BIS urges central banks to act fast and forcefully on inflation

The Bank for International Settlements (BIS) has urged central bankers to learn the lessons of the latest episode of global inflation, saying they must act forcefully and promptly to prevent price rises transitioning to a high inflation regime.

It said many underestimated the extent to which the extra monetary easing during Covid-19 would contribute to an inflation flare-up.

In its latest annual economic report, released at the weekend, the Basel-based BIS has taken a look at the monetary policy lessons of the past four years, particularly for advanced economy central banks, which were slower than many of their emerging market peers to hike interest rates when inflation started to climb in 2021 after a long period of ultra low rates.

But its comments will also resonate in SA in a week in which Reserve Bank governor Lesetja Kganyago has again called in the Bank’s annual report for the government to consider lowering SA’s inflation target to bring it closer to that of other emerging markets.

The BIS has warned that the global divergence in interest rates, particularly between the US and the rest, is likely to mean more pressure on exchange rates and capital flows. And while emerging economies are now much better able to withstand these than in the past thanks to reforms in recent decades, including inflation targeting and more flexible exchange rates, “the achilles heel going forward is fiscal policy”, said BIS monetary and economic department head Claudio Borio in an interview.

The BIS, often dubbed the central bankers’ central bank, has taken a look too at central bank balance sheets and why it’s important to ensure these underpin their operational independence. In the advanced economies of the US and Europe, central bank balance sheets were hugely inflated by the quantitative easing implemented to pump their economies after the 2008/09 global financial crisis.

The current tightening phase has raised questions about what those balance sheets should look like — the BIS said in its report they should be “as small and riskless as possible, subject to the central bank being able to perform its mandate effectively”.

Preserve autonomy

Its comments could resonate in SA after President Cyril Ramaphosa signed legislation into place that will allow R150bn of the profits on SA’s gold and foreign exchange reserves that are on the Bank’s balance sheet to be transferred to the government to reduce debt and debt costs — while also ensuring the Bank retains a R100bn buffer to pay the costs of this as well as to cushion SA from any currency reversals.

Borio would not comment on SA specifically, but said: “Clearly each country is going to be different here but what is important is to have arrangements that somehow preserve the operational autonomy of the central bank when it comes to monetary policy. That’s essential,” he said. “Ideally you would like to have filters whereby these transfers partly smooth out these huge changes in exchange rates that can occur.”

The BIS also urged countries to build up their foreign exchange reserves, intervening in markets “judiciously” when they can do so, so that they can deal with global financial conditions that may be out of sync.

On monetary policy, Borio said advanced economy central banks had not fully appreciated the limitations and side effects of strong, prolonged easing phases when they first adopted these, but lessons had been learnt.

“The general lesson is that you have to respond strongly when the risk of a transition from a low to high inflation regime arises … because for a number of reasons those transitions are self-reinforcing.”

He would not comment on SA specifically, but said the level of the inflation target did matter. “What ideally you would like is a level of inflation target or region of price stability that is low enough for inflation not to materially influence people’s behaviour. That’s nirvana,” he said.

Profits climbed

“So the level does matter a lot, because if inflation is hovering around or remaining within that region it has significant self-stabilising properties. If inflation is not a concern you don’t have an inflation psychology…. Once inflation evolves at a higher level, then if you get one bad batch of shocks, that is going to be translated into adjustments in wages, adjustments in prices and so on,” Borio said.

The Reserve Bank’s latest annual financial statements, tabled in parliament last week, show profits on the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) climbed to R532bn at end-March, up almost 16% from R458bn a year earlier as the rand weakened further and the gold price jumped to record levels (about 14% of SA’s reserves are held in the form of gold coins and bullion).

The recently signed amendment to the Gold and Foreign Exchange Contingency Reserve Account Defrayal Act of 2003 is in line with an agreement signed between the Treasury and Reserve Bank in early June. It will open the way for the first R100bn tranche of cash to flow to the Treasury in the current year, followed by two more R25bn tranches in the next two years.

The Bank will not sell foreign reserves to finance this but will instead create new bank reserves, on which it will have to pay interest of about R8bn this year rising to R12bn in 2026 and in perpetuity.

The BIS sees fiscal trajectories as the biggest medium to longer-term threat to macroeconomic, financial and price stability worldwide. Higher interest rates, with ageing populations, the green transition, political tensions and the need for more defence spending will continue to burden fiscal policies in future, Borio said. This can lead to financial and price instability.

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