

Ian Plenderleith: Is monetary policy different in Africa?

Speech by Mr Ian Plenderleith, Deputy Governor of the South African Reserve Bank, at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, 29 August 2003.

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A good deal of attention has been directed in recent years to the very interesting and germane question of how far the challenges facing central banks in conducting monetary policy in emerging market economies differ from those facing their colleagues in developed countries.

Are the very evident differences, for example in economic and social structure, in the pace of change and in exposure to shifts in the global economy, so significant as to require a difference in approach to conducting monetary policy? If so, what are the material differences and what adjustments do they require policymakers to make, in focus or in process? In particular, can inflation targeting, which was adopted with such good effect by a vanguard of (mainly) developed countries in the early-1990s, deliver similar beneficial results for the larger phalanx of emerging market economies who followed suit in the late-1990s?

The purpose of this contribution is not to add to the burgeoning theoretical literature, but to offer some observations from practical experience of both worlds.

That experience needs some disclaimer at the outset. Thirty years of wrestling with British monetary policy at the Bank of England certainly does not entitle one to claim any extended track record of success, though the last ten years went a lot better than the previous 20. Equally, six months (so far) contributing to the conduct of monetary policy in South Africa is far too narrow a span to allow one to claim any first hand expertise in the distinctive circumstances of emerging market economies. But the privilege of serving successively on the Monetary Policy Committees of two such different countries is given to relatively few central bankers and it has been fascinating to try to assess whether monetary policy really is different in Africa.

What strikes one initially, in moving from a developed to an emerging market economy, is the remarkable similarity in the monetary policy process. This, on reflection, perhaps ought not to be surprising, given the effort the international community has invested in recent years in promulgating standards of international good practice for the conduct of macro-economic policy.

In terms of the structure of the policy framework, one obvious common feature is the critical importance of government establishing a disciplined and coherent framework for fiscal and monetary policy to work in mutual support, so that weakness in the public finances does not undermine monetary discipline and so that the commitment to low inflation is seen to be embedded as a key feature of the government's overall economic strategy. Another common feature is the need for the central bank to be able to act independently in pursuing low inflation, and to have the technical expertise and professional competence to do its job and command public confidence. Yet another common feature is the need for the country to have a reasonably developed and competently-regulated financial system. In all these respects South Africa scores highly, as indeed international scrutiny through visiting IMF/World Bank missions has confirmed.

In process, too, the procedures through which monetary policy are conducted are remarkably similar. There are differences, but they are essentially ones of form, rather than substance.

Thus, as in other inflation-targeting countries, the inflation target is set as a key government economic objective. A structured Monetary Policy Committee in the central bank meets at regular, pre-announced intervals to take a considered decision on interest rates, enabling policy-makers to step aside from their day jobs for 36 hours and concentrate on a communal review of the monetary outlook. The emphasis, as elsewhere, is on a forward-looking assessment, weighing uncertainties and risks in the unknown future. Also, as elsewhere, the process is surrounded by lively public debate as to what monetary action should be taken, with market commentators showing commendable lack of reticence in arguing their views. Key to the value their contributions can add is the high degree of transparency in the process. In South Africa, as elsewhere, communication and explanation are key elements in monetary policy achieving its behavioural effects, and also critical features in the process by which the central bank is, quite properly, held accountable for its actions.

All these elements, then, look and feel remarkably similar to a central banker migrating from an advanced developed country to an emerging market economy. What is, of course, fundamentally different is the economic, social and cultural environment in which the policy process has to be operated.

This difference in the environment could simply be regarded as a feature that raises the level of uncertainty facing policy-makers as to what is going on in the economy - a difference in degree, but not such as to make the challenges different in kind in any fundamental way. A higher level of uncertainty can in fact matter a lot in itself, in making policy-makers less confident of their judgements and more inclined to wait and see. But there are grounds for arguing that the distinctly different environment in emerging market economies goes further in its implications for the way in which monetary policy has to be operated. Four possible effects can be identified.

First, because they are undergoing significant structural change, many emerging market economies may be more vulnerable to shocks than fully-developed economies. Of course, all economies experience shocks, but the frequency and scale may be greater in emerging market economies.

These shocks can have their origin in the domestic economy (a poor crop) or arrive unexpectedly from overseas (higher oil prices). Either way, they are difficult enough to handle if they impact on the demand side, but more often the emerging market central banker has to grapple with sharp movements in cost pressures on the supply side. The orthodox response to shifts in supply conditions is to accept the first-round effect on prices and concentrate monetary action on heading off second-round impacts that can otherwise generate an inflationary cycle. This may be conceptually clear, but in practice it is a hideously difficult distinction to have to translate into monetary decisions. It is a good discipline in these circumstances to remind oneself regularly that higher interest rates will not help to make the maize crop grow higher.

South Africa's experience in 2001-02 is a good case in point. A precipitate and largely inexplicable fall in the exchange rate in the latter part of 2001 combined with higher fuel costs and increases in domestic food prices to deliver a severe inflationary shock. The central bank's response, to raise interest rates in progressive steps in 2002, was exemplary and appears to have worked well, with inflation now falling steadily back towards target range as the shock recedes. But the consequences were to make the central bank's task of embedding low inflation in the fabric of the economy much more challenging, because of the inevitable questions this experience raised as to whether, faced with such shocks, monetary policy really could achieve permanently low inflation. That it can, and is doing so, is now gaining wider acceptance, as reflected in continuing evidence of falling inflationary expectations. But it has required, alongside carefully-timed monetary tightening, a strong effort by the central bank to communicate its determination. The prevalence of supply-side shocks would thus seem to be one area in which emerging market economies may face particular challenges in operating monetary policy.

Another may arise from the impact of the exchange rate. Movements in exchange rates may have a relatively larger impact in emerging market economies, and their currencies may be more exposed to underlying volatility. Certainly, recent experience in South Africa suggests that the recovery in the rand over the past year has been an important factor in containing inflation. In part this recovery has reflected the general weakening in the dollar, and factors such as higher commodity prices have also been an influence. But the currency's recovery has also been an important channel by which monetary tightening worked its way through to the economy. If the relationship between interest rates and exchange rate movements were predictable, the effectiveness of the exchange rate transmission channel would be helpful to monetary policy. But in practice this relationship remains rather inscrutable.

Moreover, the fact that emerging market currencies are subject to volatility resulting from shifts unconnected with the country itself, such as the recent substantial adjustments by the dollar and the euro, means that movements in the exchange rate can have impacts on domestic monetary conditions that can be both large in their effects and impossible to anticipate. Of course, it can always be argued that in these circumstances the central bank should try to moderate movements in the exchange rate in greater or less degree. But the instruments available, for example through capital controls or official intervention, if maintained for any period, do not have at all an encouraging track record and may have counter-productive side-effects by impeding desirable structural adjustment or actually increasing exchange rate volatility. The appropriate remedy is to stick to the fundamentals, focusing monetary action determinedly on low inflation while taking into account impacts from the exchange rate as one

amongst a range of relevant influences. But it needs to be recognised that these impacts may be particularly significant for emerging market economies.

A further distinctive feature is more straightforward, but can easily be overlooked - that policy-makers in emerging market economies tend to have less information available to them about developments in the economy. This is essentially a form of resource constraint. It applies to statistics, where relevant series may be available less frequently, or in less comprehensive or disaggregated form, or simply less reliable. In South Africa, what was in origin a relatively minor distortion in the compilation of the CPI produced a downward revision, when it was discovered, of nearly 2 percentage points in the 12-month rate of inflation. This at least had the merit of being a rare example of a good news shock. Such events are not unique to emerging market economies: the UK and others have experienced problems with important statistical series from time to time. But diverting scarce resources to statistical compilation is inevitably a problem in an economy where the relevant skills are often a key constraint on economic development as whole. The same applies, too, more generally to knowledge of the transmission mechanism: understanding of functional relationships across the economy is bound to be less secure when the structure of the economy is undergoing rapid change. The existence of a large informal economy further complicates the task.

This leads to a fourth implication for monetary policy in an emerging market economy. This is the critical role played by confidence in, and the credibility of, the policy framework. This has both a domestic and an international dimension. Domestically, there is a critical need to win public acceptance of the value of low inflation and public confidence in the determination and ability of the central bank to achieve it. Internationally, confidence that the policy framework will be adhered to can have a powerful influence on investment inflows and on the exchange rate. These factors are, of course, crucial to monetary policy in any country. But the task of buttressing them is the more challenging in emerging market economies because the track record of commitment is relatively much shorter.

These can be argued to be some of the distinctive challenges faced by monetary policy-makers in emerging market economies. Are they, however, sufficiently distinctive as to require any fundamentally different approach in the conduct of monetary policy? The answer, to quote Evelyn Waugh, has to be, "Up to a point, Lord Copper." They are not different in kind from the factors which central banks in any country have to face. But they do perhaps play a more predominant part in the monetary policy judgement in emerging market economies than elsewhere.

This suggests two final observations.

First, because of the uncertainties, central banks in emerging market economies may understandably tend to be relatively cautious in adjusting their policy stance, in the sense of spacing adjustments in relatively smaller steps over more extended periods. No central banker need ever apologise for being regarded as being cautious. But it does mean that, even in circumstances in which there may be a case for contemplating more bold action, the balance of risks may argue against such an approach.

Secondly, given the challenges, can an inflation targeting framework realistically be expected to deliver the desired results in the emerging market context? If the various distinctive features identified above - periodic unexpected shocks, exchange rate volatility, imperfect information sources and public confidence that is not yet fully robust - occurring in whatever combination, result in the central bank missing its target for any extended period, there is of course a danger that the credibility, or even the feasibility, of the process could be called into question. But arguably, it is precisely in these circumstances that the clarity an inflation target can be most helpful, and powerful, in communicating the central bank's policy intentions. That the challenges are formidable is not a reason for stepping back from clarity. It is, instead, a powerful reason in favour of the clarity of an inflation target can deliver, reinforced by effective communication by the central bank, consistency in its conduct of policy and transparency in explaining its actions. In this broader perspective, the fundamentals of monetary policy are not, in any meaningful way, different in Africa.