T T Mboweni: Transparency and the public understanding of monetary policy

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the annual banquet of the Institute of Bankers, Johannesburg, 6 March 2001

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1. Introduction

Good evening ladies and gentleman. I thank you for inviting me here this evening to speak at this prestigious event. The Institute of Bankers is an important organisation and encompasses an industry that is, as I am sure you are well aware, crucial to the South African Reserve Bank as a partner in our commitment to maintain and enhance the stability of the country's financial sector.

My remarks this evening centre on "Transparency and the Public Understanding of Monetary Policy". The public understanding of what we aim to do at the Reserve Bank is something that concerns us deeply. It is something that should go hand in hand with the work of the Bank and it is central to the Bank's commitment of making monetary policy transparent to the people affected by it – the citizens of South Africa.

First I will discuss the Reserve Bank's monetary policy framework and the developments that have occurred in this area recently. I will then move onto the institutional arrangements for the conduct of monetary policy, the work of the Monetary Policy Committee and the Bank's modelling and forecasting activities. Finally, I will say a few words about the central objective of the South African Reserve Bank.

2. The monetary policy framework

We announced the adoption of the inflation targeting monetary policy framework in February just over a year ago. The formal adoption of an inflation targeting framework indicated a shift from the previous informal policy framework. In the past, monetary policy had embraced an eclectic approach in which recognition was formally given to a medium to longer-term stance of monetary policy by monitoring developments in a number of financial aggregates and not only money supply and bank credit extension.

The eclectic approach to monetary policy was applied during the 1990s, against the background of explicitly articulated guidelines for money supply growth. This framework recognised that the Reserve Bank had to combat inflation, as outlined in the Constitution and the Reserve Bank Act. However, since the Bank's policies had their most direct impact in the area of money and credit, intermediate guidelines were set for growth in money supply. It was argued that if money supply growth could be contained, too much money would not be chasing too few goods, and inflation would be brought under control.

While formally it was stated that broad money supply growth should fall in the range of 6 to 10 percent per annum (since the mid-1990s), in practice the Bank adopted a relatively flexible approach where these guidelines were indeed treated as guidelines only. A further guideline for growth in total bank credit extension of around 10 percent was also adopted. But when these guidelines were exceeded by considerable margins, this was on occasion tolerated without strong policy adjustments, on the basis of developments in other variables.

In practice it was quite apparent that growth in the money supply could sometimes be a misleading indicator of current and future inflation. Accordingly, a number of other variables were also analysed in deciding upon the appropriate monetary policy stance. These included the pace of growth in the banking sector's credit extension, movements in consumer price and production price inflation, domestic production and expenditure, the balance of payments and exchange rate situation, and the fiscal policy stance. The inflationary potential of developments in all these and many other variables was assessed on an ongoing basis. Accordingly, growth in money supply was not really the pivotal variable around which monetary policy revolved - although excessive growth in money supply certainly did signal the need for additional caution. However, money supply growth was deemed to be important and was formally recognised as the intermediate target variable.

What has since changed? Instead of targeting guidelines for intermediate objectives, the Reserve Bank now directly targets inflation. It monitors and analyses a whole range of factors that can affect the rate of inflation. The inflation rate, or more specifically CPIX, which is the headline consumer price index excluding mortgage costs, has to fall between 6 and 3 percent by the end of the calendar year 2002.

It is within this target and this monetary policy framework that the South African Reserve Bank will strive to achieve in the short term what we are mandated to do: that is to achieve price stability. Such a framework for monetary policy ensures that monetary policy is transparent, in that the authorities have a definite and measurable aim in their conduct of monetary policy. And at the same time, it should give the citizens of this country an aspect of clarity about the future as it makes clear the Bank’s intentions. In so doing, inflation targeting should also ease the burden and take the "guesswork" out of many of the decisions that businesses have to make when planning for future expansion and investment. It should also provide an anchor for inflation expectations and guide both employers and employees when undertaking forward-looking negotiations.

However, it must be emphasised that at least some of the success of the inflation targeting framework rests on whether it is fully understood by labour, business, the private sector and the other sectors of the economy. If these sectors understand that the Bank targets inflation and that it is committed to the chosen target, this will engender public confidence about the Reserve Bank’s monetary policy procedures.

I will now turn to the specifics of our inflation targeting monetary policy framework. The Reserve Bank monitors a number of factors that have a direct influence on inflation. These include the growth in money supply and bank credit extension, the changes in nominal and real salaries and wages, the nominal unit labour costs, the gap between potential and actual national output, the exchange rate developments and import prices. The oil price is another factor that has played a major part in domestic inflationary trends of late and one that we have closely monitored. This exogenous factor is one over which we have little control. Another exogenous factor is food prices, which can be volatile as a result of drought or floods. And administered prices, those influenced by government or monopolies including medical and education costs, also have an impact on domestic inflationary trends.

In order to monitor these factors, the Reserve Bank has embraced the system of a small core model supported by other models. It has moved away from the single large-scale macroeconomic model, in keeping with international developments. The aim is to keep the core model concise so as to focus on the key economic variables that influence inflation, as I have already mentioned. The core model incorporates some basic assumptions about the economy. It presupposes, among other things, that higher output cannot be achieved in the face of persistently higher inflation and that the level of prices in money terms and the rate of inflation in the longer term depend on monetary policy.

Changes in monetary policy, that is changes in the Bank’s repo rate, are transmitted through the economy via various channels, the so-called transmission mechanism. However, the transmission mechanism is a complex structure and can encompass a large number of cause and effect scenarios. The traditional channel is the direct effect of changes in interest rates on demand and supply. Changes in the repo rate have a direct effect on other interest rates, the exchange rate and decisions on spending and investment. Changes in the repo rate, therefore, affect the demand for and the supply of goods and services. The pressure of demand against the supply capacity of the economy is the key factor influencing domestic inflationary pressures.

The link between the Reserve Bank’s modelling activities and its forecasting process is indirect and far from the mechanical, "black box" approach favoured by scientists. There is no mechanical process in which the forecast directly determines the policy decision. It must be remembered that the econometric models and forecasts are tools to help the Reserve Bank solve economic problems. They are also only one set of tools used in the policy decision-making process. I will illustrate my point by referring to a summary from the Bank of England on the use of models and the Monetary Policy Committee’s responsibilities. This summary encapsulates the philosophy behind the use of models and forecasts at the Reserve Bank. I quote:

> "In an ever-changing economy, no single model can possibly assimilate in a comprehensive way all the factors that matter for policy. Forming judgements about those factors, and their

implications for policy, is the job of the Committee, not something that can be abdicated to models or even modellers. But economic models are indispensable tools in that process."

To return to the broader picture, while inflation targeting forms the framework for the Reserve Bank's monetary policy, it must be remembered that monetary policy is only a part of macroeconomic policy. The task of macroeconomic policy is to promote economic growth and development, create employment, improve the living conditions of all the people of the country, and eliminate the unjustifiable discrepancies between the disparate average incomes of various groups in the economy. Monetary policy has a narrower focus but it occupies an important component of the foundation upon which the broader goals of macroeconomic policy rest. Monetary policy aims to create and maintain a stable financial environment within which overall economic activity can be expanded, jobs created and poverty reduced.

This monetary policy objective is supported by the legal obligations of the Reserve Bank as set out in the Constitution of the Republic and in the South African Reserve Bank Act. These statutes state that the primary objective of monetary policy is to protect the value of the currency in order to obtain balanced and sustainable economic growth in South Africa. This requires the achievement of two objectives: price stability and stable conditions in the financial sector.

Price stability is said to occur when changes in the general price level do not materially affect the economic decision-making processes. Although relative price movements will still have an impact on production, consumption, saving and investment, the rate of inflation should be so low that it is no longer an important factor in the economic decision making process.

We can say that stable conditions prevail in the financial sector when there is a high degree of confidence that the financial institutions and financial markets are able to meet their contractual obligations. These stable conditions, however, do not preclude the failure of individual financial institutions. A financial institution can fail and be allowed to fail even under stable financial conditions. It is only when there is the threat of systemic risk and an important part of the financial sector is at risk that the situation can be described as financially unstable.

Since inflation is our main focus, you may question where the exchange rate of the rand fits into the monetary policy framework? Targeting inflation does not mean that the exchange rate of the rand is ignored. On the contrary, the impact of the exchange rate on inflation is what concerns us and this is what we closely monitor. The impact of the fluctuations in the exchange rate on inflation is carefully considered when we go about the daily task of managing domestic liquidity and determining the repo rate. If signs do emerge of increased inflationary pressures arising from a depreciation of the exchange rate of the Rand, in the absence of any other counterveiling factors referred to above, then monetary policy would have to respond in the appropriate way. This, however, does not imply that the Reserve Bank will defend a specific level of the exchange rate.

3. Institutional arrangements for monetary policy

Our commitment to transparent monetary policy goes hand in hand with the attempts we have already made in communicating both our intentions and the outcomes of our meetings to the public.

The Monetary Policy Committee was set up shortly before South Africa adopted the inflation targeting framework for monetary policy. The 14-member-MPC, as it is known in short, meets seven times a year. It first met on 13 October 1999. The task of its meetings is to decide on the monetary policy stance, with a focus on the inflation targets that must be met in the target year. A press conference is held after the two-day meeting has been concluded and the Committee releases a statement fleshing out the developments in the international and domestic economy and the reasons for its monetary policy stance relating to these prevalent developments.

The Reserve Bank has also convened Monetary Policy Forums, which as the name suggests, provide a forum for open discussions on monetary policy and general economic developments. The MPFs are held twice a year in the major centres of the country and engage with labour, business, community and other organisations. The Forums also ensure that the views of interested parties are taken into account when determining monetary policy. This endeavour is an earnest attempt on our part to communicate monetary policy and economic issues with the broadest spectrum of people. Unfortunately, to date, these Forums are not that well attended, particularly on the part of the trade union movement.

The Reserve Bank will also publish a Monetary Policy Review twice a year to increase the understanding of its conduct of monetary policy. The first Review will be published on 19 March this year and will describe the monetary policy framework in more detail. It will also analyse local and international economic developments and the inflationary trends arising from these. The Reserve Bank will also publish its inflation forecasts in the form of a fan chart. The fan chart is used by many central banks to illustrate their inflation forecasts. So-called confidence bands are used to signify varying degrees of certainty for each broadly expected level of inflation.

Last but not least, the Reserve Bank regularly reports to parliament on the stance of monetary policy. This is in line with international practice and this is part of our accountability to the citizens of South Africa.

4. MPC decisions at times still misunderstood

Despite our efforts at creating transparent and open channels of communication on the conduct of monetary policy and the centrality of inflation targeting, many people in South Africa are still fixated on the fluctuations in the exchange rate of the Rand. Questions will be asked of me not about changes in consumer prices. But, almost certainly, questions will arise when the exchange rate depreciates. Together with this, the Monetary Policy Committee’s decisions are misunderstood from time to time.

One of those times was on 16 October last year when the Monetary Policy Committee convened a special meeting in between its regular scheduled meetings to review the effects of developments on the country’s inflation outlook. We decided to underprovide in the banking sector’s liquidity requirement thereby leading to a rise in the repurchase rate to 12 percent. Some saw this move as a strategy aimed at protecting the rand. Yet the Committee made it quite clear that this was not the case. It gave the following reasons, and I quote:

> "At the end of its previous meeting (21 September 2000), the Committee expressed concern about the second-round price effects of the depreciation in the exchange rate of the rand and the continued high prices of petroleum. Trade statistics that have been released since the last meeting indicate that the surplus on the current account of the balance of payments in the second quarter of 2000 could have changed to a deficit in the third quarter. At the same time non-residents again became net sellers of South African bonds, signalling a possible shortfall on the financial account. As a result of these changes and the continued strength of the US dollar, downward pressure was exerted on the rand with concomitant import price increases, raising the risk of higher inflation. These tendencies were aggravated by continued high levels of international petroleum prices."

Because of these developments and their likely impact on future price developments and expectations, the Monetary Policy Committee went on to say that it had decided to revise its monetary policy stance. Once again, I quote: "It was concluded that a modest increase in interest rates at this stage may avoid later steep increases in rates in order to meet the inflation target."

To give effect to this, the Reserve Bank marginally under-provided in the liquidity requirement of the banks at the daily repo auction on October 17, expecting this to lead to an increase of some 25 basis points in the repurchase rate.

Upon evaluating the outcome of its decision at its next Monetary Policy Committee meeting, the Committee said although prime lending rates were unchanged after the 25 basis point rise in the repo rate, other money market rates generally rose. Expectations of future rate increases also heightened immediately after the increase in the repurchase rate.

Statistics confirmed the Committee’s concern that the current account of the balance of payments would slip into a deficit from the second to the third quarter of 2000. This current account deficit, the slowdown in the inflow of portfolio capital from the beginning of September 1999 and the reversal in sentiment towards emerging markets put further pressure on the exchange rate of the rand, the Committee said. The concern was that the Rand’s depreciation could have inflationary consequences if it was not countered by other developments.

Although the weakness in the rand, the steep rise in the cost of imported crude oil and an upward shift in food prices led to a sharp increase in consumer prices excluding mortgage costs (CPIX), the Monetary Policy Committee emphasised that the exogenous shocks were not as yet then leading to visible second-round effects on consumer prices.

However, the Committee cautioned that there were signs that the second-round effects of these external shocks were appearing in domestic production prices. The production price index, excluding crude oil and food prices, rose steeply from 3,2 per cent in November 1999 to 5,7 per cent in September 2000. And the Committee also warned that this could indicate that CPIX inflation would be affected indirectly by external factors in the following months since increases in production prices usually precede increases in consumer price inflation. The influence of those factors on consumer prices, the Committee said, would depend on competitive forces in the economy and would be tempered in the medium term by prudent fiscal and monetary policies.

5. Conclusion

On occasions such as these, it is important for us to re-focus our attention on the Reserve Bank's central objective and the framework under which our mandated objectives are to be achieved. To put it another way, it is important to place the Reserve Bank's actions in context. Let me reiterate: our overriding monetary policy objective is to achieve price stability and we aim to achieve this through the framework of targeting inflation. I will stress what many of you have heard me say before: although we monitor a number of variables to extrapolate their potential impact on inflation, it is the rate of inflation that we target.

The Reserve Bank's objectives are enshrined in the Constitution and in the laws of the land. The two elements of financial stability - price stability and the stability of the financial sector - are closely related. If we fail in one area, this will result in uncertainty in the other. We regard financial stability as an important precondition for sustainable high growth and employment creation. Conversely, high rates of inflation can distort the allocation of resources and it can lead to the unequal distribution of wealth.

It is against this background, then, that we place our conduct of monetary policy squarely within the objective of price stability and within the framework of inflation targeting.

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