Introduction

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Inflation targeting as a regime governing the conduct of monetary policy has, as its central features, the setting of an announced, forward-looking numerical target level or range for an inflation measure, and a commitment by the central bank to operate monetary policy with that target as its overriding objective. South Africa formally adopted inflation targeting in 2000, setting a 3 to 6 per cent target range for inflation to be achieved in 2002. Although the South African Reserve Bank (the Bank) already had a constitutional and statutory obligation to maintain the value of the currency, the new framework set out in the Governor's statement marked a turning point in the way monetary policy was to be conducted (South African Reserve Bank, 2000).

South Africa's decision to switch to inflation targeting followed New Zealand's 1990 innovation, and an increasing number of countries that have taken similar decisions. Following New Zealand, several developed market economies adopted inflation targeting and since the late 1990s they have been joined by emerging-economy countries. By 2007, eight developed and sixteen emerging economies had adopted formal inflation targets (IMF, 2005; Portugal, 2007), and the 2006 appointment of Ben Bernanke, a proponent of inflation targeting, as Chairman of the Federal Reserve Board, raised the possibility that the United States (US) might join the trend.

A significant body of statistical evidence shows, with rare exceptions, that countries adopting inflation targeting have obtained benefits in terms of inflation levels, inflation and output volatility, and other macroeconomic measures. Nonetheless, its value for any particular country cannot be taken for granted and in any country the framework should be re-examined as circumstances change.

The papers in this volume examine inflation targeting at a time when circumstances were evidently changing. High growth in the world economy since 2001 had generated inflationary pressures, particularly through global commodity prices, as discussed in the paper by Logan Rangasamy. By late 2008, several inflation-targeting emerging countries were experiencing inflation higher than their target. In September 2008 the banking crisis, centred on the US and United Kingdom (UK), had developed into an unprecedented crisis of financial firms and markets with global impact and strong recessionary effects. As David Llewellyn,

Dennis Dykes and Hendrik Nel make clear, the financial crisis had both proximate and ultimate causes, and was partly attributable to regulatory failures and poor incentive structures. Global macroeconomic imbalances and the resulting flows of liquidity were contributory factors. Such a financial system shock, real recession and possibly interruption to the trend of increased global integration would test the value of inflation targeting.

Recognising that changing circumstances made an evaluation of policy lessons timely, the Bank initiated a focused examination of policy issues related to inflation targeting in South Africa and the papers in this volume, delivered in October 2008, are the result.

As well as contributing to the country's policy discussion, the arguments are likely to be relevant to other countries, especially those economies with similarities to South Africa. Moreover, as the papers here recognise, other countries' experience could have valuable lessons for South African policy. Relevant characteristics of South Africa's economy during the period under investigation have been a highly developed financial sector, a respected tradition of central banking, fiscal discipline, a liberal trade regime with minerals and other commodities contributing a high proportion of export revenue, openness to foreign capital, and a formal labour market based on a high degree of employer and employee organisation. What lessons can be drawn from South Africa's experience?

Brian Kahn's comprehensive paper provides the framework for thinking about inflation targeting, drawing upon both theory and experience. Most critics of international moves towards inflation targeting have argued that it too rigidly forces central banks to achieve inflation targets at the cost of growth, medium-term output and employment. In South Africa, where unemployment has been chronically high and productive investment in important sectors has been low, a perception that inflation targeting hinders growth has fuelled arguments for changing objectives. Concern over the medium-term effect of inflation targeting has focused on the susceptibility of South Africa's open economy to supply shocks – the danger of a rise in the world price of oil being a paradigmatic concern – for a rigid inflation target would be procyclical, magnifying the output effect of the shock by forcing a tightening of monetary policy. A central theme of Kahn's paper is that inflation targeting does not usually act as a rigid corset preventing monetary policy from having regard to variables such as a measure of the output gap; in Bernanke's phrase it should best be seen as a framework for constrained discretion.

An important mechanism allowing inflation targeting to adjust to medium-term output fluctuations is that, without changing the inflation target itself to accommodate deviations, the time horizon for achieving it can be chosen to allow tolerance of short- or medium-term above-target

inflation. Kahn argues that this is not only desirable, but also that South Africa's monetary policy, like that of other countries, has operated with the flexibility conferred by having a target with temporary deviations permitted. As Kahn concludes, "The target itself is an anchoring device, and the central bank should take credible action to get back to within the target. However, there is always a difficult trade-off between flexibility and credibility." The evidence on inflation targeting in South Africa, summarised in the papers by Kahn and Stan du Plessis, suggests that it has been broadly successful in terms of macroeconomic outcomes. Between September 2003 and April 2007 inflation was kept well within the target range. Since 2000 inflation rates have been lower than in the decade before the introduction of inflation targeting, and targeting has been consistent with high output growth and low volatility until 2008. It has been broadly countercyclical, although evidence of a procyclical effect in 2004 and 2005 illustrates the difficulty of judging the optimal degree of flexibility.

Colen Garrow argues that South Africa's inflation targeting has been less successful, particularly since the beginning of a monetary-tightening cycle in 2006, which has not brought inflation down to its target range. Garrow argues that global supply shocks and structural transformation in South Africa created conditions that required inflation targeting to be more flexible than it had been. While the target range had remained unchanged at 3 to 6 per cent, infrastructure investment and consumer credit growth associated with social change warranted adopting a target of 3 to 7 per cent temporarily in order to ease the effects of high interest rates on the real economy.

The effectiveness of a forward-looking inflation-targeting regime depends, to a large extent, on the ability to forecast inflation accurately. Forecasts of macroeconomic variables in any country have generally suffered from a notable weakness, namely their poor record for forecasting turning points. As Janine Aron and John Muellbauer point out, the papers in this volume were written and discussed at a historic conjuncture as a global boom had ended and economies were on the edge of a severe downturn. That posed a significant problem for forecasting price-level changes, as high inflation rates were likely to give way to low or negative rates. Simple time series models, using vector autoregressive (VAR) techniques, are not well suited to forecasting inflation, especially at turning points, and Aron and Muellbauer argue that a structural approach is superior.

Their method uses fundamentals (i.e., unit labour cost; output gap; and measures of international adjustment in goods and capital markets) as explanatory variables and attempts to take account of long lags and structural breaks. An indicator of the value of such an approach, applied to disaggregated data, is their finding that forecasting inflation in the

components of the overall consumer price index (CPI) and then aggregating produces more accurate results than estimating CPI forecasts directly. As Johannes Fedderke argues, such structural models of inflation are promising, but the modelling and estimation results have to be judged against other estimates of related structural models and, as Aron and Muellbauer suggest, their work should be seen as a stimulus to further structural modelling of inflation.

Aron and Muellbauer's approach brings into sharp focus an issue that is of wide significance for successful targeting, namely the need for good statistical series. It is illustrated by their discussion of measures of housing-cost inflation as one component of CPI inflation. More generally, it illustrates one difficulty that emerging economies, which may have relatively weak data, face in implementing inflation targeting.

Nonetheless, however imperfect the data underlying macroeconomic modelling, the Bank has to make policy judgements in the face of changing macroeconomic circumstances. For South African policy, one major challenge has been the increase in the current-account deficit since the start of inflation targeting, continuing a trend that started earlier and, by the first quarter of 2008, resulted in a deficit at 8,9 per cent of gross domestic product (GDP). The increased deficit was linked to a worsening of the balance of trade, and, as Logan Rangasamy and Roger Baxter show, fluctuations in world commodity markets and the response of South Africa's mineral producers to them are of key importance for the evolution of both the trade deficit and inflation.

Inflation targeting has been accompanied by a relatively clean float of the rand and a decline in the trade-weighted real exchange rate, but the real depreciation did not reverse the current-account trend and had been moderated by strong inflows of foreign capital. The papers by Ben Smit, Elna Moolman and Khathu Todani address the implications of the balance of payments for policy, largely by considering the sustainability of the deficit and the implications of a reversal of the current-account deficit, whether produced in response to a sudden reversal of capital flows ("sudden stop"), the likelihood of which was heightened by investors' "flight to safety" in the global crisis, or by policy measures in advance of such a shock. Based on both comparative international experience and the authors' calculations of likely South African outcomes, they find no reason to change monetary policy, or use the flexibility that Brian Kahn highlights as inherent in inflation targeting, in an attempt to adjust the current-account deficit. In any case, with free external capital flows, inflation targeting would be inconsistent with engineering a current-account adjustment by targeting a nominal exchange rate depreciation. That raises the question of whether capital controls should have a role, giving monetary policy more room to manoeuvre. The papers by Laurence Harris

and Eric Schaling conclude, on the basis of international comparisons and South Africa's own experience, that there is no case for renewed capital controls in South Africa.

The papers in this volume engage with macroeconomic challenges facing inflation targeting. As is well established in the literature, necessary conditions for the success of inflation targeting include the institutional and political economy framework in which it is embedded. More specifically, the dissemination of information and the transparency of the reasoning behind policy decisions can have important effects. This volume is a contribution to such transparency in the context of South Africa.

References

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