

# Inflation targeting in South Africa

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South Africa has successfully pursued an inflation targeting monetary policy with a range of 3 - 6% on a continuous basis since February 2000. The policy has encouraged a stable and sustainable economy that has seen an increase in the annual growth rate to an average of 3.5% since 1999, and above 5% for 2007.

But with inflation breaching the upper end of the inflation target in April 2007, a spate of generally unpopular interest rate hikes (a 200 basis point increase since June 2007), has placed the South African Reserve Bank Governor, Tito Mbonweni, and the Monetary Policy Committee (MPC) under increasing pressure. Formerly robust consumers, who are starting to feel the pinch of rising credit costs, are criticising the central bank for pursuing its mandated forward-looking and rules-based monetary policy of inflation targeting; and politicians, ever conscious of the populist view, are advocating the abandonment of inflation targets for short term job creation - and more votes.

Over and above the "eina" effect of rising interest rates felt by consumers and politicians alike, the central banks' persistent policy of inflation targeting is taking flak; particularly with a leftist surge in the ANC hierarchy which has seen a number of people begin to question the validity of the reserve bank's control policy as they advocate their more socialist preferences.

Cosatu has called for the Reserve Bank to abandon its targeted range, saying that it wants monetarists to accept that South Africa is a developing economy with a 6% growth target, and strongly advocating a trade-off of higher inflation, arguing that there is scope for inflation to be higher than the targeted range without it adversely affecting the economy.

"The present economic difficulties in South Africa are not due to incorrect monetary policy and continuously discussing monetary policy does not help. South Africa is just a small boat in a very large and tempestuous ocean," said Nicola Viegi, an economics professor at the University of Cape Town.

"The idea of using monetary policy to support growth sounds nice but does not mean much if it is not qualified. For example: monetary policy could target a devalued exchange rate to boost exports, a bit like China. Inflation targeting is the best of the alternatives because it gives quite a lot of flexibility that other monetary regimes don't have. Exchange rate targeting (the only viable alternative) is very risky," said Viegi.

It is equally important to understand that our central bank has only one tool to control inflation - and that is interest rates. "If you are pursuing the goals of the Reserve Bank, there are no other sensible instruments available," said Stan du Plessis, Professor of Economics at Stellenbosch University.

A recent argument has been put forward that it is inappropriate to fight the current surge in inflation, which is primarily caused by exogenous forces of rising energy and food prices on the international market, by raising interest rates in South Africa. Pundits reason that these inflation-causing factors are outside the control of direct monetary policy, and policy detractors do have a valid point in stating that an increase in interest rates will not roll back the increases in oil and food prices. But while advocating an easing in the interest rate to encourage economic growth and job creation, they miss the main purpose of monetary policy.

The Reserve Bank is not increasing interest rates to control exogenous price factors; it is raising interest rates with the intention of controlling the second round effect of inflation expectations, where rising inflation (in this case caused by exogenous factors) has the effect of creating an expectation of continued rising inflation which people automatically build into their future pricing structures, thereby affecting continued inflation, based on perceived inflationary pressures rather than real price pressures.

"What the reserve bank is trying to do is to prevent the relative rise in prices from becoming entrenched in our expectation of inflation. The interest rate is appropriate to check what is called the second round of inflation - the expedited future inflation that automatically gets factored into prices," explained Du Plessis.

"The reserve bank is facing a difficult situation, especially given the rise in prices of sensitive commodities like food and oil. There is a lot of political pressure on them, but the job of the reserve bank is to ensure that we do not see the second round effects on inflation expectation. This is why having an independent central bank is so important," said the Maaties professor.

"Some commentators are suggesting that we should forget inflation targeting and pursue economic growth, but this is a false trade-off in that while easy monetary policy will produce short-term economic growth, it will also produce an imbalance in the economy which will affect the long-term growth trajectory of the economy. All the evidence points the other way - it shows that for long-term growth you need to keep inflation low and stable. What the reserve bank policy is doing is not hurting economic growth as some suggest but contributing to long-term growth."

Most economists agree that an economy is most likely to function efficiently if inflation is kept low, but left wing

supporters say that South Africa's macroeconomic policy over the last seven years restored health to what they call the 'first economy' while widening the socio-economic disparities in the second or informal economy. They argue that the current macroeconomic programme has not been to the benefit of the majority of South Africa's population.

In contrast a Harvard University research paper on South Africa's macroeconomic challenges after a decade of success suggests that it is not optimal policy to respond to negative supply shocks from imports with a raise in the discount rate. The authors argue that inflation targeting on the back of important supply shock inflation exacerbates the business cycle. It points out that demand shocks move inflation and output in the same direction, so that stabilisation of one leads to stabilisation of the other; but supply shock inflation moves output and inflation in different directions, highlighting the fact that supply shocks are magnified by inflation targeting, and place the burden of stabilisation on complimentary fiscal policy.

There is a groundswell of support for following the US example where growth concerns have seen interest rate cuts, but most economists argue that emerging markets face different dynamics from established markets like the US, and cite the examples of other strong emerging markets like China and Mexico where monetary policy is also being tightened to reduce risks and keep inflation under control.

"As inflation reacts with a lag to these changes, the task of the MPC is to assess whether the observed inflation response at a particular point in time is consistent with the desired return to within the target range in future," said the South African Reserve Bank in its November 2007 Monetary Policy Review. Adding that while it will continue to apply monetary policy to achieve inflation control, recent indicators suggest that suggest inflation should return to within the target range during the second half of 2008.

#### END NOTE:

At this juncture it is important to remember that South Africa's central bank was created as an autonomous body, but this independent body has been mandated to keep domestic inflation within a targeted band to encourage long-term growth in the economy. The reason for the autonomy is simple. The Reserve Bank does not enter the political arena, and does not have to pursue a popular policy in order to garner votes, and as a result is more likely to act in the best long-term interests of the economy.

Simply put: Politicians are often tempted to exploit a possible short-term trade-off between inflation and unemployment, even though the long-term consequence of easing policy in this way is that the unemployment rate returns to where you started and inflation is higher. This article was written by Sharon Davis for the WITS Business School Journal.