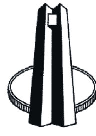


SOUTH AFRICAN RESERVE BANK

The objectives and importance of inflation targeting

What is inflation targeting?

Since the early 1990s, an increasing number of central banks have adopted inflation targeting as their preferred framework for monetary policy. This has replaced frameworks involving using targets for the exchange rate or monetary aggregates. Although initially inflation targeters were industrialised countries, recently an increasing number of emerging-market economies have also adopted this framework, spurred in part by the success of inflation-targeting countries in achieving and sustaining low levels of inflation.

As its name suggests, inflation targeting puts price stability as the primary objective of monetary policy, and the inflation target provides what is known as the nominal anchor for monetary policy. Monetary policy works in part by influencing inflation expectations and this is where the importance of inflation targeting comes in. Because it clearly specifies the inflation objective and a clear commitment to achieving this objective, it can help to anchor the public's inflation expectations, thereby improving planning for the economy, as well as providing an anchor for expectations of future inflation to influence price and wage setting. This is an important part of the rationale for inflation targeting. However, moving to inflation targeting is not enough – the commitment has to be demonstrated in the conduct of monetary policy. Although public commitments can help to shape expectations, ultimately they will only be credible if policy is conducted in a way that is consistent with them.

Inflation targeting is, however, more than simply announcing a target for inflation. The following are usually identified as essential components of an inflation-targeting framework:

- the public announcement specifying medium to long-term targets for inflation which may be a point or a range;
- an institutionalised commitment to price stability as the primary goal of monetary policy, to which other goals are subordinated. This implies that other variables such as the exchange rate should not be targeted. Institutionalising the commitment to price stability lends credibility to the pursuit of this objective;
- increased monetary policy transparency. This implies better communication with the public and the markets about the objectives of monetary policy and the rationale for decisions taken by the monetary authorities; and
- mechanisms for increasing the accountability of the central bank for attaining its inflation objectives.

It is generally accepted that there are two important institutional preconditions required for the successful implementation of inflation targeting, which relate to the relationship between government and the central bank:

- there must be a minimal burden of financing government deficits by the central bank; and
- there must be a strong degree of central bank independence, particularly instrument independence.

South Africa's inflation-targeting framework is characterised by the public announcement of official target ranges for the inflation rate over specific time horizons. Government sets the inflation target after consultations between the Reserve Bank and the National Treasury. This implies that the Bank does not have autonomy in choosing the inflation target (so-called goal independence), but it does have independence in the monetary policy decisions aimed at achieving the target (so-called instrument independence).

Inflation targeting has impacted on monetary policy in a number of ways:

- Inflation targeting has significantly strengthened the Bank's mandate to focus on price stability. Because the numerical inflation target has become the overriding objective of monetary policy, it has created greater certainty about the Bank's policy stance and has made the ultimate objective of monetary policy transparent. The Bank's transparency, accountability and communication have been mutually reinforced with inflation targeting. In previous policy regimes there was no explicit benchmark against which the performance of the Bank could be measured objectively. The adoption of inflation targeting has been followed not only by major improvements in the Bank's communication with the public and markets but there has been a significant upgrade in monetary policy transparency as well. Among the initiatives to increase transparency and communications are the Monetary Policy Forums where the business, labour and the academic sectors, among others, discuss monetary policy with members of the Bank; the publication of the Bank's bi-annual inflation report, the *Monetary Policy Review*; the monetary policy statements issued after each Monetary Policy Committee meeting, and presentations to various audiences by the Governor and deputy governors of the Bank.

Mr T T Mboweni, Governor of the South African Reserve Bank

- Inflation targeting requires nominal exchange rate flexibility. In South Africa's case a fully flexible exchange rate regime has been adopted. This means that there is no specific target for the exchange rate. It does not, however, mean that the Bank is not concerned about the exchange rate, as exchange rate changes do affect the inflation process.
- Inflation targeting increases the co-ordination between monetary policy and other economic policies. It is more effective if there is a commitment from various quarters. At a minimum, there has to be agreement between the Bank and the government. The process would be easier if a similar commitment is obtained from the private sector as well as from the trade unions. If there is credibility that a particular target will be achieved, wages and prices will have a clear reference point, and the transition to lower rates of inflation will be far smoother.
- The pursuit of inflation targets does not mean that the Bank is not concerned about the attainment of sustained high economic growth and employment creation. Monetary policy cannot contribute directly to economic growth and employment creation in the long run.

  However, by creating a stable financial environment, monetary policy fulfils an important precondition for the attainment of economic development. This issue is discussed in more detail below.
- In the application of inflation targeting in South Africa, allowance is made for serious supply shocks. Some discretion must be used in order to avoid costly losses in output and jobs. However, it is also important that the inherent discipline of inflation targeting is not foregone by using unconstrained discretion. The challenge facing the Bank is to apply this monetary policy framework without becoming too inflexible in its approach.
- By adopting a forward-looking approach, inflation targeting should allow monetary policy to reduce volatility in business activity and smooth out the growth trend. A feature of monetary policy internationally in the past was the 'stop-go' phenomenon where monetary policy was tightened only when inflation had clearly moved up. Instead of being pre-emptive, monetary policy was reactive in the sense that it was only changed when inflation became entrenched in expectations and therefore in wage demands. This required a tighter monetary policy stance in terms of higher interest rates and for longer periods than might otherwise have been the case. This resulted in greater cyclical fluctuations, making it more difficult to reduce inflation.

There is no single model of inflation targeting and, as it is a relatively new framework, it has evolved over the past decade. Therefore it should not be seen as a static framework since best practice will evolve as more and more countries adopt it. It is significant that although some countries have missed their targets at times, no country that has adopted inflation targeting has abandoned it. Although in South Africa the target for 2002 is unattainable, the view of the authorities is that the framework has nevertheless contributed to preventing an inflation spiral under difficult circumstances. This has required a tighter monetary policy stance during 2002. However, as inflation recedes and inflation expectations become better anchored, monetary policy can become more flexible. Monetary policy flexibility and greater discretion within the inflation-targeting framework depends on the credibility of economic policy in general and confidence in monetary policy's commitment to long-term price stability in particular.

Why target inflation?

The question that is often posed, not only in the South African context, is why target inflation rather than other variables such as employment or output? The Reserve Bank's mandate is set out in the Constitution as protecting the value of the currency in the interest of balanced and sustainable economic growth. Thus price stability or low inflation, which protects the value of the currency, is not an end in itself. Apart from the fact that high inflation is generally associated with poor economic performance, inflation has a number of other negative social and economic effects.

Inflation has important implications for the redistribution of income and wealth. To the extent that inflation is unexpected, savers and people on fixed incomes will tend to suffer most, while borrowers will gain. Generally people can try and hedge against inflation, but it is usually the wealthy who are most able to protect themselves, for example by borrowing money to buy non-monetary assets. The wealthy often have assets that can more easily be protected against expected inflation. It is generally the case that the poor are most vulnerable to inflation. The ability of the working poor to protect themselves will depend on their wage-bargaining power. The non-working poor are dependent on the degree to which any social welfare benefits that they may be receiving are linked to inflation. It should also be noted that the current inflation has been driven primarily by higher food prices. As the poor have a higher weight for food in their consumption basket, the inflation rate facing the poor has been significantly higher than that of the higher income groups.

Inflation also distorts the tax system, as most tax systems do not allow for inflation. Even if incomes rise with inflation, they often then move into a higher tax bracket. This results in disproportional increases in tax payments. Similarly, interest earned by taxpayers is treated as income, even though a large proportion of the interest receipts are supposed to compensate borrowers for the higher inflation, rather than being real income.

Finally, inflation results in increased uncertainty which makes economic decision-making more difficult. High inflation is usually also accompanied by greater price variability. The confusing price signals make the price system less efficient, and the result is lower levels of investment and growth. This leads the Bank to believe that the best contribution that monetary policy can make to growth is to provide a low and stable inflation environment that is conducive to sustainable long-term growth.

Why not target growth directly with monetary policy? It goes without saying that the target of monetary policy should be something that monetary policy can achieve. It is the view of the Bank that although monetary policy can impact on cyclical unemployment and growth over the cycle, it cannot determine long-run trend real growth. Growth in the long run is determined by real variables and other supply-side factors, including government policies and the general macroeconomic environment that monetary policy contributes to. Monetary policy can attempt to drive up growth rates beyond potential by having artificially low interest rates. This may work in the short run, but ultimately the result will be high inflation, a weak currency and contractionary policies to reverse the damage. Such an attempt to generate high growth will merely guarantee high inflation and lower growth. A stable monetary policy will lead to a stable environment of low inflation and low interest rates, although this in itself is not a guarantee of high growth which is determined by other real factors in the economy.

Does inflation targeting ignore growth?

Does the primacy of the inflation target mean that the Reserve Bank is not concerned with growth issues? There is a view that the response to the recent surge in inflation suggests that the Bank is not concerned with the real side of the economy. However, 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. There is nevertheless a trade-off between inflation variability and output variability in the short run.

It is perhaps instructive to distinguish here between what is usually referred to as strict and flexible inflation targeting. Strict inflation targeting is when only inflation enters the central bank's objective function, while flexible inflation targeting is when other variables, such as output, have a positive weight in the objective function. The fact that most central banks do not disregard other variables means that flexible inflation targeting is the general case. It is also generally the case that in the early phase of inflation targeting, a greater weight is put on inflation as credibility is built up. The question then becomes how flexible, or what weight is assigned to output in the reaction function?

A strict inflation targeter will try to hit the target as quickly as possible under all circumstances. A flexible targeter will gradually push inflation towards its target. Most inflation targeting models show that the stricter the inflation targeter is, the more variable output will be. Too narrow a focus on inflation will result in interest rate and output instability.

By contrast, too much of a focus on the cyclical growth issues will result in greater inflation variability, and lower credibility for the whole inflation targeting framework, particularly in the early days of the introduction of inflation targeting. The issue then is the appropriate trade-off between rigid adherence to the inflation target on the one hand and a steady path of output on the other, bearing in mind credibility considerations.

Should the Reserve Bank be classified as a 'strict inflation targeter'? It is not the case that monetary policy is not concerned with the real economy.

Strict inflation targeting would have attempted, perhaps vainly and at a high cost, to achieve the 2002 target after the exchange rate shock of late last year.

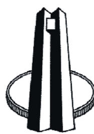
The concern is also about the pace of disinflation. Had the Bank been a strict inflation targeter, there would have been a much tighter schedule for reaching the inflation targets and much lower targets. The initial and subsequent targets were set on the basis of what was attainable without putting undue pressure on output. The objective remains the reduction of inflation but implicit in this is a recognition that an excessively fast reduction in inflation will have high costs.

Whether or not inflation targeting had been adopted, monetary policy would still have to be focused to some extent on inflation. Had there been an exchange rate target and the economy had been subjected to an exchange rate shock of a magnitude as was recently the case, the need to defend the exchange rate would most likely have resulted in significantly higher interest rates. Similarly, had monetary aggregates been targeted, there can be no presumption that it would have resulted in a lower interest rate outcome.

It is likely, as was acknowledged in the March Monetary Policy Committee statement, that recent monetary policy actions would have some negative effect on output. This, however, should be weighed against the cost that would have been incurred if a different framework had been adopted, and indeed against the cost of not acting at all, and having to adopt an even tighter stance in the future. Acting sooner, if successful in preventing an inflation spiral, could reduce the amplitude of the interest rate cycle and contribute to lower output variability.

One of the consequences of inflation targeting has been greater interest rate stability. This is reflected in the less vigorous response to events such as the oil price shock in 2000, the exchange rate developments in 2000 and 2001 and the money supply developments in the second half of 2001. Excessive focus on or targeting of these variables would probably have resulted in greater variability in interest rates.

A more stable interest rate environment, particularly a more stable real interest rate environment, is more conducive to sustained economic growth.



SOUTH AFRICAN RESERVE BANK

The revision of the targets: have the Government and Reserve Bank gone soft on inflation?

The initial inflation target was for CPIX, which is headline consumer inflation excluding mortgage interest cost, to average between 3 and 6 per cent in 2002. Subsequently the target for 2003 was set at 3 – 6 per cent and 3 – 5 per cent for 2004 and 2005. Inflation then accelerated sharply in the wake of exchange rate developments in late 2001. The Minister of Finance and the Governor conceded recently that despite the cumulative 400 basis point increase in the repo rate during the course of the year, the targets for 2002 and 2003 might not be attained. In addition, the target for 2004 was amended to 3 – 6 per cent and the 3 – 5 per cent target fell away until further notice.

Although the change of the target for 2004 has generally been favourably received, it has been criticised by some as representing a lack of commitment to the inflation target. It should however be emphasised that whereas the goal of inflation targeting is to achieve the target, the objective is not to hit it as quickly as possible or at all costs.

Most central banks would regard themselves as flexible inflation targeters. This does not necessarily mean that they have dual or multiple objectives, but rather they are mindful of the costs of attaining the target or getting back to the target when they are knocked off course. It is generally the case that central banks, when they find themselves outside the target, do not try to get back to the target as quickly as possible. Most central banks choose a policy horizon within which to influence inflation outcomes. The horizon is determined by various factors including the time lags between a change in monetary policy and its impact on inflation, the behaviour of inflation expectations and the importance a central bank may attach to other policy objectives.

How do some of the other central banks behave? In Canada, a policy horizon of six to eight quarters is specified for getting back to the target. Other countries have greater flexibility. The Swedish framework specifies an horizon of one to two years, although departures from this general rule may be warranted. According to Sweden's central bank, the Riksbank, a mechanical approach that invariably attempts to bring inflation back to the targeted level within the next one to two years could, in certain cases, lead to unduly large and undesirable fluctuations in economic activity. Such extensions to the horizon should not represent a change in the fundamental commitment to long-term price stability.

> "... a mechanical approach that invariably attempts to bring inflation back to the targeted level within the next one to two years could, in certain cases, lead to unduly large and undesirable fluctuations in economic activity."

In the UK, the Monetary Policy Committee of the Bank of England is given the flexibility to propose the horizon over which a deviation from the target will be rectified. This will depend on the nature and severity of the initial shock which caused inflation to deviate from the target.

The Australian approach recognises the fact that responses to monetary policy actions may differ depending on the phase of the business cycle. The target is therefore specified as keeping the underlying inflation between 2 and 3 per cent on average over the cycle, which allows for short-run variations and deviations from target. Recently the New Zealand system has adopted a similar approach whereby the inflation target is specified over the medium term to give the Reserve Bank greater flexibility in deciding how to respond to shocks to the economy and inflation variations around the target.

In South Africa, the issue is complicated by the fact that inflation has not yet come down to its long-run level. When inflation gets thrown off course, the question is not only how quickly to get back to where it was before the shock, but also whether the original disinflation path and time frame should be maintained. The original targets were set on the basis of what was believed to be an attainable and sustainable disinflation path. This path and speed of disinflation were chosen as it was felt to be the optimal rate of disinflation that would not unduly affect the real economy.

At the time when these targets were set there was a general belief that the targets for 2002 and 2003 would be attained. For example, in September 2001, at the time when the targets were being decided upon, the Reuters consensus forecast for the CPIX average for 2002 was 5,8 per cent and 5,4 per cent for 2003. In October the consensus forecast for 2002 was 5,7 per cent and 5,4 per cent in 2003. The Reserve Bank and National Treasury forecasts were in line with these forecasts.

The targets therefore can be said to have been set on the basis of some notion of an optimal disinflation path. Subsequent to the setting of the targets, the unexpected increase in inflation made the target for 2002 unattainable unless draconian monetary policy measures were adopted. A policy of strict inflation targeting would have required getting back to the target as quickly as possible, irrespective of the cost. However, the higher level of inflation meant that to try and achieve the original targets within the same time period would clearly not be optimal.

Under such circumstances, maintaining the target at 3 – 6 per cent for 2004 does not mean that the authorities have reduced their commitment to lower inflation. Rather, it is a recognition that there are long lags in monetary policy; trying to achieve a target too quickly may not be technically feasible; and achieving a target too quickly may come at an unacceptably high price, particularly if the reason for the deviation from the disinflation path is not the result of Reserve Bank policy in the first place. Missing or changing a target does not necessarily undermine the inflation targeting framework as a whole, as long as there is a sustained commitment to low inflation.

SOUTH AFRICAN RESERVE BANK

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Making monetary policy decisions

One of the questions often raised in the context of monetary policy is the monetary policy decision-making process. More particularly, many people are curious about the practical aspects of how the Bank decides whether or not to change interest rates.

The Monetary Policy Committee (MPC) was reconstituted at the beginning of 2002 and currently comprises seven members: the Governor, two deputy governors and four senior officials of the Reserve Bank. The MPC will increase to eight when the vacant position of third deputy governor is filled.

Previously, meetings were held every six to eight weeks, but since the beginning of this year quarterly meetings have been scheduled to coincide with the release of quarterly data in the Bank's *Quarterly Bulletin*. However, provision is made for unscheduled meetings if the need arises, as was the case with the unscheduled meeting in January 2002.

Although the meetings are held quarterly, there is an almost continuous monitoring of economic developments, particularly those that impact on inflation and monetary policy. Members receive briefing updates and analysis and research output from various units in the Bank, as well as material from various external domestic and international sources, including financial institutions, academic economists, and international organisations such as the International Monetary Fund and the Bank for International Settlements.

The MPC cycle begins in earnest approximately two to three weeks prior to the scheduled meeting, when members meet with the Macro Models Unit. By then the modellers will have consulted various other units regarding the assumptions made about the exogenous variables of the models. The assumptions are presented to the committee and, in the ensuing discussions, changes to the assumptions may be suggested, or requests made for alternative scenarios to be considered during the forecasting process. This process ensures that there is 'ownership' of the forecast by the committee.

The first day of the scheduled MPC meeting starts with presentations on special items of topical interest that are prepared on an ad hoc basis, usually at the prior request of the MPC. In the past, such topics have included analyses of food prices, international oil prices and the role of monetary aggregates in the inflation process. This is followed by a review of economic developments which entails presentations on different aspects of the economy, prepared by various departments in the Bank and presented by the respective unit or departmental heads. The members of the committee will have received a full set of documentation the previous week.

The standard agenda for the economic developments is as follows:

- **International economic conditions:**
  prepared by the International Economy Unit of the Research Department.
- **International financial markets:**
  prepared by the International Banking Department.
- **Domestic money and capital markets:**
  prepared by the Money and Capital Markets Department.
- **Financial and fiscal developments:**
  prepared by the Financial Analysis and Public Finance Unit of the Research Department.
- **National economic conditions:**
  prepared by the National Economy Unit of the Research Department.
- **Economic projections:**
  the forecasts of the various econometric models developed by the Macro Models Unit of the Bank's Research Department are presented, along with surveys of inflation expectations.

Each presentation is followed by a discussion. These presentations usually continue until late afternoon, and up to that point the monetary policy stance is not discussed. In the evening there is a working dinner where some of the issues raised during the course of the day are discussed further, with a focus on the implications for the monetary policy stance.

The following morning begins with a summary of the discussion of the previous evening. A discussion of the monetary policy stance ensues. Committee members are then asked in turn to express their views on the appropriate monetary policy stance and on any interest rate changes that may be deemed appropriate. In general, decisions are made by consensus or with a majority view, without a formal vote being taken.

Once the decision is taken, the statement to be issued is finalised. To ensure that the embargo on the release of the decision is not broken, the statement is released to the press at the same time that the Governor reads the statement live on national television at 15:00.

Monetary policy decisions are made on the basis of current and expected developments in a number of variables, which are also the main drivers of the Bank's forecasting models. As described above, the MPC monitors a number of factors that influence inflation. These factors include money supply and credit extension; changes in wages and productivity and unit labour cost; the output gap, exchange rate developments and import prices, oil prices and other administered prices. There is no target for any of these variables other than for CPIX, which is the benchmark for monetary policy decisions.

This implies that greater emphasis is given to the forecast than in the past. However, it is important to stress that there is not a mechanical relationship between the forecast and monetary policy decisions. Because of the uncertainties inherent in the forecast, the models and forecasts are aids to policy making, but the final decision has to be a judgement call based not only on the forecast but also on other information.