Gill Marcus: Fourteen years of inflation targeting in South Africa and the challenge of a changing mandate

Opening address by Ms Gill Marcus, Governor of the South African Reserve Bank, at the Biennial Conference of the Bank "Fourteen Years of Inflation Targeting in South Africa and the Challenge of a Changing Mandate", Pretoria, 30 October 2014.

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It gives me great pleasure to welcome you all to the biennial conference of the South African Reserve Bank. The theme this year is "Fourteen Years of Inflation Targeting in South Africa and the Challenge of a Changing Mandate". Lessons from history tell us that nothing is static, that societies and economies evolve, as do policies and policy frameworks. When things appear to be going well, it is often difficult to imagine that this will not continue or that the status quo will change, or how indeed it will or can change. During the so-called "great moderation" of the mid-2000s, when global inflation was low, the battle against business cycles was seemingly won, and inflation targeting, or some variant thereof had gained widespread acceptability, it was hard to envisage what would come next, and what would cause us to reconsider the adequacy of the framework.

Little did we know that very soon, in the wake of the global financial crisis, we would be asking the question whether inflation targeting was enough, and if not, how should the framework be modified or augmented, and should central bank mandates be expanded? The global financial crisis was a salutary reminder that nothing is static, that central banks largely deal with the unknown future, and that we have to adapt to changing and unexpected circumstances. However, there is still an intense debate about whether monetary policy should change, and how it should change. The aim of this conference is to provide a platform to debate these issues rigorously, and we are indeed privileged to have a high-level line-up of recognised authorities in the field, both international and local, to stimulate these discussions.

Although the focus of the conference is more about the future, the topic does imply some assessment of the framework, and I will attempt to provide brief reflections of the past 14 years of inflation targeting in South Africa. I will also reflect on global developments in monetary policy and in particular in respect of the expanding mandates of central banks and how these developments relate to our domestic circumstances.

Has inflation targeting been a success in South Africa? It is hard to say in the absence of the counterfactual, but there are a number of indicators that suggest it has been a positive experience. One way of looking at it is to compare the pre- and post-inflation targeting period outcomes. While this approach gives us some indications, the causal relationships may be unclear, and the different periods were subject to different shocks which may distort the picture. Nevertheless, the data does show that inflation targeting has been consistent with an average inflation rate lower than in the previous decade, and accompanied by lower volatility and lower nominal and real interest rates. Similarly, growth outcomes have been more favourable, which undercuts the argument that is sometimes made that inflation targeting is inimical to growth.

We have adopted a flexible inflation targeting approach, conscious of the trade-off between short-term inflation variability and output variability. This approach has been appropriate both in dealing with exogenous shocks, as well as responding to periods of slow growth, as is currently the case. While growth does have a positive weight in the MPC's objective function, and consideration is given to the real economy in making monetary policy decisions, we believe that monetary policy, whatever the framework, does not impact significantly on long term potential output growth.

Looking at some of the comparative data, we see that in the 10 years before inflation targeting was adopted, inflation averaged 9,7 per cent, and this declined to 6,3 per cent in the full inflation targeting period, while average GDP growth improved from 1,6 per cent to 3,3 per cent. The average nominal policy rate declined from 15,5 percent to 8,5 per cent, while the average real policy rate declined from 5,7 per cent to 2,2 per cent. If we simply look at the period from 2010, inflation has averaged 5,3 per cent, real GDP growth 2,6 per cent, the repo rate 5,5 per cent and the real repo 0,3 per cent. The volatility of all these variables is also lower in the inflation targeting period. Other positive indicators are the increased contra-cyclical nature of monetary policy (as noted inter alia in work by Ben Smit and Stan du Plessis), as well as the relative stability of inflation expectations, albeit, in the last three years, at the upper end of the target range. This topic will be explored further in the presentation by Alain Kabundi.

But it has not all been plain-sailing, and as the averages suggest, inflation has not always been within the target range. Despite the improved outcomes during the inflation targeting period, there have been significant divergences of inflation from the target range, particularly in 2002–03 and 2006–08. However, these deviations were primarily a result of exogenous shocks, and therefore "justifiable" in a flexible inflation targeting framework. Such deviations, if communicated and responded to appropriately, should not undermine the credibility of the framework. These shocks have been primarily in the form of significant exchange rate changes, and global oil and food price increases. A criticism sometimes leveled at inflation targeting is that the response to such supply side shocks could lead to pro-cyclicality of monetary policy. Our approach has been to try to "see through" the first round effects of such increases, and focus on the possible impact on inflation expectations and the emergence of second-round effects. Depending on the extent to which inflation expectations are anchored, we could also take a more flexible approach by, for example, extending the policy time horizon. However, this is often easier said than done as a lot depends on the nature and duration of the shock, which is not always easy to discern ex ante.

For example, the oil price increases in January 2004 from around US$30 per barrel, were initially expected to be temporary. Prices did not reverse, but then settled in the US$60-US$70 per barrel range for some time. From the beginning of 2007, oil prices began to increase almost persistently, but our own forecasts, based to a large extent on market forecasts at the time, kept underestimating these increases. Oil price increases continuously surprised on the upside, resulting in almost continuous upward adjustments in the Bank's inflation forecasts. Each forecast round produced a higher trajectory, and a higher oil price assumption. As these increases fed quickly through to headline inflation, coupled with accelerating global food prices and a depreciating currency, disentangling first and second round effects became increasingly difficult. It may be relatively easy to see through a temporary shock or a once-off permanent shock, but dealing with a continuous or persistent one-sided shock is more challenging, particularly in the emerging market context.

One approach to dealing with exogenous shocks would be to target core inflation, which would strip out volatile supply side shocks. Most countries target headline inflation, but some use a measure of core inflation for operational purposes. While we have paid increasing attention over the years to a measure of core inflation, and we publish our forecast for this measure alongside our forecast for headline inflation, we have kept the main emphasis on headline inflation for ease of communication. We have, however, found core inflation to be a good indicator of the underlying inflation pressures excluding some exogenous and volatile components and exogenous shocks, and therefore a useful policy guide. Whether or not policy should focus primarily on core inflation is an issue that will be addressed by Stan du Plessis, and I am sure it will generate some interesting debate.

A related challenge to the inflation targeting framework has been dealing with large exchange rate changes which were primarily responsible for the deviations from target experienced in 2002–3 and to some extent in 2014. Although pass-through from the exchange rate to CPI has declined significantly over the period, it remains an important driver of inflation. The rand is prone to overshooting in both directions, at times for extended periods, and is vulnerable to terms of trade swings. In addition, because of the openness and depth of the South African foreign exchange market, the exchange rate is sensitive to changes in risk perceptions in global financial markets and associated changes in capital flows, an issue highlighted in Shakill Hassan's paper.

Reacting to exchange rate movements has the potential to confuse the signals about the objectives of monetary policy and the commitment to the inflation target, particularly when a conflict between the objectives arises. However, while an inflation targeting framework requires exchange rate flexibility, it is generally accepted that some intervention is not inconsistent with the framework, as long as the motives are fully communicated and understood, and that precedence is given to the inflation objective when a conflict between the objectives arises.

Changes in the exchange rate could have inflationary impacts, but reacting to them could pose a challenge for communication, particularly when a currency depreciation has been accompanied by a tightening of monetary policy. We have tried to emphasise that such a reaction is to the potential inflationary impact of the exchange rate change and not an attempt to target the exchange rate itself. The exchange rate is one of a number of determinants of inflation, so any response to an exchange rate change would have to be assessed in conjunction with the simultaneous impact of changes in other variables, some of which may be offsetting.

The response to exchange rate changes would depend on the nature of the shock, where monetary and portfolio type shocks would require different interest rate responses. The reaction of the exchange rate to interest rate changes has also been uncertain: during the mid-2000s, when equity capital flows dominated in South Africa, lower interest rates encouraged growth sensitive inflows, and currency appreciation. The impact of the exchange rate has become even more relevant given increasing evidence of monetary policy spill-over effects from advanced economies. In particular, low interest rates and quantitative easing in the US and associated capital flows (and reversals) have impacted on the rand, with attendant consequences for inflation and inflation expectations. In this regard, domestic monetary policy has had to respond to both domestic factors and changes or potential changes in policy globally. The issue of spillover effects will be taken further by John Taylor, while Vivek Arora highlights the diverse response of emerging markets to shocks.

Inflation targeting, however, has not been without its domestic critics and political economy challenges. There has been a lot of resistance to the framework from sections of the labour movement in particular, where the idea of a long run trade-off between inflation and employment persists, and, not surprisingly, opposition has tended to intensify during upward phases of the interest rate cycle. This animosity is problematic, as societal buy-in and public support are considered to be important prerequisites for the successful implementation of the framework. Nicola Viegi, for example, argues in his paper that a lack of a strong response of wages to labour market conditions is likely to undermine the efficiency of the framework. Initially, inflation targeting was introduced without much prior publicity, public education or consultation beyond the Bank and the National Treasury. In retrospect, we could have embarked on a more aggressive education campaign to underline the benefits of low inflation, the limits to what monetary policy can do with respect to growth, and why a flexible inflation targeting framework is not necessarily inimical to growth. There was, and still is, a widely held view that monetary policy can do more for structural growth and employment than it can in reality.

To counter this, during the past few years, we have engaged in intensive stakeholder consultations and instituted an "outreach programme" where we meet regularly with political parties, trade unions, business federations and civil society to discuss our view on the economy in general and on monetary policy in particular. Communication with the public has become an integral part of our overall strategy. It has taken time to develop a modus operandi for communicating with the public, and this remains an area of constant evolution and refinement.

Unfortunately, although the animosity towards inflation targeting has declined significantly, almost 15 years after the implementation of the framework, and despite our communication initiatives, the views of some segments of society have not changed much. For example, following the 25 basis point increase in the repo rate in July, the Cosatu response was one of "bitter disappointment", laying the blame for low growth at the door of "conservative monetary and fiscal policies", despite a slightly negative real policy rate and a fiscal deficit of 4.5 per cent of GDP.

Communication has another dimension that relates to transparency of policy decision-making and forward guidance, which is more about future policy actions rather than communication about what monetary policy can and cannot do. Although transparency and communication, which is the corollary to accountability, is not unique to inflation targeting, there is no doubt that it is integral to the framework and most countries, including South Africa, have made great strides in increasing this aspect over the past two decades. Alan Blinder has appropriately referred to this process as the "quiet revolution in central banking". But there are disagreements around the limits of this transparency, particularly around the issue of forward guidance. Although forward guidance, in the form of setting the path for policy rates, predated the crisis, (in New Zealand, Sweden and Norway), as monetary policy reached the zero lower bound in a number of the advanced economies forward guidance of some form became more common-place, although the nature of the guidance often differs across countries, and has been changing in the US and UK in particular.

The debate is now whether or not such guidance has been useful, and whether or not it should continue once interest rates normalise. Although we have chosen not to give guidance in the form of an explicit path, we have moved in the direction of being more open, but prefer to provide a more generalised form of guidance, to act consistently and allow the market to deduce the appropriate policy path. Along with a number of other features of inflation targeting or monetary policy, central bank communication is likely to continue to evolve particularly given the increased demand for greater public accountability.

Since the crisis there has been some questioning as to whether inflation targeting is enough to ensure price and financial stability and should there be any adjustments to the framework and policy mandates. In general, most conclusions are that some variant of inflation targeting is appropriate, and that long run price stability should remain a key goal of monetary policy. But beyond that there are disagreements.

In particular, there are concerns that the low inflation environment and the narrow focus on inflation contributed to the financial crisis: that the period of low interest rate volatility lowered perceived risks, and encouraged increased leverage and lending. Economists at the BIS, for example, were warning that credit cycles tend to be longer than business cycles, and that failure to focus on the former could lead to excessive leverage and the emergence of asset price bubbles. The conventional response at the time, as typified in Chairman Greenspan's Jackson Hole address in 2003, was that central banks could not recognise asset price bubbles, and therefore should not lean against them, but should rather clean up after the bubbles had popped (Bill White's so-called "lean or clean" debate).

It is now generally accepted that a narrow focus on inflation to the exclusion of asset prices is not sufficient. However, a number of unresolved issues remain, one being whether or not monetary policy should lean against asset prices. For example Claudio Borio at the Bank for International Settlements, proposes extending the time horizon for monetary policy to take the financial cycle into account. Alternatively, should interest rates remain focused on monetary policy, and macroprudential tools be used to deal with asset price excesses? And if macroprudential tools are used, should this be done by the central bank, or by a separate agency? There are very different views still on this issue. A Brazilian proposal by da Silva and Minella is to integrate a focus on credit gaps into the monetary policy framework. By contrast John Taylor argues for a return to a rules-based approach rather than trying to fine-tune sectors of the economy over the cycle while Lars Svennson highlights the output costs of "leaning against the asset price winds" with monetary policy.

Our approach is one of separation of goals and instruments, that the repo rate will maintain its traditional role as the main monetary policy instrument, while macroprudential tools will be used for financial stability purposes. This toolkit is being developed, and the Bank closely observes how different instruments are being used in varied circumstances by other central banks. This does not mean, however, that interest rates could or should not be used in combination with macroprudential tools should the need arise.

The Bank's experience during the pre-crisis period, when we did not have a focused macroprudential approach, is instructive. During the period 2003–2006, the economy was growing at rates above potential, with an average growth rate of around 5,5 per cent, at a time when the potential growth rate was estimated to have been around 4 per cent. The exchange rate was appreciating, partly in response to the commodity price cycle; annual growth rates in credit extension were around 30 per cent; real household consumption expenditure growth was around 9 per cent; and house price growth was in excess of 30 per cent. Had we had a macroprudential focus, such a combination of settings would have been a cause for concern, and may have elicited a policy response through higher interest rates. However, over that period, inflation was steadily declining and threatening to fall below the lower end of the target range when it reached a low of 3,1 per cent, which could have required a further easing of monetary policy. There was perhaps a failure on our part to recognise this as a broader financial stability risk, and to react either with a tighter monetary policy stance, or with macroprudential tools. Similar settings would probably result in a different response today, given our explicit financial stability mandate. How effective our macroprudential policies will be in solving financial stability issues and dealing with situations such as those described above is, however, still an open question.

The expansion of central bank mandates to include financial stability explicitly could have implications for central bank independence. Central bank independence is not absolute, however, and independence relates mostly to monetary policy at the operational level. The inflation targeting framework lends itself well to the separation of instrument and goal independence, in that generally central banks do not have goal independence (as the target is usually, but not always, set by government), but, in order to prevent the so-called political interest rate cycle, central banks have independence to pursue the mandate given to them. But, as I have stressed on a number of occasions in the past, we are not independent of the economy or society that we live in, and therefore we have to take a number of factors into consideration when making decisions. However, compared to financial stability, monetary policy decisions, while not easy, are more straightforward and better understood by the public. These decisions generally involve the use of one tool (the interest rate), although quantitative easing has complicated this argument, and there is a clear objective, even if there is some weight on output variability in the Bank's objective function.

However, a financial stability mandate is more complicated. It generally involves government, particularly when public funds are involved, in crisis resolution and the policy tools are more directed at particular sectors, and therefore may be more politically sensitive as the distributional impacts are more apparent than in the case of monetary policy. Furthermore, challenges for communications are likely to arise if interest rates are used for both monetary policy and financial stability purposes. And, as a recent IMF paper has argued, financial stability is difficult to measure but crises are evident, so policy failures are observable, unlike successes. To quote from the paper, "central banks would find it difficult, (even ex post) to defend potentially unpopular measures, precisely because they succeeded in maintaining financial stability." And any perceived failures on the financial stability front have the potential to undermine monetary policy independence through a general loss of credibility of the central bank.

A final issue is the debate around the optimal level of inflation. In particular, is the 2 per cent inflation target norm in advanced economies too low? Olivier Blanchard at the IMF mooted this in 2010, but the idea persists, and was recently raised again by Paul Krugman. The argument relates to a fear of deflation, the dangers of a low inflation trap, and the economic costs of deflation. But it does not undermine the basic tenet that long run price stability remains at the core of central bank mandates. Rather, it appears to be a call for a moderate upward adjustment to what would be regarded as the advanced economy norm for price stability.

This debate, however, is not really that relevant in South Africa or many emerging market economies where structural features, price setting behaviour and vulnerability to exogenous shocks has generally required higher inflation targets. These structural features include factors such as the weight of administered prices in the inflation basket, the weight of volatile elements such as food, vulnerability to terms of trade changes, particularly in the case of commodity producers, and the impact of exchange rate volatility on the exchange rate.

Although our inflation target of between 3 and 6 per cent is higher than the advanced economy norm, this does not mean that there have not been times when there have been calls to raise the inflation target, even from the current high level, in order to bring about a looser monetary policy stance. Our current level of inflation and our target are not close to the low inflation trap, and our view is that a higher inflation target would merely raise inflation expectations, and actual inflation would then likely increase. The end result would be higher nominal interest rates, and because of possible higher inflation variability and other risk premia, we could end up with higher real interest rates as well.

In conclusion, inflation targeting is not as straight-forward as its name suggests. There are many contentious issues, and the challenges facing emerging market economies are different to those of the advanced economies. We are extremely fortunate to have a strong line-up of international and local experts on this topic to provide us with their thinking on this important policy question and to stimulate discussion. There is also keen interest and participation in the conference, with a wide range of delegates, and I am sure you will all be active participants in the discussions. I am particularly grateful to our international visitors who have undertaken the long journey to be with us, and we hope that you will enjoy your stay with us and will have time to gain an appreciation of our country beyond the confines of the central bank and monetary policy.

Thank you.