Macroeconomic Overview – May 2007 *By Dr Roelof Botha*

The costs of combating inflation

During the 1960s and early 1970s, Keynesian demand-side policies ruled the roost and policy-makers in industrialised countries believed that the answer had been found to the quest for full employment output in a non-inflationary environment.

This seemingly ideal macroeconomic scenario was shaken to its foundations towards the end of the 1970s when it had become apparent that most governments had ignored John Maynard Keynes' prudent advice to keep a vigilant eye on both the nature and extent of government expenditure programmes. In his own inimitable style, the neo-classical economist Kenneth Boulding remarked that: "A snake long since has been found lurking in this Keynesian Garden of Eden – the viper of inflation".

The viper is back

Just as the South African economy was gaining momentum in its arduous journey towards a GDP growth rate approximating that of its peers amongst the emerging markets, the "viper" of inflation has returned to frustrate these ideals.

The South African Reserve Bank's immediate policy reaction to higher inflation was rather predictable – the repo rate has been increased for the fifth time in less than a year. The chorus of tacit approval of the latest interest rate hike from the ranks of economists and the financial media seems to indicate a lack of awareness of three crucial, yet neglected elements of the debate on inflation in South Africa.

The background to the debate is quite clinical – the Reserve Bank decided many years ago that an inflation target of between 3% and 6% was appropriate for a country like South Africa and when inflation breaches the upper end of the target range (or threatens to do so), money market rates are increased. This is exactly what has happened during the past twelve months and the cost of servicing debt relating to working capital has increased by 24% between June 2006 and June 2007.

The Reserve Bank's task is certainly not easy. Efforts at containing inflation and securing an exchange rate level that is relatively stable, whilst not being unduly biased in favour of either exporters or importers, constitute a huge challenge for every emerging market and even some post-industrial economies.

Three caveats

Three caveats should, however, be applied before consideration of blanket approval of the Reserve Bank's current monetary policy stance.

1. <u>Looking at the past</u>

The first of these relates to the technical nature of the way in which inflation is recorded and reported on. The annualised figure published every month by Statistics South Africa is, in fact, the sum of the immediate past twelve months' incremental monthly changes in the consumer price index (CPI).

It is, therefore, a historical figure that gains a new monthly value (the change in the CPI), whilst simultaneously shedding the same month's CPI change a year ago. And so the CPI moves into the future backwards, so to speak, as is common with several other economic indicators. Technically, therefore, the current CPI could conceivably include a number of high-inflation months of late-2006.

In the fortuitous case of relatively low inflation being experienced over the next two to four months (perhaps on the back of a stronger currency and a lower oil price), the technical nature of the CPI calculation predicates that gains in low monthly increments and the shedding of relatively high ones for the same months last year would yield a lower overall CPI.

The obvious policy implication would be to remain patient and also to provide the public with more detailed information on the nature of inflation and its calculation, including a future perspective.

2. The rigidity of the target range

A second issue that requires closer scrutiny is the choice of target range. The original decision to set this range at between 3% and 6% was taken at a time when the oil price was at a significantly lower level and also before the structural improvement in the economic growth performance of the world's largest democracy, India.

Combined with China, these two countries house 37% of the world's total population and their economies show signs of being able to record GDP growth rates of between 7% and 9% for many years to come. The commodity boom that has followed in the wake of strong and sustained economic growth in South East Asia has predictably led to a global expansion of a number of key industries, most notably mining and manufacturing (especially in the areas of mineral and metal beneficiation).

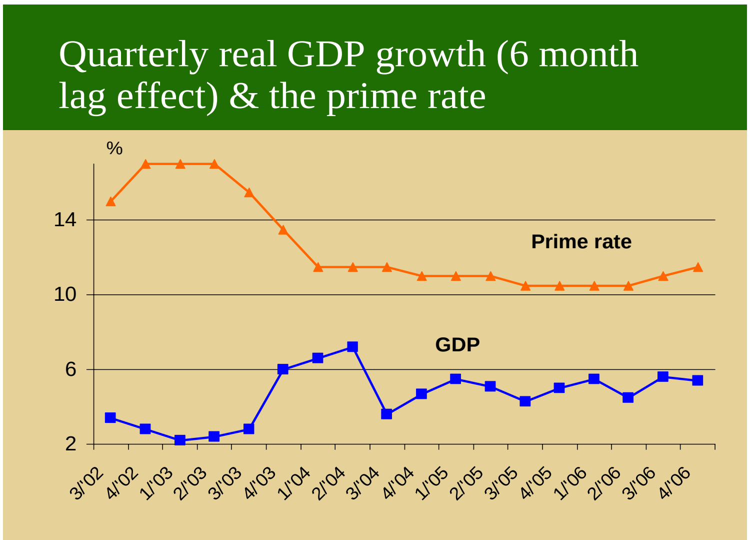
In several of these industries, short-term capacity constraints have witnessed a situation where supply curves are playing catch-up with increased demand, with a predictable increase in global inflationary pressures.

In this environment, combined with the inflationary effect of the recent drought on domestic agriculture and food processing, it seems entirely prudent to adopt a more flexible stance towards monetary policy, even if only over the medium term. This could entail a temporary adjustment of the inflation targets to levels that are more realistic in the current global and domestic macroeconomic climate.

3. The costs of combating inflation

The third caveat is regarded as potentially the strongest argument in favour of a more flexible monetary policy stance, namely an assessment of the costs associated with the knee-jerk reaction of raising interest rates every time inflation increases. Several costs to the economy at large can be identified:

- Firstly, money market rate movements are inversely correlated to GDP growth (with a six month time lag), as aptly illustrated by the accompanying figure. Although economic growth has not yet lost the momentum gained since the last quarter of 2004, the latest increase in the prime rate (which effectively follows the repo rate) may shift the economy back into lower gear again.



- Secondly, higher lending rates equate directly to increases in the cost of doing business, via working capital requirements. A recent comprehensive survey amongst private businesses conducted by PricewaterhouseCoopers indicated that financing costs constituted a significant element of total business costs.

- Thirdly, the lower demand that will ensue in some industries on the back of the higher interest rates will raise the fixed overhead cost per unit, thereby placing upward pressure on the producer price index.

- Lastly, higher mortgage loan instalments will directly add to the housing cost component of the CPI (for households).

Policy initiatives should be considered to redress the extent to which these costs harm the ability of first-time home owners and small businesses to remain solvent in an unstable monetary policy environment (an increase of 24% in the cost of capital in a twelve month period is neither predictable nor stable).

Tax breaks on the interest costs of housing for low and middle income groups is one option, whilst subsidisation of interest costs for small businesses via a venture capital fund (administered by National Treasury) would be another. If government is serious about achieving its new GDP growth target and reducing unemployment, it will have to find novel ways to counter monetary policy intransigence.