



SLIPSTREAM

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The cost of monetary policy lethargy

Recent reports in the financial media have suggested that the Reserve Bank's policies have failed to respond in time to the business cycle trend of the past year.

This is a fairly strong accusation, as insufficient insight into the state of the economy by the monetary policy makers can exert a significant impact on the economy – particularly through the negative effect of unduly high interest rates on the levels of disposable incomes of households.

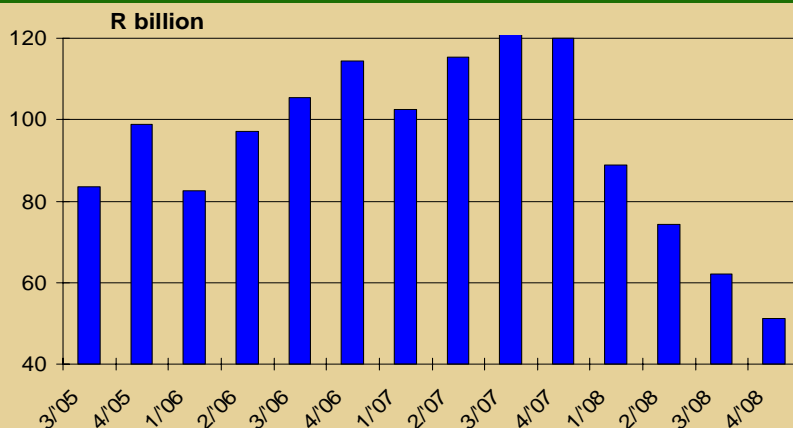
One is reminded of the well-worn quip surrounding a head of state of a military dictatorship during the annual parade of well-drilled soldiers and an impressive array of weapons of all kinds of destruction. Included in the military parade were the country's leading monetary economists, marching neatly in pin-striped suits.

This amazing phenomenon was questioned by an international observer as totally out of kilter with the rest of the proceedings, upon which the commanding General replied: "Have you seen how much damage they can inflict upon a country?"

The painful truth

Unfortunately for South Africa, a measure of truth exists in this piece of humour, as clearly illustrated by the data in the accompanying figure and table.

Mortgage loans paid out by banks (quarterly)



Economic policy makers are supposed to be vigilant in pursuing policies that do not steer the economy on a volatile growth path. The latter will be manifested in deep recessions (during downswings of the business cycle) and unduly high inflation (during growth phases).

In defense of policy makers, it should be borne in mind that certain events (such as a commodity boom or global systemic financial instability) fall outside of their realm of control. However, exogenous influences are often present and they reinforce the need for policy makers to timely analyse relevant data.

Increase in total credit extension to the private sector (annualised)	
Month	%
January 2007	24.8
February	26.1
March	24.1
April	25.0
May	24.8
June	24.8
July	23.2
August	23.3
September	22.6
October	22.4
November	22.7
December	21.5
January 2008	23.3
February	20.8
March	22.6
April	20.0
May	20.4
June	20.9
July	19.7
August	18.8
September	16.4
October	16.4
November	15.4
December	13.6

The golden rule should be to always act against the business cycle. Counter-cyclical fiscal and monetary policies, if co-ordinated, possess the potential to avoid unnecessary volatility and to allow for so-called ‘soft landings’.

Unfortunately, the Reserve Bank has apparently ignored this rule with regard to a lag in reaction to at least two crucial indicators of the state of economic activity. Firstly, the annualised rate of increase in private sector credit extension declined by more than 45% between January 2007 and December 2008. The decline in the last six months of 2008 alone amounted to almost 35%.

Secondly, an even more pronounced decline occurred in the value of new mortgage loans paid out by banks. The figure of almost R120 billion during the fourth quarter of 2007 declined by an astonishing 57% to below R52 billion during the fourth quarter of last year.

Negative changes of these magnitudes to key indicators of economic activity do not bode well for growth in output and reflect dramatic declines in the levels of business confidence. Although the Reserve Bank must have been aware of the steepness of decline in these variables during the third quarter of last year, it chose to wait until the end of December before the first cut in money market rates was announced.

It was also clear from trade data released during the third quarter of 2008 that non-gold exports were in sharp decline (in real terms), but the Reserve Bank doggedly stuck to its policy of considering interest rate changes only every second month (as opposed to a more appropriate *ad hoc* procedure in most other countries).

Interest relief

Owners of debt that are not heavily involved with the analysis of economic data have every right to feel aggrieved over the lethargy of the Reserve Bank's policy response to the global financial contagion and the dramatic decline in the level of domestic credit extension .

This is borne out by a fairly simple calculation. A one percentage point decline in money market rates virtually automatically leads to an increase in the disposable income of households of R1.69 billion every month (the calculation is based on interest savings on leases, mortgages, credit cards, foreign loans and overdrafts). To place this amount in perspective, it is almost 50% more than the total monthly individual taxation relief announced in the February budget by the Minister of Finance.

It has become fairly evident that the delay with the easing of monetary policy contributed to the suppressing of total demand in the economy at a time when there was no evidence whatsoever of demand-side inflation in the economy.

Obsession with inflation

In fact, the undue emphasis on combating inflation should shoulder most of the blame for the recent lethargy in monetary policy adjustment. It also provides further evidence of the lack of foresight by the Reserve Bank in appraising the nature of inflation and the reversal of the commodity price boom in 2008.

During the second half of last year, most commodity prices declined by between 25% and 45% from the record highs recorded earlier in the year. It was abundantly clear that this would result in a sharp decline in the rate of increase of South Africa's producer price index (with a lag of between three and six months).

The latter figure for April was merely 2.9% and, despite some resistance with the declining trend of the consumer price index, the latter should fall to within the Reserve Bank's target range within the next three months. In these circumstances the prime overdraft rate should be below its current level of 11%.

Perhaps the new Minister of Finance shares the frustration amongst several economists (especially outside the banking sector) over the Reserve Bank's apparent clouded perception of key economic variables. The suggestion by the Minister to subject the issue of inflation targeting to public debate should be welcomed, as a flexible (and higher) target range represents a practical way to effectively stimulate demand in the economy (as is now necessary).