South Africa's (SA) Accelerating Inflation at a Time of Hesitant Economic Recovery: Implications for Monetary Policy.

Is this situation cause for concern regarding conduct of monetary policy in SA?...........

Introduction

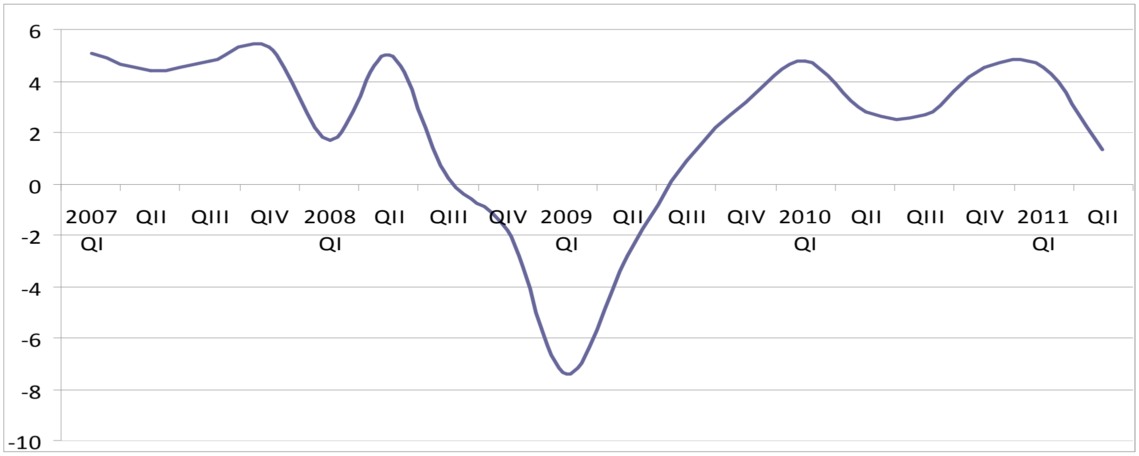
Inflation in South Africa (SA) has recently assumed an upward trend along with global trends. This acceleration has raised concerns that inflation might exceed the SARB's inflation target range of 3-6 per cent before the end of this year. Recovery of the SA economy so far is uncertain, accelerating in one quarter and decelerating in the next. This situation has somehow put the SARB in a dilemma in terms of conduct of monetary policy. Low economic recovery and high unemployment call for easing of monetary policy, while trotting inflation is calling for tightening of monetary policy.

RSA's Inflation and Economic Growth Developments

South Africa's economy is struggling to recover from the effects of the global financial and economic slump. Following three consecutive negative growth rates from the fourth quarter of 2008 to the second quarter of 2009, the SA economy recovered into positive territory in the third quarter of 2009 and has been registering positive growth rates since then. Nevertheless, it did not grow steadily but has been fluctuating from one quarter to the other. Real output growth in the SA economy slowed considerably to 1.3 per cent in the second quarter of 2011 compared with 4.5 per cent in the previous quarter. Fluctuations are more pronounced in the agriculture, mining and manufacturing sectors. Real value added by the agriculture and mining sectors contracted in the first and second quarters of 2011 while manufacturing production slumped in the second quarter. Mining production, though still increasing, may be negatively affected by weak global economic conditions and lower global demand for some mining commodities. The manufacturing sector, particularly motor vehicle manufacturing sector is faced with high and rising production costs, increased wage demands and components supply constraints related to the natural disaster that hit Japan in March 2011. SA's weak recovery is largely blamed on the surge in unemployment, high household debt, low capacity utilization, the slowdown in advanced economies and the exchange rate appreciation from early 2009 up to the first half of 2011.

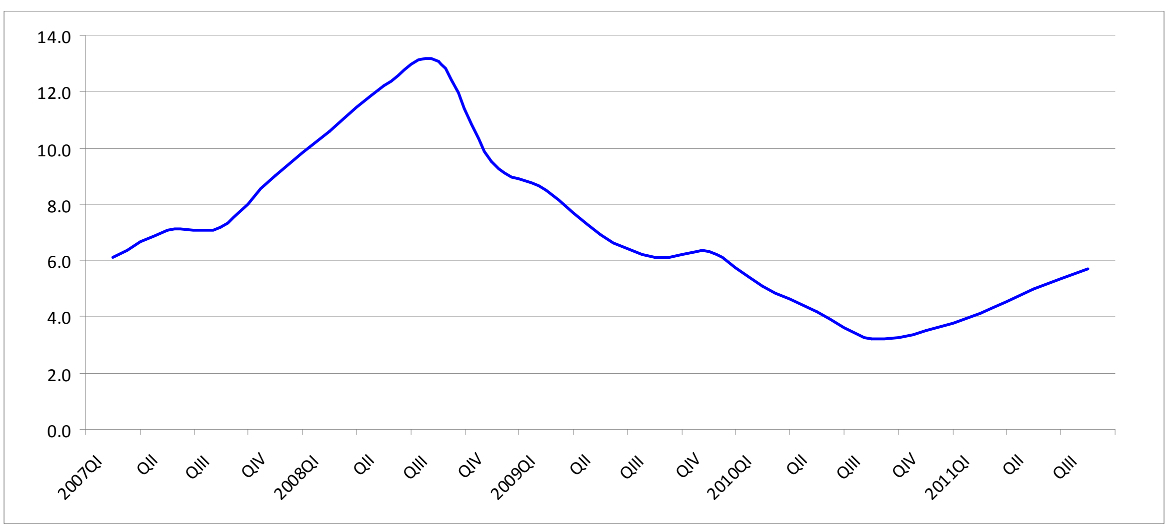
Figure 1: Real Gross Domestic Product

Percentage change at seasonally adjusted annualised rates



While SA's economic recovery remains weak and demand pressures on inflation are low, exogenous supply factors are fueling inflation acceleration and deterioration of the inflation outlook. Inflation in SA took an upward trajectory in line with global trends, mainly as a result of the surge in commodity prices, particularly food and fuel prices. SA's inflation accelerated from 3.2 per cent in the year to September 2010, to 5.3 per cent in the year to August 2011. In August 2011, the SA inflation rate remained within the target range of 3-6 per cent for 19 consecutive months since February 2010. Nonetheless, inflationary pressures appear to be rising.

Figure 2: SA Headline Consumer Price Index (CPI)



In terms of the outlook, the SA Reserve Bank's Monetary Policy Committee statement of 22 August 2011 indicated that inflation in SA would breach the upper limit of the inflation target range in the fourth quarter of 2011. It would further peak in the first quarter of 2012 before falling gradually to within the target range in the fourth quarter of the same year. It would remain within the target range in 2013 and close the same year at 5.2 per cent.

According to data published by South Africa's Bureau for Economic Research, inflation expectations have increased though they remain largely well anchored. Expectations of businesses have increased more than those of analysts and trade unions. This could imply that firms are forecasting deterioration in profits in proportion to the high increase in input costs associated with the rise in energy costs and they will probably pass the increase in production costs to consumers.

Table 1: SA's Inflation Expectations

2011 Q3 CPI SURVEY				
	Analysts	**Business**	**Unions**	**Average**
2011	5.1	5.6	5.7	5.5
2012	5.7	6.1	6.0	5.9
2013	5.5	6.3	5.9	5.9
2011 Q2 CPI SURVEY				
2011	5.0	5.4	5.5	5.3
2012	5.7	5.8	6.1	5.8
2013	5.5	6.0	5.9	5.8

Source: SA's Bureau for Economic Research

Trade unions, which generally represent workers, expected inflation to remain within the target range through to 2013 implying that there was no threat to price stability. Nonetheless, labour unions in SA are famous for demanding high wage increases, which do not augur well for inflation.

The SA rand started depreciating somewhere in the middle of July 2011, thus imparting an upside risk to the inflation outlook. If the rand depreciates further, the inflation rate could breach the target of 3-6 per cent for longer than previously forecast. The possible extended breach would potentially impact adversely on inflation expectations. Should the SA inflation stay above the target for much longer, especially if it surprises on the upside, inflation expectations will become more precarious, exerting more risk to the inflation outlook.

Implications for Conduct of Monetary Policy in SA

The main objective of monetary policy in SA is to "achieve and maintain price stability in the interest of sustainable and balanced economic development and growth". The South African Reserve Bank, through its Monetary Policy Committee (MPC), conducts monetary policy "within an inflation targeting framework with a target range of 3-6 per cent. This framework allows for inflation to be out of the target range as a result of first round effects of a supply shock and for the SARB to determine the appropriate time horizon for restoring inflation to within the target range".

What should the SARB do under the prevailing circumstances? Should they tighten monetary policy even though the economy is struggling to recover? Or should they consider the rise in inflation as a temporary phenomenon that results from cost-push factors and opt for an expansionary policy to boost the weak economy?

The inflation targeting regime, which is at the core of monetary policy in SA, increases accountability of the SARB because of the announcement of a numerical target for inflation and hence reduces the changes that the SARB will, under any circumstances, fall into a time-inconsistency trap. One other requirement for this regime to work is that there must be a strong institutional commitment to make price stability the primary mandate of the Reserve Bank so that when there is a conflict with other macroeconomic goals such as exchange rate stability or promotion of high employment, price stability is given priority.

This implies that, if the inflation rate should edge above the target and remain there for long and or risk fuelling inflation expectations, the SARB would tighten monetary policy despite the slow economic growth and recovery prospects. This should happen regardless of the fact that the acceleration in inflation appears to be mainly a result of supply shocks rather than demand pressures. This is because empirical research and experience have demonstrated that higher and more volatile inflation hampers long-term growth. In addition, once inflation expectations increase, they tend to be sticky and difficult to reverse and hence should be kept well anchored at all times.

SA has been using the inflation targeting since February 2000. At that time, inflation in SA was already low and continued to moderate even in the following year. It edged up in 2002 owing mainly to the protracted depreciation of the rand against major world currencies. High international food and crude oil prices and domestic administered prices also contributed to the rise in inflation.

The monetary authorities in South Africa responded to this upsurge in inflation by increasing the repo rate four times from January to September 2002. This together with the recovery in the value of the rand and the moderation in food prices resulted in a deceleration in inflation towards the end of 2002. The repo rate was increased despite the lacklustre economic growth conditions that prevailed. In 2002 the SA economy was struggling to recover and registered a seasonally adjusted and annualised growth rate of 3.7 per cent compared with 2.7 per cent in the previous year.

The inflation rate fell further to 2.9 per cent in 2003. Thereafter, it declined and remained below the upper limit of the target until early 2007 when it rose above the target and remained there till January 2010. In response, the SARB reduced rates by 650 basis points between end of 2008 and end of 2010 and maintained it at 5.5 per cent to date. This indicates that monetary policy authorities in South Africa adhered to the inflation targeting regime and responded appropriately to inflation developments.

Implications for Lesotho's Economy

The fixed exchange rate regime, whereby the Lesotho loti is pegged at par to the SA rand is at the core of conduct of monetary policy in Lesotho. Through the fixed exchange rate regime, Lesotho has surrendered its monetary policy discretion to South Africa. This regime has so far served Lesotho well by enabling it to enjoy low and stable inflation. South Africa has historically been characterized by moderate and stable inflation environment and the situation has improved even more following the adoption of inflation targeting, thus imparting more benefits to Lesotho.

By adopting inflation targeting, the SARB has committed itself to price stability as its first priority. By announcing an explicit inflation target, the SARB has increased its accountability to SA businesses and the public at large and hence minimized the chances that it could renege on its number one mandate of ensuring price stability. As indicated above, SARB has demonstrated loyalty to price stability in the past. This implies that the SARB will, in the interest of long term growth and stability, ensure that inflation expectations remain well anchored and price stability is maintained despite the currently subdued economic growth. This augurs well for inflation developments and price stability as well as for long term economic growth in Lesotho.

The Companies Act 2011 and Its Potential Impact on Economic Development in Lesotho

The Government of Lesotho has recently reviewed the Companies' Act 1967 and has replaced it with Companies' Act 2011 as part of legal and regulatory reforms that are intended to promote economic growth and hence economic development in Lesotho …………………………………..

Introduction

Improvement of the Company law in Lesotho is a crucial step towards enabling private sector-led growth. The main purpose of reviewing company law was to provide a legal and regulatory environment that would facilitate efficient and productive business sector. Creating an enabling legal and regulatory environment also promotes accountability and protects companies' directors as well as stakeholders. This is because these two players have a crucial role in the development of the company, the business sector, employment and productivity of the overall economy.

Early in the post-independence era, Lesotho enacted a law governing the companies' life – The Companies Act 1967. Since then the companies' law had not been harmonized with the changing business environment. The recent global financial crisis has also influenced how companies behave, and it has forever changed the way they are managed. Companies in Lesotho have not been immune to the economic, social and political transformations as well as the pace of globalization that have taken place over the years.

As a result, some clauses that are critical to business sector development had become outdated and the Companies' Act 1967 has been rendered unresponsive to the current business sector and economic demands. This has necessitated the Government of Lesotho to repeal the Companies' Act 1967 and replace it with the Companies' Act 2011.
The main objectives of the Companies' Act 2011 are: to promote investment and innovativeness in Lesotho through strengthening education in order to encourage self compliance to traders, to promote efficiency of companies and their management through changing the role of directors in the company to reflect changing demands of the business world and to encourage transparency as well as high standards of corporate governance.

This article, therefore, highlights the channels through which company law affects economic growth. It also highlights economic implications of the recent review of the Companies' Act in Lesotho.

Company Law and Economic Development

The role played by the companies' law, company registration and the consequent corporate governance codes emanating from these laws vary from individual companies to the economy as a whole.

First, the key strategy in encouraging economic growth is to shore up the rights of invertors and creditors. When their rights are better protected by law, these investors are willing to pay more for financial assets such as equity and debt. They pay more on recognition that with better legal protection, especially from expropriation, more of the firms' profits would come back to them with interest or dividends as opposed to expropriation by managers. By limiting the prevalence of expropriation, the company law also raises the prices that securities fetch from the market. In turn, this promotes and deepens the development of the equity and debt markets, which enhance expansion of financial markets and provision of financial capital that is necessary for investment.

Second, the existence of an efficient company law and company registration facilities can affect economic growth through automated registries, which can be an information center for risk management and analysis in the era of greater and growing pace of globalization. The center can enable information seekers to get data on the degree of success or failure of certain types of business corporation, capital structure, base and minimum requirement and any other relevant data that can assist in performing risk analysis. Sound and prudent risk management and analysis fosters efficient decisions making at all levels. At the macro level, risk analysis fosters country's preparedness in handling tough macroeconomic situations.

Third, company law that enables efficient business registries has a direct impact on business sector development. As earlier mentioned, properly developed business registries facilitate efficient transmission of business information and, hence transforms how business activity is conducted. This information enables trade and fosters international competitiveness. As a country becomes more competitive, its economic base increases, leading to more economic growth.

Fourth, company law that enables business registration can serve as the front line player in ensuring that business operates transparently and within the boundaries of law. This helps in exposing and discouraging illegal business activities such as money laundering and other financial crimes which derail economic growth. Money laundering negatively affects economic growth by hampering the development of the financial sector, distorting investment and depressing financial asset and real productivity.

Fifth, good company law that fosters sound corporate governance codes drives the mechanisms which are growth-enhancing. In this case it is important to mention that an effective approach of corporate governance fosters national as well as the international competitiveness of a country's businesses. When these companies become competitive and produce more, the demand for labour and hence employment increases and this may translate into higher and sustainable economic growth. A sound corporate governance structure also attracts foreign direct investment which comes with a host of other economic benefits.

Finally, by facilitating growth of the private sector, the company law may help increase the country's tax base.

Implications for the economy of Lesotho

For more than four decades, the companies' law in Lesotho has not been reviewed to keep up with the emerging economic and business developments. This made it harder for companies to be efficient and competitive, particularly at the international arena. This has made Lesotho to consistently lose on the international competitiveness index. Nonetheless, following a spate of reforms sweeping across the country's national development agenda, the Company's Act 2011 has been enacted. This act which is repealing the Companies' Act 1967 is intended to have benefits for the business and the country as whole.

First, the review of the former companies act in Lesotho is intended to remove and replace outdated business codes that no longer serve to promote business efficiency and productivity. The current companies' act is tailored to promote investment by defining the rights and the role of the shareholders and creditors in the company's life. Promoting efficiency of management of the company increases the value of the assets of company and limits the extent of the expropriation which, in turn, increases investor confidence. Together this will go a long way in promoting business sector development, hence economic growth.

Second, the new law is expected to increase the speed at which companies are registered. As more companies are opened and become operational, the level of tax receipts will increase and this may ultimately have a positive bearing on Lesotho's economy.

Third, Lesotho is set to benefit from the new companies act through sound corporate governance structure. As earlier mentioned, the law will encourage transparency and high standards of corporate governance in the business sector. This is because, by demanding transparency in corporate transactions, in accounting and auditing procedures, in purchasing and in all other individual business transactions, corporate governance prevents corruption, which can harm the economy. Corruption drains companies' resources and erodes competiveness, chasing investors away. Moreover, a strong system of corporate governance deters systemic banking crises that have dire consequences on economic growth. Having sound bankruptcy procedures ensures that business failures are well monitored and addressed on time in order to avoid economic collapse of Lesotho's economy.

Lastly, Lesotho may benefit from the new company law and good corporate governance in terms of the development of the capital market. Larger and liquid capital markets are positively related with higher economic growth through promotion of access to finance.

Table 2. Selected Monetary and Financial Indicators

	2011		
	June	July	August
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	10.50	10.50	10.50
1.2 Prime Lending rate in RSA	9.00	9.00	9.00
1.3 Savings Deposit Rate	1.21	1.21	1.15
1.4 Interest rate Margin (1.1 – 1.3)	9.29	9.29	9.35
1.5 Treasury Bill Yield (91-day)	5.36	5.35	5.36
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	6386.453	6395.196	6615.158
2.2 Net Claims on Government by the Banking System	-2613.461	-3021.994	-2635.382
2.3 Net Foreign Assets – Banking System	10101.730	10427.624	10488.058
2.4 CBL Net Foreign Assets	6688.492	7173.229	7025.405
2.5 Domestic Credit	-166.860	-431.601	-112.660
2.6 Reserve Money	804.526	920.110	961.912
3. Spot Loti/US$ Exchange Rate (monthly average)	6.7962	6.7953	7.0754
4. Inflation Rate (Annual Percentage Changes)	4.7	4.9	5.5