A new monetary policy framework

Appendix to the statement issued by Mr T T Mboweni, Governor of the South African Reserve Bank, on 6 April 2000

Introduction

On 23 February 2000 the Minister of Finance announced in the Budget Speech that the government had decided to set an inflation target range of 3 to 6 per cent for the year 2002. The Reserve Bank has therefore formally adopted an inflation-targeting monetary policy framework. This means that the monetary authorities are now targeting the rate of inflation directly instead of following the previously applied "eclectic" monetary policy approach in which intermediate objectives still played a prominent role. In this statement the new monetary policy framework is explained in more detail.

Primary objective of monetary policy

The primary objective of monetary policy is to protect the value of the currency in order to obtain balanced and sustainable economic growth in the country. This objective is articulated in both the Constitution of the Republic of South Africa and in the South African Reserve Bank Act, No 90 of 1989. It requires the achievement of financial stability, i.e. price stability as well as stable conditions in the financial sector as a whole.

Price stability is achieved when changes in the general price level do not materially affect the economic decision-making processes. Although relative price movements will still have an impact on production, consumption, saving and investment, the rate of inflation or deflation would be so low that it would no longer be an important factor in economic decision making.

Stable conditions in the financial sector are achieved when there is a high degree of confidence that the financial institutions and financial markets are able to meet contractual obligations without interruption or recourse to outside assistance. Such stable conditions do not preclude the failure of individual financial institutions. A financial institution may fail and be allowed to fail even under stable financial conditions. It is only when the whole, or an important part, of the financial sector is at risk, that the situation can be described as financially unstable.

The two elements of financial stability, i.e. price stability and the stability of the financial sector, are closely related. Failure to maintain one of these elements provides an uncertain operating environment for the other, with causality running in both directions. For example, high inflation could lead to tighter monetary policy, higher interest rates, an increase in the non-performing loans of banks and a fall in asset and collateral values, which could precipitate bank and other failures in the financial sector. Conversely, disruptions in the financial system will make the transmission of monetary policy less effective and could materially affect changes in the general price level.

Financial stability is not an end in itself, but is regarded as an important precondition for sustainable high growth and employment creation. By establishing and maintaining financial stability the monetary authorities make their unique contribution to general economic development in South Africa. If financial institutions and markets are uncertain or unstable it is difficult to produce, consume and invest, and therefore to increase employment. The recent emerging-market financial crisis in 1997 and

1998 has also clearly illustrated that foreign investment can be withdrawn easily and in large amounts from countries that investors perceive as high-risk destinations. Moreover, it is difficult for a country with a high rate of inflation to remain competitive in a global environment where more and more countries have already successfully reduced inflation to low levels.

Inflation has many other disadvantages, such as:

- distorting the allocation of resources and often directing the efforts of entrepreneurs and investors into hedging operations instead of productive activity;

- discouraging saving: people spend money now rather than save for investment and future consumption if the expected value is much less;

- discriminating against fixed salaried workers, pensioners and low-income earners who cannot protect themselves against the impact of inflation; and

- usually leading to an even more unequal distribution of income and wealth.

The new inflation-targeting monetary policy framework is primarily concerned with one element of financial stability, i.e. price stability. For overall financial stability it is important that the Reserve Bank

- ensures the availability of high-quality currency in circulation in various denominations to serve as a reliable means to execute financial transactions in the economy;

- facilitates the development and maintenance of an efficient national payment, clearing and settlement system;

- encourages the development and efficient functioning of the money, capital and foreign exchange markets;

- monitors the financial risks of banks and supports the development of sound and well-managed banking institutions; and

- where appropriate, acts as lender of last resort providing assistance to solvent banks to safeguard the system from systemic risks arising from temporary liquidity shortages.

Inflation targeting

The government decided to set an inflation target as part of a new approach to monetary policy and price stabilisation because of certain advantages that such a framework is expected to have, such as:

- making the objective of monetary policy clear and thereby improving planning in the private and public sectors;

- forming part of a formalised co-ordinated effort to contain inflation in pursuit of the broader economic objective of sustainable high economic growth and employment creation;

- helping to focus monetary policy and enhancing the accountability of the central bank to the public; and

- providing an anchor for expectations of future inflation which should influence price and wage setting.

Inflation targeting is a monetary policy framework characterised by an announcement of a numerical target for the inflation rate that is intended to be achieved over a specific time period. In this definition it is important to note that inflation targeting is a framework not a rule, that the numerical rate is made public and that a definite time horizon is specified.

Although the achievement of the target becomes the overriding objective of monetary policy in an inflation-targeting framework, the adoption of the new framework does not mean that the central bank must apply rigid rules and is left without any discretion. Exclusive emphasis on inflation goals without a careful analysis of economic conditions can lead to serious distortions in the economy which could result in higher inflation over the long term. A rigorously applied rule deprives the central bank of its ability to deal with unusual or unforeseen circumstances.

In the application of inflation targeting in South Africa allowance will be made for serious supply shocks. Some discretion must be applied in order to avoid costly losses in terms of output and jobs. The Reserve Bank will have to monitor economic developments closely to determine the origin and likely impact of such supply shocks. It is not possible to specify in advance all the economic shocks that could affect monetary policy. Such shocks could include developments affecting the terms of trade of the country or large disruptive international capital flows. They could also arise from natural disasters. If such developments do occur, the public will be duly informed of the likely consequences for attainment of the monetary policy objective.

It is, however, also important that the inherent discipline of inflation targeting should not be foregone by applying discretion. The objective of the exercise is, after all, to achieve the target range. An inflation-targeting monetary policy framework can only be successful if the public is convinced that the central bank is serious about containing inflation. The benefits of inflation targeting depend on whether wage and price setting are responsive to the inflation target of the authorities. Public buy-in is essential to obtain low inflation and its consequent benefits for all. This requires a national effort, anchoring expectations around the inflation range. The challenge that the Reserve Bank faces is to apply this monetary policy framework without becoming too inflexible in its approach.

The numerical inflation target becomes the ultimate objective of inflation targeting. The immediate focus on intermediate targets such as the growth in money supply and bank credit extension falls away because an intermediate target can only be responded to when it is the dominating factor determining inflation within the specified time frame.

The growth in money supply and bank credit extension will, however, still be monitored closely, together with other economic indicators. These include the level of international interest rates, the shape and position of the yield curve, changes in nominal and real salaries and wages, changes in employment, nominal unit labour costs, the gap between potential and actual national output, general money-market conditions, changes in asset prices, the overall balance of payments position, the terms of trade, exchange rate developments and the public sector borrowing requirement.

The numerical inflation target is announced explicitly to the public to indicate clearly what the Reserve Bank should be held accountable for and to make the application of this framework as transparent as possible. The announcement of the target makes the intentions of monetary policy explicit. If targets are not met, the central bank has to explain what went wrong. Regular reporting on the stance of monetary policy, as is the case internationally, will be made to Parliament.

The monetary policy stance will also be communicated regularly to the public. This is already done by means of a monetary policy statement after the completion of every meeting of the Monetary Policy Committee. A Monetary Policy Forum has also been established to open an avenue for ongoing discussions on monetary policy and general economic developments and to ensure that the views of interested parties are taken into account in the determination of monetary policy. The Monetary Policy Forum will meet twice a year in the major centres of South Africa to allow as many stakeholders as possible to participate in these discussions.

The Reserve Bank will also publish twice a year a Monetary Policy Review to increase transparency in the application of monetary policy. This Monetary Policy Review will attempt to describe in more detail the decisions taken by the central bank and will analyse developments in South Africa and the rest of the world that could affect inflation.

These reporting mechanisms should lead to a better understanding on the part of the public of the basis on which monetary policy decisions are made.

The fact that a definite time horizon is specified in inflation targeting makes it important that the central bank has a reliable forecasting framework. Although South Africa has experienced major structural changes in recent years, inflation still appears to be relatively predictable. The Reserve Bank currently makes regular inflation forecasts using a large, multipurpose, econometric model. However, this model is not suitable for inflation targeting. With the assistance of a number of central banks, the Reserve Bank is in the process of completing the development of a new core model specifically for the forecasting of inflation. In addition to this core model, Philips-curve models, other small-scale macroeconomic models, vector autoregressive models and indicator models are being developed.

Although these models are important tools for forecasting the future path of inflation, of course they cannot provide the ultimate answer. In determining the monetary policy stance, the predicted inflation rate of these models cannot be followed blindly. A careful analysis is also needed of underlying economic conditions which could affect the predicted outcome of the models. The Reserve Bank has, in addition, initiated a survey of inflation expectations to be undertaken by the Bureau of Economic Research of the Stellenbosch University. This should further enhance the information available for our forecasting framework.

Specification of the inflation target

The inflation target has been specified as achieving an average rate of increase in the overall consumer price index, excluding mortgage interest cost, (called the CPIX) of between 3 and 6 per cent for the year 2002.

The authorities opted for a variant of the consumer price index because the headline or overall consumer price index is influenced directly by changes in the Reserve Bank's repo rate through its effect on interest rates. A reduction in the repo rate or a relaxation of monetary policy leads, with a short lag, to a decrease in the consumer price index signalling lower inflation, while an increase in the repo rate or a more stringent monetary policy stance leads, with a short lag as well, to an increase in the consumer price index signalling higher inflation. To overcome this problem, it was decided to exclude mortgage interest cost from the consumer price index for inflation targeting purposes.

The authorities also decided against using the core inflation rate (i.e. the change in the overall consumer price index excluding the prices of certain food products, interest rates on mortgage bonds, overdrafts and personal loans, value-added tax and property taxes) for inflation-targeting purposes, despite certain advantages that the use of this index could have had. The measurement of core inflation has the advantage that it excludes prices directly affected by policy measures as well as some prices over which policy has no direct control and which could lead to misleading signals when these prices are affected by economic shocks. However, it does not exclude the impact of all of these kinds of prices, such as changes in oil prices. The measurement of core inflation has further disadvantages in that it does not comprehensively reflect the cost of living, is difficult for the public to understand and is less credible than headline inflation.

The Bank in agreement with the Department of Finance therefore opted to target the overall consumer price index excluding mortgage interest cost as measured for metropolitan and other urban areas, CPIX(mu)[1]. Using the consumer price index for only the metropolitan areas would have restricted the measurement of inflation to 14 metropolitan areas. By opting for this more comprehensive measure of inflation, price changes in 53 metropolitan and other urban areas covering approximately 75 per cent of all consumption expenditure are taken into consideration in the inflation target. If in due course Statistics South Africa were to broaden the calculations to include the rural areas in measuring the consumer price index, excluding mortgage interest cost, this measure of inflation should be used for inflation targeting purposes.

1 M = metropolitan and u = other urban

The inflation target has been specified as a range or band because it affords the central bank some discretion in taking decisions on the monetary policy stance, and allows for a degree of uncertainty and statistical variability inherent in all economic processes. The range indicates that the Reserve Bank will have been successful in its pursuit of the target if the average annual rate in the stated measure of inflation lies somewhere within 3 to 6 per cent range in the calendar year 2002. It does not imply that the measured rate must be at the midpoint of this range. If it was required that the inflation rate should be at a specific level, a single point target would have been set.

The time horizon over which the target must be reached, has been determined as the average rate of increase in the defined index in the year 2002. It will therefore be calculated as the average annual increase in the relevant price index for the year 2002 as a whole. It was decided to use this medium-term target in view of the long lags between monetary policy steps and their impact on inflation. Changes in interest rates in South Africa generally take from 18 to 24 months to have a material influence on the underlying rate of inflation.

Monetary policy operational procedures

The application of an inflation-targeting monetary policy framework in South Africa will not directly affect the monetary policy operational procedures of the Reserve Bank. As in the past, the Reserve Bank's operations will be aimed at influencing the overall lending policies of banks, and also the demand for money and credit in the economy indirectly through changes in bank liquidity and interest rates in the money market.

The regular repurchase transactions between the Reserve Bank and banks will remain the main apparatus to regulate liquidity in the market. Fine-tuning measures will also be utilised to neutralise temporary fluctuations in bank liquidity and to steer money-market interest rates and yields in the desired direction. The instruments that will be used for fine-tuning will consist of additional repurchase or reverse-repurchase transactions, sales or purchases of short-term Treasury bills, Reserve Bank debentures, adjustments in the asset portfolio of the Corporation for Public Deposits, the transferring of government funds between Tax and Loan Accounts at private banks and the Exchequer Account at the Reserve Bank, and foreign currency swaps.

At times longer-run adjustments may be needed due to structural changes in the liquidity needs of the money market, or because of changes in the monetary policy stance. These adjustments are usually made to increase or decrease the private banks' need for central bank money on a lasting or longer-term basis. In addition to repurchase transactions, outright sales or purchases of domestic securities and variable cash reserve requirements are being and will still be applied to adjust the structural liquidity needs of banks.

Conclusion

The adoption of an inflation-targeting monetary policy framework provides the Reserve Bank with an explicit anchor or ultimate objective for monetary policy. At the same time it enhances the transparency of monetary policy and the accountability of the central bank. With this framework it should be clearer why interest rate or other policy changes are made. By achieving the target in the year 2002 the Reserve Bank will have taken a further significant step in the achievement of price stability in the country.