Inflation Targeting in South Africa

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1. Introduction

Mr Governor, Mr. Executive Director, Senior Staff members of the Bank of Mauritius, Mr David Coe, IMF colleagues, ladies and gentlemen. Honor and privilege is indeed mine for the opportunity accorded to me by the Governor of the Bank of Mauritius in conjunction with Mr Coe to express views on the experience of the South African Reserve Bank (SARB) on the Inflation Targeting Framework (ITF).

In accordance with the subject I will thus place particular attention on strategic issues pertaining to South Africa's current monetary policy practices. This exercise, I view it as a continuous process of interaction between our central banks in the region in an effort to meet the world's best practices in the central banking arena, especially as preparation for regional and continental financial integration which is a prerequisite for our (African) countries' economic growth.

Price stability, independence of central banks and common monetary policy frameworks are key ingredients of the envisaged monetary union in Africa, as explicitly explained in the New Partnership for African Development (NEPAD).

Adopting the ITF was an IMF imposition or conditionally. Both South Africa's fiscal and monetary policy authorities deemed it necessary to implement a sensible and a credible monetary policy framework that would fit our environment and economic objectives. IMF and other Central Bank's expertise were solicited and today continue to be of great significance and/or importance in this stage of our economic development.

The current phenomenon of inflation targeting framework provides significant micro and macroeconomic opportunities for individual countries, at the same time it also posits significant

challenges and credibility risks - particularly for emerging market economies like South Africa and Mauritius.

South African monetary policy has changed significantly in recent years and since February 2000 has been firmly rooted in an inflation-targeting framework. The framework in the case of South Africa is characterised by the public announcement of an official quantitative target range for the inflation rate over a specific time horizon and efforts to communicate with the public about the plans and objectives of the monetary authorities.

Under the inflation-targeting framework there are limits to the discretionary powers of the SARB but this does not mean that rigid policy rules are applied with no room for discretion. Monetary authorities subscribe that Inflation targeting is a framework rather than a rule. In essence, it allows for constrained discretion. In a country such as South Africa, that has only adopted inflation targeting recently and is still trying to establish a record of low inflation, a relatively strict approach to achieving the inflation target is called for until a record of low inflation and the concomitant credibility of the policy regime and policy-makers have been established.

The inflation-targeting monetary policy framework is essentially based on the view that the complexity of the transmission of monetary policy decisions to overall economic activity prevents the use of monetary policy for fine tuning the economy. The absence of nominal anchors for monetary policy, such as monetary aggregates, exchange rates or interest rates, means that the SARB abandoned any attempt to specifically target money supply or exchange rates when the inflation-targeting monetary policy framework was adopted.

To be successful, an inflation-targeting monetary policy framework requires nominal exchange rate flexibility. The Reserve Bank in its policy deliberations nevertheless takes cognisance of the potential second-round impact of exchange rate movements on the inflation rate. In adopting inflation targeting, some significant changes have been introduced to the decision-making processes at the SARB in order to improve accountability and transparency.

2. Reasons for adopting inflation targeting

Although significant success had been achieved with the previous monetary policy framework, important structural changes in the South African financial system in recent years altered the

transmission mechanism. This weakened the more stable relationships that had previously prevailed between changes in the money supply and in bank credit extension, on the one hand, and in nominal spending on goods and services and in prices on the other.

Large deviations from the money supply target had already occurred during the 1980s and persistent overshooting from 1994 onwards, after the sharp increase in capital inflows to South Africa. From 1994 onwards M3 money supply increased at rates consistently higher than the indicated guideline ranges for growth, but inflation nevertheless declined, contradicting previous expectations.

Changes in the monetary aggregates lost some of their usefulness as the most important indicators of possible future trends in inflation, and therefore also as an anchor for monetary policy decisions. The money supply guidelines had been increasingly supplemented by an eclectic set of indicators during the course of the 1990s, including the exchange rate, asset prices and the output gap.

The guideline three-year average growth rate in M3 was expected to contain inflation without inhibiting stronger economic growth. However, if conflicting signals were to emanate from the money supply and from inflation it was not quite clear which objective would carry the most weight.

Inflation had been brought down successfully in recent years in South Africa but core inflation remained stubbornly higher than that of South Africa's most important trading partners, despite having fallen to a single-digit level. A number of important factors associated with a formal inflation-targeting framework, such as improved policy focus, policy co-ordination, transparency and accountability, also contributed to the move to an inflation-targeting monetary policy framework.

3. Key characteristics of the South Africa’s inflation-targeting policy framework

After the Governor of the South African Reserve Bank mentioned the possible introduction of formal inflation targeting in a section of his address to the annual ordinary meeting of shareholders of the Bank in August 1999, a number of initiatives followed. These included further research on the topic, the development of the Bank's inflation-forecasting and modelling capacity, technical discussions on the issue with the National Treasury, consultation with other central banks that were already engaged in formal inflation targeting, and discussions with trade unions and business organisations in South Africa.

Following the recommendations of the Joint Technical Committee on Inflation Targeting composed of officials of the South African Reserve Bank and the National Treasury, agreement was reached between the South African Reserve Bank and the Government on inflation targets for the period 2003 to 2005. South Africa's inflation target specifies that the Reserve Bank is to achieve an average rate of increase in the CPIX measure of inflation of between 3 and 6 per cent for the year 2002 and 2003, and between 3 and 5 per cent for the years 2004 and 2005. These targets are taken into account in all monetary policy decisions.

The CPIX is a variant of the consumer price index covering metropolitan and other urban areas. The CPIX measure is derived by excluding mortgage interest costs from the overall consumer price index. It was chosen to ensure a wide coverage of consumer items, but without the mortgage interest component that would perversely fall as the Reserve Bank relaxed monetary policy, and vice versa.

The South African authorities chose a target range rather than a single numerical point as target. A specific numerical target is clear and straightforward and focuses attention, expectations and policy actions on a single numerical value. It implies a degree of precision that cannot realistically be expected of monetary policy, especially in a small, open economy. A degree of variation in inflation is to be expected, even under the calmest economic conditions, and many inflation-targeting countries explicitly allow for such variation by setting a target range.

Unforeseen shocks to the economy, such as a doubling of oil prices or the effects of a severe drought, could steer inflation off the required course during a disinflation process. For instance, a doubling of the oil price in a particular year would make the set target extremely difficult to achieve, especially if such a shock occurs close to or during the period when the quantitative target

is to be achieved. A temporary deviation from the target may therefore be unavoidable. It would certainly be counterproductive to try immediately to neutralise the first-round effects on inflation of a large economic shock through monetary policy. Such an outcome would require a huge adjustment to interest rates, with a significant negative effect on the real economy. In some countries, therefore, the conditions under which temporary deviations from the inflation target are permissible are stipulated in a formal document.

In South Africa the Finance Minister wrote a letter to the Governor in February 2000, outlining the handling of unforeseen economic shocks beyond the control of monetary policy, which could make it difficult to achieve the inflation target. The letter represents the agreement between the Bank and the Government on inflation targeting. The shocks mentioned include a sharp rise in international oil prices, drought, changes in indirect taxes and international financial contagion.

The Finance Minister has stated that if these circumstances result in the failure to achieve the target, the Reserve Bank would have to give a full public explanation. He has nevertheless reaffirmed that the Bank has "complete instrument independence" in attaining the target. The Minister's letter to the Governor emphasises the benefits of a low inflation rate, stresses that the success of the inflation-targeting regime would require the participation of all South Africans and restates the government's belief that there is no long-term trade-off between inflation and unemployment.

4. Instrument independence

The task of a central bank operating an independent monetary policy is in a sense a limited task, not least because it effectively has only one important instrument – its control over short-term interest rates. The central bank's role is essentially to use that instrument to influence aggregate demand in the economy, with the aim of keeping demand broadly in line with the supply-side capacity of the economy.

The measure of its success is consistently low or steady state inflation. A significant degree of central bank independence (in particular the freedom to set policy instruments and freedom from budgetary demands) is deemed an essential precondition for successful inflation targeting. A

central bank shielded from political pressures is more likely to give priority to price stability; as a result financial markets will regard its policies as more credible. This enables an independent central bank to deliver lower inflation and more stable growth.

The South African Reserve Bank has the necessary degree of independence, granted under the Constitution read together with the SARB Act. Consultation with the Ministry of Finance continues in the interest of policy co-ordination. Policy is formulated with a view to ensuring inflation outcomes within the target range. If there are clear indications that with unchanged short-term interest rates, the inflation outcome in the target period will exceed the target, interest rates will be raised, and the converse if undershooting of the target is expected.

5. Accountability and transparency

The new inflation-targeting framework has substantially improved the accountability and transparency of monetary policy. In previous policy regimes there was no explicit benchmark against which the performance of the Bank could be judged objectively but in the new inflation-targeting regime, the Ministry of Finance in cooperation with the Bank determines a specific target range for a particular price index to be achieved within a specific time frame.

Transparency increases monetary policy efficiency, especially in an environment of uncertainty. It encompasses communication with the markets and the public in order not only to be understood but also to be effective. The nature of the inflation-targeting framework, progress towards the target and the policy steps taken have to be communicated to all relevant parties, including the general public, so that this communication will have an appropriate influence on inflation expectations and enhance public understanding of and support for monetary policy. Several actions have nevertheless been taken to improve monetary policy transparency:

the inflation target is publicly announced;

a brief policy statement is issued after each meeting of the Reserve Bank's Monetary Policy Committee (MPC);

economic developments and monetary policy actions are comprehensively discussed in the Reserve Bank's *Quarterly Bulletin*, *Annual Economic Review*;

- a *Monetary Policy Review* detailing monetary policy developments and prospects is issued every six months;

- Monetary Policy Forum meetings, in which the Bank's governors and senior staff members of the Bank explain developments in monetary policy to and obtain feedback from organised business, labour, politicians and academics, are held twice a year in ten centres, covering all provinces of the Republic;

- the Governor accompanied by senior staff members from the Research Department regularly appears in Parliament before the Portfolio Committee on Finance; and

in June 2001 the Governor initiated an annual Economic Forum of economists from the private sector, state enterprises and trade unions as part of the strategy for improving domestic economic debate and promoting transparency.

6. The new monetary policy decision-making process

In practice, the Bank’s new monetary policy process centres on four formal MPC meetings scheduled during March, June, September and November. It involves the production and submission to the MPC of economic projections, a comprehensive macroeconomic and financial market review and the release of a brief Monetary Policy Statement after an MPC meeting. Key data series in South Africa are assessed as soon as they become available. The Bank works with all available relevant data to ensure accurate projections, as the MPC’s attitude to current policy is conditioned by emerging data on the recent past and projections based thereon. The projections assist the MPC in identifying the monetary stance that it deems necessary to bring CPIX inflation into the target band.

A brief Monetary Policy Statement is released to the media at the conclusion of each of the MPC meetings during the course of the year. In the preparatory weeks of the quarterly cycle, the Bank’s economists do an intensive analysis of a comprehensive range of the latest available macroeconomic data covering the domestic economy and important international economies.

The Bank's Research Department thereafter prepares alternative model simulations. A suite of models is used to test more and less aggressive monetary policy approaches given consensus assumptions for key exogenous variables. The Research Department prepares draft economic forecasts and a domestic and international review for presentation to the MPC for its detailed consideration, and other key departments also prepare an overview of, for example, developments in the capital market and international banking sectors. The MPC then meets and ultimately drafts a brief Monetary Policy Statement and releases it to the media at the conclusion of the MPC meeting.

On the basis of comprehensive analysis and deliberations, the Bank announces its monetary policy stance and, if necessary, the change to its repurchase rate, the principal instrument of policy. If deemed appropriate, the repurchase rate is changed, based on current macroeconomic data and inflation prospects for the target year. An extraordinary review of economic conditions and updated projections, but without the advantage of a fully developed set of macroeconomic data, can also be scheduled between formal MPC meetings if the need arises in reaching decisions on the monetary policy stance and on the desired level of the Bank's repurchase rate.

7. The Bank's econometric modeling framework

Attempts in recent years by the South African Reserve Bank to measure and model the relationships between the main variables of macroeconomics such as aggregate income, consumption, investment, price indices, interest rates, exchange rates and unemployment have been subjected to comprehensive review.

In co-operation with the staff of other central banks, a suite of new models have been developed, comprising a core model, a small-scale model, vector models using vector autoregressions (VAR) or error-correction specifications, Phillips-curve models and indicator models.

Since the introduction of formal inflation targeting, the Bank's own research has been increasingly focused on the transmission mechanism of monetary policy in South Africa and the development of state-of-the-art inflation forecasting models. The Bank is also currently developing and using structural VARs to estimate the effect of monetary policy on output and inflation as part of the new suite of models. The Bank's suite of forecasting models has become the cornerstone in assessing

the prospects for inflation and growth in the economy. The models have enabled the Bank to assess more effectively the risks associated with the predicted outcomes of several variables. The forecasts do not in themselves indicate how the monetary policy stance should be changed but they are a crucial source of information for the MPC.

The MPC also uses a fan chart to assess the risks inherent in the forecast and to communicate to the public the uncertainties that lie ahead. The fan chart allows the MPC to focus its discussions on the potential upside and downside risks lying ahead and more particularly on the possible effect of these risks on inflation.

Inflation-targeting central banks use fan charts not only to illustrate the large degree of uncertainty to which an inflation forecast is subject but also to give a clear indication of the probability of a particular outcome. The models used to investigate the outcome of various scenarios are indispensable for inflation targeting but the monetary policy decisions are taken on the basis of professional judgement rather than relying solely on the models' results.

8. Assessment of the inflation-targeting monetary policy framework

South Africa could not escape the inflationary consequences of rising international crude oil prices over the past two years but has been more successful than many countries in withstanding inflationary pressures. Since the introduction of the inflation-targeting monetary policy framework in South Africa in February 2000, monetary policy has been characterised by greater interest rate stability. The MPC has adjusted the rate on repurchase transactions on only four occasions during this period despite an increasingly volatile international environment.

Despite the weakening in the value of the rand and higher oil prices, the Bank held the repurchase rate steady at 11.75 per cent from 14 January 2000 until 16 October 2000, when it raised the rate by 25 basis points. The MPC had been concerned about the inflationary consequences of a depreciation in the exchange rate of the rand and rising crude oil prices. A special meeting of the MPC was convened to assess the potential inflationary consequences of the depreciation of the rand and the high world market price of petroleum.

The decision to tighten monetary conditions marginally was viewed as an appropriate signal that

second-round price effects following the depreciation in the value of the rand would not be accommodated. Among the most important counter-inflationary forces working to subdue inflation in South Africa during 2000 were the adoption of the new formal inflation target early in the year which focused inflation expectations and moderated nominal remuneration demands; solid productivity growth; slow growth in nominal unit labour cost; continued trade liberalisation which prevented domestic producers from raising prices in the face of increased competition by international suppliers; and Government's commitment to fiscal prudence and greater efficiency in public-service delivery.

The rate on repurchase transactions by the Reserve Bank declined again from 12 to 11 per cent on 15 June 2001 when evidence accumulated that inflation for 2002 would fall within the target range. Since the introduction of formal inflation targeting, public acceptance of the price stability target had grown significantly and inflation expectations became better anchored.

This was borne out by the successive results of the inflation expectations survey conducted on the Bank’s behalf by the Bureau for Economic Research (BER) at Stellenbosch. Although South Africans turned in somewhat conflicting sets of inflation expectations according to the successive surveys during the period, inflation expectations had become somewhat more forward looking.

Furthermore, the year-on-year rate of increase in the consumer price index for metropolitan and other urban areas excluding mortgage cost (CPIX) declined from 8.2 per cent in August 2000 to 6.0 per cent in August 2001. This favourable outcome was largely related to, low increases in unit labour cost, no signs of excess aggregate demand, surplus production capacity in the economy, fiscal prudence, moderate credit growth, sound monetary discipline and declines in petrol prices.

The MPC decided to lower the repurchase rate by 50 basis points from 21 September 2001. The CPIX declined from 7.7 per cent in 2000 to 6.6 per cent in 2001. However, after the sharp depreciation of the rand towards the end of last year, a special MPC meeting was called on 15 January this year to discuss the appropriate monetary policy stance in view of the effects of recent economic developments on the outlook for inflation. The steep depreciation of the rand had altered inflationary expectations in South Africa which endangered the attainment of the inflation targets for 2003 and the remaining periods. To counter second round effects of the depreciation on inflation, the MPC decided to increase the repo rate by 1 percentage point from 9,50 to 10,50 per cent with effect from 16 January 2002.

The inflation-targeting policy framework provides a fair measure of flexibility for the Bank. First, it is an average inflation rate of 3 to 6 per cent for 2002 that needs to be achieved. Second, as in other countries that target inflation, the policy allows for some discretion in the case of serious supply shocks to avoid costly losses in terms of output and jobs. However, global financial integration has brought with it the problem of how to cope with movements in financial asset prices, including exchange rates.

In the context of macroeconomic stabilisation, central banks have to take account of asset prices in their projections and policy decisions. The behaviour of the exchange rate is a factor influencing inflationary pressures in the economy, through its direct effect on prices and through its indirect impact on net external demand. Although a central bank can try to allow for these effects, it cannot predict future asset price movements accurately and therefore these movements remain a major source of uncertainty. They also, of course, represent a major potential threat to the financial stability that is a necessary component of monetary stability.

9. In conclusion

Price stability has been adopted by more and more countries as the sole or primary objective of monetary policy since the early 1980s and this trend accelerated during the 1990s. More specifically, the early 1990s witnessed a rapid rise in the number of industrial countries that adopted explicit inflation-targeting monetary policy regimes.

Monetary policy credibility has increasingly come to rely on clearly defined and publicly understood long-term policy objectives. In recent years South Africa has established a broader framework for economic stability. South Africa's new framework equips the country far better to cope with the ups and downs of the economic cycle. The new framework includes clear policy rules, a stated formal inflation target and fiscal discipline.

The South African Government believes that our country's economic prosperity will be enhanced by a price stability approach to monetary policy. Although some economists think that a monetary policy based on price stability will compromise economic growth, governments and central banks internationally have recognised that inflation harms people, and not just economies in some

abstract sense.

The rate of depreciation of the rand towards the end of last year was of great concern to the Bank and the depreciation took place in a world where the economic outlook also remains of great concern to the international community. While a slowdown was evident prior to the tragic events of September 11th, subsequently world economic forecasts have been consistently revised downwards. Increased risk aversion and growing negative sentiment towards emerging markets were further fuelled by the Argentinean crisis.

The economic fundamentals in South Africa remain sound amidst a challenging world environment. Despite higher levels of volatility in the domestic financial market, Moody's Investment Services endorsed the current policy stance and upgraded South Africa's sovereign risk rating to BAA2, stating that the rand's steep depreciation in recent weeks was not warranted by the country's economic fundamentals.

Fiscal policy objectives are furthermore being met: the budget deficit remains modest at 2,3% for the fiscal year and real economic growth is expected to be over 2 per cent this year; government expenditure is well within budget while revenue collections continue to outperform expectations. Monetary policy objectives remain firmly in place: price stability within a growing economy, and a commitment to ensure a downward trend over time in inflation. Monetary policy is therefore firmly aimed at achieving the inflation targets that have been announced.

Although the South African Reserve Bank has had a relatively brief experience with the new inflation-targeting framework, this framework has undoubtedly already reinforced the longer-term focus of monetary policy. The immediate effects of shocks are discounted by reverting to the question of what their consequences will be for inflation eighteen months into the future and reacting to that, rather than attempting to neutralise the shock immediately.

This has reduced the amplitude of policy changes. In a wider context, inflation targeting is part of a process in which economic policy-making is becoming more transparent and subject to more accountability and technical rules, and less to unconstrained discretion. Inflation targeting is a more complex and in many senses more demanding monetary policy framework, and requires a strengthening of the institutional framework and an increasing market orientation. An effective analytical framework for forecasting inflation and assessing the effects of monetary policy is

crucial. The implementation of the framework requires addressing important issues related to the choice of the inflation measure, the level and path of the inflation target and practical escape clauses.

Coordinated regional policies and adequate transparency in central banking in this region regarding the operation of the financial system and regulatory regimes could reduce infection of severe currency distress (SA) that can also be experienced in stable economies such as this of Mauritius. Inflation targeting in South Africa has been tested. Achieving the targets is significant. But if not, credibility may be an issue - however more critical is the focus on price stability and preparation of expectations of the populous.

About the recent movements in the rand exchange rate, what else is there to say. Also worth noting is that the International Monetary Fund and World Bank Financial Assessment Program reported favorably on the overall economic situation in South Africa. Good will emerge soon from the unplanned depreciation in the balance of payment accounts. Citing Toney Trahar, the CEO of Anglo American Corporation, in his speech at the globalisation conference in London:

> "It is important for all of us to combat afropessimism. We know what the problems are we often forget the successes or fail to see opportunities in adversity." In the same speech he argued that that "in case of South Africa we have allowed the abnormal and excessive decline of the rand's to blind us to how strong the country's competitive position has become."

Mainstream economists, Keynesians, Kalecksian, Schumpeterians and Rationalists can continue to hypothesize about the rand's debacle. Hopefully their facts will tally and we'll learn something out of that debate. I can anticipate Marxist explanation. It must be stressed however, that this cavalier attitude by the markets in our emerging and productive economy will no doubt have deleterious effects in our country and the region, if it has not already, engendering crises formed essentially out of context.

To put it in mildly and in a diplomatic language, these market operators will always attempt to buttress economic growth in vulnerable market economies. It is, therefore, for us to be always awake and to safeguard hard earned gains from a free market economy, being members and active participants of a free market global village.

That is why in South Africa we did not commit our hard-earned reserves to defend the exchange rate of the rand and instead stuck our guns to inflation targeting regime.

ONCE AGAIN, THANK YOU

A. Castelyn (28 May 2001) ‘Central Bank Monetary Policy Frameworks Economic Forum’
X.P. Guma (30-31 August 2001) "Notes for a presentation to the Association of the Advancement of Black
T Mboweni (6 April 2001) “A New Monetary Policy Framework”
M. Mnyande (18 May 2001) “The Role of the South African Reserve Bank in the South African Economy”, Old Mutual
M. Mnyande (October 2001) “SARB Monetary Policy Framework” First National Bank
Notes from the SARB MPC Statements