Monetary policy at odds with economic realities

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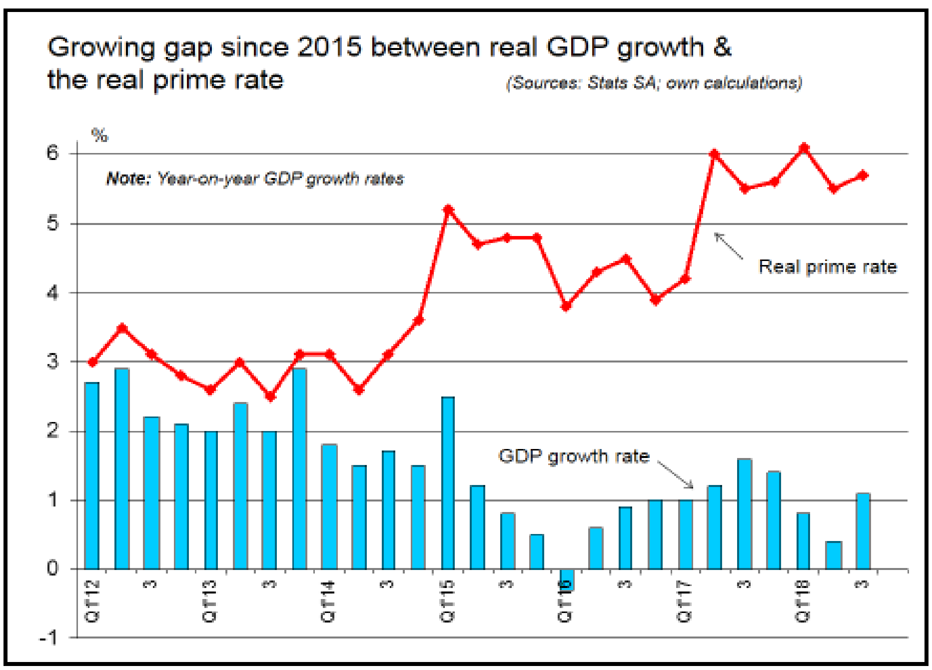
The decision by the Reserve Bank's Monetary Policy Committee to raise the official lending rate is devoid of logic and flies in the face of fundamental economic theory.

It is also thwarting the efforts of the South African government to accelerate economic growth and to secure the fiscal stability required to retain investor grade status (by *Moody's)* for the country's government bonds.

A cursory analysis of the origin of the marginal increase in the consumer price index (CPI) over the past four months clearly reveals that administered prices, particularly fuel and energy, are mainly to blame for the uptick as at the end of October. When all administered prices are excluded, CPI is merely 3.9% and when fuel end energy alone are excluded, CPI is 4.1%, a full percentage point lower than the overall CPI.

Growth should be the priority

To imagine that higher interest rates will lead to lower administered prices and a lower oil price defies comprehension. Furthermore, most undergraduate students of economics in South Africa would concur with the view that higher economic growth and employment creation should currently be afforded a higher policy priority than attempts to reduce inflation further.



There can be no doubt that the MPC's refusal to follow a more accommodating monetary policy stance has contributed to the downward trajectory of the economic growth rate since 2015. The really sad part of this unnecessary obstacle to higher economic growth is the fact that inflation has been comfortably within the Reserve Bank's target range for the past 19 months.

Furthermore, inflation targets are never cast in stone and one of the basic tenets of this policy approach is that it should always be subjected to a degree of flexibility, depending of course, on the prevailing economic and socio-political environment in the particular jurisdiction.

In the case of South Africa, socio-political unrest has escalated in recent years as a result of, *inter alia,* corruption, state capture and the growing incompetence in several key public sector institutions. Add to this mix a cumbersome public service bureaucracy, a plethora of regulations that act to constrain business development, the prevalence of unprotected strike action, and a large degree of policy uncertainty and it becomes clear why capital formation has been declining and economic growth has been paltry.

The new political leadership that is gradually being forged by President Cyril Ramaphosa needs all the assistance it can get to improve economic welfare. High interest rates fly in the face of efforts to achieve this.

Policy shift raises cost of capital

It remains a mystery why the Reserve Bank decided to depart from the policy approach followed between 2009 and 2014, when Gill Marcus was at the helm. During her tenure as Governor, the Reserve Bank aligned its policy fairly closely to the near-universal trend in advanced economies, aimed at maintaining positive economic growth.

During this period the real prime rate in South Africa was maintained at a level of around 3% - marginally higher than in most of South Africa's key trading partners, but low enough to secure an average annual real GDP growth rate of 2.6%. Since her departure, the average real prime rate has almost doubled and real GDP growth has plummeted to an average annual rate of 0.6%.

Ever since the departure of Gill Marcus, a significant shift has occurred monetary policy, to the detriment of economic growth. Currently, the real prime rate is at a level of 5.65%, which represents an increase of close to 90% in the cost of credit and capital formation, which is not conducive to the expansion of productive capacity or private consumption expenditure.

One of the strongest justifications for the call to reverse the current monetary policy approach is provided by the fact that a measure of the increase in the cost of capital will be shifted forward to other elements of a particular supply chain and, ultimately, to the consumer, depending on the price elasticities at play.

Serious consideration should be given to a reconstituted MPC, whose members should only consist of persons with appropriate qualifications and experience in macro-economic theory and policy application. The Committee should ideally also be expanded to include private sector economists and senior officials from National Treasury.

This recommendation will receive overwhelming support from the whole of the country's business fraternity and the nine million people who cannot find a job.