South African Reserve Bank

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In the shadow of COVID: lessons from 20 years of inflation targeting

Good afternoon, ladies and gentlemen.

This speech is about 20 years of inflation targeting.

For two decades, we have been part of a great international experiment in getting monetary policy right. Inflation targeting has delivered a long period of price stability, comparable to the best years of the post-War Bretton Woods system, and should be considered a success for South Africa and for many other countries.

To understand how we got to where we are now, looking back at 20 years of inflation targeting, we can start further back: with a speech from 1979, titled 'The anguish of central banking', by Arthur Burns, who was Chair of the US Federal Reserve for most of the 1970s.

This was a period of high inflation, in the US and globally. Burns asked why inflation was 'proving so stubborn', and why central bankers were failing to stop it. He offered a remarkable confession: that the Fed could have stopped this inflation at any time, but didn't because it lacked the will to do so.[1] To quote from the speech directly:

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[1] This text paraphrases the following: "Viewed in the abstract, the Federal Reserve System had the power to abort the inflation at its incipient stage fifteen years ago or at any later point, and it has the power to end it today. At any time within that period, it could have restricted the money supply and created sufficient strains in financial and industrial markets to terminate inflation with little delay."

> Inflation came to be widely viewed as a temporary phenomenon – or, provided it remained mild, as an acceptable condition. 'Maximum' or 'full' employment, after all, had become the nation's major economic goal – not stability of the price level. That inflation ultimately brings on recession and otherwise nullifies many of the benefits sought through social legislation was largely ignored.[2]

During Burns' tenure at the Fed, inflation averaged nearly 7% in the US, well above the 2% levels of the preceding two decades.[3] Indeed, the decade ended in tears, with high inflation giving way to falling investment and growth, and eventually a sharp and persistent increase in unemployment, which took years to resolve.

How easily could we have made the same mistakes! We could have said that – with high unemployment, and such great economic demands after apartheid – it was just not possible to control inflation. And then we would have ended up with no social benefits – no more growth, no extra jobs – but with high and stubborn inflation instead, just as it did for Burns.

But the story of South African central banking, in the democratic era, is not one of regret. The 1980s and early 1990s made it very clear that high inflation creates uncertainty, destroys savings, and undermines growth. The growth/inflation trade-off doesn't work. We realised that inflation targeting, as a transparent and accountable policy framework, provided our best shot at price stability with growth.

In fact, the inflation-targeting era has been one of lower inflation and lower interest rates than prevailed previously. Following our mandate, inflation has been kept under control.[4] Even now, at this very difficult time for the economy, we can see the inflation-

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Please see Arthur Burns, 30 September 1979, 'The anguish of central banking', available at http://www.perjacobsson.org/lectures/1979.pdf, p. 15.

[2] Ibid, p. 13.

[3] Precisely, CPI inflation averaged 6.5% during Burns' tenure as Fed Chair (February 1970 – March 1978). For the 1970s as a whole, inflation averaged 7.1%. For the 1960s, it was 2.3%. For the 1950s, it was 2.1%. (Data from the St Louis Fed FRED database.)

[4] For this period, inflation has averaged 5.9%. The volatility of growth, inflation and interest rates has also been lower. Specifically, for the periods 1970-2000 and 2000-2020, the standard deviation of growth has declined from 4.3 to 2.6, the standard deviation of inflation has fallen from 3.9 to 2.4, and the standard deviation of interest rates (the lowest SARB lending rate) has gone from 4.9 to 2.5. The pattern of lower volatility following the introduction of inflation targeting also holds when contrasting 1980-2000 with 2000-2020 (i.e. two 20-year windows).

targeting framework functioning properly, delivering historically low interest rates in the context of low inflation.

What are the chances, 20 years from now, that we will still have price stability and low interest rates? Will we be agonising, 20 years from now, over how we lost control of inflation?

Today, there is a new generation coming of age, in very difficult circumstances. They have many questions – about the economy in general, and about how monetary policy fits into the picture. Some of the questions are asked in a fiery tone, and I think that young people are right to be angry. Not only have they been unlucky, reaching adulthood during one of the worst economic disasters in modern history. They are also now discovering that, over the past 10 years, South Africa has been accumulating debt at a rapid pace, faster than any big emerging market except Argentina. So, while the economy struggles to grow, and job creation remains elusive despite the spending, there is a heavy burden of debt for future generations to carry.

Justified though this anger is, we need to channel that energy into positive action. We also need to guard against making policy mistakes that could sink us into deeper trouble.

Perhaps, in the audience here today, there are future macroeconomic policymakers, future reserve bank governors and finance ministers. There are surely many people who will be leaders in this country, in one role or another. This speech is primarily for you. You will decide much of our economic future, through your choices and the ideas behind them. We are giving you many problems, but at least we have achieved price stability. It will be up to you to keep it. Here are some lessons we have learned to help you do that.

The first lesson has to do with Arthur Burns' problem, which is about losing track of your mission and living to regret it. Perhaps the most common criticism of inflation targeting, over the past two decades, has been that South Africa needs a more growth-friendly monetary policy. Burns, however, learned the hard way that there is no permanent gain to growth from short-run increases in inflation.

While we would all like South Africa to reach permanently high growth, this is beyond the powers of a central bank. As we have often communicated, most of our growth problems should be addressed through structural reforms and confidence-boosting measures. To give just one example, the central bank cannot stop electricity load-shedding with interest rates.

The South African Reserve Bank (SARB) can be held accountable for achieving low and stable inflation. But economic growth requires collaborative effort. It is simply not within the power of one institution to deliver. It is a team sport. It needs contributions from education, from the development finance institutions, from the private sector, and from many other players.

Our emphasis on growth as a team sport, however, does not crowd out our concern for the specific growth problem we can address, which is weak demand. Right now, demand has been badly damaged by the coronavirus lockdowns. In technical terms, we think the output gap is deeply negative. This feeds into our policy stance: we have slashed interest rates to support aggregate demand and the spending power of South Africans. In doing this, we are supporting that part of growth in the near term which we can influence.

We have become clearer about this in recent years, as part of adopting the Quarterly Projection Model (QPM) as the main forecasting tool for the Monetary Policy Committee (MPC) back in 2017. The QPM sets out a proposed path for interest rates, which it gets from a so-called 'Taylor rule'. That rule responds to the output gap as well as inflation. Indeed, because the output gap also affects the inflation rate, the rule responds to weak growth twice. The output gap gives us a measure of slack – and that gap, in turn, has an impact on inflation.

Would it make sense to add growth or employment to the mandate of the SARB, alongside the price stability mandate?[5] I doubt this would change policy much. After

[5] See also Lesetja Kganyago, 25 April 2017, 'Monetary policy: why we target inflation', available at https://www.resbank.co.za/Lists/Speeches/Attachments/492/Address%20by%20Governor%20Kganya

all, we already include growth in our models and decision making – through the output gap, a comprehensive measure of economic slack.[6] The problem is that formally adding an extra mandate, in the context of our propensity to stagflation, could encourage policy mistakes and weaken credibility.

South Africa's growth and employment problems are bigger than monetary policy.[7] For instance, even when the economy was booming, unemployment stayed above 20%. As with growth, the bedrock of this problem is structural, not cyclical. In this case, it's the legacy of Bantustans, apartheid education, and the failure to fix those problems.

Our labour markets have also historically raised the cost of hiring people even when the economy is weak and people are losing jobs. This cost inflation has further undermined job creation even when growth picks up.

For these kinds of structural reasons, an employment mandate is unlikely to be effective. More likely, we would find ourselves in Arthur Burns' shoes: we would not get unemployment permanently lower, but we would be stuck with higher inflation, making our growth and jobs challenges even worse.

We want to be crystal-clear that we won't make that mistake. With inflation well anchored, moves to lower interest rates should get us more real growth than inflation. And this is exactly where we are now.

But doesn't everyone have low inflation now? Isn't this due to the coronavirus, not monetary policy? This brings me to the second common argument we have heard, which is that lower inflation has been a global phenomenon, not an accomplishment of inflation targeting.

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go%20at%20UKZN%20Graduate%20School%20of%20Business%20and%20Leadership.pdf, especially pp. 7-9.

[6] Employment could be used in place of an output gap, but this would be a less comprehensive assessment of how strong or weak the economy is, and the data are even more difficult to use than output gap estimates.

[7] For a detailed discussion of this subject, see Lesetja Kganyago, 24 August 2016, 'Inflation, but no jobs or growth', available at https://www.resbank.co.za/Lists/Speeches/Attachments/478/Address%20by%20Governor%20Kganyago%20at%20the%20Labour%20Law%20Conference%20-%2024%20August%202016.pdf.

There's no doubt that global factors affect inflation. Globalisation and low-cost manufacturing have made many goods cheaper. The recent collapse in oil prices has been a big disinflationary shock.

But we also have good evidence that countries with independent, inflation-targeting central banks have lower and less volatile inflation.[8] And we can see that there are still countries with high inflation rates, despite low global inflation. The easy examples of this are the hyperinflation cases, like Venezuela and Zimbabwe.

But there are less extreme cases that show the value of sensible monetary policy.

Consider Turkey, a middle-income country like South Africa. In June this year, Turkish inflation was 12.6%. In South Africa, it was 2.2%. Both these economies had low growth, of less than 1%, before COVID-19 hit. Both countries have experienced big currency depreciations this year. Both are major importers of oil, and have benefitted from its price collapse. So why are their inflation rates so different?

The point here is that the independence of the central bank matters, with the experience of other emerging and developing economies bearing testimony to this.[9] Since 2015, Turkey's inflation rate has averaged 11.6% against a target of 5%. For the same period, South African inflation has been within our 3-6% target range, averaging 5%.

Examples like this make it crystal-clear that low inflation is not just a worldwide fact that countries can have 'for free'. If individual countries don't make an effort, they can easily get stuck with high inflation.

The third argument is that inflation targeting is a rich-country policy, inappropriate for an emerging market like South Africa. In fact, inflation targeting has been adopted

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[8] Jongrim Ha, Ayhan Kose and Franziska Ohnsorge, eds., 2020, *Inflation in emerging and developing economies,* available at https://www.worldbank.org/en/research/publication/inflation-in-emerging-and-developing-economies, p. i13.

[9] See, for instance, 'Turkey's president removes head of central bank', available at https://www.nytimes.com/2019/07/06/business/erdogan-removes-turkey-governor-central-bank.html, published in the *New York Times* on 6 July 2019.

widely by emerging markets. This makes sense, as many of us have learned from bitter experience that tolerating inflation isn't developmental – it just creates instability.

It is worth noting that there are more developing-country inflation targetters, about 25, compared to 11 among the advanced economies.[10] And while New Zealand gets the credit for being first to implement inflation targeting, the second country was an emerging market: Chile.[11] Differences between advanced and emerging economies tend to be reflected in target designs that are not 'one size fits all'. Most rich countries have found they like a 2% target, but emerging markets have used other sizes, often 3% or 4%.

More recently, critics of monetary policy here in South Africa have flipped by 180 degrees. The SARB was originally accused of wrongly importing a first-world policy to South Africa. But now we are told to follow major advanced economies and launch a big Quantitative Easing (QE) programme. So much for the claim that rich-country policies don't work in developing countries!

This brings me to the next part of my speech, which is about new challenges to inflation targeting.

In South Africa, there is a surprising amount of interest in QE. From being arcane jargon, many people have suddenly developed passionate views about it, and it gets lots of media interest. Given all this, let me summarise where we are in this conversation.

As I explained in a recent speech at Wits University, QE will become appropriate when interest rates are at the zero lower bound and there is deflation risk. While inflation has eased and created space for lower rates, I am not aware of any professional analyst who projects deflation in South Africa. Our own SARB forecasts are in line with this consensus.

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[10] Klaus Schmidt-Hebbel and Martín Carrasco, 2016, 'The past and future of inflation targeting: implications for emerging-market and developing economies', *Monetary Policy in India.*
[11] Klaus Schmidt-Hebbel and Matías Tapia, 2002, 'Inflation targeting in Chile', *North American Journal of Economics and Finance*, 13, p. 125.

Nonetheless, should deflation take root, we would be prepared to deploy the tools at our disposal, as appropriate, to achieve our mandate. Our inflation-targeting framework would help us make that decision, and would underpin the credibility of any steps we might need to take.

In the current circumstances, however, we think that a QE programme doesn't make much sense for South Africa. Some advocates of QE argue that it is a free way of financing government deficits. This is not true. The funds created to buy bonds would flow into the interbank money market, lowering the cost of funding. This cost of funding is in fact the repurchase rate (repo rate), which is our main monetary policy tool. To ensure that the repo rate stays where the MPC wants it, despite the extra funds in the system, we would have to borrow those funds back ourselves, which could be costly. To repeat: QE would not be 'free money'.

Nonetheless, there are still claims that QE could work because the SARB could buy long-term bonds at a high interest rate, in the region of 9%, and then pay sterilisation costs equal to the repo rate, at 3.5% currently, and profit from the spread. Borrow at 3.5% and lend at 9% – what a great business model! Fortunately, the SARB is driven by public interest and not by profit. And, clearly, there are some risks embedded in this pricing, or private buyers who do look for profits would have eaten this 'free lunch' already. In fact, if we intervened to bring down long yields, we would be transferring risk back to the public balance sheet, while also removing incentives for new lending to the public sector.

One of South Africa's fiscal advantages is that the average maturity of government debt is unusually long relative to its peers. At the start of this year, it was a bit over 12 years. The whole point of borrowing long-term like this, even though it costs a bit more, is to share risk with investors. This means that when things like the coronavirus and credit rating downgrades happen, bond prices fall and borrowing costs go up – but this debt need not be rolled over at higher interest rates, because government has already received the funds, long-term, at the old interest rates. The risk is shared.

Should the SARB start doing QE, however, by buying bonds on the secondary market, then investors could shift risk back onto the public sector's balance sheet, at a higher price. In other words, it would be a private sector bailout, arranged by the SARB. Worse, QE would reduce the incentives for new investors to come and buy long-term sovereign debt, because there would not be enough yield or compensation for the longer-term risks now visible.

What happens with QE, instead, is that public borrowing switches to the short-end of the curve. As the central bank buys longer-term bonds, it also sells, to the private sector, short-term instruments in their place, with the net result that the only *new* debt the private sector ends up with is that short-term debt. Given that our short-term instruments, like SARB debentures, are much like Treasury bills, it turns out that QE is much less exciting than it looks. Not only can National Treasury effectively make its own QE by funding itself through Treasury bills, but it is actually doing so.[12] Its pre-crisis borrowing strategy was astute: it left room in the short-end of the yield curve to borrow in an emergency. Lower inflation and a lower repo rate have made that borrowing cheaper than it otherwise would have been. In these circumstances, it's not at all clear what a SARB QE programme would add.

Rather than trying to supplant private investors or taking away the risk of investing, we have focused on liquidity. Specifically, we have been buying bonds in the secondary market, at different maturities, in the context of a sudden stop in global capital flows. As the central bank, we have unique powers to provide liquidity, and we have used them to restore market functioning. These interventions have been helpful so far. Yields have fallen. We didn't set out to lower yields, specifically, but it turns out that market dysfunction was part of the reason why yields were so high.

Putting all the pieces together, this monetary-fiscal mix allows more spending in the context of a major emergency. We are helping by setting low interest rates, and by ensuring that the government bond market remains liquid. National Treasury is able

[12] As two economists at the Bank for International Settlements have put it, 'almost any balance sheet policy that the central bank carries out can, or could be, replicated by the government'. See Claudio Borio and Piti Disyatat, November 2009, 'Unconventional monetary policies: an appraisal', available at https://www.bis.org/publ/work292.pdf, p. 2.

to sell its debt to investors. This approach is going to deliver a historically high level of government spending this year, even adjusting for population growth and inflation, and excluding interest costs.[13] National Treasury is not cutting spending in the middle of a crisis; they are raising it, to the highest levels on record.

However, we also need to think about the next few years. National Treasury is already planning to run deficits of 14.6% of gross domestic product (GDP) this year, 9.3% of GDP next year, and 7.7% the year after that.[14] In this context, high long-term interest rates are a critically important signal about what savings are available. We should be listening to this message, not trying to temporarily suppress it through SARB interventions, which really just switch long-term debt for short-term debt.

We are in very difficult circumstances, but QE isn't the answer. We need to focus on real solutions.

Our discussion of QE takes me to the final part of my speech, which is about new challenges to the inflation-targeting paradigm.

As Mervyn King has noted, all previous monetary policy paradigms have fallen, sooner or later.[15] The current one will also be replaced, eventually, by one that works better for future circumstances. What might change?

In many of the advanced economies, inflation targeting is facing large challenges. Inflation has been *below* their inflation targets for many years now. Policy rates have been stuck at zero. And instruments like QE and forward guidance have not been powerful enough to solve this problem. It is now hard to explain why the Bank of Japan, or the European Central Bank, has been unable to push inflation to targeted levels of around 2% despite aggressive monetary policies.

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[13] The data underpinning this claim go back to 2002.

[14] These numbers are drawn from National Treasury, 24 June 2020, *Supplementary Budget*, specifically Table 4.1 on p. 35, available at http://www.treasury.gov.za/documents/National%20Budget/2020S/review/FullSBR.pdf.

[15] Mervyn King, 2016, *The end of alchemy: money, banking and the future of the global economy*, Chapter 2.

At this stage, there is little consensus on the answers, and even less on policy solutions.

There are two basic sets of explanations for why inflation has stayed so low in advanced economies, and why central banks have been unable to lift it.

One set emphasises factors beyond the control of central banks, such as changes in labour markets or demographics. For instance, in an aging society, people want to save, and they don't want to take risks, so demand is limited and interest rates are low.[16] This explanation works well for places like Japan.

Another kind of explanation puts the emphasis on debt. Where borrowers have too much debt, even small interest rate increases have large effects on demand, while large rate cuts do little to boost it further. As one paper in this literature puts it, the 'black hole' of debt is inescapable, pulling down inflation and interest rates permanently.[17] An alternative version is that low interest rates encourage financial risk-taking, which leads to crisis, depressing the economy, lowering inflation, and generating even lower interest rates.[18]

In these cases, too loose monetary policy eventually causes very high debt levels that smother economic growth, or it ends up causing financial crises.

I don't think South Africa has these problems yet. Right now, we don't have the high inflation and high interest rates of the past, but we also don't have the zero rates and close-to-zero inflation of the rich countries. The inflation-targeting paradigm is working pretty well.

Given all the challenges facing South Africa, we should recognise that monetary policy is the last place where we should consider risky changes. We have a well-established

[16] Joseph Kopecky and Alan M. Taylor, April 2020, 'The murder-suicide of the rentier: population aging and the risk premium', available at https://www.nber.org/papers/w26943.pdf.
[17] Atif Mian, Ludwig Straub and Amir Sufi, 26 March 2020, 'Indebted demand', available at https://scholar.harvard.edu/files/straub/files/mss_indebteddemand.pdf, especially p. 4.
[18] For instance, see Paul Volcker with Christine Harper, 2018, *Keeping at it*, p. 227.

inflation-targeting framework, which is delivering low interest rates and low inflation. This is the most functional part of the macroeconomic framework.

Unfortunately, getting monetary policy right isn't going to be enough. South Africa's debt situation is critical. And our rebound from lockdown is looking weak compared with other countries.[19] As a country, we need to find a path back to fiscal sustainability and growth. We can borrow from new creditors; we can shift our debt towards short-term borrowing; we can move things around different balance sheets – but this is not a recovery strategy; it is just a way to buy time. If public sector borrowing were the way to achieve sustained growth, the last 10 years of debt accumulation should have been enough. The real task now is restoring our fiscal credibility and implementing structural reforms so the economy has a way to become more efficient and grow.

In many ways, as a country, we seem to be depressed, unable to get out of bed. Yes, it's winter, and it's cold. But we can't live like this. Spring is coming, and inflation and interest rates are low. We need to focus on the opportunities, get up, and get to work.

Thank you.

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[19] Based on consensus forecasts, three-quarters of countries will have output back to 2019 levels by 2022. This includes 12.9 pp expected to have net positive growth this year, 18.3 pp which will be above 2019 levels in 2021, and 44.1 pp expected to get there in 2022. South Africa is in the remaining quarter of countries expected to recover to 2019 levels of output only after 2022.