Ian Plenderleith: The aim and operation of monetary policy

Speech by Mr Ian Plenderleith, Deputy Governor of the South African Reserve Bank, at the Merrill Lynch Macro Day, Johannesburg, 25 March 2003.

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I was honoured and delighted to have the opportunity to join the South African Reserve Bank as a Deputy Governor at the start of this year. As still very much a newcomer to the South African scene, I thought I might take this opportunity to share of few of my early impressions of the South African economy - and specifically of the operation of monetary policy, which is the particular responsibility of the Reserve Bank

I should say at the outset that these impressions are very positive. There is, in my view, a great deal to be admired in the performance of the economy, and in the contribution monetary policy is making to promoting that performance; and in parallel, a great deal of progress is being made in pressing ahead with structural reform, across a wide front, in order to ensure that the economy can fulfill its potential in the future.

Perhaps the most remarkable achievement that strikes me in the economic sphere is that the South African economy has continued to achieve steady and sustained growth over the past few years despite the global economic slowdown in the surrounding world economy. As the world economy has moved into slowdown over the past two years or so, the South African economy has continued to grow at around 3% - not, to be sure, as fast as one would hope to achieve in a more favourable world environment, but nonetheless a great deal better than many other economies have experienced. The current cyclical upswing in the South African economy, which began in September 1999, has now been in progress for 3½ years; and, looking ahead, the prospects are encouraging for the economy to continue to grow.

How has this been achieved? There are no doubt many contributory factors, but I think an important one is the coherent and responsible macroeconomic policy framework which the authorities have steadily and consistently pursued over recent years, covering both fiscal and monetary policy.

The fiscal side is not for me, as a central banker, to dwell on. But there is no doubt that the steady commitment the government has shown to keeping the budget deficit to low and manageable levels and to containing the burden of public sector debt has delivered real benefits in terms of a strong and sustainable structure in the public finances. The result, as evident in the Budget last month, is that, as the economy has grown and as revenue collection has strengthened, there has been enhanced scope both to reduce taxes and to continue building up essential spending programmes on a sustainable basis.

In the monetary field, on which I want to say a little more, there has similarly been a commitment to a coherent and responsible framework steadily and consistently pursued. This is the inflation-targeting framework, which mandates the Reserve Bank to keep inflation low in order to deliver broad price stability across the economy as a whole.

South Africa is, of course, not alone in setting price stability as the priority for monetary policy. Maintenance of low inflation is the universal aim that central banks around the world are set to pursue. But in pursuing this aim within the framework of an explicit low inflation target, South Africa is very much in the forefront of international best practice.

Why this emphasis on low inflation and the commitment to price stability? At one level, the socio-economic damage that flows from a failure to control inflation is all too evident. High and volatile rates of inflation disadvantage the poor, who are least able to protect themselves from the ravages of inflation, to the benefit of those more able to preserve their standards of living. Inflation disadvantages in particular those living on fixed incomes, often the elderly reliant on pensions or savings. Across the board, inflation will tend to discourage savings and undermine the ability of people to plan their future personal finances on a prudent, long-term basis. By eroding values in a corrosive and insidious fashion, inflation can undermine sociably responsible behaviour and threaten the stability of society as a whole. Not for nothing has inflation been called a silent and invisible thief.

In more specifically economic terms, too, inflation is the enemy of long-term sustainable economic growth, weakening the capacity of the economy to achieve the rate of growth of which it is capable.

Past history, in South Africa and in many other countries, illustrates this all too vividly. If demand in the economy is allowed to grow faster than the output supply capacity of the economy, the result is inevitably rising inflation. This is because excess demand cannot induce the economy to deliver more output than it is capable of producing: it simply bids up the price of the output the economy can produce, generating inflation. If inflation is allowed to gather pace, the process of reining back excess demand, through higher interest rates, is inevitably more wasteful, in terms of an extended period of growth below capacity, than if timely action is taken by the monetary authorities to keep the pace of demand in line with the supply capacity of the economy. To try to maintain that balance, between demand and supply in the economy, is essentially the task of monetary policy and the aim the central bank is pursuing when it sets interest rates. If it succeeds, inflation will be kept low and the economy can continue to grow at a steady and sustainable rate on a continuing and lasting basis.

There is an important corollary of this process. This is that there is not, in any meaningful sense, a trade-off between growth and low inflation. It is not in practice feasible to contemplate living with a somewhat higher rate of inflation, even for a period, in the hope that this would bring higher growth. The reason is that low inflation is not an alternative to growth, but a necessary and essential pre-condition. Without a commitment - made and delivered - to keeping inflation low, we will not achieve on a sustainable basis the growth of which the economy is capable. With low inflation, demand, and hence output, in the economy can continue to grow on a steady and sustainable basis. In pursuing low inflation, therefore, the central bank is aiming for exactly the same goals that we all desire - continuing sustainable growth in output and employment and living standards across the economy as a whole.

The inflation-targeting framework in South Africa has a critical role to play in maintaining low inflation. Its strength lies in the fact that its structure contains what I believe to be the four key elements for an effective monetary framework. Let me say a word briefly about each.

First, the framework provides for an explicit target to be set for inflation. This is currently that inflation, as measured by the CPIX, should be brought back down to, and held within, a range of 3-6%. The value of setting an explicit target in this form is that it helps to anchor inflation expectations to a low level. Business and industry, and individuals, in making their own financial plans, will hopefully do so on the basis that inflation will be kept in that range over time; and on the basis that, if, as at present, inflation moves outside that range, the policy stance will be adjusted promptly to bring it back within range - as indeed was done last year. Anchoring expectations in this way helps in turn to build low inflation into the fabric of the economy as a whole. The target also, importantly, provides a means, quite properly, of holding the central bank to account for its performance. I shall touch on this last aspect again in a moment.

Secondly, the inflation-targeting framework gives the responsibility for achieving the target to the central bank, and specifically to the Reserve Bank's Monetary Policy Committee, acting independently and under a clear mandate to deliver the target. It also gives the MPC the means to achieve the target, through its decision on setting the Reserve Bank's repo rate at each of its meetings. The framework thus ensures that there is a clear allocation of responsibility; and it ensures that interest rate decisions are taken by a competent authority dedicated to the task and acting independently.

Thirdly and fourthly, the inflation-targeting framework is one that delivers a high degree of transparency and accountability. Transparency and accountability is achieved through the full statement the MPC issues immediately after each meeting, through the range of publications the Reserve Bank issues setting out its view of developments, and through the public appearances the Governor and his colleagues make in explaining the Reserve Bank's policy activities. I think this is a very important and beneficial part of the process for several reasons - partly because it is right that in a democratic system public agencies should be required to be open and accountable in explaining their activities; partly because that process hopefully helps to maintain public confidence in the performance of the agency and public support for the objective of low inflation; partly because that in turn should encourage business and individuals to conduct their affairs on the basis that low inflation will be maintained; and partly because openness and accountability helps promote a better public debate on the issues. These are all elements that I believe help to strengthen the effectiveness of the inflation-targeting process.

This framework has, of course, been tested in the past 18 months by the inflationary shocks the economy has faced from the fall in the value of the rand in the latter half of 2001 and the accompanying upwards pressure on food prices and fuel costs. The steps taken last year to raise interest rates were necessary to prevent these shocks generating a self-reinforcing process of rising inflation. As indicated in the statement issued after last week's meeting of the MPC, there are now signs that the inflationary pressures are beginning to abate and that the outlook for inflation is improving, though there is little room for complacency given the considerable risks we still face.

But to return to my initial impressions, what is particularly encouraging, I believe, is that the coherent and responsible policy framework provided by inflation-targeting has demonstrated its ability to address the shocks in a steady and considered manner and, in doing so, has helped considerably to maintain confidence in the economy. This is particularly evident in the international markets, where confidence in the fundamentals of the South African economy has undoubtedly been a factor in the recovery of the rand; and it is evident, too, in the positive attitude to South Africa encountered more generally abroad - notably, for example, in the upgrades that have already been put in place by the rating agencies, with further upgrades in prospect. This, more than anything, - a well-structured policy framework, steadily and consistently pursued - is what has helped the South African economy to continue to grow through the current world slowdown. This is strong evidence that a commitment to low inflation works, in helping to maintain sustainable growth, and that it will help us to achieve the future growth that is essential to enable all of us to develop the huge potential of this fine country.