South African Reserve Bank

A public lecture by Lesetja Kganyago,

Governor of the South African Reserve Bank,

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Independence and policy flexibility: 'Why should central banks be independent?'

Good evening, ladies and gentlemen.

Thank you for your kind invitation to come and speak at Stellenbosch University today.

At a time when our country is embarking on a course of political and economic renewal, I would like to focus for the time that I am here with you on the public good enshrined in our Constitution that concerns monetary policy. In particular, I would like to talk about why central bank independence matters for that broader public good and how it relates to achieving our inflation-targeting objective.

The constitutional mandate and independence

Our Constitution provides the mandate for the South African Reserve Bank (SARB): protect the value of the currency in the interest of balanced and sustainable growth. The Constitution sets our mandate in this way for a simple reason: it is an expression of a public good. When we attain that public good, it helps us to reach the kind of economic growth we want. It does not mean that achieving our mandate alone will necessarily generate that outcome. But it is necessary for achieving it. Many other policies and behaviours play similar and necessary, but not sufficient, roles.

Having been given a mandate, the central bank needs to achieve it. This requires setting out an operationally relevant policy target and ensuring that the institution has the powers to achieve it. Central bank independence is really just about giving the SARB the institutional freedom to get on with those two things. But, of course, hitting an inflation target is not a simple matter of declaring a target and then browbeating economic actors to set prices and wage demands in line with this target. For those actors, the gains of higher (or lower) inflation exceed the costs they experience, but they do not exceed the costs to society as a whole. This is a common political economy problem; it arises in many areas of policy. And because of it, nearly all countries choose monetary policy frameworks with clear and simple targets, and with targets that imply balanced growth. I will return a bit later to the issue of alternative policy frameworks.

However, ensuring that independence delivers good, socially optimal outcomes also requires that it is conditioned by a complementary framework which ensures transparency and accountability. Paul Tucker, a former Deputy Governor of the Bank of England, sets it out in this way in his recent book: central bank delegation should have the following principles, namely ‘a clearly articulated regime, simple instruments, principles for the exercise of discretion, transparency that is not deceptive, engagement with multiple audiences, and, most crucially, testimony to legislative committees’.[1]

In line with those principles, and in order to get to low inflation, central banks need to explain to the public what they are doing and how they are doing it. And they also need to be held accountable for their efforts. Independence is the flip side of accountability; a central bank cannot be easily held to account if private and/or political actors have

[1] Tucker, P. 2018. *Unelected power.* Princeton, New Jersey: Princeton University Press.

the ability to sway its decisions. Nor can a transparent target be easily manipulated to show success when there is in fact none.

Our mandate is implemented by targeting an inflation rate, which is interpreted not as literal price stability (an inflation rate of 0%) but as a low and stable growth rate in the price level. Our targeted inflation rate, set in consultation with government, is a range of inflation between 3 and 6% on an ongoing annual basis. In other words: we target a monthly, year-on-year inflation rate of not lower than 3% and not higher than 6%.

In practice, we aim for inflation to come out near the middle of our target range, at around 4.5%. This gives scope for variation and shocks to hit the economy. These shocks move inflation above and below 4.5% but, by the design of our framework, they do not necessarily require policy adjustments. This is the meaning of 'flexible' inflation targeting, and it allows us considerable leeway in looking through or past temporary shocks to the inflation rate. Since the beginning of the inflation-targeting period, which started in 2000, our average annual inflation rate has been 5.5%, a full percentage point higher than the midpoint.

This points to mixed success in the history of our inflation management. Inflation has stayed moderate, well below the high levels of the 1980s and 1990s. But inflation has not really been sufficiently low to get our high long-term interest rates lower, and this creates an economic cost that weighs more heavily on job creation as time goes on. We have indicated that a consistently lower rate in the near term, at the midpoint of our target band (4.5%), would lower long-term interest rates and be more supportive of balance in the economy.

What do we mean by balance? First, let me say what it is not. Balance is not about achieving an inflation rate that meets the demands of some groups of people but not others. And it is not about reaching an inflation rate that causes economic damage – neither too low nor too high.

Rather, balance is about supporting competitiveness and job creation in the export industries and about reducing the bias to growth in the non-tradeables sectors caused by high inflation. As it happens for most countries, emerging and advanced, that inflation target is between 2 and 3%.[2] Our trading partners and competitors typically have lower inflation than we do. It is also about getting the balance right between saving and investing; inflation should be at or around a rate which maximises both the supply of credit and the demand for it.

So why would anyone want higher inflation? Prices rise at different rates. Some sectors may see stronger rises than others, giving them stronger revenue growth relative to those not seeing the same price increases. This implies redistribution. For example, some businesses like higher inflation because, via currency depreciation, it increases the prices of the goods they sell faster than the cost of production. Of course, the costs eventually catch up as inflation rises in response to the weaker currency, but while these prices are catching up, exporters get a small and temporary gain. In this instance, higher inflation redistributes a little from exporters in other countries that compete with ours. But, more importantly, it redistributes from domestic consumers and producers to those gaining from higher prices. Once costs rise, however, the economy is where it started in the first place.

Along similar lines, debtors prefer higher inflation because, over time, it reduces the real value of their debt. A particular example I like to think about is those who want higher inflation because they like to borrow to make their living out of short-term activities, often in the financial markets. Their frequent criticisms are always the same: we worry too much about inflation, both now and in the future, and, if we didn't worry so much, we could all enjoy lower short-term interest rates today.

The catch here is that when lower short-term rates today push up inflation in the long run, then borrowing for investment is skewed away from the long term to the short

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

term. We shouldn’t be surprised if this also skews job creation away from the types of jobs that are sustained over the long run. That is not a trade-off that we believe is consistent with the public good mandate set out in the Constitution. The real test of monetary policy is not the short-term interest rate but what happens to the long-term rate.

We should by now be able to recognise the problem with allowing inflation to go up in ways that benefit some groups: the gain is temporary and costs other groups. To claim back what they have lost, the losers want compensation, which creates additional negative distortions. And, because the advantage is temporary, the beneficiaries want policy to give them the gain again and again. Giving in to this desire, trying to conjure up temporary gains, lies behind many, if not most, historical instances of macroeconomic failure.

Let me turn now to the losers from high inflation. There are three social groups that we should all worry quite a lot about, for both economic and ethical reasons.

The first are younger people. Higher inflation and higher interest rates make it more expensive (and often impossible) to start borrowing for housing, education or transport, or starting new businesses.

The second group are workers. Here it is often argued that more inflation would create more jobs for blue-collar workers. This is the old idea of the Phillips curve which has proven, except in very particular circumstances, to be wrong.

First, some basic facts. For South Africa, the economy grows more strongly when inflation is low. If you don’t believe me, take a look at the historical data series yourself.[3]

[3] Simple correlations show that, since 1990, growth has always been lower when inflation was higher.

Second, some empirics. The original Phillips curve idea worked as follows. If there are suddenly higher prices, businesses will believe that this is stronger real demand. They will respond to this demand by increasing production because they think they will be able to sell more and because their return is higher relative to the cost of production. But this is not 'time-consistent'. When workers respond to their real loss of income (higher inflation minus last year's wage level), they ask for higher wages and the cost of production rises. Suddenly, the business is not more profitable anymore, cannot sell more of its product, and retrenches.

In macroeconomic policy, the temporary gain of the Phillips curve is illusory. You end up with less employment and higher inflation. Your 'misery index' increases – and yes, there is such a thing, invented by Arthur Okun, and it measures exactly that.

Finally, I would like to note that the third group that gets hurt the most by higher inflation includes those that cannot defend themselves from it: the poor. Without the power to demand higher compensation for inflation, the poor and those living off fixed nominal incomes, pensioners in particular, are most vulnerable. It is for these people, above all others, that low inflation is both morally and economically right.

At the end of the day, central bank independence allows the SARB to hear what different interest groups have to say, but gives it the policy space to make decisions about inflation that on balance benefit all. By having an inflation target range, we make a commitment to explaining transparently how we have achieved that target.

Monetary and fiscal policy coordination

Independence also matters for ensuring effective monetary and fiscal policy coordination.

Much monetary theory involves figuring out how to avoid high inflation and its impoverishing effects. Sometimes high inflation is caused by the excessive ambitions of sovereigns to spend fiscal resources on projects that do little to generate long-run economic growth. Continuous fiscal deficits reflect those ambitions, and because those deficits are financed with debt, they create a tax liability for citizens in the future. When debt rises too rapidly and above certain levels, our borrowing today both constrains what future generations of South Africans can do (as they are forced to repay our debt) and undermines their own living standards (as they pay the higher taxes). All of this directly generates pressure to allow inflation to rise. We cannot blame future generations for this. It is a function of the choices we make now.

Some of you may disagree with this and argue that governments need to address social deficits and therefore will always run large deficits. But while I certainly agree that those social deficits need to be rectified, it has to be done sustainably and with a critical emphasis on spending public funds on those things that raise the potential growth rate of the economy. If our spending does not do this, then we will end up not being able to spend more in the future. Future generations might simply end up having to pay more interest and more tax.

Another important argument for ensuring central bank independence is avoiding what is called 'fiscal dominance', which is the need for monetary policy to prevent the sovereign from going bankrupt because of excessive spending on current consumption.

Inflation targeting as an expression of the mandate

Let me now turn to a discussion of how inflation targeting is a good expression of our constitutional mandate to support balanced and sustainable growth.

The independence of central banks gives them the opportunity to keep on top of global research and use human capital to best understand how to achieve their mandates.

Oftentimes, criticism of their independence is really about not liking the objective set out in the Constitution. If the SARB had no independence, then other objectives could be imposed on it. But what are those other objectives, and where do they come from? Have they been researched and understood properly? Or are they wishful thinking? Perhaps they do reflect good intentions and legitimate aspirations. But the test of whether they are the right or even useful objectives has to be based on analysis and research, comparative assessment, and technical know-how. Inflation targeting has, in recent times, become a popular policy framework mainly because it has proven successful in achieving good outcomes where other approaches have failed. Nonetheless, it is always useful to consider alternatives.

Dual-mandate frameworks are one alternative. But even the central banks with multiple mandates tend to act as if they were inflation targeters because low inflation helps to keep interest rates low, and the two together help to maximise employment. The mandate is achieved because the rate of inflation determines the sustainable outcome of the other two objectives.

For this reason, the move to include employment creation as a mandate alongside inflation targeting for the Reserve Bank of New Zealand has proven less eventful than its political sponsors had advertised. Why? One reason is that employment levels are determined by many different things, so putting a specific target on it for the central bank to try and achieve is unrealistic and can result in unintended consequences. Say, for example, that inflation is rising and employment is falling because of adverse technological change. In this instance, there is little monetary policy can do to increase employment levels. But responding by cutting rates, which seems like the right thing to do, only increases inflation further and eventually undermines job creation further as well.

Like other central banks, we already include concern about growth and employment in our Taylor rule. And because we apply the framework flexibly, we don’t respond with policy to every upward move in inflation. The difference between a flexible inflation target and a dual-mandate central bank just isn’t very meaningful. Over time, keeping inflation expectations low and well-anchored is the clearest and most effective way of helping the economy to achieve full employment.

Another alternative is to target the exchange rate directly. Keeping it perfectly stable would, at least on the surface, suggest a better fit with the letter of the mandate in the Constitution. But it is often not well understood just what maintaining a fixed currency actually means, or what this requires in terms of policy. In a nutshell, fixing the currency requires fixing it against another currency or a basket of currencies. Then, our monetary and fiscal policies are required to adjust regularly to keep the rand's value stable against those currencies. But those third currencies keep moving, and this means that we need to move our policies in line with their moves, even when the economic cost may be high.

To give you a concrete example of how problematic this can be, let's consider the case of Argentina in the early 1990s. Argentina had pegged its currency to the US dollar. But Argentina was not as productive as the United States (US), despite the peg giving them a similar inflation rate. Eventually, Argentina could not afford to maintain the peg, as the peso's value was under pressure to fall and the country had no reserves left. The peg was dropped and the economy fell into a deep recession, with very high inflation, massive job losses and a sharp rise in poverty.

You may think that Argentina is an extreme case, but it demonstrates how a country's policies can become subordinate to, and ultimately determined by, the actions of other countries. Our inflation-targeting framework and floating currency means that we have considerable freedom to set our policies in line with the inflation outcome that we want to achieve.

Some commentators have suggested that this freedom to float the currency means that our monetary policy works against export-led growth. Our currency is too strong in this view. It is worth reminding ourselves of what the International Growth Panel, led by Prof. Ricardo Hausmann, suggested to us back in 2006. They showed us how a more export-led growth strategy needs to be predicated on a more competitive exchange rate achieved by running a fiscal surplus to create space for lower interest rates, and supplemented by an effective inflation-targeting framework.[4]

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. All else being equal, the inflation-targeting framework has lowered inflation and rates, reducing the pull on hot money in recent times. In fact, a fundamental objective of inflation targeting has always been to achieve a more competitive exchange rate, and the best way to achieve this is to get inflation to be permanently low.

Conclusion

The Constitution recognises and expresses the public good which is price stability because it helps societies to achieve balanced and sustainable economic growth. It is necessary but not sufficient. Like the mandate, central bank independence is also not a static, ivory-tower concept. It is a living and breathing idea. It is an idea that is practical. It gives life to the mandate set out for the SARB by the Constitution.

This independence means that the SARB can make the case for how best to achieve that goal, in consultation with government and with full transparency to the general public. As an institution, we have worked with government to identify the inflation-targeting framework as the best way of achieving the mandate, for all the reasons I have set out today.

We believe that the case for the existing framework is very strong. We have achieved a historically low rate of inflation and, as a direct consequence of this, historically low

[4] For the Panel's recommendations, please 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.

interest rates. Of course we would like to improve on this track record and edge both inflation and interest rates lower on a sustainable basis. This is the most important contribution that monetary policy can make to full employment, economic growth and the well-being of our society.

Thank you.