rising inflation the market would judge it soft on inflation and push long dated bond yields ever higher and the rand weaker.

There is no statistical analysis that can support or contradict this particular what if. Economic life does not allow for trial runs. But we would argue that such possible market reactions are of the Reserve Bank's own making. It has pretended to be able to control inflation and meet inflation targets that are in fact beyond its remit. The market place should be guided otherwise. Newly guided to understand that while the Reserve Bank can influence domestic demand it cannot determine inflation in any predictably useful way. Its job therefore is to try, as best it can with interest rates and other actions, to match the growth in demand to the growth in potential output. If it does this well it can influence the fragile link between domestic demand and measured inflation. That is when growth in demand threatens to outpace predicted growth in supply it should attempt to slow down spending. And as or even more important when growth is predicted to fall short of its potential for want of domestic demand to attempt to speed it up. And that is all it should be expected to do. That is to pursue a balanced mandate realistically conceived and well understood That is its task is to prevent excess demand from pushing up inflation but that how inflation turns out– given all the possible supply side shocks- will be largely unpredictable and should not be regarded as a Reserve Bank responsibility. Current policies and market expectations of such policies serve unfortunately to damage growth and the growth outlook without any predictably helpful influence on inflation. By so doing they drive capital away from SA and weaken rather than strengthen the rand. They savage irony is that they cause more not less inflation.