Once More Into the Breech: Should South Africa Abandon its Inflation Targeting Regime?

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"Only a crisis, real or perceived, produces real change", so spoke Milton Friedman (1982: ix) when faced with the challenge of changing government policy. This quote seems particularly apt given the current global economic meltdown, which has already seen attacks on the way global finance, corporate governance and international trade are structured. How many more 'holy cows' will be led to the slaughter before the dust settles no one can say. However, if governments wish to change major policies, there can be no question about 'wasting' the crises. Now is the time for action.

With this in mind the question of whether inflation targeting is the right monetary policy regime for South Africa can be addressed. This essay will start by questioning the fundamental role of monetary policy and how an inflation targeting regime can help fulfill that role. The challenges and alternatives to inflation targeting will then be assessed in the context of South Africa's status as an emerging market economy. It will be argued that, while inflation targeting is not a cost-free policy, it remains the best option available to constrain inflation and maintain macroeconomic stability in South Africa.

The Role of Monetary Policy: Why Target Inflation?

In his study on the role of monetary policy Friedman (1968) suggests that monetary policy's use of *nominal* instruments fundamentally limits its long-term effect on *real* economic variables such as growth, employment or the real interest rate. Instead, Friedman suggests, monetary policy should focus on creating a stable macroeconomic environment. This should be done to stop money itself from becoming a source of economic difficulty through effects like inflation. This view is historically validated by the failure of the Federal Reserve and the Bank of England to address both unemployment and inflation using a 'Go-Stop' monetary policy during the 1970s (Goodfriend, 2007).

Furthermore, Fischer (2003) showed that inflation has a persistent negative effect on a nation's long-run growth with causality running from macroeconomic policy to growth. Countries who wish to maximise their growth should therefore coordinate their macroeconomic policies to actively limit inflation. In line with this view the South African Reserve Bank (SARB) has been given a constitutional mandate to protect the value of the national currency (SARB, 2002). The SARB should therefore aim to minimise the macroeconomic instability and uncertainty inflation causes.

Easterly and Fischer (2001) also show that inflation tends to exacerbate inequality within societies. This is as the poor, who hold most of their wealth in cash, lack access to advanced financial instruments which act as protection against inflation for the rich. Given the high levels of inequality within South Africa this effect should be of particular concern to policy makers.

Inflation Targeting as a Monetary Policy Regime

As with all policy decisions, electing how to address macroeconomic stability comes with certain trade-offs. The principle of the impossible trinity states that given the policy goals of monetary independence, exchange rate stability and full financial integration choosing any two goals would eliminate the possibility of choosing the third. Most nations, including SA, are unlikely to abandon financial integration with the rest of the world. This leaves policy with one of two choices; they can focus on stabilising the exchange rate by 'pegging' their currency, thereby abandoning independent monetary policy. Alternatively they can adopt an independent monetary policy such as inflation targeting, allowing market forces to determine the exchange rate.

An inflation targeting regime can be described as one whose main objective is to keep prices, as measured by some price index, stable (Svensson, 2008). In 2000 the SARB adopted an inflation targeting regime as the core of its monetary policy by setting its long term goal for CPIX (consumer price inflation less mortgage payments) in the band 3-6%. Towards this end the primary policy instrument used is the *repo* rate, which has an indirect impact on inflation through its effect on the demand for loanable funds (SARB, 2002). To ensure the

success of inflation targeting the SARB also adopted certain policy features found in all 'true' inflation targeting regimes (see table 1).

Table 1: Features of Inflation Targeting Regimes

Feature	Reason	Effect on SARB policy
Clear Inflation Targets.	Helps anchor the expected inflation rate.	CPIX inflation target set between 3-6%.
Increased transparency and accountability.	Helps avoid time inconsistency in monetary policy and helps keep the public informed.	Clear target sets an explicit benchmark. Regular monetary policy forums and publications allow for transparency.
Periodic reassessments of policy based on updated forecasts.	The effect of monetary policy on the economy has a lag. Clear forecasts help adapt policy and achieve targets.	Forecasted inflation models of the reserve bank are continually updated. Policy is adjusted accordingly.
High levels of discretion when setting Monetary policy.	Helps to ease the effect of external shocks on the economy and avoid radical shifts in monetary policy.	The implementation of explanation clauses and lengthening of target horizons.
Autonomous central bank, especially instrument independence.	To avoid political interference in monetary policy.	No goal independence but instrument independence through the *repo* rate.

Source: Jonnson(1999), SARB (2002), Kydland and Prescott (1977), Lucas & Sargent (1981)

Table 1 expands on policy features which enhance the success of inflation targeting regimes and have been followed by the SARB. The first two policy features suggest a radical shift towards openness amongst central banks. The basis for this shift is twofold:

Firstly the work of Lucas & Sargent (1981) showed that credible commitment to a specific inflation rate would lead rational expectations to conform to that rate. This in turn would help stabilise the macroeconomic environment. Secondly, Kydland and Prescott (1977) showed that in the absence of a clear commitment central banks would have incentive to

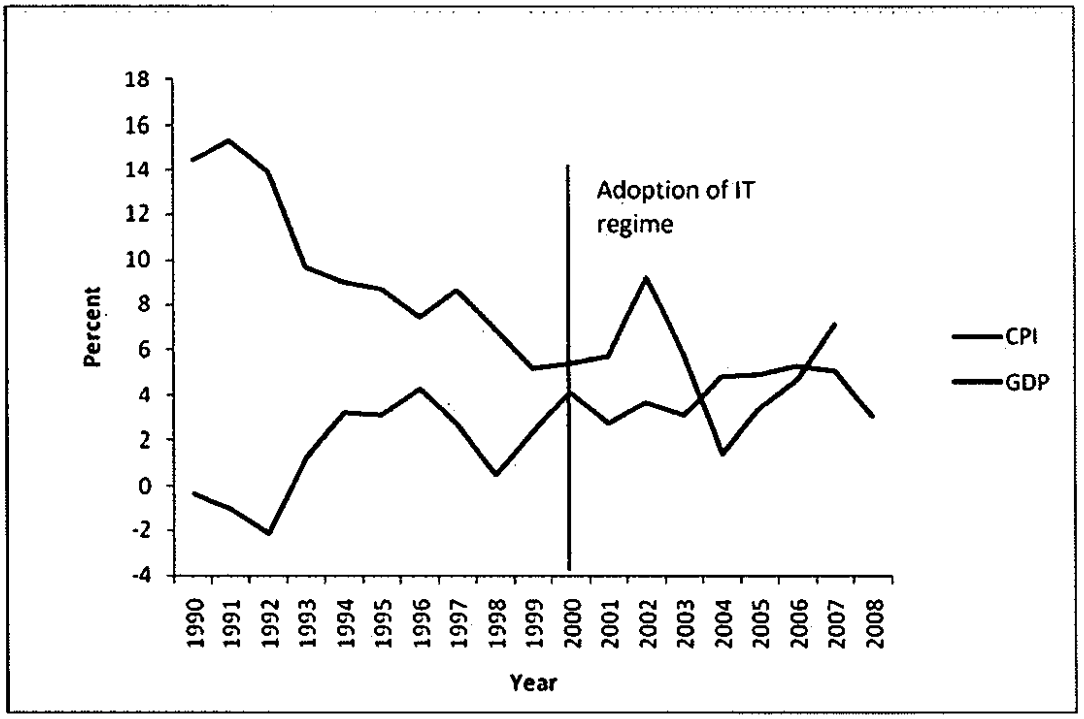
run 'time inconsistent' monetary policy by promising stable prices while simultaneously running an expansionary monetary policy to lower unemployment.

The latter three features secures central bank independence, freeing central banks from having to make policy shifts due to political pressure and allowing them to use their discretion in running a conservative monetary policy. Rogoff (1985) showed that such an independent conservative central banker could effectively decrease inflationary bias by placing a greater weight on inflation-stabilisation, as opposed to employment stabilisation, than the rest of society.

The Bumpy Road to Stability: Inflation Targeting in South Africa

To see whether or not inflation targeting has been successful we can consider the effect it has had on macroeconomic stability through variables such as real GDP growth and inflation (Jonnson, 1999).

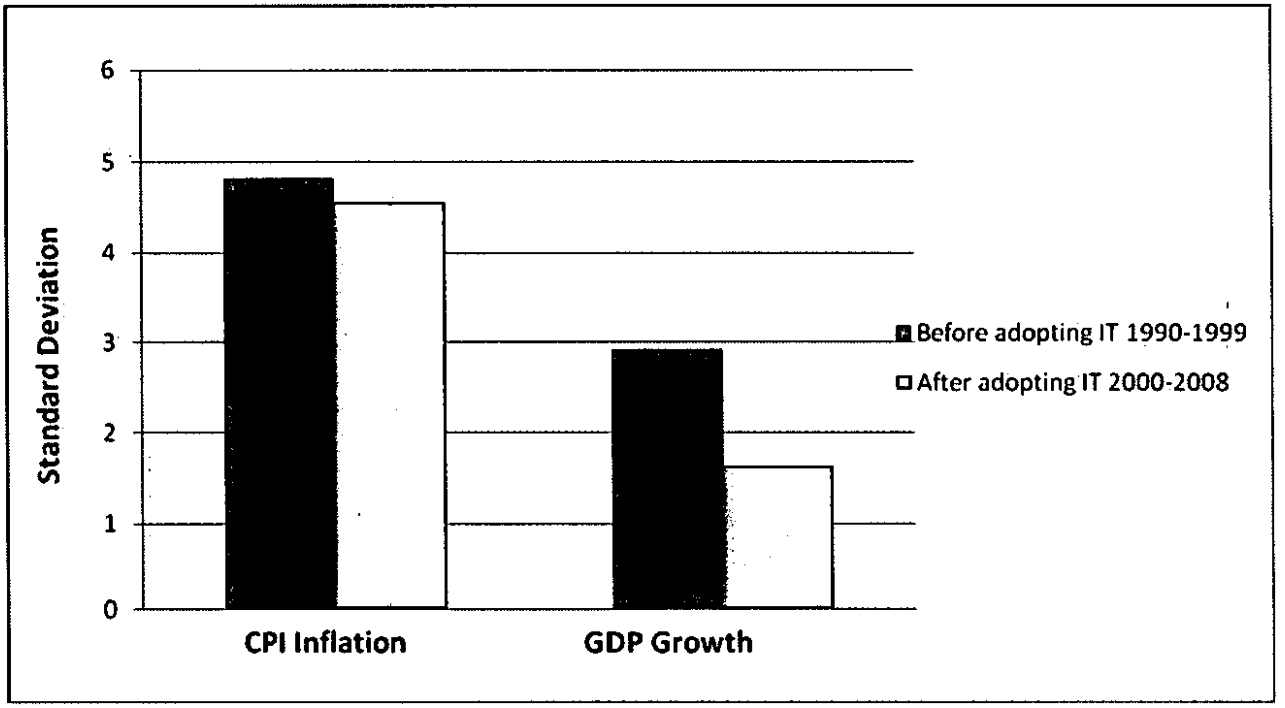
Figure 1: GDP Growth and CPI inflation in South Africa 1990-2008



Source: SARB (2009)

Figure 1 suggests that the ten year period before inflation targeting showed lower growth and higher inflation than the period after. On average growth during the 2000s increased to 4.10% from 1.61 % during the 1990s, CPI inflation is found to have decreased from an average of 9.51% to 6.44% over the same period (SARB, 2009).

Figure 2 Volatility in GDP Growth and CPI Inflation



Source: SARB (2009)

Figure 2 suggests both inflation- and growth volatility have declined after the inception of inflation targeting. Although the decline in CPI volatility is rather meagre (from 4.83% to 4.55%) output volatility made a much more impressive decline from 2.91% to 1.64% (SARB, 2009).

There may be an argument that some if not all of these effects have been due to exogenous variables such as prudent fiscal policy, sustained global growth over the period or a better investment climate. Nonetheless it can be seen that the implementation of IT has not had any observable negative effect on macroeconomic stability and growth. The more pertinent question therefore is not whether the effect of inflation targeting has been positive or negative, but rather, why has the positive effect been so limited?

Ricci (2005) suggests that the success of inflation targeting in the South African economy has to be considered in the context of South Africa's emerging market status. The small size and lack of diversity in the South African economy leaves it more susceptible to external shocks and low investor confidence.

These external shocks have dire effects on the current account and the capital account and can lead to volatile capital flows, amplifying the negative effects on the South African economy. Consequently the implementation of a successful inflation targeting regime significantly more difficult in SA than in most developed nations.

In his study on inflation targeting in emerging economies Mishkin (2000) raises four other possible challenges to operating an inflation targeting regime in an emerging market:

- *Excessive Autonomy*

The high level of central bank autonomy associated with inflation targeting may lead to excessively rigid policy or possibly an increase of output instability. Such fears do not apply to the SARB which has used discretion to practice a conservative and prudent monetary policy.

- *Weak Accountability*

Inflation is generally thought to be hard to control especially in emerging markets which can be dramatically affected by external shocks. Periods of high inflation are likely to lead to a re-evaluation of targets and forecasts which may have disastrous effects on the credibility of a central bank. As mentioned earlier, the SARB has implemented steps to enforce greater transparency and accountability within that institution.

- *Fear of Floating*

As has been discussed, inflation targeting tends to necessitate a floating exchange rate regime. Emerging markets which face volatile capital flows, large stocks of foreign currency and high levels of dollar denominated debt may be justifiably hesitant to allowing their exchange rate to float. In these instances nations may choose to manage their exchange rate causing the exchange rate to be viewed as the nominal anchor of policy as opposed to

the inflation rate. The volatility of the South African rand along with the relatively low level of dollar denominated debt in South Africa suggests that this concern is unfounded.

- *Level of Fiscal Dominance*

Consistently large fiscal deficits are not compatible with an inflation targeting regime. Countries which run both will eventually have to abandon its inflation targets by monetizing its debt to avoid default. Similarly, sound financial systems are a prerequisite for an effective inflation targeting regime. Emerging economies who wish to employ an inflation targeting regime will therefore need to make certain that they maintain fiscal responsibility and comprehensive financial regulation. South Africa however, has a proven track record for both the prudency of its fiscal policy and the stability of its financial institutions.

South Africa's status as an emerging economy has not, however, been the only impediment to the successful implementation of inflation targeting. Du Plessis (2005) raises several active institutional barriers which are incoherent with the implementation of a successful inflation targeting policy including:

- *Un-indexed capital gains tax*

Given that treasury sets South Africa's inflation target, they may have a bias to run inflationary policy to accrue the additional revenue in taxation on the increased nominal value of assets.

- *Target Inconsistent government administered prices.*

While government sets the inflation targets it also fragrantly breaks them by increasing the prices of goods distributed through government owned enterprises by more than the target.

- *Centralised wage bargaining*

By raising wages above gains in productivity and limiting the effective transmission of wage and price mechanisms through the economy, centralised wage bargaining further limits the success of inflation targeting.

- *Necessary Policy reforms*

Du Plessis(2005) also suggests certain reforms in Reserve Bank Policy would increase the effectiveness of inflation targeting by increasing the transparency of monetary policy. These reforms include distinguishing between the forward looking and backward looking dimension of inflation targeting in communications and publishing detailed conditional forecasts and expected paths of policy instruments.

Biased Critiques or Valid Criticisms: COSATU's Viewpoint

For all the benefits inflation targeting can bring a country, inflation targeting is not a free lunch. As the most vocal opponent of inflation targeting COSATU has raised two main objections to the SARB's inflation targeting policy:

Firstly COSATU claims that inflation targeting *"has contributed directly to slowing down the rate of economic growth and thus of job creation and poverty alleviation"* (COSATU, 2007:1). COSATU's argument is that the SARB should run an expansionary monetary policy, allowing inflation to increase in order for unemployment to decline. Theoretically this trade off between inflation and unemployment or growth implies a reiteration of the widely discredited Phillips curve effect (Goodfriend, 2007). Akinboade *et al* (2002) also suggest that the structural nature of South African inflation is likely to make any inflation targeting regime slow and costly in terms of output and employment, however, COSATU's argument is flawed on two levels:

While there does seem to be a relationship between short term inflation and output in South Africa, no such relationship exists between inflation and unemployment (Hodge, 2002). Instead South Africa's unemployment rate is unresponsive to both inflation and growth due to structural inflexibility of its labour market (Barker, 1999).

The second flaw in COSATU's argument relates more to what an expansionary monetary policy aimed at unemployment will in fact achieve. As Friedman (1968) explains, the short-term increase in output associated with inflation is not related to real economic capacity, but rather to the unexpected change in prices. Targeting output through monetary policy will therefore mean running an ever more expansionary monetary policy, creating an

effective inflation spiral. If policy makers which to decrease unemployment in a stable sustainable way the determinants of the non-accelerating inflation rate of unemployment (NAIRU), such as the structural mobility- and the education of the labour force need to be addressed. While the effect inflation targeting has on growth and employment should not be ignored this effect is trivial when compared to other more prominent barriers to employment creation in South Africa.

COSATU's second grievance is that inflation targeting has damaged South African exporting industries. They base their argument on the fact that inflation targeting has caused an *"overvalued currency ... a consequence of the significant inflow of capital; attracted by relatively high interest rates"* (COSATU, 2007:1).

The argument begs the question: If COSATU sees an inflow of foreign capital as negative, how would they plan to fund the investment necessary for growth in South Africa? This challenge would be rendered near impossible by South Africa's low savings rate (Aron and Muellbauer, 2000). Foreign investment is generally considered positive for growth and several "fast developing" countries have actively courted FDI in the past (COGAD, 2008). Nonetheless exchange rate controls will be considered in more depth in the following section of this paper.

Real Alternatives to Inflation Targeting

Monetary policy is widely considered to have three possible policy regimes: price stability, growth in the money supply (so called M3 targeting) or exchange rate stability (Friedman, 1968). The latter two of these are valid alternatives to inflation targeting and will now be considered in more depth.

M3 Targeting

M3 targeting formed the core of the SARB monetary policy up until the mid 1990s. Ultimately the M3 targeting policy was abandoned due to the seemingly unstable and uncertain relationship between money supply and aggregate prices. New evidence suggests that the relationship between M3 and inflation was probably undermined by the relatively high growth rates and short term interest rates in the 1990s (Ricci, 2005). This being said,

inflation targeting remains considered as generally preferable to M3 targeting due to its more comprehensive approach to inflation. Furthermore returning to a M3 targeting policy will raise serious credibility concerns, given the policy's historical failure in South Africa (Akinboade *et al*, 2002). As a final caveat, re-implementing M3 targeting will likely fail due to the mobility of foreign capital which could drastically alter the money supply over night.

Exchange Rate Targeting

The question however remains as to whether it would be preferable for South Africa to abandon inflation targeting, and target a stable exchange rate instead. Balassa (1982) suggests a competitive exchange rate can be essential in allowing developing nations to develop competitive non-traditional export industries. For this reason a number of developing nations have chosen to fix or 'peg' their exchange rate to some foreign country's, effectively 'importing' a foreign monetary policy. Methods of 'pegging' the exchange rate include restricting capital flows, sterilized intervention in exchange markets and adjusting the domestic interest rate.

Sterilised intervention and interest rate manipulation represents the 'active' component of exchange rate policy. Under sterilized intervention foreign exchange is bought or sold to manipulate the domestic currency's price, it is effective but limited by the extent of a nation's foreign exchange and gold reserves. Interest rate manipulation is used to encourage (or discourage) the investment of foreign capital and thereby to affect the demand for- and price of domestic currency (Williamson, 2003).

Table 2: Exchange Rate Regimes

Flexibility	Regime
More Flexible	Free Float
	Managed Float (Dirty Float)
	Target Band
	Basket Peg
	Crawling Peg
	Adjustable Peg
	Truly Fixed
More Rigid	Currency Board
	Currency Union

Source: Frankel (1999)

Table 2 lists the different exchange rate regimes available to countries. These range in flexibility from a free float, where pure market forces determine the exchange rate, to a currency union, where a common currency is used. Certain of these policies can be combined, such as the basket, band and peg regime. Williamson (2003) states the motivation for choosing a specific policy can be broken down into three approaches:

- *Nominal anchor approach*

Countries using this approach view exchange rates as vital in price stability. By fixing the exchange rates they intend to stabilize the current account balance and thereby prices. Such rigid policies were used extensively by Latin American countries in the 1970s leading to excessive macroeconomic volatility. Similarly Jonnson (1999) suggest that a rigid exchange rate regime would cause constant speculative attacks on the rand in SA, leaving the policy ultimately politically untenable.

- *Real targets approach*

This approach views the exchange rate as vital in determining macroeconomic equilibrium for real economic variables. As stated by Mundell (1968), this approach views fiscal-, monetary- and exchange rate policy as tools for achieving internal and external balance in an economy. However Williamson (1971) showed this Mundellian equilibrium to be dynamically unstable as it requires ever increasing interest rates to offset the chronic current account deficits it creates. For this reason the modern approach is to allow a floating exchange rate thereby solving the problem of an external balance and assigning monetary-fiscal policy the role of attaining internal balance. This approach is congruous with an inflation targeting regime as practiced in South Africa.

- *Exchange rate stability approach*

This approach sees exchange volatility as a major barrier to growth. It is reasoned that, since a floating exchange regime can be quite volatile, monetary policy should stabilise variations in the exchange rate. However, as Williamson (2003) suggests, this approach does not address the underlying cause of exchange volatility. If exchange volatility is based on underlying real economic factors implementing exchange stability will come at the price of real economic volatility. Alternatively if economic expectations are the source of exchange rate volatility stabilising the exchange rate will cause interest rate instability as speculation takes hold. Akinboade *et al* (2002) suggest that 'middle path' exchange rate regimes are unlikely to be successful in South Africa given its relatively small foreign currency and gold reserves.

Finally, the foreign exchange market distortions caused by adapting an inflexible exchange rate regime have been shown to have a negative effect on long run growth (Fischer,1993). It is for these reasons that only a flexible exchange rate regime, with limited government intervention, is currently sustainable in South Africa.

Concluding Remarks

The pathway to hell, it is said, is lined with good intentions. Similarly COSATU's belief that, *"all policies should be judged by how far they help to create and preserve jobs and to reduce*

poverty" (COSATU, 2007), has caused it to myopically label inflation targeting as 'bad for growth'. The claim, that inflation targeting has limited employment creation, is tenuous at best and at worst simply ignores the true determinants of unemployment in SA.

Moreover the only realistic alternatives to inflation targeting, namely M3 targeting or 'pegging' the exchange rate, are unlikely to be successful in South Africa for reasons of practicality and stability. While by no means a perfect system, the transparency and clear targets of inflation targeting means that it remains the best possible policy with which to stabilise inflation and the macroeconomic environment in South Africa.

This is not to suggest that policy makers should sit idly by in the midst of all this turmoil. Streamlining the policies associated with inflation targeting can play a significant role in providing long-term macroeconomic stability in South Africa. To this end a long hard look needs to be taken at the pricing system of government owned enterprises, the structural immobility of the South African labour market and the information provided by the SARB to the public. By doing so it can be ensured that, when the global downturn ends, South Africa will be in a prime position to accelerate and maintain its growth and development.

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