

## Double, double, toil and trouble

by Chantal Valentine

Higher inflation plus slower growth make for a tricky monetary policy equation

A witches' brew, indeed. The onset of the credit crunch against a background where a number of emerging markets are still growing fast (and gobbling commodities as they do so) has led to one of the trickier outcomes for many countries: a combination of slowing growth and rising inflation. Tricky for monetary policy, because what works for one works against the other.

That these episodes of 'stagflation lite' are creating dilemmas for central bankers is clear in the differing responses of various central banks. Of course, no two countries face exactly the same set of circumstances, but generally circumstances are similar - lower growth, higher inflation. The US Federal Reserve (Fed), with most fear about recession, has slashed rates even in the face of inflationary pressures. The normally conservative Bank of England has cut rates in more moderate fashion on growth fears - despite inflation being above target in the short term. The European Central Bank (ECB) has steadfastly refused to countenance rate cuts - indeed, it continues to talk of the risk of hikes - despite a deteriorating growth picture, as inflation stays above target. The Reserve Bank of Australia, admittedly with less growth concerns than the others mentioned and with inflation also at a multi-year high, has kept raising rates. It's worth noting that globally, pressure on food and fuel prices is the principal inflation driver.

Even while admitting that circumstances in different countries are unique, it seems likely that such a widely varying response to essentially similar circumstances (there are many other central banks at various points along the spectrum outlined above) probably means that there is policy error somewhere. It's not that easy to figure where, but if there is a candidate it is most likely to be the US. Admittedly, the US right now is probably more concerned with stabilising the financial system than with where inflation is going to be a year from now. Also, the Fed has justified cutting rates by pointing to anchored long-term inflation expectations, as well as the fact that slower growth in the US should dampen inflationary pressures. It's a nice theory, but it remains to be seen how well it will work in practice; getting the inflation genie back in the bottle once higher expectations have been allowed to take hold is always a very tricky task. Indeed, this is exactly why the ECB has been unwavering (thus far) on rates.

Where does South Africa fit in the global picture? It seems itself to be going through a 'stagflation lite' episode - with growth slowing and inflation rising - with a cherry on the top in the form of Eskom, currently exacerbating both those factors. And all this puts South Africa squarely in the 'monetary policy dilemma' camp.

The interest rate rises that we have already seen in 2006 and 2007 are working - hard - on consumers especially. Car and retail sales have slumped, and overall consumption expenditure (even including food, fuel, etc) is slowing sharply. The domestic manufacturing sector is showing signs of either a sharp slowdown or recession - and worse, it appears to be losing jobs as well. Private sector investment will not remain unaffected by all this, even as the public sector infrastructure programme will help keep overall growth reasonable.

The problem is that interest rate increases are not working very much on inflation. This is not to say they are not working on the categories they can affect: durable and semi-durable goods' inflation rates are either very low or in outright deflation. But food, fuel, and many prices that are either fully or partly administered are still going up.

This puts the SA Reserve Bank, basically, at the heart of the dilemma that has seen the Fed and the ECB take such widely divergent routes on monetary policy. Domestic demand growth has probably already slowed to below potential, meaning there should be downward pressure on inflation.

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But... driven by cost-push pressures, actual inflation keeps rising, and there has already been a significant effect on inflation expectations, which could lead to second-round pressures. Interest rates cannot meaningfully affect any of the first-round effects, but credibility becomes a key issue here. The SA Reserve Bank clearly felt that the increase in inflation expectations (where CPIX is now seen outside the target range through to 2010) was unacceptable and raised rates in April in response. Eskom will remain a key concern: if large increases (30% - 60%) are approved by the regulator, there will almost certainly be another negative effect on inflation expectations.

Policy will thus remain on a knife-edge until it becomes clear that some of the factors driving inflation have started to subside - and there will be uncertainty over some of these (especially oil and the actual extent of Eskom price hikes to come) for some time. (As we noted last quarter, we are less worried about food. Although prices may remain high, we are already seeing signs that the base effect is starting to work and food inflation should peak within the next few months.)

Another 'eye of newt' thrown into the witches' cauldron this past quarter was a sharp rand depreciation: against a background of rising global risk aversion, the current account proved as dangerous as we had feared. The rand lost some 20% of its value on a trade-weighted basis over the first quarter. Good news, where it can be found in circumstances like this, is that there are early signs that the current account is beginning to adjust to both the weaker currency (from last year too) as well as interest rates, and it will probably improve, if slowly, from here. It is also worth noting that in past episodes of sharp rand depreciation, one tends to see a very quick, sharp adjustment, followed by a period of broad sideways movement. The fall in the rand/dollar brought it roughly in line with our perceived fair value, and while the risk of overshooting is always possible - especially against such a nervous global backdrop - we think the brunt of the adjustment is in. Indeed, we would go so far as to say that the rand might be somewhat undervalued against the euro, and we would expect some better performance against that - most likely to come against a background of a general euro/US dollar retracement, which we think we might see from later this year. In the meanwhile, however, the effects of the weaker rand will not help the inflation outlook.

In the shorter term, things are likely to stay relatively bleak. Growth will slow further, inflation will rise further, the SA Reserve Bank will remain between a rock and a hard place, the world will wait to see the effects of the rest of the unwind of the credit crunch on global growth and risk aversion; and all this is likely to be an unsettling shorter-term environment for financial asset markets. Longer term, there is more reason to be sanguine. The US is still the most flexible economy in the world, and it will resolve in due course - even if there is more pain to come in the interim. In South Africa, a floating exchange rate and conservative macroeconomic policies have indeed helped South Africa weather the storm and, as mentioned above, adjustments are already under way where needed. The downward part of a cycle is never a pleasant place to be, but this will be one of the 'best' down phases South Africa will have had for many years - as the structural underpin is so much better now.

#### **Chantal Valentine**

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