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at the Unisa Graduate School of Business

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Balanced and sustainable growth: the role and mandate of the SARB

Good evening, ladies and gentlemen.

The mandate and role of central banks is a hotly debated topic in many countries around the world. In South Africa, we tend to engage in this debate through rhetoric rather than facts. In our article published on 2 July, we set the basis for a more informed discussion.[1] I would like to open the next chapter in that dialogue tonight.

Let me start by asking: why does our money have value? Why can you exchange it for goods and services? The money is not backed by silver or gold or platinum. It is not backed by land. It is not pegged to another currency, such as the dollar or the pound. It works because of trust – trust in a promise made in the Constitution, which gives the South African Reserve Bank (SARB) a very specific job: “to protect the value of the currency in the interests of balanced and sustainable economic growth in the Republic.”

Today, I will explain how we go about doing that job. While there are questions of constitutional principle in recent debates about the SARB’s mandate, I would prefer to give you the economic argument for what we do. Independence needs to be earned; it is not enough for it to be

[1] Kganyago, Lesetja. ‘Why low inflation is the best way to stimulate economic growth’. *The Sunday Times*, 2 July 2017.

enshrined in the Constitution. The economic argument is crucial for assessing our effectiveness – and for understanding why the SARB should be independent.

There is no distinction, and hence no choice to be made, between protecting the value of the currency and attending to the socio-economic well-being of South Africans. Destroying the value of the rand through inflation, reducing what it purchases in terms of daily sustenance, would be of no benefit to anyone. The recent report by Statistics South Africa shows that our tragic rise in poverty coincides with a time of rising inflation and weakening growth, between 2011 and 2015.[2]

While we are happy to discuss alternatives to policy targets and to the way in which we now make monetary policy, the case for the existing framework is very strong; our own experiences and those of other countries overwhelmingly support it. Our monetary policy framework has helped us to achieve a historically low rate of inflation and, as a direct consequence of that, historically low interest rates. This suggests that, in our current economic predicament, rethinking monetary policy may not be the best use of our time. South Africa has far more urgent economic challenges, in particular reducing our structural unemployment rate.

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[2] Statistics South Africa, *Poverty trends in South Africa: an examination of absolute poverty between 2006 and 2011, 2015.* 22 August 2017. The South African Multidimensional Poverty Index (SAMPI) shows a sharp decline in poverty, from 17.9% in 2001 to 8% in 2011, falling somewhat further to 7% by 2016.

How we protect the value of the currency

Let me start with a classic problem of central banking. In general, everyone wants money to keep its value. However, everyone also wants lower interest rates – and there are always some people who ignore inflation and demand lower rates straight away. Unfortunately, if you give in to these short-term demands, you end up with more inflation and higher interest rates. When people see that the short-term demand for low interest rates is stronger than the long-term preference for low inflation, they change their behaviour. For instance, banks may charge more to lend, as protection against higher inflation. Or businesses may put up prices in advance, speeding up inflation. As a result, the short-term desire for lower rates ultimately gives you higher inflation and higher rates.

This is a well-understood problem. It is what economists call a 'time inconsistency' problem. A solution is to make a binding commitment, a promise people can believe over time. In monetary policy, this has meant giving central banks their independence, leaving them to target inflation and set the marginal cost of borrowing in the money markets. The inflation target allows for some inflation but not too much. This is precisely why the Constitution tells us to protect the value of the currency – and to do so without fear or favour. We disregard short-term, private demands for higher inflation so that we can look after the longer-run interests of the general public.

How, then, do we go about delivering on this mandate? Since 2000 we have used an inflation target. This means we protect the value of the currency as measured by changes in consumer prices. We like this measure of value because it is relevant to the lives of all South Africans. Furthermore, we have had more success hitting our inflation targets than we have had with other, older approaches, such as pursuing money supply targets or trying to control the exchange rate. Importantly, like many other countries, we have found that inflation targeting has helped to deliver good economic outcomes.

Why inflation targeting produces good economic outcomes

For a start, as intended, inflation targeting has helped us to get lower inflation. In the 1980s inflation averaged about 15%. It was almost 10% in the 1990s. Since the adoption of inflation targeting in 2000 it has been close to 6%.

Lower inflation protects South Africans’ living standards, especially of people without the power or financial knowledge to shield themselves from price increases – most of all the poor. I will give you a very simple example. Bread costs about R11 at the moment.[3] If inflation stays at around 6%, bread is going to cost R35 in 20 years’ time. If inflation goes back to pre-democracy levels, that same loaf of bread is going to cost R180 in 20 years. These kinds of huge price increases will leave many more people behind. This is why higher inflation is a recipe for more poverty and more inequality.

Lower inflation has also permitted lower interest rates. The average prime rate in the 1990s was almost 19%. It was about 13% in the 2000s and has averaged just under 10% since 2010. Among other benefits – like supporting long-term, job-creating investment – this decline in rates

[3] Sasko Premium Brown Bread, 700g, Pick ’n Pay, R10.99, priced on 13 July 2017

has contributed to the inclusion of millions more South Africans in the market for financial services.[4]

Furthermore, targeting inflation has allowed us to be more flexible. When you are aiming at a relatively slow-moving variable like inflation, you do not need to react as rapidly as you might have had to with something like the exchange rate. As a result, interest rate changes have been smoother. Back in 1998, for example, before we started inflation targeting, we raised interest rates by almost 7 percentage points in just five months. The policy rate went to nearly 22% and the prime rate reached 25.5%. In more recent years, by contrast, we adjusted the policy rate by just 2 percentage points over three-and-a-half years, to 7%, before lowering it to 6.75% in July. This sort of smooth adjustment is much easier on firms, households and government than large, rapid adjustments.

In textbooks, there is a short-term trade-off between growth and inflation. Many people think of this as permanent and wonder why we do not accept more inflation so we can have more growth and more jobs. This is not how it works. In fact, the data show clearly that inflation and growth have moved in opposite directions, with more inflation coinciding with lower growth and higher growth accompanied by lower inflation. This makes sense: inflation eats into peoples' real incomes, making them poorer – as they can buy fewer goods with the same money. It also generates higher and more volatile interest rates. All of this affects

[4] For instance, the proportion of South Africans with a financial product from a regulated provider has risen from 55% in 2005 to 85% in 2016. See National Treasury, 2017, *A financial sector that serves all South Africans*, available at http://www.treasury.gov.za/documents/national%20budget/2017/review/Annexure%20F.pdf.

growth. So keeping inflation under control should be growth-friendly, which is just what the numbers show.

This pattern also holds in a comparison across countries. Besides South Africa, 11 other emerging markets adopted inflation targeting in the late 1990s and early 2000s. These included Brazil, Thailand, and Colombia. Those with lower inflation than South Africa have had better growth and less unemployment. This suggests that there is nothing growth-friendly about higher inflation targets. Of course, there are many things that affect a country's growth rate. But if inflation targeting is such a big 'problem', and if there is a significant trade-off between growth and inflation, then countries with lower, tighter targets should have suffered more. They did not. They did better.[5]

Since the Public Protector's report, some old complaints about the inflation-targeting framework have reappeared in the press. One objection is that inflation targeting is appropriate only for advanced economies, not for emerging markets. A second is that we should be targeting growth or employment instead. A third objection is that inflation targeting hurts exports because high interest rates keep the rand too strong. I would like to explain why these are not convincing arguments for replacing inflation targeting.

First, let me tackle the criticism that inflation targeting is allegedly more of a 'rich country policy'. In fact, inflation targeting is popular in both advanced economies and emerging markets. Research by the

[5] Since 2000, South Africa has had the second-highest inflation rate, on average, of these 12 countries. (Brazil is first.) South Africa ranks eighth for growth and last for unemployment. Since the most recent global financial crisis, South Africa has once again had the second-highest inflation rate, after Brazil, but its growth rank has slipped to ninth place. It remains last for unemployment.

International Monetary Fund identifies 28 ‘pure’ inflation-targeting countries.[6] Of these, 20 (or 71%) are emerging markets. If we use a broader definition, more countries qualify. There are 64 countries with a published inflation target for 2017; 49 of these (or 77%) are emerging markets.[7] Furthermore, if anyone is having trouble hitting inflation targets, it is the advanced economies.

Most of the central banks in the major advanced economies are below their inflation targets and have been so for some time. By contrast, emerging markets are mostly on target or getting there. South African inflation, to take the most immediate example, fell back within the target range in April this year and is expected to stay there for the foreseeable future. The reason why emerging market central banks are doing better than their rich country peers is probably because we know more about lowering inflation than raising it – especially when interest rates are already at zero. My conclusion is therefore that inflation targeting is more of an emerging market practice than an advanced economy one – one that has been working better in emerging markets, too.

Should we be targeting something besides inflation? I know of no central banks that are employment targeters or growth targeters. There are good reasons for this. Contemporary economic thinking and lots of experience indicates that monetary policies cannot do much about structural growth and employment problems. If you do not have enough skilled workers, the central bank cannot mint doctors and engineers. The thinking and experience also stresses that any trade-off between growth

[6] See Sarwat J, March 2012, *Inflation targeting: holding the line*, available at http://www.imf.org/external/pubs/ft/fandd/basics/target.htm.
[7] The data for 2017 inflation targets are drawn from http://www.centralbanknews.info/p/inflation-targets.html.

and inflation, or unemployment and inflation, is short-term only. What you can do is stabilise inflation at the target and employment or growth at its sustainable rate.

For this reason, even the central banks with multiple mandates tend to behave a lot like inflation targeters. The US Federal Reserve (Fed), for instance, has a triple mandate, for low inflation, low unemployment, and low interest rates.[8] In practice, the Fed aims to anchor inflation expectations in line with its 2% target. In turn, low inflation helps to keep interest rates low, and the two together help to maximise employment.

One can explain US interest rate decisions pretty well using a simple rule, as the economist John Taylor famously showed. Simply put, the Fed reacts when inflation is not on target and when unemployment is away from its normal levels. We consult very similar models in the SARB, and they also describe our policy decisions pretty well. This is because we, as monetary policymakers, already care about cyclical variations in employment and growth. This is the nature of flexible inflation targeting; I have never sat in an MPC[9] meeting where we just looked at the inflation rate and ignored everything else. Of course, any inflation-targeting central bank can give you low rates if inflation is well behaved; you do not need an extra mandate to do that. We try very hard to keep interest rates as low as they can be given the inflation forecast.

Finally, does inflation targeting get in the way of export-led growth, by keeping the exchange rate too strong? Back in the late 2000s, the visiting International Growth Advisory Panel suggested that a more

[8] Although the Fed is widely thought to have a dual mandate, the Federal Reserve Act actually specifies three objectives. Ben Bernanke discusses this in *The Courage to Act*, published in 2015.
[9] Monetary Policy Committee

competitive exchange rate could be helpful for boosting exports. The Panel also suggested running a fiscal surplus to create space for lower interest rates, and they encouraged us to keep inflation targeting.[10] More recently, some people have claimed that the Harvard Panel report shows that even experts have a problem with inflation targeting – ignoring what the Panel really said.[11] They also forget that by the time the Panel's report was released, this suggestion had been overtaken by events, with the rand having weakened again.[12]

In fact, under inflation targeting, excessive exchange rate appreciation has been rare and short-lived. These discrete periods occurred when capital flowed in as a result of high commodity prices, sustained public borrowing, and low yields in advanced economies – not because of inflation targeting. The inflation-targeting framework, all else being equal, has lowered inflation and interest rates, reducing the pull on hot money in recent times. In fact, a fundamental, and achieved, objective of inflation targeting was to obtain a more competitive exchange rate. Exchange rate targeting, the implicit policy of the 1990s, kept the rand uncompetitive.

It is likely that the act of introducing the inflation-targeting framework helped to attract capital in 2000 because it signalled a move to a much better policy framework, but South Africa was starved of capital at the

[10] For the Panel's recommendations, see Ricardo Hausmann's *Final recommendations of the International Panel on Growth*, available at http://www.treasury.gov.za/comm_media/press/2008/Final%20Recommendations%20of%20the%20International%20Panel.pdf, especially pages 6 and 12-13.
[11] See, for instance, Luke Jordan's *It's time to debate the central bank's mandate*, available at https://www.dailymaverick.co.za/opinionista/2017-06-23-its-time-to-debate-the-central-banks-mandate/#.WVuR5RWGOUm (June 2017).
[12] This point was made at the time by Kenneth Creamer, in "SA needs an inclusive growth path", *Mail & Guardian,* published on 4 July 2008.

time. Any other policy framework that improved on the previous one would have had the same effect.

Let me make a broader point about this debate. South Africa needs capital to develop. It also needs a reasonably competitive real exchange rate. Achieving both is not easy, but the simple solutions occasionally proffered are seriously inadequate. First, they invariably focus on nominal depreciation and not on real depreciation; the inflationary side-effects of nominal depreciation are ignored. Second, the proposals never say anything about the implications for the fiscus, for interest rates, and for the broader economy of targeting a specific exchange rate level.[13] Third, I would like to hear why this effort would be successful in South Africa when it has not worked well in other democracies that have tried it. Even a cursory review of the Asian success stories shows they had a very high savings rate and used financial and wage repression and price controls to achieve real undervaluation. How exactly would these authoritarian approaches to policy be implemented here?

At the end of the day, we have had a major depreciation in both nominal and real terms of the exchange rate since 2011, yet the net export response has been very weak. If nominal depreciation is so critical, we should have experienced an export boom. I do not doubt that a competitive exchange rate is useful, but it is the real depreciation that matters here and, on balance, keeping inflation low contributes to that aim.

[13] Maintaining a specific exchange rate level requires the daily management of the supply and demand for foreign currency, often involving large and abrupt moves in interest rates, access to unlimited foreign currency, and large swings in economic activity.

Have we been too focused on inflation?

I think that inflation targeting makes sense for South Africa as it is an effective way to uphold our constitutional duty to protect the value of the rand. That said, we need to have some important conversations about the South African version of inflation targeting. Reading (and believing) some of our critics, you would think the SARB is obsessed with inflation – and little else.

From a worldwide comparative perspective, South African inflation has become quite high. Back in 2005, we had lower inflation than 60% of all countries. More recently, in 2011, we were about in the middle – lower than half, higher than half. In 2016, however, we had higher inflation than most other countries – 80% of them. This is not just because we had a drought and food prices were high. Based on forecasts, it will be much the same story for 2017.[14]

One big reason why we have higher inflation than most other countries is because our target is unusually high and wide, plus we typically have inflation right at the top of the target range, close to 6%. Furthermore, of the peer emerging markets I mentioned earlier, we are the only one where the inflation target has not been revised down at least once. Nowadays most emerging markets have targets of around 3% or 4%. For instance, India adopted a 4% inflation target last year, and Brazil has just revised its target down to 4%. A frank reassessment of the 3-6% inflation target – which is now almost 18 years old – would probably conclude that the target should be lower. My economists have worked on the numbers, and they report that if we want an inflation rate in line

[14] This comparison uses IMF data from the April 2017 *World Economic Outlook.*

with our trading partners, we should be aiming for 3-4%[15] - that is not where we are today.

As you can see, we are certainly willing to reflect critically on monetary policy. But let me add that we also need to prioritise. We have been suffering from a recession provoked chiefly by a collapse in confidence, driven by serious policy uncertainty. We have been downgraded by all the major ratings agencies, and we are barely clinging to investment grade status for our rand-denominated debt. The ratings agencies tell us that the major policy pillar that supports the South African investment case is our monetary policy framework. Why then, in this environment, would you want to make the discussion about changing the monetary policy framework? As a matter of science, there are no settled questions and more research is always appropriate. As a matter of policy, this focus seems misguided.

Central bank accountability

What about accountability? Our fundamental purpose, as with the other parts of South Africa's system of government, comes from the Constitution. Our job is to figure out a monetary policy framework that delivers on this mandate. In line with many other countries, we use an inflation target. We identify the precise inflation target after consultation with National Treasury. This is as transparent to the public as it can be. No one can give the SARB secret instructions. Our mission is in plain view, and the evidence for judging us is independently produced and

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[15] For details, see 'Box 4, South African inflation: an international perspective' in the *Monetary Policy Review*, published by the SARB in October 2016, available at http://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/7504/MPROctober2016.pdf.

publicly available, in the form of the consumer price index published by Statistics South Africa.

Of course, this is not the only way in which the SARB is held accountable. Our other roles and powers, such as bank supervision and financial stability, are assigned to us by laws passed by Parliament and signed by the President. We submit our Annual Report to Parliament. Furthermore, the Governor and the Deputy Governors are appointed by the President following consultation with the Minister of Finance and the SARB's Board of Directors.[16] This system is designed to create the space for the SARB to make good decisions while maintaining democratic accountability. If you believe that the SARB is so independent that it can ignore the public interest, you need to reflect on how our work is specified in law and how we consult on our target.

At this point in the conversation, you can usually rely on someone to ask about the SARB's private shareholders. What is a central bank with private shareholders doing in South Africa's Constitution? Does this not mean the SARB is run in the interests of private individuals, not in the interests of South Africans? This has become something of a zombie argument: no matter how many times you kill it, it keeps coming back. The fact is: private shareholders have no influence whatsoever on monetary policy, financial stability, or banking regulation. Their rights are highly circumscribed. A shareholder, and his or her associates, cannot hold more than 10 000 shares out of the total of 2 million shares in issue. According to the SARB Act, shareholders receive a fixed annual

[16] Governors and Deputy Governors are appointed for fixed five-year terms. My current term, for instance, began in November 2014 and expires in late 2019. Of the Deputy Governors, Daniel Mminele concludes his current term in June 2019, Kuben Naidoo in March 2020, and Francois Groepe in December 2022?.

dividend of 10c per share. This dividend policy has not been updated in 90 years, so I am afraid it has not been a great investment.

Our total dividend payout each year is R200 000. Some of the shareholders are annoyed by this and would like to be paid much more. However, this is not the way the shares work. Instead, the SARB's after-tax profits – which were R1.4 billion for the last financial year – mostly go to National Treasury, with a small portion being kept for the SARB's own reserves. The shareholders got 0.014%, or roughly one ten-thousandth, of total profits made. For the record, R200 000 is somewhat less than the salary we pay a single junior economist. In other words, come work for us in a junior role and you will make more than all the SARB's shareholders combined.

The fact that we have private shareholders is admittedly slightly unusual. It used to be a common practice, and today there are still a few other central banks with a degree of private ownership, including those of the US, Japan, Turkey, and Switzerland. I think our shareholders are helpful with some governance issues. It is useful, for instance, to hear from the members of our Board with experience in the agriculture, mining, and public sectors.

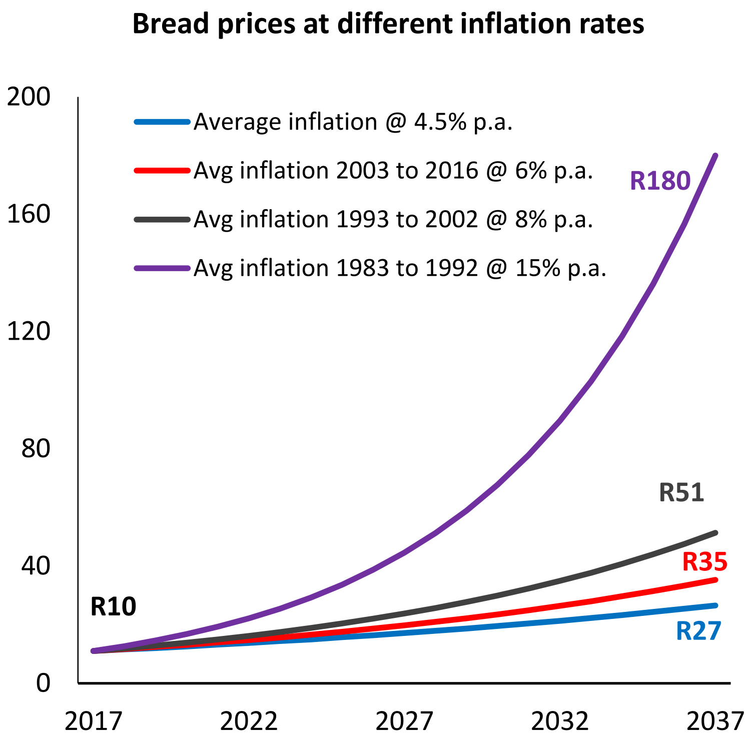
However, if we had a fully nationalised central bank, I would not be giving speeches suggesting that we privatise it. So why not just nationalise the SARB? Simple. It would not change anything useful that we cannot change anyway, and it would be expensive. It would not change anything useful because shareholders already have no control over the SARB's policy responsibilities, as I have explained. Why would it be expensive? I will tell you another story. SARB shares normally trade for about R3. The funny thing is: if you ask about buying SARB shares, you will find there are standing offers to sell from people whose price is R7 900 per share. Who would charge almost R8 000 for something that normally sells for R3? I suspect there are sellers out there who think we will have to nationalise the SARB in the end because it will be the only way to kill this zombie argument about private shareholders once and for all. As a result, they will get to make a nice profit at the expense of the South African people. My economic advice is: let us not pay large sums of money for purely cosmetic changes.

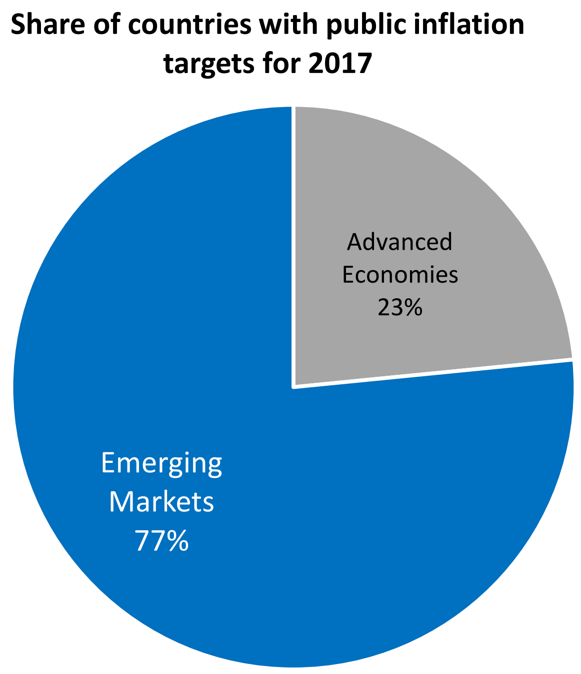
Conclusion

In this lecture, I have discussed how the SARB protects the long-run interests of South Africans, and I have demonstrated that South Africa has experienced better economic outcomes under inflation targeting than it did previously. We are always interested in monetary policy research, but a major overhaul of the monetary policy framework does not strike me as our most pressing issue. Maintaining a relatively low inflation rate helps to keep long-term interest rates low, and, all else being equal, supports long-term investment. This also works against the real appreciation of our currency. This is as much as monetary policy can do to support economic growth. Low inflation and low interest rates – just like our commodity endowment, our population growth rate and demographic dividend, our excellent higher education system, and our creativity and spirit – are critical to long-run growth and job creation.

Thank you.

Charts:





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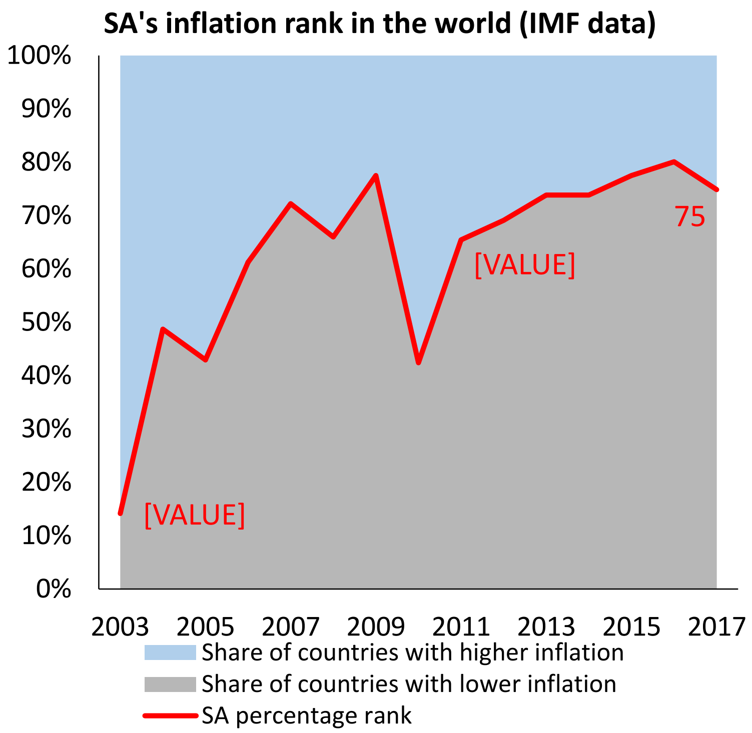
SA's inflation rank in the world (IMF data)
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
[VALUE]
[VALUE]
75
2003
2005
2007
2009
2011
2013
2015
2017
Share of countries with higher inflation
Share of countries with lower inflation
SA percentage rank