Inflation targeting in a time of financial and economic crisis – South Africa's experience

Presentation at the Wits Business School, on 23 April 2009 by Dr M Mnyande, Chief Economist and Executive General Manager. South African Reserve Bank

Introduction

The run-up to the present financial and economic crisis started a long time ago and some of its elements were pre-empted in various discussions. For instance, at the World Economic Forum held in January 2008, a recession in the United States(US) was identified as an important threat to global financial stability and economic growth.

Concerns were raised about the impact of the sub-prime crisis and declining US house prices on the US banking sector, as well as the possible systemic risks to other financial markets and economies globally. A continued sharp decline in US house prices did materialise in 2008 and had a significant impact on economic activity worldwide.

During the past year global financial markets have witnessed the collapse of renowned financial institutions and have experienced contagion and increasing systemic risk on the largest scale since the Great Depression era. Various organisations, including the International Monetary Fund (IMF), foresee huge further potential aggregate losses and writedowns relating to loans and securities globally.

The uncertainty and the bigger-than-expected losses that have already occurred have caused exceptional volatility in global financial markets and have resulted in a reduction in risk appetite especially towards emerging-market economies. This global financial turmoil has impacted severely on real economic activity in both the industrialised and developing countries, and declining economic and business sentiment and weak consumer demand have resulted in a sharp slowdown in global economic growth.

Today I would like to discuss how South Africa's monetary policy framework has performed thus far in the pre- and contemporaneous crisis period, and how financial stability considerations have increasingly informed monetary policy decision-making globally in recent months.

The South African Reserve Bank's (Bank) primary goal and operational autonomy

At the outset, in this great institution of learning, allow me to re-emphasise the primary goal of the Bank. This I believe is critical in our quest to enhance the awareness of what the Bank can and should do.

The primary goal of the Bank in the South African economic system is the achievement and maintenance of price stability. This goal is assigned to the Bank in terms of the Constitution of the Republic. In pursuing its objective, the Bank assumes responsibility for the functions as set out in its mission statement. Although it is possible to pursue price stability using alternative approaches, the current monetary policy framework is inflation targeting. As stated clearly and time again in our communication with the public, sound monetary policy in the Bank's view, provides a stable platform for sustainable economic and employment growth (Mboweni, 2005).

The Bank is operationally independent in terms of the Constitution and the South African Reserve Bank Act. This means that while the Ministry of Finance and the Bank jointly recommended the inflation-target range to be adopted by Government and sanctioned by Parliament, the Bank retains complete autonomy to decide on the instruments used to achieve the goals of monetary policy and instrument settings.

To strengthen policy co-ordination, the consultative process between the Bank and the National Treasury was strengthened with the conclusion of a memorandum of understanding which set out a framework for the consultative process to oversee macroeconomic, banking, financial and regulatory issues.

South Africa' s experience with inflation targeting

The South African experience with respect to inflation and output variability during the inflation-targeting era has generally been favourable. In his recent paper, Brian Kahn (2008) compared the inflation-targeting period from 2000 with the period of the 1990s, and found that in the pre-targeting period, the inflation-targeting measure, (CPIX) inflation, averaged 10,8 per cent in the 1990s, and declined to 6,5 per cent in the targeting period.[1]

The average real economic growth rates in the two periods were 1,4 per cent and 4,25 per cent, respectively (measured as year-on-year percentage changes in real gross domestic product). Our inflation-targeting framework over the recent past has therefore been consistent with higher average output growth. Under this framework by luck or fact, the period from 1999 to 2008 in the broadest measure, has turned out to be the longest sustained period of economic growth in South Africa's economic history, complemented by both a lower rate of inflation and a stable monetary policy.

In terms of variability, the standard deviation of inflation in South Africa declined from 3,56 to 2,17 percentage points over this period, while the standard deviation of output growth declined from 2,28 to 1,06 percentage points. Simply put, not only did average inflation and inflation variability decline, but output growth variability declined as well. This is a good thing, and should clearly be viewed as supportive of long-term economic growth and development.

Kahn's (2008) paper also found that there has been greater stability in the real interest rate, measured as the official policy rate (repo rate) adjusted by the inflation rate. On this basis, the real policy rate averaged 5,7 per cent in the 1990s, and 3,3 per cent in the inflation-targeting period. Of greater significance perhaps is the relative stability of

[1] CPIX inflation (then, headline inflation excluding mortgage interest cost) was the inflation targeting measure from 2000 to 2008. It was formally calculated from 1998 by Statistics South Africa. Own estimates of CPIX prior to 1998 were made by the South African Reserve Bank and were used by Kahn (2008) starting from 1990.

the real rate in the inflation-targeting period, with the standard deviation falling from 4,08 in the 1990s to 1,29 percentage points in the 2000s.

However, the inflation outcome has exceeded the target range since April 2007, initially under pressure from strong domestic demand, and international oil and food price increases. As general inflation pressures began to emerge, the Monetary Policy Committee (MPC) initially began to communicate strongly the consequences of excessive domestic spending and cautioned consumers against this. In June 2006 the Monetary Policy Committee began to tighten the monetary policy stance. Monetary policy was reacting to supply-side shocks and exuberant real growth in household consumption expenditure (the latter eventually reached a rate of 9 per cent by the final quarter of 2006).

Much of the MPC's focus in 2008 continued to be on emerging second-round effects. Furthermore, inflation expectations, which for some time had been anchored within the inflation-target range, also showed evidence of increasing, along with wage settlements. While expectations were no longer anchored within the target range, there was still an expectation that inflation would moderate over the next two years.

The interest rate cycle was reversed in December 2008 with a reduction of 50 basis points in the repurchase rate on the basis of the expected return of inflation to within the target range. Meanwhile, as I mentioned earlier, the domestic and global economic outlook had weakened significantly. Domestic demand conditions deteriorated as gross domestic expenditure and domestic final demand contracted in the fourth quarter of 2008. Domestic demand conditions are expected to remain under pressure as a result of declining disposable incomes, tighter credit conditions and negative wealth effects.

Credit extension to the private sector continued along its spiral of deceleration owing to lower demand and more stringent lending criteria being applied by banks. Against the backdrop of a slowing global and domestic economy and an improved medium-term outlook for inflation, the MPC decided to reduce the repurchase rate by a further 100 basis points at each of its subsequent meetings in February and March 2009.

The most recent central forecast of the Bank shows consumer price inflation averaging 8,1 per cent in the first quarter of 2009 and then declining to below 6 per cent in the third quarter of the year. However, on account of technical base effects, inflation is expected to subsequently edge higher and marginally exceed the upper end of the inflation-target range, before returning to within the range in the second quarter of 2010. It is projected to remain within the range until the end of the forecast period in the fourth quarter of 2010, when it is expected to average 5,3 per cent. Having stated that, we must however understand that the heightened levels of uncertainty and the rate of change of global developments make these forecasts subject to higher risk than is usually the case.

Monetary policy and financial stability

Prior to the current financial crisis, the interaction between financial stability and monetary policy had been fairly loose. Although warning signals about the potential economic impact of financial crises had been given by a number of less severe crises, these crises mainly affected specific geographical regions, mostly in emerging markets. As a result, they did not have such a severe impact on industrialised countries and the world economy.

In the South African Reserve Bank as well as in most central banks, financial stability had generally been treated as an extension of the regulatory responsibilities, while monetary policy focused primarily on inflation/or price stability. Thus financial stability considerations did not generally play a major role in the formulation and/or implementation of monetary policy.

The intensity of the current crisis has since brought the issue of financial stability to the fore and is forcing central banks to reconsider their thinking about the links between financial stability and monetary policy. This is also true for the Bank. For example, this issue was discussed extensively recently in the Bank's senior management strategy meeting. Evidence presented at the meeting seems to suggest that there is a strong likelihood of some profound changes in the roles and responsibilities entrusted to central banks, regarding the stability of the financial system.

Even at this developmental stage of the crisis, one can clearly identify a number of linkages between monetary policy and financial stability that were not fully recognised before or, if they were, had not been actively pursued by central banks. I'll briefly address a few of these linkages, some of which are operational in nature, and some more conceptual or philosophical.

Financial stability is necessary for effective transmission of monetary policy

The current crisis is the most compelling example yet of the extent to which the functioning of financial markets can fail if confidence is lost. Central banks had, in a sense, taken for granted that they will always be able to implement monetary policy through their various policy instruments, no matter what.

After all, although there have been financial crises before, the almost complete and broad-based breakdown of certain markets that occurred in many of the developed countries during 2008 has been unprecedented. Suddenly, the major central banks found themselves in the peculiar situation where market rates became disjointed from policy rates.

Interbank rates became almost irrelevant as interbank lending activity stalled, and some central banks had to assume a 'brokering' role between banks. Longer-term rates responded to various influences stemming from the instability of financial markets and the general loss of confidence among market participants, rather than to policy rates. As a result, the spreads between policy and market rates, as well as between short- and longer-term rates widened significantly. In this environment it became clear to all that it is impossible to implement monetary policy in the absence of financial stability.

This is the first operational linkage that central banks and governments have to acknowledge. Central banks cannot formulate and implement monetary policy without pursuing financial stability, because financial stability is essential for the effective implementation of monetary policy.

Monetary policy tools are being used to protect financial stability

The most visible part of monetary policy is the level of a central bank's policy interest rates, which should determine the price of credit in the market. Since the onset of the financial crisis, the major central banks have reduced their interest rates dramatically, some to a level close to zero. It was fortunate, though probably not a coincidence, that these reductions coincided with declining inflation worldwide. However, it was also evident that, in the current circumstances, concerns about the state of the global economy and the need to restore financial stability were the main drivers behind these interest rate decisions, rather than the normal monetary policy considerations of central banks.

While policy rates represent the visible component of monetary policy, there is also a less visible component, namely the amount of liquidity that a central bank makes available in the market. Central banks have the ability to create additional money-market liquidity, for example by lending additional funds to institutions or by purchasing financial assets.

In particular, since October 2008, the major central banks have provided significant amounts of liquidity to their respective banking sectors in order to help overcome the malfunctioning of interbank and credit markets. This provisioning of additional liquidity is often referred to as "quantitative easing". If left unsterilised, it increases the monetary base in a financial system just as directly as printing more banknotes would do, and can be inherently inflationary in future. It is a policy option that remains available to central banks and can be pursued even when they are unable to reduce policy rates further.

The ability of the major central banks to 'sterilise' their liquidity injections has been varied. In the case of the European Central Bank, the additional liquidity provided did not significantly increase overall market liquidity, because banks chose to deposit similar amounts with the ECB. It did, however, change the role of the ECB to that equivalent to an interbank broker, leaving it exposed to increased credit risk on its balance sheet.

In the case of the US, the Federal Reserve managed to drain most of the additional liquidity until October 2008, but thereafter was no longer able to do so as the cumulative amount lent by the Federal Reserve became too large[2]. Nevertheless, it is evident that quantitative easing, which essentially is a monetary policy tool and in normal conditions should primarily be aimed at supporting a central bank's monetary policy stance, is a tool that is being used by central banks to restore financial stability.

Central banks put greater emphasis on their financial stability responsibilities

All the major central banks, and a number of emerging-market central banks, have acknowledged the need to restructure their functions in order to give more emphasis, and in some cases, more legal support to their financial stability responsibilities. Perhaps one of the reasons why this has not been done previously is that financial stability is a much more difficult and elusive concept to define than price stability, and therefore more difficult to measure. Also, financial instability can arise from various sources, and policy responses are less clear-cut and predictable. Sometimes, policy options lie outside the domain of central banking.

[2] Lacker, J, President of the Federal Reserve Bank of Richmond. Remarks made at a meeting of the National Association for Business Economics. 2 March 2009.

Be that as it may, recent events have shown that when systemic instability arises, it is up to the central banks to restore confidence in the markets, and they are better equipped to do this by giving adequate attention (in advance) to their roles, responsibilities and legal powers in this regard. Sir John Gieve, Deputy Governor of the Bank of England (BoE), recently said that, with reference to the collapse of securitisation markets in August 2007 and the failure of Northern Rock, "with the benefit of hindsight, the main problem was not the handling of the initial rescue, but that […] having stepped in, the authorities were hamstrung by the inadequacy of the legal powers to resolve it quickly and cleanly" (Gieve, 2009).

There are a number of examples of steps taken to strengthen central banks' financial stability functions. The BoE has recently restructured to enhance its ability to deal with systemic instability. A new Banking Act was passed in February 2009[3], which puts the BoE's financial stability objective onto a statutory footing. The BoE's authority to respond to systemic threats to financial stability has been increased and tightened. This Act gives a statutory financial stability objective to the BoE and provides a permanent set of tools to strengthen the ability of the tripartite authorities in the UK to deal with distressed banks. In terms of the Act, a Special Resolution Regime was created in the BoE to deal with distressed banks.

In March 2009 the Bundesbank also announced that it intends to strengthen its role in financial stability by establishing a new department as part of a significant structural overhaul. Much more resources will be dedicated to expert financial stability analysis. The Governor of the Bundesbank, Mr Axel Weber, indicated that the Bundesbank was attaching greater importance to financial stability analysis and that central banks had a natural interest in financial stability, given their systemic insights and closeness to markets.[4]

---

[3] UK Banking Act 2009, available on the Bank of England internet website.
[4] CentralBankNews.Com. 23 March 2009. Buba to strenghthen stability role.

Last month the Federal Reserve System (the Fed) also clarified its role as a guardian of financial stability. In agreement with the US Treasury, it formulated four points that set out in detail the limits of its role in preserving stability, namely that,

- There should be co-operation between the US Treasury and the Fed in improving the functioning of credit markets and fostering financial stability;
- the Fed should avoid credit risk and credit allocation;
- the pursuit of financial stability should not constrain the preservation of monetary stability; and
- there is a need for a comprehensive resolution regime for systemically critical financial institutions.[5]

It is clear that recent events have forced central banks into unchartered territory with regard to their roles in preserving financial stability. While it is clear that they are likely to carry bigger and better-defined financial stability responsibilities, they will also have to find new balances between these responsibilities and their monetary policy objectives.

The scope of monetary policy may widen

Economists and central bankers alike have long debated the role that asset price developments should play in the formulation of monetary policy. This debate can be approached from two perspectives. The first perspective raises the question whether asset prices should be considered as important inputs to policy formulation. This question relates to the increasing emphasis that is placed on macro-prudential analyses to identify possible threats to systemic stability, which includes threats emanating from excessive asset price developments that cause increasing and unsustainable imbalances between the fundamental and market values of assets.

The second perspective focuses on whether monetary policy should be aimed at achieving specific asset price levels, or perhaps to burst perceived asset bubbles.

[5] Federal Reserve System. 23 March 2009. Joint statement by Treasury and the Federal Reserve on the Federal Reserve's role in preserving financial and monetary stability.

From this perspective, asset prices become an objective or target of monetary policy. There is little consensus about this contentious issue. Some argue that an inflation-targeting regime is too narrow, forcing central banks to focus on consumer price developments, while ignoring broader prices and market developments.

A counterargument is that inflation targeting should not be so narrowly interpreted, but within the broader scope of economic and financial market developments. Nevertheless, in the speech referenced earlier, Sir John Gieve makes the point that "if inflation targeting by a central bank is an essential foundation of policy, it is pretty clearly not sufficient on its own", and that central banks may need to prevent asset price and credit booms, as well as control consumer prices (for which they may need more than one instrument).

It is not my intention to enter into this debate at this early stage. I am sure there will be heated arguments about it in years to come, and various approaches will be researched and tested. Suffice it to say, that the current crisis has illustrated the costly consequences of not giving adequate attention to asset prices and allowing a build-up of risks and positions that, with hindsight, were clearly unsustainable at a systemic level.

However, central banks and governments of especially the developed countries have been busy technically repairing credit systems, assessing dysfunctional housing markets and developing measures to counter declines in private incomes and spending. One of the most important aims of all these rescue missions is also to restore public confidence. More specifically, on monetary policy positioning, the recent *OECD Economic Outlook* has urged that monetary authorities in the member countries attempt to "to bring or keep policy rates to near zero," while on the Fiscal Policy the report also urged fiscal authorities to "adopt discretionary fiscal stimulus depending on country – specific circumstances, but should also guard against fuelling long-term inflation ….."

Conclusion

The mandate of the Bank remains to focus on and counter inflation. The inflation-targeting monetary policy framework has improved the policy responses to the sizeable domestic and external shocks encountered during the period of inflation targeting. The responses of the MPC have been directed at the expected increase in inflation if exogenous shocks are expected to feed through strongly to generalised price increases. This is consistent with the forward-looking application of monetary policy implied by an inflation-targeting policy framework.

However, in the absence of an explicit target for inflation, monetary policy would still have remained focused on achieving price stability, and would have had to respond to the same shocks that the economy has been exposed to. Inflation targeting makes this process more transparent and provides an explicit anchor for the managing of inflation expectations.

Although price stability is regarded as a necessary prerequisite for sustained economic growth, the Bank holds the view that success with this goal is strongly dependent on financial system stability. The Bank has consequently intensified its focus on macroeconomic issues concerning the financial system since 2004. To this end, the Bank on an ongoing basis monitors all sections of the financial system to spot signs of potential imbalances that could have adverse effects on the soundness of the financial system. The Bank contributes to a transparent discourse concerning financial stability through the ongoing publication of the *Financial Stability Review*, which is published biannually.

Internationally through substantive monetary and fiscal policy intervention, most important financial markets have remained functional, but confidence levels remain low and have continued to fall in some countries. Some impaired credit markets have gradually started to function properly, going by market spreads, although in many instances such markets remain critically dependent on central bank and government support.

The depth and duration of the current global recession and the eventual full impact on South Africa will be determined by the extent to which success is achieved with the wide range of monetary and fiscal policy steps that have been announced by policy-makers worldwide in recent months. To the extent that banking crises have proven historically to take quite long to resolve fully, the current synchronised global recession could prove to endure somewhat longer than expected. However, the fact that many of the policy steps that have been announced to combat the crisis have been implemented speedily and on a co-ordinated basis between countries, is a positive force in shaping the global outlook.

The domestic slowdown in the third quarter of 2008 followed by the first output growth contraction in ten years clearly indicate that South Africa's real economy has not been spared by the global financial crisis. Although the deficit on the current account of the balance of payments narrowed significantly in the fourth quarter of 2008, preliminary trade data for January and February 2009 suggested that the country's trade deficit with the rest of the world could have widened again in the first quarter of 2009. In addition, the financing of the current account deficit remains a challenge considering the contraction in cross-border lending in an environment characterised by uncertainty in global financial markets.

The short-term, miscellaneous business cycle indicators have weakened significantly in the most recent months, almost guaranteeing a further contraction in the first quarter of this year. Though the composite leading business cycle indicator increased somewhat in February this year, seven of the eleven component time series available declined, as four increased. This was attributed to a sharp increase in the interest rate spread component. Thus, the February uptick does not indicate a turning point by any means. Instead the trend still points to a continued slowdown in aggregate economic activity this year.

A dismal performance by the country's most critical sectors, that is, manufacturing and mining output, calls upon new ideas by New Growth Theorists, to make more than just sense for South Africa, if growth and development objectives have to be achieved on a sustainable basis. Contraction in the real disposable income of households in the last quarter of 2008 has visibly dampened household spending, reflecting the early outcomes of "Tough Times."

Cost structures and pricing differ across sectors of the economy and at a micro level are affected by a variety of issues ranging from the prevalence of parity pricing models, import regulations, logistics in accessing markets and the barriers to entry in certain sectors. The Da Gama in Zwelitsha, King William's Town in the Eastern Cape, is one example of such firms that are currently experiencing an uphill – considering the above-mentioned, including the input costs of coal, electricity, chemicals, cotton, and ultimately internal and external demand for the final product.

During the Bank's recent visits to the provinces and discussions held with local firms, private and public officials and trade unions, it became clear that none of the above-mentioned are controlled by monetary policy except to, a lesser extent, the impact on consumer demand, if purchases are done through credit. Monetary policy is, but part of a bigger picture, where all the role-players ranging from the National Treasury, Department of Trade and Industry, the agricultural, chemicals, financial, wholesale and retail sectors - to name but a few, need to address the serious concerns and causes of South Africa's economic hardships at a micro and macro levels. The Bank, at all times and in different platforms such as this one, attempts to conduct open-mouth operations to morally persuade businesses and public entities to price within the inflation-target range.

These troubling times with undesirable contractions should be viewed as a passing phase – a short-run experience – which in Neo Walrasian terms cannot be placed as a "center of gravitation" for the South African economy. Observing some key economic variables there is evidence to suggest that the economy will move away from this current position into another (long-term) positive growth territory in the near term.

Thank you

References:

Gieve, 2009, “Seven lessons from the past three years”, speech delivered at the London School of Economics, February 19.

Kahn, S 2008, “Challenges of Inflation Targeting for Emerging Market economies: The South African Case”, paper prepared for the South African Reserve Bank Conference on Challenges for Monetary Policy-makers in Emerging Markets, October 29 to 31.

CDE, 2009, “Roundtable, accelerating growth in tough times, March 2009, Number 1

Mboweni, T T 2005, “Monetary policy and sustainable economic growth”, Address to the Bureau for Economic Research Conference on Growing the South African Economy, November 9.

Quarterly Bulletin, March 2009, South African Reserve Bank, No 251

OECD Interim Economic Outlook, March 2009, www.oecd.org/oecdEconomicOutlook