T T Mboweni: Monetary policy, inflation targeting and inflation pressures

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1. Introduction

The monetary policy framework in South Africa is facing its most severe challenge since the inception of inflation targeting in the year 2000. Inflation pressures have been building up strongly, and the most recent CPIX figure of 10,1 per cent is significantly above our inflation target and inconsistent with price stability. These pressures originated primarily from exogenous shocks such as oil, food and electricity price developments. However it is clear that inflation pressures have become more generalised, as evidenced by the continuous upward trajectory in the core indicators. For example, in June 2006 CPIX excluding food and energy measured 2,5 per cent. By April this year it had risen to 5,6 per cent, and indications are that this measure could rise further.

Of great concern is the significant deterioration of inflation expectations, which will give further impetus to these inflationary pressures. Over the past year inflation expectations have drifted upwards gradually, but nevertheless appeared to remain anchored within the inflation target range. This picture has changed significantly in the first quarter of this year. We have now observed the biggest increase in inflation expectations since the inception of the inflation expectations survey eight years ago. Reference here is made to the BER inflation expectations survey conducted on behalf of the South African Reserve Bank (SARB). This, together with the possible upward trend in unit labour costs, does not bode well for the inflation outlook going forward.

In response to these developments, and to the robust domestic demand that we have been experiencing, the monetary policy stance of the South African Reserve Bank has been tightened since June 2006 by a cumulative 450 basis points. The SARB, more specifically the Monetary Policy Committee (MPC), has been criticised by some commentators now that inflation has breached the upper limit of the target range, and this is interpreted as a sign of lack of determination, commitment, and the will to achieve and maintain price stability. At the same time, others have suggested that the degree to which the SARB has responded to those inflation developments has been excessive, too strict, dogmatic like inflation targeting “nutters”, insensitive to the plight of the poor, that monetary policy is after-all powerless in the face of supply side shocks, and that these actions have demonstrated a lack of concern for growth and employment in South Africa. Nothing can be further from the truth.

2. The inflation targeting framework

At this point it may be useful to make a few comments about inflation targeting in general. Some recent statements from many commentators about the appropriateness of inflation targeting often seem to misunderstand what the framework is about. Here we wish to emphasise the word framework, because that is what it is. It is not a policy, and it is not an instrument. It is not a dogma. Take away inflation targeting, and we will still have monetary policy, we will still have the same instruments of monetary policy, and the Bank will still have a constitutional mandate to maintain low inflation. Furthermore, any central bank worth its salt would want in any case to achieve and maintain price stability, meaning low and stable sustainable inflation levels. So even if we did not have an explicit inflation target as set out in the inflation targeting framework, we would still want to pursue price stability. Central banks are in the business of price stability. Our monetary policy objectives would therefore remain the same, and we would face the same challenges as we confront today on how to respond to exogenous shocks and second round effects. It should be noted that it is not only formal inflation targeting central banks that successfully pursue a low inflation objective. The US Fed and the European Central Bank are cases in point.

The advantage of an inflation targeting framework is that it provides an anchor for inflation expectations, as it makes explicit the goal of monetary policy. That publicly stated goal is very, very significant in that it also binds politicians to abide by it. This is in our case ex-ante coordination of policy. The more anchored expectations are the more flexibility monetary policy has in responding to exogenous shocks. But announcing a target on its own does not guarantee success. It is not a magic wand. It has to be backed up by appropriate actions to build monetary policy credibility in the eyes of the public. Credibility has to be earned, it is not ordained.

Those who criticise inflation targeting often argue that the framework is a straight-jacket which induces procyclical monetary policy particularly in the presence of supply-side shocks. Whether or not this is the case is an empirical question for debate, and is determined in part by the flexibility with which monetary policy is implemented. There is in our view, a distinction between what is referred to as strict and flexible inflation targeting. Strict inflation targeting central banks (or what Governor Mervyn King of the Bank of England has termed “inflation nutters”) would give no weight to short-term output considerations in the conduct of monetary policy. Most central banks, including the SARB, regard themselves as flexible inflation targeting institutions. By this we mean that there is factored into our decision-making systems concern about what the output costs of our monetary policy actions are going to be. In the jargon of economists, there is some weight on output variability in the Bank’s objective function. The inflation objective is not discarded, but rather there is a more pragmatic approach to the speed with which inflation is brought back to within the target range. However there is a trade-off between an excessively long period, which would reduce credibility and raise questions about the commitment of the monetary authorities to low inflation, and an excessively short period in which real costs may be high. The rest is judgement for which a central bank must and shall be held accountable.

Inflation targeting has been an increasingly popular framework since it was first adopted by New Zealand in 1990. Most studies have shown that it has been a useful framework for assisting in bringing down and maintaining inflation at low levels. Currently inflation targeting is probably facing its most severe challenge, as international oil prices have quadrupled since the beginning of 2004, and global food and other commodity prices are experiencing persistent strong increases. Whereas a few years ago most countries were within their inflation targets, this unfortunately and regrettably is not the case today. The latest data show that 3 out of 7 industrial countries, and 4 out of 16 emerging market economies are within their targets, although the extent and persistence of the deviation differs somewhat. Does this mean that inflation targeting has failed? The true test of the framework will be whether inflation expectations can be sufficiently anchored to weather the current inflationary pressures, and facilitate a return to within the officially set targets.

3. Dealing with shocks

The nature of the original cost pressures that are facing the economy is well known. These pressures – food and energy – do not appear to be cyclical. This might be a debatable assertion. We are facing a significant and probably a permanent change in relative prices globally. We also have to be concerned about pricing and unit labour cost responses to these relative price changes. If producers simply pass on these increases, and if wages increase to compensate labour for these increases without higher levels of productivity growth, and if we allow this process to take effect, inflation expectations will deteriorate and generalised inflation will accelerate. We cannot simply sit back idly, the stakes are too high.

However, dealing with supply side shocks always poses difficulties for monetary policy makers. The situation we are facing now differs in important respects from the standard case which sees either a shock which is expected to reverse, in which case not much action is required, or a discrete one-off change in relative prices. In the latter more difficult case, the usual response is to look through the inevitable impact on measured inflation, and once this change is through the system, inflation should ideally return to its normal levels. If inflation expectations are firmly entrenched within the inflation target range, then very little response may be required from the monetary authorities, whose main objective under such circumstances would be to ensure that this process does not feed through to more generalised inflation pressures.

The challenge, however, is that we are not being faced by a discrete once-off event. Rather, we are facing what can best be described as a rolling or continuous shock. International oil prices have been on an upward trend since 2004, apart from some moderation in the latter half of 2006. Oil price increases have almost consistently surprised on the upside, requiring a continuous revision of our assumption and thus the forecasts. Indications are that food price inflation is expected to continue to remain high for some considerable time. This is most definitely not seen to be a temporary phenomenon. Similarly, electricity price increases significantly in excess of the average inflation rate are expected to become a multiyear event, as the process of increasing generating capacity is rolled out. These are unusual developments. Unusual responses might be necessary. Things, it seems, might get worse before they become better. We are going through bad times.

The magnitude of these inflationary pressures has been such that a breach of the target was inevitable. Whereas we have to accept that we will be unavoidably outside the target range for longer than we would wish, we are determined to bring CPIX inflation back to within the target range within a reasonable time period. If we seem to be abrogating our responsibilities, inflation expectations could get out of hand, price-setting and unit labour costs could become excessive and we could experience an inflation spiral. As noted earlier, we have already seen evidence of second-round effects, deteriorating inflation expectations and elevated wage demands coming through, and these have required a response to prevent inflation getting out of hand.

4. Has the monetary policy response been excessive?

This raises the question of whether the SARB has gone for the overkill. There is no doubt that the tighter stance of monetary policy has caused a slowdown in domestic household consumption expenditure. That is good. This is something that we wanted to achieve in order to moderate demand pressures in the economy. There are signs that output growth is also slowing down, but this is not solely due to monetary policy actions alone. The global economic slowdown and electricity supply constraints in South Africa are also important variables influencing this outcome. Nevertheless we are of the view that output growth will decline significantly below the potential growth rate of the economy (4.5 per cent), but economic growth will continue to be underpinned by the massive infrastructure expenditure programme that is currently underway to improve the quality of our transport system, electricity supply and telecommunications networks. These initiatives will not only sustain growth but also increase the potential real GDP growth rate of the South African economy over time. The forecast of the South African National Treasury is for real GDP growth to measure 4.0 per cent this year and to increase over the coming two years. That is not bad at all. Private sector forecasts are slightly less optimistic. The latest consensus forecast is a real GDP growth rate of 3.6 per cent for this year. While lower than in previous years, it is still relatively robust in the context of a weak global economy and overall domestic constraints.

From a technical monetary policy perspective, although nominal interest rates have been increased significantly, real rates have not, and in fact may have fallen depending on the deflator used. Interest rates, in other words, have not increased by more than the increase in inflation. Does this mean that we have not been aggressive enough as some would argue? As noted earlier, we have to some extent allowed for first-round effects to happen, and therefore it may have been inappropriate to have responded to those developments, but rather pre-emptively focus on the second-round effects.

5. Changing the target?

A number of commentators have suggested that the inflation target range should be changed as a means of avoiding further tightening of the monetary policy stance. We do not support such a course of action. It would be very easy for government to announce tomorrow that our target has been changed from 3-6 per cent, to say 10-15 per cent. We would then be inside the target range, and for a short while no further interest rate action would be required. This would however signal that we are happy with inflation at these levels. But what would be the implication of setting a higher target range? Almost immediately long-term inflation expectations would be adjusted to these levels, and wage and price setting behaviour would be adjusted as well. Our inflation rate would most probably very soon be entrenched around the 15 per cent level, and in order to prevent it from rising further, we would very soon have to raise interest rates further. We cannot escape from the fact that a higher inflation trend requires even higher nominal interest rates. The increased risk premium associated with a higher expected inflation may result in even higher real interest rates. There can be no presumption that real interest rates with a higher target range will be any lower – they may in fact be higher.

We cannot simply adjust the target range higher every time we move out of the existing one. The ultimate objective is low inflation, rather than to be within a target range. We would rather be outside a low target range, and focus on getting back to within it, than define ourselves to within a high target range. We accept that we could be outside the target range for longer than we would like as a result of these exogenous shocks. But we are nevertheless determined to maintain a focus on the inflation target range and get back to within it within a reasonable time frame. Having a higher target will not only reduce our credibility and make South Africa a less attractive investment destination for foreign capital, it will also result in a continuously depreciating exchange rate, as our inflation rate will be significantly higher than that of our trading partners. This is turn would translate into further inflation pressures.

Alternative proposals seek to redefine the target basket to exclude exogenous items such as food, electricity and petrol. That is a cop-out. In deciding on the appropriate monetary policy stance, we do look at various underlying core measures which do provide us with some idea of the underlying pressures in the economy. But we cannot ignore the headline figures which influence inflation expectation and other pressure points. We cannot run away from the problem and simply exclude a category every time its behaviour does not suit us. This will be a cosmetic change which will not help us get to grips with the underlying problem. We will also, most certainly, lose credibility in the eyes of investors (both domestic and international) as well as amongst global policy makers. This will not be helpful to South Africa’s poor or the South African economy generally.

6. The explanation clause

There have been suggestions that we invoke the explanation clause as a means to avoid further monetary policy tightening. There appears to be confusion about the applicability of the explanation clause. There is an assumption that the clause relieves us of the need to react to supply side shocks and that we do not have to worry about the inflation target. This is a misinterpretation of the explanation clause. The clause is worded very carefully and it says that “when the economy is buffeted by a supply side shock similar to those envisaged by the original escape clause that will take CPIX inflation outside the target range (e.g. an oil price shock, a drought, a natural disaster, or financial contagion affecting the currency), at the subsequent meeting of the Monetary Policy Committee, the SARB will fully inform the public of the nature of the “shock”, the anticipated impact on CPIX inflation and the monetary policy response to ensure that inflation returns to the target and the time frame over which this will occur.”

There are two important points worth noting. First, the clause clearly allows for us to be outside the target range because of first-round effects of supply side shocks. Second, it does **not** relieve us of the responsibility of getting inflation back to within the target range. The clause clearly stipulates that if CPIX is out of the target range, we have to explain why, and what we are doing about it. This is something we do after each MPC meeting in any case. But it does not tell us that no effort should be made to ensure a return into the target range. CPIX is currently outside the target range primarily but not only as a result of factors beyond our control, and in line with the explanation clause, we are now taking strong steps to ensure that CPIX returns to within the target range. As we have noted in our most recent MPC statement, we currently expect CPIX to be back within the target range by the end of 2009. However, this is not an unconditional commitment. The outlook may deteriorate further in the light of new developments, and require a reassessment of the monetary policy stance.

7. Conclusion

We appear to be going through an extended adjustment in relative prices. The good news is that these relative price adjustments will eventually come to an end. The bad news is that we do not know when and what the long-term levels are going to be. Monetary policy decisions are made under conditions of uncertainty. Unfortunately, some periods are more uncertain than others.

Given the extent of these supply-side shocks, no amount of monetary policy tightening could have prevented the first-round effects from emerging and a breach of the upper limit of the target range was unavoidable. However current evidence of more generalised inflation and higher expectations means that we have to be firm in our resolve to contain these pressures. The Monetary Policy Committee will continue to implement inflation targeting in a flexible manner. While at times reducing inflation may lead to some output costs in the short run, achieving the long-term goal of price stability remains our primary objective. A low inflation environment supports growth as evidenced in South Africa’s growth rates in excess of 5 per cent since 2004. There is ample evidence that high inflation does not create jobs on a sustainable basis. Rather, it is simply a tax on the poor.

Thank you.