Domestic monetary policy cannot curb inflation that is driven by world fuel and food prices

Reserve Bank even has doubts about rate hikes

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DEBATE is swirling over whether looming increases in electricity prices will expose the limitations of inflation targeting — and whether steps should be taken to avert knee-jerk interest rate hikes.

SA's main inflation gauge has now breached the upper end of its 3%-6% target for 11 months running. Figures due next week are expected to show it climbed to 10% last month, a level that was seen earlier as the likely peak.

But if Eskom gets the go-ahead to double its electricity tariffs over the next 18 months, the annual rise in CPIX could break its previous record of 11,3% — scaled in October and November 2002 — in the second half of this year.

Reserve Bank Governor Tito Mboweni has made it clear that this scenario would prompt further hikes in interest rates, which many analysts believe would be unjustified given the nature of the price shock.

Mboweni appears to think so too. When he announced the latest interest rate rise last week, he highlighted possible electricity price hikes as the biggest inflation threat, and urged Finance Minister Trevor Manuel to do something to help the Bank achieve its official mandate — the inflation target.

The question is, what could — or should — the government do? Steep electricity price rises are seen as inevitable, given that in the past decade tariffs have not kept pace with costs.

Even if the National Energy Regulator of SA does not approve the whole price hike Eskom has requested, the 14,2% rise it was granted for this year so far is likely to increase substantially.

Electricity prices have a low weighting of about 3,5% in the basket of goods making up CPIX, which is consumer prices excluding home loan costs. But hefty hikes will have an effect.

At a time when global food and fuel prices — the main inflation culprits so far — are still rising relentlessly, the chances of driving inflation back into its target range in the next two years look slim.

There is also a big risk of another 50-basis-point rate hike at the Bank's next monetary policy meeting in June. Some analysts predict another one after that.

Given that the sources of price pressures are external and will not respond to higher interest rates, the hikes may further curb SA's slowing economy without taming inflation.

"Meeting the inflation target is not as simple as it seems — right now there is a risk it will strangle the economy," says Brait economist Colen Garrow.

"The knock-on impact of these electricity price increases will be enormous. Inflation may break its all-time high and there's a real risk the Reserve Bank will put interest rates up."

Garrow wants the Bank to discriminate between demand pressure — which can be tamed by higher interest rates — and supply side shocks, which can't.

He thinks it should take its cue from the European Central Bank and acknowledge that price pressures are rising, but keep interest rates on hold.

The next step should be to widen the inflation target to 3%-7%, a decision only the government can make.

"Alternately, we have to target a much better definition of inflation excluding food, fuel and electricity. That would assess demand pressures in the economy more accurately."

Both Manuel and Mboweni have said it would be meaningless to target an inflation measure that excludes basics.

Some analysts think the Bank would not lose credibility if it invoked an "explanation clause" which would give it some leeway to miss the target.

Mboweni , last week dismissed this option, saying it amounted to "running away". So far, Manuel has not responded to his plea for support.

Standard Bank economist Danelee van Dyk shares Garrow's concerns, and is revising down growth forecasts for this year and next because of the latest rate hike.

It might make sense now to exclude electricity, food and fuel from the core inflation measure, she says. This would help the Bank to get a better idea of "second-round" inflation effects, which are its main concern. "We are dealing with an unusual price increase which skews the underlying inflation picture. It sends the wrong signal to foreign investors," she says.

ETM economist Russell Lamberti believes consumers will have to bite the bullet and there is enough resilience in the economy for them to cope.

"We need to go through a painful process of playing catch-up on energy prices now. Someone has to foot the bill. It's going to be inflationary in the short term and if that leads to further rate hikes we'll just have to grin and bear it," he says.

Dynamic Wealth economist Chris Harmse draws attention to a factor most of us have forgotten. Stats SA has re-weighted its consumer price indices to more accurately reflect modern spending, reducing the number of items to 386 from 1 124.

The new series is being run alongside the existing one now, but will only be published at the start of next year. It gives less weight to food — a quarter of CPIX — and electricity, but more to fuel.

The process will probably result in a different inflation rate — whether higher or lower is not known. "The impact should be taken into account by the Bank's monetary policy committee" and it was not clear this was happening, he said.

At a time when fuel prices are still rising relentlessly, the chances of driving inflation into the Bank's target range in the next two years look very slim.