Clearing up the mystique of central banking

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By Stan du Plessis

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When the Bank of England's former governor, Mervyn King, was relatively new at the British central bank, he asked the legendary Paul Volcker for advice on how to be a central banker.

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The former Federal Reserve Board chairman condensed his advice into a single word: mystique. That was in 1991. Central banking here in South Africa, no less than internationally, has come a long way since then.

It is hard for most of us to remember a period when central banks were deliberately obscure about their policy decisions and when policy meetings were not pre-announced. Their decisions were not publicly announced. Then there were no policy meetings at all in South Africa, just the wisdom of the governor. Over the last 25 years we have moved a long way to clear up the mystique of central banking.

Transparent policy decisions

The South African Reserve Bank's practice since the late 1990s is a fine example of these developments. It now has a transparent target for monetary policy, regular and pre-announced meetings of the monetary policy committee, and a communications strategy.

At the end of every monetary policy meeting the bank releases a detailed statement and the governor addresses a press conference about the main themes of the meeting and the policy decision.

The recent meeting of the Monetary Policy Committee (MPC) of the Reserve Bank displayed all the hallmarks of a 21st-century approach to central banking.

Two characteristics in particular stand out: clear communication on the decision taken (the committee decided to keep interest rates where they are), and a carefully crafted statement to manage future expectations.

Sending clear signals

The committee created the clear expectation that the rate at which the Reserve Bank lends money to commercial banks -

the repo rate - will rise in the not too distant future. By raising or decreasing the repo rate, the bank influences the interest rate that banks charge their clients.

There is general agreement among economists that too much money circulating in an economy leads to inflation, a sustained and general increase in prices. So by making money relatively more expensive or cheap to borrow, a central bank can affect the general direction of prices.

The committee said the deteriorating outlook for inflation suggested that the unchanged interest rate stance could not be maintained indefinitely. This warning came in the concluding section of the report, which typically has a four-part structure.

Setting the scene: up or down

An opening paragraph sets the stage for the report by summarising the committee's expectations for inflation and the context within which they arrived at that expectation.

In the most recent report, the summary gave the sobering message that the Reserve Bank's inflation forecast has deteriorated and that inflation is not only likely to rise above 6%, the upper end of the target range, but also to remain close to the upper end of the target range over the forecast horizon.

The major factors that may push inflation higher are a weak rand, rising electricity prices, and higher domestic wage increases are the major upside risks to this forecast. The local economy is weaker than previously thought.

Reserve Bank has flexibility in fighting inflation

The weaker economic performance was an important factor in the committee's decision last week. The Reserve Bank pursues its inflation target flexibly, meaning it can allow inflation to rise temporarily above 6% while the economy is adjusting to unexpected events that may have a large effect. Flexibility also means the bank takes into account the impact of interest rate increases on the real economy.

There is little doubt that economy's weakness stayed the hands of a committee this time round. Given better economic conditions, it may have been ready to raise the repo rate had growth been more robust.

The first substantive part of the report is all about inflation: a detailed analysis of the major price developments in food, energy and a range of other items in recent months. It uses this data to make inflation forecasts over the next two years.

This forecast is a major factor in the committee's decision, and the deterioration in the forecast since the previous meeting would have been an important reason why two of the six committee members voted for a higher repo rate.

Four against two

But four members voted against an immediate interest rate tightening last week. Their motivation can be found in the next section of the report, which discusses the recent developments and expectations for the local and international economy.

The message here is of continuing weakness in the global economy: slow growth in Europe, slowdown in emerging market economies and of disappointing growth in the US.

Locally, various surveys of economic activity, business and consumer confidence, building confidence, and purchasing managers expectations all point to weak and deteriorating economic activity.

Reasonable decision

Given such poor prospects for economic growth there was no evidence that rising demand for goods and services would push prices higher. Hence there was little reason to constrain demand by raising interest rates to manage inflation. Instead our inflation risks lie with increases in the prices of inputs used in the production of goods and services such as electricity prices and wages, known as the supply side.

Against this background the committee's decision was reasonable. But the MPC also reminded us that these supply side and international factors are likely to spill over to sustained inflation if the committee is complacent.

The information about a 4-2 vote split was meant to assure us that it will not be, and the statement made it clear that the interest rate pause is only temporary. South Africans will soon have to adjust to the reality of higher interest rates.

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