Daniel Mminele: Inflation targeting in the wake of the crisis and the South African experience

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Luncheon of the Southern African-German Chamber of Commerce and Industry, Johannesburg, 25 July 2012.

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1. Introduction

Good afternoon and thank you to the Southern African – German Chamber of Commerce and Industry for the invitation. I thought it may be an appropriate time to take stock of monetary policy in general and more specifically in South Africa since the sub-prime crisis.

The years between the mid-1980s until the outbreak of the sub-prime crisis are often referred to as the "Great Moderation".[1] This period of reduced macroeconomic volatility came to an abrupt end in 2007, following which uncertainty, instability, extraordinary volatility and strain in financial markets became the norm. Increasing trade and financial inter-linkages with the global environment meant transference of this volatility and uncertainty to the South African economy, with consequences for monetary policy. South Africa's monetary policy has been influenced by developments in the US and Europe, however, it is also true that our experience has been vastly different to that of central banks abroad. I say this because at no time did we employ unconventional monetary policies, nor did we implement capital controls or intervene in the foreign exchange market. We were one of the few emerging market central banks not to have tightened monetary policy during this period.

The crisis in Europe shows no signs of abating and the threat of the US fiscal cliff looms large. Judging by the most recent developments, things seem to be getting worse. Speculation about the likelihood of a third round of quantitative easing by the US Federal Reserve and a third long-term refinancing operation by the European Central Bank, is gaining impetus. Globally, the stance of m onetary policy is accommodative and one would be hard pressed to find anyone betting on a change in the state of affairs anytime soon.

I will discuss how inflation targeting has fared through the crisis and then share some thoughts with you on South Africa's experience and recent developments on the monetary policy front.

2. The appropriateness of inflation targeting?

New Zealand was the pioneer of inflation targeting[2] and adopted the framework just over two decades ago. The idea of explicitly targeting inflation proved to be an attractive proposition for central banks and thus became much more widely embraced, with approximately 39 central banks[3] said to have inflation targets at the beginning of 2012. Much as there is no one correct way of implementing inflation targeting, as there are various nuances depending on individual country circumstances, it can be safely argued that it is the consensus position when it comes to monetary policy frameworks. Among the most recent central banks to move in this direction are Bank of Japan and US Federal Reserve System.

[1] Featuring a reduction in macroeconomic volatility, of both output and inflation

[2] Germany is known for having adopted many elements of inflation targeting earlier than 1990

[3] Central Bank News, The Central Bank Inflation Targeting Report Card for 2011

Inflation targeting was thus presented as the primary mandate of central banks, although in reality even without an explicit inflation target, ultimately all central banks are concerned with inflation. The policy is not without its critics, of course, who argue that because it was implemented in a period of low and stable inflation and steady economic growth, that this environment paved the way for the success of the framework. Others would argue that it was precisely the adoption of inflation targeting that helped to contribute to the years known as the Great Moderation.

Some steadfastly believe that inflation targeting is harmful to economic activity, failing to recognise that the adoption of inflation targeting is in fact consistent with stabilising output in periods when the economy may be faced with a shock (such as excessive growth in aggregate demand). Promoting lower and more stable inflation is important for long-run economic growth and stability.

The belief that central bankers care only about inflation without any regard for factors such as output growth is clearly a misconception. Since 1990, the manner in which inflation targeting has been applied has largely converged, with many central banks practising flexible inflation targeting – allowing where appropriate for shifts away from the target, and returning within some reasonable time horizon, therefore taking into consideration factors such as output. It would therefore be fundamentally incorrect to characterize inflation targeting (as conducted in practice) as an iron-clad policy rule. Ben Bernanke, prior to being appointed as Chairman of the Federal Reserve, said that inflation targeting is better thought of as a policy framework, in which policy is "tied down" in the long run by the inflation target (which serves as a nominal anchor for the system), but in which there is also considerable leeway for policymakers to pursue other objectives in the short run.[4] Transparency and flexibility have been key in the success of inflation targeting and produced a sound underpinning for monetary policy in pursuit of price stability.

The sub-prime crisis and subsequent developments raised question marks as to the suitability and relevance of inflation targeting in the aftermath of the crisis. During 2008, the significant financial market disruptions and rises in food and energy prices led to increases in headline inflation. As the financial crises worsened, many advanced economies entered recession or experienced sharp declines in economic activity as well as disinflation. Consequently, concerns swung from inflation to deflation. As you know, inflation targeting countries do not just operate with an upper bound but also with a lower bound for the inflation target or certain tolerances around the target where there is a point target as opposed to a range. The severity of the recession in fact strengthened the arguments in favour of inflation targeting, as the credibility of inflation targeting central banks resulted in stable inflation expectations, helping reduce the risk of deflation. Even in the current environment of loose monetary policy and substantial global liquidity, inflation expectations appear to be well anchored. This is not to say that the framework is perfect as it is, there are refinements to be made, not least of which would include incorporating financial conditions into monetary policy deliberations, and including financial stability as part of the central bank's mandate, because as we know, achieving price stability does not equate to achieving financial stability.

Including financial stability or macro-prudential policy into the central bank's mandate requires a combination of monetary and regulatory tools, however, the implementation of macro-prudential policies will have an impact on the transmission mechanism of monetary policy, given that it works through the same channels (bank lending and balance sheets of financial institutions) and focuses on the same institutions (monetary and financial) as monetary policy does. It is uncertain exactly how macro-prudential policy and monetary policy will interact. This is uncharted territory and there is still much research which is

[4] The National Bureau of Economic Research, Ben S Bernanke, Inflation Targeting

going into this topic. In this new world of co-habitation of monetary policy and financial stability, the challenge for the future will be to find the right mix between the two, such that some of the inherent conflicts that could arise in pursuing both simultaneously, are in some defensible balance.

Interestingly, in an IMF staff position note entitled “Rethinking Macroeconomic Policy”,[5] the authors argue that low inflation limits the scope of monetary policy in deflationary recessions and poses the question whether higher average inflation and higher nominal interest rates to start with, would have made it possible to cut interest rates more, thereby probably reducing the drop in output and the deterioration in fiscal positions. They question whether the net costs of inflation would be much higher at 4 per cent than at 2 per cent and how much more difficult it may be to anchor expectations around a higher level. These are interesting questions indeed, but as the quote about hindsight goes, “one cannot ride a horse backwards and still hold its reins”. The authors conclude by noting that the ultimate goals should be to achieve a stable output gap and stable inflation, but that policy makers will need to watch many more targets and have many more instruments at their disposal – the challenge is in learning how to use these optimally.

In another interesting and unfolding debate, the view of the role of the exchange rate and intervention in the foreign exchange market, whilst having an explicit inflation target appears to be changing somewhat since the crisis. Under inflation targeting, the credibility of the regime entails an institutional commitment to price stability with other goals such as the exchange rate subordinated to price stability. The traditional view has been that inflation targeting was incompatible with intervention in the foreign exchange market. It appears there may be a shift in this view, and we have witnessed this in practise, where some countries have moved from freely floating exchange rates towards some form of managed float. There is also a growing conviction that flexible inflation targeting can include foreign exchange intervention, but not with a view to targeting a specific level or range for the exchange rate, but to “lean against the wind” to avoid abrupt adjustments and for purposes of smoothing volatility.

Emerging market economies generally suffer high exchange rate volatility, as well as a higher pass-through from the exchange rate to inflation. For this reason, it is not feasible to neglect the exchange rate; consequently many emerging markets may adjust interest rates to contain the effect of temporary exchange rate shocks on inflation and financial stability. Since the global financial crisis, many emerging markets intervened in the foreign exchange market to try and limit exchange rate volatility. The view is that foreign exchange intervention could reduce exchange rate volatility and thus lead to a more favourable trade-off between stable inflation and real economic activity, and by so doing, could improve the overall performance of the inflation targeting regime. There is the risk of course, that central banks could lose credibility if they rely too heavily on intervention.

3. The South African experience

The South African experience with the implementation of inflation targeting has been a positive one. Work done by my MPC colleague Brian Kahn and others has shown that South Africa has benefited from a flexible approach to inflation targeting and managed to weather the storms that came along with challenges of multiple supply side shocks of an extended duration, and exchange rate shocks. This was done by looking through short-term impacts and focusing on second rounds effects, thus resulting in inflation being allowed to be outside the target for longer, but not overreacting with policy, while keeping a close watch on inflation expectations.

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5 Rethinking Macroeconomic Policy, Olivier Blanchard, Giovanni Dell'Ariccia and Paolo Mauro, IMF Staff position note, February 12 2010

In August 2008, South Africa's headline inflation rate peaked at 13.7 per cent, at which time the repo rate had been increased to 12 per cent. This occurred in a period when global inflation had started edging lower and policy rates in advanced economies were being reduced. Towards the end of 2008, when it became quite clear that the US sub-prime crisis was to have a much more devastating impact on the local economy than had initially been expected, the Monetary Policy Committee started to reduce the repo rate. At this time, inflation pressures had started to abate and by the end of 2010, the repo rate had been reduced to 5.5 per cent, by which time inflation had again started to rise. Nonetheless, the repo rate was kept at this low level in response to the crisis, taking into consideration that the nature of the rise in inflation over this period was largely cost-push, and did not appear to be feeding into more general price pressures in the economy. The CPI inflation rate has since come back within the 3 – 6 per cent target range, and looks likely to decelerate in the months ahead, given evidence of softer food prices and moderating demand. The Bank expects inflation to decelerate to 4.9 per cent in the second quarter of 2013 and remain stable around 5 per cent to the end of 2014.

Like other countries, South Africa is drawing lessons from the financial crisis and the changing role of central banks. Our mandate has been clarified to more explicitly include a financial stability responsibility, and we are working on clarifying the role of financial stability in monetary policy formulation and implementation, having elevated the status of the Financial Stability Committee in the Bank.

As for the exchange rate, the South African rand has been one of the most volatile currencies among emerging market currencies and also has a significant effect on inflation. The SARB did not at any time intervene in the foreign exchange market to try and influence the value of the rand. However, significant portfolio inflows and FDI flows have been absorbed by the Bank and used to build the country's foreign exchange reserves. While sticking to the policy of not targeting the exchange, a much healthier position with regard to the level of foreign exchange reserves places the Bank in a better position to smooth abrupt movements in the foreign exchange market should conditions warrant in future.

Of course some old lessons remain, namely that controlling inflation at lower and stable levels continues to be of paramount importance to central banks, given its vagaries and distortive and erosive effects.

Questions are often asked as to why South Africa does not instead target employment. Monetary policy cannot contribute directly to economic growth and employment creation in the long run, but by creating a stable financial environment, monetary policy fulfils an important precondition for the attainment of economic development. The underlying rationale for controlling inflation is that low inflation will provide an appropriate basis for sustainable growth. The Bank's view is that there is no long-run trade-off between unemployment and inflation.

Flexible inflation targeting may not be perfect, but compared to whatever else there is to choose from currently, it is probably the closest you can get based on what we know today.

4. Recent developments

The recovery thus far has been bumpy and fragile, largely led by private and public consumption growth, while export volumes and private investment have remained markedly below pre-crisis levels. South Africa has also not fully recovered the jobs lost in the previous recession, and although jobs are being created, it is not at sufficient enough a pace to absorb the new labour market entrants. The number of discouraged job seekers is increasing. Unemployment in the first quarter of 2012 was 25.2 per cent, and the level of the index of formal non-agricultural employment was still about 1 per cent lower than in the third quarter of 2008.

World trade has improved since 2009, surpassing levels before the global financial crisis. Advanced economy exports have not fully recovered but emerging market exports have recovered robustly. In sharp contrast to the performance of most other emerging market economies, South Africa's real exports have not recovered to 2008 levels, with real exports still 13 per cent lower in the first quarter of 2012 than in the third quarter of 2008, notwithstanding the recovery in trading partner country import demand to pre-crisis levels. South Africa's share of global exports has increased modestly since 2005, despite strong terms of trade gains, whereas other comparable countries have seen significant increases in market share. The IMF estimates SA's export volumes to remain around 15 per cent below their pre-crisis peaks.[6]

More recent economic data reveals a softening growth momentum, pointing to a moderation in household consumption expenditure, which has been the main engine of growth thus far during the recovery. The rise in unemployment is impacting aggregate demand, while consumer confidence declined considerably in the second quarter of 2012 to its lowest level since the most recent recession. Real retail sales also reflect a slowing momentum, as the strong year-on-year headline figure hides substantial base effects.

Apart from signs of a further moderation in growth, there are continued risks emanating from the European sovereign debt and banking crisis which have culminated in a number of emerging market countries, resuming an easing monetary policy bias and advanced economies employing further unconventional measures. The Bank's forecast for domestic growth has been revised lower from 2.9 per cent in 2012 to a modest 2.7 per cent and 3.8 per cent in 2013. The risks to this forecast are tilted to the downside.

It was against this backdrop of soft growth and moderating inflation, that the Bank further reduced the repo rate to 5.0 per cent at the most recent Monetary Policy Committee meeting last week.

As indicated in our most recent monetary policy statement, while we believe that the most recent policy action will alleviate certain pressures and will be supportive, monetary policy on its own will not overcome all the challenges that the economy is facing. While monetary policy needs to play its part and remain relevant to the context, there are limits to what monetary policy can do, and it needs to be part of a carefully defined overall macro economic policy mix.

5. Conclusion

I would like to end my remarks by highlighting that the inflation targeting framework has served South Africa very well, both before and during the crisis. South Africa has practised "flexible" inflation targeting, and considers all factors driving inflation, including output growth and the external environment. With financial stability also being a part of the central bank's mandate, the factors to consider have grown and the universe of instruments have to be expanded. We have an interesting time ahead as central bankers and no doubt still many challenges to face.

I thank you.

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6 IMF Article IV Report, South Africa, 2011