South African Reserve Bank

Let's base discussion of monetary policy on facts

By Lesetja Kganyago

As the Governor of the South African Reserve Bank, I welcome debate on the part played by monetary policy in national development. But on the emotive topic of money, we should insist that our national discussion is informed by facts. All too often, public debate is framed by those who claim to speak for 'the person in the street' while their arguments suggest otherwise.

It's on the basis of informed debate that our society can progress and millions of our fellow citizens can achieve a higher standard of living and a better quality of life. So, in the spirit of informed debate I shall share some evidence and analysis. At the outset, I would like to make a few general points about monetary policy.

First, no matter the policy framework, monetary policy is always about supporting economic growth in a sustainable way. Experience shows that economies grow stronger and more consistently at lower inflation rates. This applies irrespective of the policy framework, be it inflation targeting, money-supply targeting, fixing the exchange rate, or even administratively-determined credit extension. However, each approach has its pros and cons. And some have proven over time to be better at achieving that basic mission of controlling inflation in support of sustainable economic growth.

It would appear from the present discussion that some proponents of a new approach to monetary policy favour higher inflation. This is a legitimate position to hold, and I would encourage that we have a transparent debate around this. Advocates of policy change should specify which approach they favour, clarify why they prefer it, demonstrate how it would improve on the current outcomes, and then explain how it would be implemented.

Why does monetary policy seek to keep inflation low and encourage a sustainable rate of economic growth? Because the costs of inflation are substantial – and often severe. And because inflation nearly always imposes the greatest costs on the poor and other vulnerable citizens.

Among those with short memories, a common argument is that the working class in particular benefits from inflation. The idea is that businesses can be lured into hiring more people and paying higher salaries if interest rates are cut and/or more money is printed by surprise. But businesses cannot be surprised continuously; they inevitably figure out what the central bank is trying to do. The end result is more inflation, higher interest rates, and declining confidence and investment. This policy was tried and subsequently discredited by the experience of many developed economies in the 1970s. Developing countries such as Brazil adopted this approach in the 1980s. The results were damaging, as the jobs created early in the period of

rising inflation had to be cut later. Indeed, the past half-century is littered with examples of drawn-out and painful recessions caused by the need to reduce runaway inflation created by authorities trying to use the 'money illusion' to create more growth by printing money.

Rising inflation also generates its own self-fulfilling outcome because it causes currencies to depreciate and drives up import prices, in turn creating more inflation and pushing up interest rates. We need only to look at the price of petrol to understand this: whenever the rand weakens, all South Africans pay more for fuel, paraffin and transport. We then demand higher salary increases, broadening the import price increase into a generalised inflation problem. So even as economic growth weakens, price inflation remains high – and so too do interest rates.

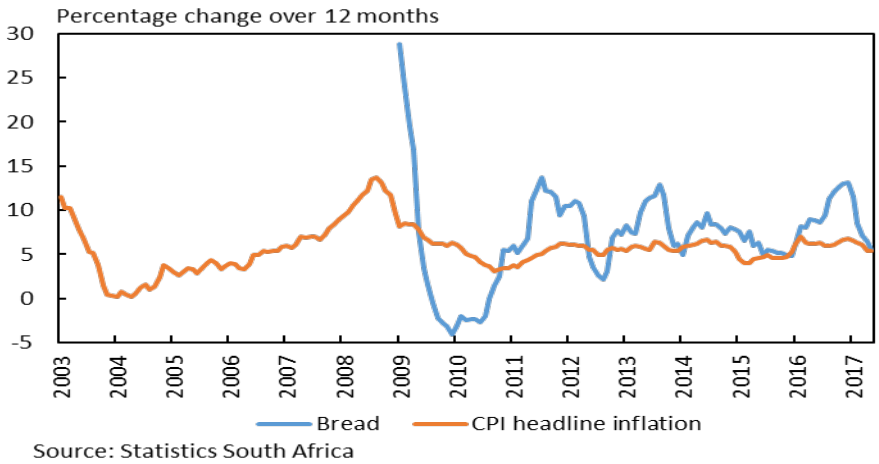
Second, high inflation penalises the poor, not the wealthy, and deepens inequality. Table 1 shows that, since 2000, the inflation rate faced by poorer South Africans has been nearly 1 percentage point higher per year than that for wealthier citizens (7.0% compared to 6.1%). This means that, with an average inflation rate of 6.2% over the past 16 years, poorer South Africans' income has fallen behind by about 13.5% compared to that of wealthier South Africans – a significant contribution to inequality driven entirely by different rates of inflation experienced.

Table 1: Headline inflation and per expenditure quintile, 2000–2016 (average)

	Per cent
Targeted inflation	6.2
Lowest quintile	7.0
Fourth quintile	6.8
Middle quintile	6.6
Second quintile	6.5
Top quintile	6.1

Why the difference? For the most part, it is because average spending patterns vary according to different income levels, resulting in varying inflation rates. Consider, for instance, the price of bread, which is more volatile than consumer price inflation (CPI). As Figure 1 shows, from January 2009 to May 2017, bread prices rose annually by an average of 7.1% compared with a 5.6% increase in overall consumer prices. So households that spend more of their income on bread would have experienced higher inflation than those that consume less of it, all else being equal.

Figure 1: Bread prices compared to consumer prices



The solution to this problem is not to encourage higher inflation, which would only push up the price of bread. The solution is to keep inflation low, keeping critical prices (like the cost of borrowing) low to support investment and grow the economy, stimulating job creation and raising wages for millions of South Africans. Effective competition policy also plays an important role in this regard.

Third, what about economic growth? In the 1970s, many economists and commentators supported the idea that higher inflation would increase real economic growth. This is clearly not true today, and certainly not in South Africa. Below, in Table 2, are the period averages for the prime rate and CPI in South Africa.

Table 2: Period averages for the prime rate and CPI in South Africa – 1990 to now

	Prime rate	Inflation	Real prime rate	Real GDP growth
1990s	18.9	9.9	9.0	1.4
2000-2009	13.2	6.8	6.4	3.6
2010-now	9.4	5.4	4.0	2.0

Table 2 shows us that the average prime rate has consistently declined since the 1990s. And as inflation fell, average gross domestic product (GDP) growth strengthened. The introduction of inflation targeting reinforced that trend. What about more recently?

Table 3 compares South Africa to 11 of its developing-country peers. Since the most recent global recession, South Africa has had the second-*highest* average inflation rate but the fourth-*weakest* growth rate. Countries that have succeeded in getting rid of high inflation have improved their growth performance. If we compare performance before and after the global financial crisis, we see the same pattern. South Africa has had a consistently higher inflation rate *and* a lower economic growth outcome.

Table 3: Comparative inflation targets, inflation, and growth outcomes

	Since 1990		Since the introduction of inflation targeting (2000)		Since the global financial crisis (2007/08)	
	Inflation	**Growth**	**Inflation**	**Growth**	**Inflation**	**Growth**
Brazil	316.6	2.2	6.7	2.4	6.8	1.4
Chile	6.5	4.8	3.4	3.8	3.2	3.9
Colombia	11.5	3.6	5.5	3.6	3.8	4.1
Czech Republic	3.2	2.5	2.6	2.5	1.4	1.8
Hungary	11.1	1.2	4.2	2.0	2.3	1.7
Korea	3.8	5.3	2.6	3.9	1.9	3.5
Mexico	10.4	2.8	4.2	2.2	3.6	3.1
Philippines	6.1	4.3	3.9	5.4	3.1	6.3
Peru	301.0	4.4	2.8	5.6	3.1	5.2
Poland	33.1	3.3	3.4	3.7	1.4	3.1
Thailand	3.0	4.5	1.9	4.0	1.9	3.6
South Africa	**7.3**	**2.4**	**5.8**	**3.0**	**5.4**	**2.0**
Median	8.9	3.4	3.7	3.6	3.1	3.3
Mean	59.5	3.4	3.9	3.5	3.2	3.3

So, we've had higher inflation outcomes and lower growth outcomes than our peers. We've also had higher inflation targets, as shown in Table 4.

One of the reasons why low inflation supports economic growth is because it helps to reduce interest rates over time. Financial systems become more inclusive when the cost of borrowing falls. This is of immense importance to working-class and middle-income families who seek to borrow money for education, or to start a business. Moreover, low inflation encourages long-term investment, creating growth and sustainable jobs. But these things do not happen simply when the repo rate is lowered; they happen when inflation is lower permanently.

I would like to conclude with an apology and an appeal. My apology is that, because monetary policy is a complex topic, I cannot deal with all its complexities here. But in the period ahead, my colleagues and I will increase our engagement with the public and clarify what we think is a sensible view of monetary policy for South Africa. At the heart of that view is the recognition that a central bank's accountability is critical to how it achieves its mission. This was one of the reasons why we adopted inflation targeting in the first place: it allows for a transparent target against which the South African Reserve Bank can be judged.

My appeal, to all South Africans, is to discuss policy options based on evidence and analysis. For our part, in addition to our monetary policy forums across the country, we will come up with more and better ways to foster that dialogue. Stay tuned.

Table 4: Emerging market inflation targets and dates of adoption

	Inflation target	Date adopted
Brazil	4.5% +/- 2%	1999
Chile	3% +/- 1%	1999
Colombia	3% +/- 1%	1999
Czech Republic	2%	1998
Hungary	3% +/- 1%	2001
Korea	3% +/- 1%	2001

Mexico	3% +/- 1%	2001
Philippines	4% +/- 1%	2002
Peru	2% +/- 1%	2002
Poland	2.5% +/- 1%	1998
Thailand	0.5%-3.0%	2000
South Africa	**3%-6%**	**2000**