

## T T Mboweni: Inflation targeting in South Africa

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the BIS/SARB Reserve Management Seminar dinner, South African Reserve Bank, Pretoria, 2 September 2003.

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It is my pleasure to welcome you, our guests and Reserve Bank personnel, to a dinner I gladly host in your honour. I know that you have formally been welcomed to the Reserve Bank this morning by Mr Plenderleith. But at a seminar of this stature, co-hosted by our good friends at the Bank for International Settlements, I, as Governor, felt it correct to re-iterate a warm welcome. I am especially delighted that we are able to co-host this reserve management seminar as I believe that all of us can learn from each other's experiences regarding this important central-bank function.

I know you have had a long day at the seminar and, I believe, a productive one, so I shall keep my speech brief. I have chosen not to focus on reserve management in the South African Reserve Bank, as the topic was covered to some degree in the seminar this afternoon, but rather to talk to you briefly about inflation targeting.

As you probably know, inflation targeting, initially adopted by New Zealand in 1990, has been the choice of a growing number of central banks in both industrialised and emerging countries. As on November 2000, authors Mishkin and Schmidt-Hebbel had counted 19 inflation-targeting countries. Since then, the numbers have increased. Precisely by how many is debatable and will depend on the precise definition of inflation-targeting countries but I note that the merits of inflation targeting continue to be debated in the US.

Inflation targeting in South Africa was formally introduced on 23 February 2000 with the announcement of a 3 to 6 per cent target for 2002. At that time, CPIX inflation - the rate we target - stood at 7 per cent. (Just for your information, we define CPIX as the CPI excluding the interest cost of mortgage bonds, for the historical metropolitan and other urban areas.) The target range of 3 to 6 per cent set was an ambitious one. Whilst there may be debates today about whether the target range was set at the correct level, it is important to note that for both the credibility of the central bank, as well as the management of expectations in respect of inflation being a problem, the target range had to be set at a level which would properly demonstrate commitment to lowering inflation. In spite of the above-mentioned quite ambitious target, by September 2001, twelve-month CPIX inflation had decelerated to 5,8% per cent and many analysts thought that the 2002 target would be met fairly easily.

To say the least, circumstances changed! The exchange rate depreciation of some 37 per cent in 2001 - that is another interesting story! - mostly in the closing stages of the year, was significantly responsible for pushing up CPIX inflation up to a peak of 11,3% per cent in November 2002. On 12 September 2002, the Reserve Bank's Monetary Policy Committee had announced the fourth and final 100 basis points increase for the year of the Bank's repurchase rate. As you may well imagine, I was not everyone's most-favourite Governor!

Fortunately, inflationary pressures have abated, partly related to the rand's appreciation since December 2001 and as reflected in the year-on-year change in CPIX falling to 6,6 per cent in July 2003, and the MPC has seen fit to lower the repo rate. On 14 August 2003, following the most recent meeting of the MPC, the repo rate was further reduced by 100bp to 11 per cent effective from 15 August 2003. (Should there be anyone amongst you interested in the factors weighing on this decision, I refer you to the statement of the Monetary Policy Committee which is on the Reserve Bank website). Whilst a Governor is certainly more popular during a declining interest-rate cycle, rest assured there were critics who felt that the Bank had not been bold enough and should have, at least, reduced the repo rate by 150 basis points!

Technically, what the Reserve Bank is doing could more accurately be described as inflation-forecast targeting. Given the roughly 12 to 24-month lag between interest-rate changes and their having their full impact felt on inflation, the repurchase rate is set at a level *judged* to be consistent with bringing inflation to within the target range within an 12- to 24-month time horizon. I am referring to the intricacies of the transmission mechanism, the clear understanding of which represents the single biggest challenge for any inflation-targeting central bank. Inflation targets of 3 to 6 per cent for 2004 and 2005 have been set by the Government, and guide current policy formulation. Given the lags,

current policy changes clearly have virtually no impact on the 2003 inflation outcome; the focus is further ahead.

With the CPIX again approaching the target range, it is relatively easy to somewhat superficially argue the merits of an inflation-targeting regime. Some *disadvantages* of inflation targeting must, however, be acknowledged. Whilst easily understood in terms of its objective, it is a complicated approach, more demanding and more difficult to implement than a monetary framework based on targeting monetary growth or a more discretionary framework. It implies greater reliance on forward indicators of inflation and a continuous assessment of the relationship between the instruments of monetary policy and the inflation target. Where forecasts turn out to be wrong, even if for completely unforeseeable reasons, the central bank's credibility could be impaired. Of course, the counter-argument being that it simply makes visible the uncertainty that would remain hidden in other monetary-policy frameworks.

Inflation targeting, if pursued at any costs, runs the risk of inefficient output stabilisation. Significant supply shocks to the economy such as sharp oil price movements, could require very large monetary-policy adjustments to bring inflation back inside the target range within the stated time horizon. For such exceptional events, some discretion and patience in re-achieving the target range should be allowed for.

In this regard I wish to confirm that the Reserve Bank generally views it inappropriate to resort to the escape clause, and would rather provide an explanation to any deviation from the target range once the final outcome of the CPIX average for that year had been published. This view is held so that the market has no doubt regarding the Bank's vigilance and commitment to achieving its targets. Indeed, following the CPIX average for the year 2002, which could only be calculated early in 2003, where the average exceeded the target, an explanation was provided in the Monetary Policy Review document of April 2003. (The bi-annual Monetary Policy Review is also available on our website).

The advantages of inflation targeting are also worth highlighting. Firstly, transparency - the concept is easily understandable, with the ultimate policy objective translated into an explicit target value. Secondly, inflation targeting provides enhanced clarity about the objective of monetary policy, which is conducive to sound planning in both private and public sectors. Thirdly, the framework provides for improved accountability of the Reserve Bank. It eliminates the need to rely on a stable relationship between the money stock and inflation, which has become increasingly difficult to identify; inflation targeting enhances economic policy co-ordination with government and the central bank both publicly committed to the same inflation target. And lastly inflation targeting provides an anchor for inflation expectations and price and wage setting, thus reducing the friction which arises from widely divergent inflation expectations.

May I conclude with the comment that, whilst inflation targeting is certainly no panacea, the Reserve Bank still regards it as the most appropriate framework for achieving relative price stability. I quote from our Annual Economic report 2003, released last week: "Sound and consistent price signals are invaluable in directing resources towards their most efficient uses"; achieving this goal is, we believe, our most important contribution we can make towards optimal economic growth and development.

Finally, I also, as Governor, thank the BIS most sincerely for their invaluable role in co-hosting the seminar. Our relationship with the BIS is excellent and we have derived much value in our interaction with this much-esteemed institution over many years. I hope you, as delegates, will extract maximum value from the expertise which is available to be shared. May you all safely return home, and your return on your FX assets be stable and gratifying!

I thank you.