Open ‘developmental windows’ for cheaper lending when needs are greatest

Professor Ben Turok interviews leading economist and columnist, Duma Gqubule, Director of the Centre for Economic Development & Transformation, who argues that the South African Reserve Bank (SARB) has been too focused on inflation targeting and has not been responding to the serious economic conditions in the country.

BEN TUROK:

Do you think our bank is too rigid in its stance on inflation?

DUMA GQUBULE:

Yes, the bank is way too rigid on this. We now have a prime lending rate of about 6 percent. In the US for about the last 50 years the average interest rate drop after each recession was about 500 basis points. In South Africa, we had an increase in interest rates after the recession. So the SARB is not responding to the real economic situation in the country.

A lot of the debate gets bogged down in monetary policy and we should be looking at the other instruments. The global financial crisis has shown that central banks can be more involved. One instrument we can use is what I call “developmental windows”.

The Bank of England, the ECB [European Central Bank] and the People’s Bank of China all have funding for lending. I will just simplify this: what they do is create a developmental window where there is cheaper finance. In South Africa we can look at our needs, for example housing, education or whatever. We could create a window where lending is much cheaper in that area to stimulate investment in the real economy. There has been a disconnect and excessive financialisation so to counteract this we could steer investment developmentally. In China they use a lot of developmental windows. They fund developmental institutions. They have three policy banks that do policy-based lending and these are funded through central bank funding.

The third thing we should talk about is the issue of monetary financing of government expenditure. In South Africa our debates about the role of the central bank are too narrow in talking only about interest rates. The global debate about the role of central banks also considers the extent to which they can be involved in direct monetary financing of government expenditure, which requires co-ordination of monetary and fiscal policy.

BEN TUROK:

Isn’t the IDC [Industrial Development Corporation] supposed to be doing that?

DUMA GQUBULE:

Yes, but in order to stimulate the economy, there has to be spending in addition to what we are already spending. A few years ago I looked at all the industrial policy instruments that we have. These amounted to about 0.5 percent of GDP and the IDC was about half of this, so this is a very small part of the economy. If we need spending to stimulate the economy then we could have the central bank providing additional funding to the IDC.

BEN TUROK:

We will come back to that in a minute. So how much inflation can we bear without disturbing the economy?

DUMA GQUBULE:

There is a study done regularly by Stats SA that looks at bare manufacturing capacity. Currently the average South African factory is at about 80 percent capacity so we can expand production by 20 percent without stoking inflation. In South Africa there is currently no inflation because we are nearing recession. Even the SARB admits in their policy statements that there is no demand-side pressure. They are responding to supply-side shocks.

I have read that the Reserve Bank of New Zealand says that they won't respond to supply-side shocks. They have a new Labour government which has an employment mandate.

In its latest monetary policy statement, it says that it will not respond to temporary supply-side shocks.

I must mention that exchange rate depreciation works its way out of the system. So you can accommodate an exchange rate depreciation, even a sharp one, and not respond to it. In 2001, we had a currency crisis and the exchange rate went to R14 and the Reserve Bank responded by increasing the interest rates by 400 basis points. That was very unnecessary because the following year our currency became the best performing one and inflation came crashing down which kickstarted the boom period. In short, the base effect ensures that exchange rates and inflation work themselves out after one year.

BEN TUROK:

The argument is that if you boost demand without boosting supply then you cause inflation. Is that correct?

DUMA GQUBULE:

As we said earlier, there is a lot of spare capacity in South African firms. Let us say in the clothing sector we have 30 percent spare capacity, factories just sitting idle. We can boost demand by 30 percent without stoking inflation. That is according to our theoretical models. So what I am saying is that there is a lot of spare capacity in the economy where increased production can happen.

BEN TUROK:

Is there spare capacity because we don't have demand or because there is something wrong with supply?

DUMA GQUBULE:

It says quite clearly in the annual report by Stats SA, which surveys people and asks about why they have this spare capacity, and about two-thirds say it is about lack of demand. It is not about a lack of skills or other problems in production.

BEN TUROK:

So, you have very strong views that the issue at the moment is ineffective demand not ineffective supply?

DUMA GQUBULE:

This may become a problem later on, but it is not our immediate problem.

BEN TUROK:

In effect now we are focusing on 4.5 percent (the mid-range of the 4-6 percent target set out by the SARB). How much higher could that go? People like Stiglitz have said that you could go to 10 percent without hurting the economy.

DUMA GQUBULE:

I think what we need is to change the mandate of the Reserve Bank and have a growth target and have an inflation constraint. Yes, yes, absolutely [you could go over 10 percent]. If you look at a lot of Asian countries, South Korea for example, during their high-growth phase inflation was in double digits over three decades and this did not affect growth. In some definitions inflation is a by-product of high-growth phases. It is something that you cannot avoid when you are growing very fast. I don't know what the level is, but we should tolerate a higher level than the current situation.

BEN TUROK:

I think that we are all agreed, however, that hyper-inflation is a very serious danger.

DUMA GQUBULE:

Yes, but hyper-inflation is seldom caused by demand-side pressures. It is usually caused by collapsed production on the supply-side of the economy. There are very few cases in history where we have had hyper-inflation so we shouldn't be planning against hyper-inflation. I believe that most of the causes of hyper-inflation are political and have very little to do with the economy.

BEN TUROK:

Can we go back to the question of stimulus? Does the Reserve Bank have a role in stimulus?

DUMA GQUBULE:

Yes, the Reserve Bank should have a role in stimulus. I believe we need about R500 billion or about 3 percent of GDP a year for three years. We could have a pact with the financial sector; you could call it a voluntary investment accord. The financial sector got really scared about this thinking it would mean investing in Eskom but it doesn't have to be. It could be investing in specific projects, housing, student accommodation, etc. Things that stimulate the economy.

The second part can involve the central bank directly providing developmental windows to banks, to the developmental agencies. The third thing is that the central bank can be involved in direct financing of government expenditure on infrastructure. In the UK, Jeremy Corbyn has talked about the idea of "People's Quantitative Easing" where you set up an investment bank and the central bank will buy bonds in this which will be used to fund the projects. But you need a coordination of fiscal and monetary policy to stimulate the economy. They could print a little bit more money to stimulate the economy.

In China they currently have a growth target of about 6 percent and the role of the central bank, before inflation, before currency is to provide the liquidity to support that growth rate. That is the first thing they do every year.

BEN TUROK:

What do you say about the argument that price stability guarantees growth?

DUMA GQUBULE:

No. There is a lot of confusion. The Constitution says, "in the interests of balanced growth". Now the Reserve Bank's interpretation is that "no, we don't have to do balanced growth. We must just control prices and this is automatically in the interest of balanced growth." This is very different from saying that you must target balanced growth. If the economy is collapsing, you need to make sure there is instability in output as well. So that is a completely different thing.

BEN TUROK:

What do you say about co-operation between the Reserve Bank and Treasury, because the Constitution actually requires that?

DUMA GQUBULE:

Yes, there is a big debate about the independence of central banks in the US with Trump, with Modi in India and with Erdogan in Turkey. The President of Mexico as well. Politicians around the world on the right and the left are questioning this situation of the independence of the central banks. I think co-ordination can take many forms. We need fiscal-monetary co-ordination to stimulate the economy but the type of co-ordination needed is what we need to be clear on.

Two decades ago the Chinese banks were all bust and there was a joint operation between the Central Bank of China, The People's Bank, and the Treasury to recapitalise the banks with over $500 billion. This was a joint operation to save the banking system. In South Africa, we have Eskom in crisis and I believe we need a joint operation between the Reserve Bank, Treasury and the PIC [Public Investment Corporation] to sort this out.

BEN TUROK:

Should there be regular consultations between the SARB and Treasury?

DUMA GQUBULE:

Yes, there should be formalised, regular consultations and a regular committee. But this must not be done in a vacuum. It must be in the interests of a growth target and a national plan for the country. If we take the NDP [National Development Plan], there is a 5 percent growth target and they should meet there and say what can we do from the monetary policy side and the fiscal policy side to achieve this target? This is what happens in China.

BEN TUROK:

My view is that the word independence is getting in the way of discussing the question seriously. When I did a study for parliament, I talked to Chris Stoltz who said that he preferred the word "autonomy" not independence.

DUMA GQUBULE:

Yes, "relative autonomy". People forget that the Bank of England was a department within Treasury until 1997. This was the situation in most countries. There are two types of independence. There is political independence and no central bank has political independence. The government sets the inflation or the growth target. But they have instrument independence. However, I don't believe that we should allow them to decide that they only use interest rates for example. I think we should be able to specify to them a bit more clearly that we want them to use a lot more policy tools that are in their arsenal to stimulate the economy. I don't believe in either political or goal independence. NA