T T Mboweni: The monetary policy framework of South Africa

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the International Investors Conference, Sun City, 24 March 2004.

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1. Introduction

The main task of macro-economic policy is the promotion of sustainable high economic growth, the creation of employment opportunities, the containment of inflation, improvement of the living conditions of all the residents of a country, and the elimination of unjustifiable discrepancies in the distribution of income amongst our people. These economic objectives can best be obtained amongst other things in a stable financial environment. Financial instability is a major obstacle in the fulfilment of this task. Stable financial conditions should be maintained throughout the various phases of the business cycle to attain maximum economic development.

2. Primary objective of monetary policy

The role of the South African Reserve Bank (SARB) in this process is to achieve and maintain price stability and to develop and supervise a healthy banking sector. This objective is spelled out in both the Constitution of South Africa and in the SARB Act. In section 224 of the Constitution and section 3 of the SARB Act it is stated that the primary objective of the Bank is to protect the value of the currency of the Republic in the interest of balanced and sustainable economic growth. This, in our view, means price stability. These laws therefore recognise that only by protecting the currency can balanced and sustainable economic growth be achieved. It is believed in the Bank, and indeed in most other central banks in the rest of the world, that the potential growth rate of an economy and the optimum creation of employment opportunities can only by attained under stable financial conditions. By fulfilling this primary objective, the SARB will be making its contribution to sustainable high economic growth in South Africa.

Section 224(2) of the Constitution determines further that the SARB, in pursuit of its primary objective, must perform its functions independently and without fear, favour or prejudice. Regular consultation must, however, take place between the Minister of Finance and the Governor of the SARB. In addition to this legal requirement, section 10(2) of the SARB Act clearly states that “the rates at which the Bank will discount or rediscount the various classes of bills, promissory notes and other securities shall be determined and announced by the Bank from time to time”. This gives the Bank the right to determine the official rate, or as it is now called the repo rate. These laws therefore provide the executive management of the Bank with complete instrumental independence, with the one precondition that regular consultation should take place with the Minister of Finance. The Bank can accordingly perform its work in an autonomous manner.

Having established that the task of the Bank is the achievement and maintenance of price stability, what does the term price stability convey? In the economic literature price stability is normally regarded as a situation wherein changes in the general price level do not materially affect the economic decision-making process. Although relative price movements still have an impact on production, consumption and investment, the rate of inflation in such conditions is no longer an important factor in the decisions taken by producers, consumers and investors.

Price stability is heavily dependent on stability in the financial sector. The Bank has accordingly also been tasked to promote the soundness and management of domestic banks through the effective application of international best practise in the regulatory and supervisory area. The objective of banking supervision is to ensure that banks manage their risks in such a way that systemic risk in the banking sector is minimised, thereby ensuring the safety of depositor’s money. It is aimed at promoting the financial soundness of banks and the banking system as a whole.

In the fulfilment of its mission the Bank performs virtually the full range of functions and duties that are customarily carried out by central banks. The other main functions of the Bank are:

1) the issuing of banknotes and coin;

2) acting as banker to the government;

3) acting as bank to private banks;

4) providing facilities for the clearing and settlement of claims between banks;

5) providing liquidity to banks and acting on a case by case basis as “lender of last resort”;

6) engaging in open-market operations; and

7) collecting, processing and interpreting economic statistics and other information.

3. The importance of price stability

The objective of achieving and maintaining price stability is based on the proposition that inflation is bad for economic growth, employment creation and the distribution of income. Is this indeed the case, or can more growth be attained by allowing an acceleration in inflation?

It is often argued that there is a trade-off between inflation and growth based on the Philips-curve analysis. In this analysis it was argued that at a low level of inflation real economic growth can be stimulated through an expansionary monetary policy even if this policy should lead to higher inflation. There may be some truth in this analysis over the short term, but such a policy will not achieve long-term sustainable high economic growth and employment creation. An artificial stimulation of demand inevitably results in higher inflation rather than production over the long term. If demand is allowed to grow more rapidly than the production capacity of the economy, this leads to inflation. It also results in rising deficits on the current account of the balance of payment. If these deficits are not readily financed by means of financial inflows, the exchange rate of the currency could come under pressure. A depreciating currency can bring forth further pressures on domestic prices. A little bit of inflation once started can easily gain momentum, which could require very restrictive measures to again attain balance between demand and supply. Substantial swings in interest rates to achieve such a balance make business planning difficult and could lead to lower average economic growth over the long term.

The maintenance of price stability over the long term implies low and more stable interest rates. With low inflation, output increases become more dependent on increases in investment and the quantity and quality of labour, and on the way that these production factors are employed. Economic growth becomes propelled by healthy permanent factors and is not dependent on an artificial stimulation of demand. Low inflation is therefore an important factor for sustainable high growth. In such a stable environment demand and output will grow on a steady and sustainable basis.

If price stability is not achieved, the well known disadvantages of inflation come into play. High inflation distorts the allocation of resources and favours investment in non-productive hedge assets rather than in capital formation. High inflation discourages saving and leads to more consumption. High inflation erodes the competitiveness of local manufacturers and other producers *vis-à-vis* foreign producers. High inflation leads to an unfair redistribution of wealth by penalising the poor more than the rich. The general conclusion is accordingly that high inflation in the medium to long term leads to lower growth, fewer jobs, more unemployment and a more unequal distribution of income and wealth.

4. Inflation targeting

How do we achieve price stability? Inflation is a monetary phenomenon, i.e. inflation cannot take place without a more rapid increase in the quantity of money than in output, provided that the velocity of circulation of money remains unchanged. As Mervyn King, Governor of the Bank of England, has coined it: “No money, no inflation.” An increase in the inflation rate can originate from many developments in the international and domestic economy and it is impossible for any individual institution to prevent these causes of inflation to take effect. The SARB can only use the powers at its disposal to reduce inflationary pressures. This consists basically of influencing liquidity in the banking sector and/or influencing the general level of interest rates. In pursuing price stability, the main operational variable that the Bank uses to influence prices is the repo rate, that is the interest rate at which the SARB meets the liquidity needs of banking institutions. By changing the repo rate, the Bank directly affects other domestic interest rates, the demand for money and credit, and eventually changes in prices.

From February 2000 changes in the repo rate are based on the inflation targeting monetary policy framework. With the adoption of this framework, the Bank moved away from an eclectic monetary policy framework or informal inflation targeting. In the eclectic monetary policy framework the growth in money supply and bank credit extension were used as intermediate guidelines for the determination of short-term interest rates. In addition, in deciding on the most appropriate monetary policy stance, developments in a number of other variables were also taken into consideration, because the monetary aggregates had lost some of their usefulness as indicators of future inflation due to structural changes in the economy.

The adoption of an inflation targeting framework reduced the role of these intermediate guidelines. Instead, the SARB adopted a strategy of determining directly what the likely path of inflation would be. This led to the detailed assessment of factors that could affect inflation based on past experience. The indicators that the SARB monitors include the growth in money supply and bank credit extension, the changes in nominal and real salaries and wages, the nominal unit labour costs, the gap between potential and actual domestic output, exchange rate developments, producer prices and import prices. Developments in a number of exogenous factors are also regarded as important in this analysis, such as oil prices, food prices and administered prices. Unfortunately the Bank has little control over these exogenous price changes, but they may have an important bearing on inflationary pressures.

In analysing these factors the SARB is acutely aware of the long and variable lags of the effect of interest rate changes on inflation. This is generally believed to be about 18 to 24 months. These lags in monetary policy were an important consideration in the decision to determine directly what the likely path of inflation will be. In adopting an inflation targeting framework the Bank's research has become increasingly focussed on the transmission mechanism of monetary policy in South Africa and the development of inflation forecasting models. In co-operation with the staff of other central banks a suite of models was developed, comprising a core model, a small-scale model, vector models, Philips-curve models and indicator models.

The prediction of inflation is of the utmost importance in the implementation of monetary policy because changes in policy measures must always be based on likely future price developments. The fact that inflation targeting has to rely on forecasting has led to the criticism that this is a weakness of this framework as forecasts are inherently unreliable. This limitation, however, applies in the case of all other monetary policy frameworks. If the objective of a central bank is the attainment of price stability, it will always have to take a view on how its current policy stance will affect future price developments, whichever monetary policy framework it decides to pursue. The difference between inflation targeting and other monetary policy frameworks, is that inflation targeting should make forecasting explicit and transparent.

Although the forecasting of inflation is an important tool in deciding on the appropriate monetary policy stance, the SARB still applies discretion in reaching a decision. Every forecast is based on assumptions and no model is perfect. A careful analysis of all economic data and the risks involved is made to ensure that the correct decision is taken. For this reason the central bank also applies a suite of models to minimise these risks and possible limitations of the individual models.

This analysis of current and possible future developments is important because the achievement of the target is the overriding objective of monetary policy in an inflation targeting monetary policy framework. Such a framework can only be successful if the public is convinced that the central bank is serious about the achievement of the target. Missing the target by a wide margin and consistently will lead to lost prestige and credibility for the central bank.

The SARB also realises that exclusive emphasis on inflation goals over the short term could lead to a highly unstable real economy over the longer term. If a severe exogenous shock affects the economy, extreme measures to reach the inflation target could be very costly in terms of lost output and employment. In such cases, some discretion is applied by the Bank. The monetary policy framework at first made allowance for such occurrences by including an escape clause stipulating the circumstances under which the Bank did not need to meet the target. Experience showed that this escape clause created problems in communicating monetary policy decisions. It was accordingly replaced in November 2003 by the introduction of an "explanation clause". In the case of a supply shock the Bank must now fully inform the public of the nature of the shock, the anticipated impact on inflation and the monetary policy response to ensure that inflation returns to the target.

5. The institutional arrangements

The decision on the appropriate monetary policy stance is taken by a Monetary Policy Committee (MPC). This committee was set up shortly before South Africa adopted the inflation targeting framework for monetary policy. It first met on 13 October 1999. The Committee at present consists of the Governor, three deputy governors and four senior officials of the Bank. Six meetings are held in a year with intervals of about two months between each meeting. These meetings are normally held over two days. On the first day members of the Bank's staff inform the committee about international and domestic economic developments and present a forecast of likely future developments. On the second day a decision is taken about the monetary policy stance and the statement explaining this decision is finalised. This statement is then released at a press conference and broadcast live on SABC TV.

This process has improved the transparency of monetary policy considerably. In order to further develop a better understanding of monetary policy, Monetary Policy Forums have been convened by the Bank. These forums provide a means for open discussion on monetary policy and recent international and domestic economic developments. The Monetary Policy Forums are held twice a year in the major centres of South Africa and representatives of labour organisations, the business, community and academic institutions are invited to attend them. The forums ensure that the views of interested parties are taken into account in the determination of monetary policy and that the monetary policy stance is explained in some detail to the public.

In addition, the Bank publishes a Monetary Policy Review twice a year to increase the understanding of its conduct of monetary policy. The first review was published in March 2001. In these reviews a more detailed analysis is made of domestic and international economic developments and the way that inflation is and could be affected. The SARB's core forecast of inflation is also published in the review in the form of a fan chart. Confidence bands in the fan chart show the varying degrees of certainty for projected rates of increase in the general price level.

6. Assessment of inflation targeting in South Africa

The inflation target was originally specified as an average annual rate of increase of between 3 and 6 per cent in the consumer price index for metropolitan and other urban areas excluding mortgage interest costs (the CPIX) for the years 2002 and 2003. In November 2003 it was decided to terminate the annual average specification because it complicates the implementation of the inflation targeting framework and could lead to inconsistencies in monetary policy arising from excessive interest rate volatility and ineffective management of inflation expectations. It was then replaced by a continuous target of 3 to 6 per cent for the period beyond 2006. In other words, the target is specified as an inflation rate of between 3 and 6 per cent which must be obtained continuously over a twelve-month period in the coming years.

In 2002 the rate of increase in the CPIX averaged 10 per cent, or 4 percentage points above the upper limit of the target range. Four exogenous factors were mainly responsible for this inflation outcome. Firstly, the nominal value of the rand on a trade-weighted basis declined by approximately 34 per cent from the end of June 2001 to the end of that year. Secondly, the prices of food increased by almost 17 per cent in 2002. Thirdly, the Brent price of oil rose from US$20 per barrel in February 2002 to US$28 per barrel in December 2002. Fourthly, administered prices increased at very high rates of about 10 per cent or more in 2002.

In view of the effect of these extraordinary events on inflation, the Monetary Policy Committee opted to bring the inflation rate down to target levels in a gradual manner. In January 2002 the first corrective step was taken. At this meeting the Committee increased the repo rate by 100 basis points, followed by a further three increases of 100 basis points at the next three meetings. This brought the repurchase rate to 13,5 per cent in September 2002, at which level the rate was kept until June 2003.

These corrective measures had the desired result. The twelve-month rate of increase in the CPIX slowed down from 11,3 per cent in November 2002, and moved below the 6 per cent upper limit of the inflation target range to 5,4 per cent in September 2003. CPIX inflation then decelerated further to a year-on-year rate of 4,0 per cent in December 2003, before increasing marginally to 4,2 per cent in January 2004. For the year 2003 as a whole CPIX inflation averaged 6,8 per cent. These developments allowed the SARB to reduce the repo rate by 5,5 percentage points in the second half of 2003.

In bringing CPIX inflation down to these lower levels, the restrictive monetary policy stance was assisted by a number of other factors. Particularly important in this regard was the discipline in government finances that helped considerably to reduce inflation expectations. The monetary policy stance was further assisted by a recovery in the exchange rate of the rand from the beginning of 2002 and slower rates of increases in food and energy prices.

It can nevertheless be stated that the consistent application of the inflation targeting monetary policy framework was successful in bringing inflation down to the target range as it is now defined by government. Moreover, the inflation outlook remains favourable. Most analyst and economic commentators, including the SARB, expect CPIX inflation to remain within the inflation target range over the next two years. Inflation is projected to accelerate moderately in the course of 2004 to levels close to the upper limit of the inflation target, followed by somewhat slower rates of increase during 2005. This improved inflation performance should be accompanied by a pick-up in economic growth during 2004 and 2005.

The inflation targeting monetary policy framework not only assisted the Bank in bringing about a better inflation performance, but also strengthened the SARB's mandate to focus on price stability. In previous policy regimes there was no explicit benchmark against which the performance of the Bank could be judged objectively. In the inflation targeting framework, a specific target range is set for a price index to be achieved over a specific time frame, subject to the structural reform of the economy.

As already indicated, inflation targeting has also been accompanied by major improvements in the Bank's communication with the public, making monetary policy more transparent. By the specification of a target range, the accountability of monetary policy has been improved. The fact that government decides on the level of the target range has improved the co-ordination between monetary policy and other economic policy measures. To some extent, inflation targeting is already leading to a weakening of the importance of backward-looking inflation in decision-making of business and labour. However, many wage demands are still based on historic inflation figures. It can nevertheless be stated that the introduction of inflation targeting in South Africa has been a big success.

7. Improvement in international liquidity position

Before concluding this address on the inflation-targeting monetary policy framework of South Africa, I would also like to mention that the application of this framework has been accompanied by a consistent effort to improve the liquidity management of the South African SARB.

At the end of September 1998 the net open foreign-currency position of the SARB (NOFP) still amounted to US$23,2 billion, i.e. the difference between an oversold forward book of US$25,3 billion and net gold and foreign exchange reserves of US$2,1 billion. At that stage a decision was taken to reduce the NOFP gradually to zero. Underlying circumstances allowed the Bank to reduce this position relatively rapidly to US$9,5 billion at the end of December 2000. Then a more gradual approach had to be adopted due to the weakness in the external value of the rand. Using only proceeds from privatisation and of funds raised abroad by government, the NOFP was brought down to US$4,8 billion at the end of 2001. In May 2003 the oversold NOFP was finally converted to an overbought position of US$0,7 billion.

With the expunction of the oversold NOFP, the SARB shifted its focus to reducing its oversold forward book and to seeking over time to strengthen the official foreign exchange reserve position. The oversold forward book of the Bank amounted to US$4,7 billion at that time. This oversold forward book was closed out during February 2004. At the end of February 2004, the international liquidity position of the Bank was a positive US$4,7 billion. Although this is probably still relatively low in relation to some of our significant peers, the achievement of this positive balance has been a major accomplishment. The SARB's focus in the coming years will be to increase this position gradually to higher levels.

8. Conclusion

These improvements in the international liquidity position and the lower rate of inflation should provide a platform for the more rapid economic development of South Africa. Stability in interest rates and in the value of the rand are important pre-conditions for the attainment of high economic growth and employment creation. The focus of the SARB will therefore continue to be on the objective of price stability. We can only develop an environment favouring price stability and in this way contribute to the attainment of the other important objectives of economic policy.

Welcome to South Africa. Welcome to the North West Province of South Africa. Enjoy!

Thank you very much.