MONETARY POLICY WILL HURT THE ECONOMY FOR NO GOOD REASON

By Dr Roelof Botha, Joint Managing Director, GOPA Group SA (4 October 2022)

The Monetary Policy Committee (MPC) of the South African Reserve Bank (SARB) is making a habit of overreacting whenever the rate of inflation is approaching or rising above its inflation targets.

The backdrop to the latest episode of futile attempts by the MPC to curb inflation by raising lending rates is the universal spike in price levels, with the consumer price index (CPI) in the US reaching its highest rate of increase in 40 years.

Responding to the abrupt deviation from many years of relative price stability, the US Federal Reserve (Fed) acted entirely within its mandate by starting to raise interest rates in March, turning on the heat as the year progressed.

US Federal Reserve rate hikes in 2022

Date	Rate increase (basis points)	Federal Funds rate (%)
17 March	25	0.25 to 0.5
5 May	50	0.75 to 1
16 June	75	1.5 to 1.75
27 July	75	2.25 to 2.5
21 September	75	3 to 3.25

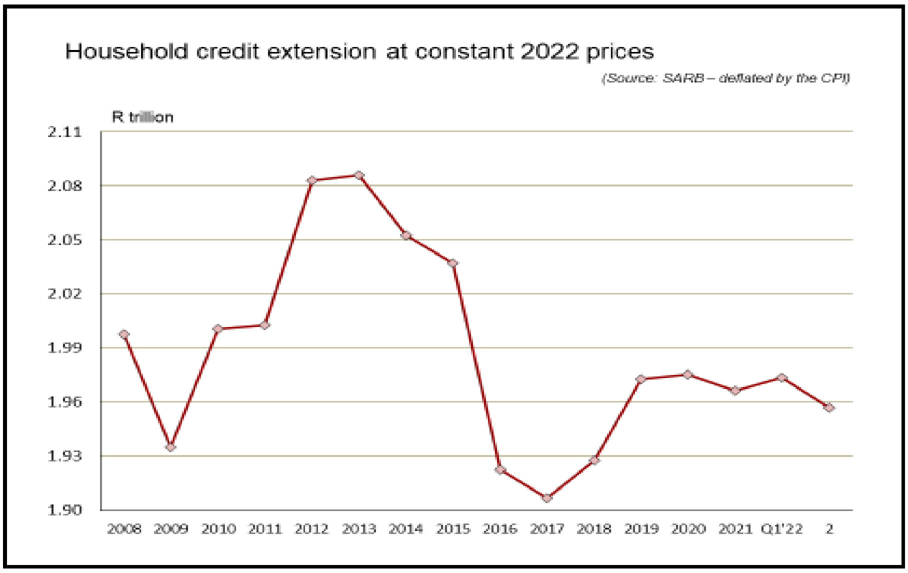
It is important to remember that the Fed was holding the country's official bank rate at just above zero as recently as the first quarter of 2022. The Fed was also still buying billions of dollars of bonds every month to stimulate the economy, despite indications that various measures of inflation were rising rapidly.

The delay in what has become an aggressive about-turn to a hawkish monetary policy stance was obviously influenced by the emphasis placed on ensuring maximum employment levels in the US, which is one part of the Fed's dual mandate (the other part being the maintenance of price stability).

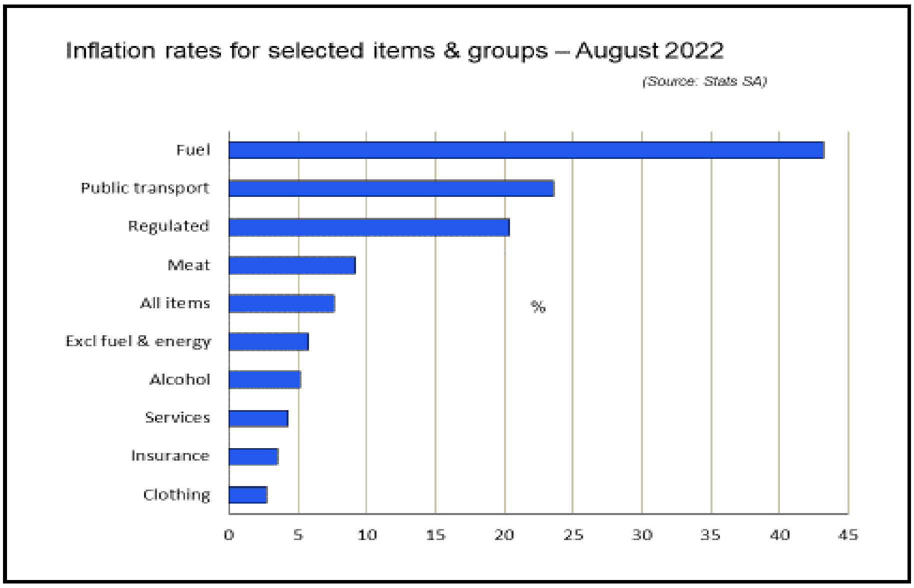
Once the Fed realised that consumer spending was still increasing at a healthy pace and the labour market was as strong as it could be (once the natural rate of unemployment had been factored in), tighter monetary policy became inevitable (and advisable). Central banks are supposed to raise interest rates when the economy starts to overheat (too much demand) and cut rates when the economy is weak and unemployment is high.

Turning from Washington to Pretoria and the response of the SARB is quite perverse. In sharp contrast to the US, South Africa is grappling with the challenges of record unemployment and a manufacturing sector where unutilised capacity remains much higher than prior to the Covid pandemic.

Although inflation has risen to above the SARBs target range of 3% to 6%, it may already have peaked in July and is considerably lower than in most of South Africa's key trading partners. Furthermore, higher domestic inflation has not been caused by excessive consumption expenditure or rising levels of household credit extension. Quite the opposite, in fact - at the end of June 2022, total credit extended to households was 6.2% lower than in 2013 (in real terms).



A cursory analysis of the relationship between this indicator and GDP reveals a strong positive correlation – sustained economic growth is simply not possible in the absence of real growth of consumer credit. When disaggregating key items and groups of items that comprise the CPI in South Africa, it becomes abundantly clear that abnormal spikes in the prices of fuel, public transport and services regulated by government constitute the root causes of the current rise in inflation.



Further analysis also reveals the inflationary impact of the overvalued US dollar and the 800% increase in global shipping rates between 2019 and 2021. These are related to temporary problems on the supply-side of the macroeconomic equation and none of them are responsive to the influence of restrictive monetary policy (via higher interest rates).

Inflationary pressure will certainly ease in coming months, as the recent inordinately large monthly incremental increases in the CPI literally start disappearing from the annualised index. This will occur with or without higher interest rates. In the meantime, however, the higher cost of capital engineered by the SARB's ignorance of the nature of inflation will hurt the economy and thwart efforts to create jobs for millions of desperate unemployed South Africans.