

### **3. South Africa's inflation targeting framework**

#### **3.1 Introduction**

South Africa's economic and political history in the past decade has been one of great change as the country re-entered the international economy. In the mid-eighties, prior to the introduction of democracy, South Africa faced economic sanctions and disinvestment. This resulted in large capital outflows and the declaration of a partial debt standstill. However, as signs emerged that a peaceful political transition was imminent, many countries began to normalise trade relations with South Africa.

In the early 1990s, however, domestic industries were still heavily protected by import substitution, the promotion of mineral beneficiation, duties and surcharges. Following the first democratic elections in 1994, a tariff reduction and rationalisation programme was introduced and the export subsidy scheme was phased out. Exchange controls were also gradually lifted although some exchange controls are still in place for residents. Alongside the trade reforms initiated, significant emphasis was placed on restoring fiscal stability and credibility. To its advantage, the government established itself as a credible borrower in the international capital markets but has contained its foreign debt to within internationally acceptable levels (Mboweni, 2004a).

Monetary policy also underwent significant changes. The SARB adopted different monetary policy frameworks over time: credit ceilings and credit controls were used in the 1960s and 1970s, money supply growth targets from the middle of the 1980s, money supply growth guidelines by the early 1990s, an eclectic monetary policy from the middle 1990s and inflation targeting since 2000 (Mboweni, 2003a).

However, successive mission statements confirm the SARB's fundamental commitment to low inflation. The SARB's initial mission statement, published in 1990, was the protection of the internal and external value of the rand. This

was changed by the mid-1990s to the protection of the value of the rand. In 1999 the mission was reformulated to the achievement and maintenance of financial stability.

The formal money supply targets, introduced in 1985, contributed significantly to reducing inflation from the double-digit levels of between 12 and 20 per cent from 1972 to 1992 to an average of below 10 per cent from 1994 to 1999 (Stals, 1999). The use of these targets was based on the assumption that a stable relationship existed between changes in money supply and inflation. Monetary policy was, therefore, aimed at controlling the rate of expansion in total money supply as an intermediate objective with the ultimate objective of protecting the value of the currency. As Stals (1999) explains, in this model the central bank's ultimate objective is to protect the value of the currency, the intermediate objective is to control the money supply and the supportive objective is to influence the amount of bank credit extension. Money supply targets fell away as the liberalisation of the financial markets, increase in the volume of financial market transactions and a more open economy called into question the usefulness of money supply as an indicator of inflation (Stals, 1999).



After the use of money supply targets as the sole anchor for monetary policy was called into question, the SARB turned to using what Casteleijn (1999: 64) refers to as a “package” of economic indicators for making monetary policy decisions in an eclectic approach where bank credit extension, the yield curve, interest rates, changes in gold and foreign exchange reserves, movements in the exchange rate of the rand and actual and expected movements in inflation were considered.

In a sense the eclectic approach to monetary policy recognised that the SARB had to combat inflation (Mboweni, 2001). With this recognition, the SARB entered a phase of informal inflation targeting. The phase of informal inflation targeting was so named because of the emphasis on lowering inflation without specifying the time period over which it would be achieved (Mboweni, 2004a). The SARB announced in March 1998 a range of 1 to 5 per cent per year as

an inflation objective that would be considered when formulating monetary policy (Casteleijn, 1999: 65). Guidelines for growth in broad money supply and bank credit extension were announced at the same time. This was in line with the directive contained in the Constitution, in terms of which the SARB was tasked with “the responsibility of protecting the South African rand in the interest of economic development in the country” (Stals, 1999).

South Africa formally adopted the inflation targeting framework for monetary policy when the Minister of Finance, Trevor Manuel, announced the adoption of a 3 to 6 per cent target for the year 2002 in his Budget Speech on 23 February 2000. Moving to formal inflation targeting, the SARB now directly targets inflation rather than following guidelines or intermediate objectives. The ultimate goal of monetary policy is price stability. However, the SARB still considers a range of factors that affect inflation when deciding on a monetary policy stance, in line with Mishkin’s information-inclusive strategy. According to Mboweni (2001) these factors include among others the growth in money supply and bank credit extension, the changes in salaries and wages, nominal unit labour costs, and exchange rate developments. The institutional arrangements for South Africa’s inflation targeting framework bear some resemblance to the Bank of England’s arrangements but with important differences, as will become evident in this Chapter.

The ensuing discussion explores South Africa’s rationale for adopting inflation targeting as well as the design of the framework and the institutional arrangements constructed to support such a framework.

### **3.2 Rationale for adopting inflation targeting in South Africa**

For the 20-year period from 1972 to 1992 South Africa experienced double-digit inflation, with average yearly headline consumer price inflation reaching a high of 18.8 per cent in 1986. Inflation has trended downwards and single digit inflation has prevailed since 1993 (see Table 1). Annual inflation continued to drop and reached an average of 5.2 per cent in 1999. For the year to August 2004, CPI averaged 1 per cent (Statistics South Africa, 2004). CPIX, the

targeted measure of inflation, which excludes mortgage costs from headline consumer inflation, was at 7 per cent in 1998, the first year of measurement. It remained above 6 per cent and reached a high of 9.3 per cent before falling to 3.7 per cent, within the target range for the year to August 2004. The reduction in inflation to under 10 per cent was due in part to the adoption of money supply targets (Stals, 1999) introduced in the mid-1980s to anchor monetary policy.

Given that the SARB did achieve success in bringing down inflation under an informal inflation targeting regime, Van der Merwe raises the question as to why the SARB then moved to formal inflation targeting. Van der Merwe (2004: 1) gives four reasons for the SARB's decision. First, the informal inflation targeting framework was not all that clear in conveying reasons for the monetary policy stance adopted by the authorities. This was partly because of the breakdown in the relationship between money supply and inflation. The frequent above-guideline money supply figures did not always result in a rise in short-term interest rates because the SARB viewed this as a consequence of structural changes in the economy. Mboweni (1999: 400) notes that he conveyed to the ordinary general meeting of shareholders on 24 August 1999 that it would be advisable to move away from the "eclectic" or informal inflation targeting monetary policy framework to formal inflation targeting. The reason was that the eclectic framework had at times created uncertainties about SARB decisions and actions which were "perceived as being in conflict with the stated guidelines for the growth in money supply and bank credit extension."

**Table 1: Average annual headline CPI and CPIX (South Africa)**

Year	Average annual percentage change in CPI (%)	Average annual percentage change in CPIX (%)
1976	11.5	-
1977	11.8	-
1978	10.5	-
1979	13.1	-
1980	13.7	-
1981	15.7	-
1982	14.4	-
1983	12.6	-
1984	11.2	-
1985	16.2	-
1986	18.8	-
1987	16.2	-
1988	12.9	-
1989	14.5	-
1990	14.3	-
1991	15.6	-
1992	13.7	-
1993	9.9	-
1994	8.8	-
1995	8.7	-
1996	7.3	-
1997	8.6	-
1998	6.9	7
1999	5.2	6.9
2000	5.4	7.8
2001	5.7	6.6
2002	9.2	9.3
2003	5.8	6.8

Source: Statistics South Africa, 2004

The second reason Van der Merwe puts forward is that inflation targeting is more successful than other monetary policy frameworks at improving the co-ordination between monetary policy and other economic policies. It formally defines the co-ordinated effort necessary to implement the framework in order to achieve the broader objective of sustainable economic growth and employment creation. In South Africa's case, although technical consultations were conducted since the inception of inflation targeting, it was only formalised in 2004 in a formal Memorandum of Understanding (MoU) which sets out a framework for a consultative process to oversee macroeconomic and other issues (Mboweni, 2004: 14).

Third, inflation targeting imposes discipline on monetary policy and increases central bank accountability. It does so by setting targets which have to be met. The framework fulfils this criterion by detailing how deviations from the target will be addressed, chiefly in the form of escape clauses. In South Africa's case, an escape clause detailed the circumstances (exogenous shocks) under which a deviation from the target would be allowed. These included an oil price shock, a drought, natural disaster or financial contagion affecting the currency (SARB, 2003: 3 – see Table 2). However, this was replaced by an explanation clause in November 2003 when experience showed that the escape clause created problems in communicating monetary policy decisions (Van der Merwe, 2004: 7).

**Table 2: Key parameters of South Africa’s inflation targeting framework**

Parameter	Before 12 November 2003	From 12 November 2003
Target variable	CPIX	CPIX
Target range	3 to 6 per cent	3 to 6 per cent
To apply until	2005	2006
Measurement option	Annual average: Average CPIX inflation over a calendar year	Continuous basis: 12-month CPIX inflation must remain in the target range at all times
Exception handling	<p><b>Escape clause:</b> It is recognised that there may be some economic supply shocks or extraordinary events impacting on CPIX inflation that are unforeseen and beyond the control or influence of monetary policy. Most of these factors reverse over time. It is not possible to specify in advance all the economic shocks that could affect CPIX inflation, but such factors include a sharp rise in international oil prices, drought, changes in indirect taxes, and international financial contagion causing major changes in the exchange rate which are unrelated to domestic economic fundamentals and domestic monetary policy. Reacting to such events could result in costly losses in terms of output and jobs. In such circumstances where it is expected that the target for CPIX inflation will not be met, it will be indicated in a monetary policy statement and the Monetary Policy Committee will set out the path and time horizon over which the inflation rate will be brought back in line with the target.</p>	<p><b>Explanation clause:</b> When the economy is buffeted by a supply-side shock similar to those envisaged by the original escape clause that will take CPIX inflation outside the target range (e.g. an oil price shock, a drought, a natural disaster, or financial contagion affecting the currency), at the subsequent meeting of the Monetary Policy Committee, the SARB will fully inform the public of the nature of the “shock”, the anticipated impact on CPIX inflation and the monetary policy response to ensure that inflation returns to the target and the timeframe over which this will occur.</p>

Source: South African Reserve Bank, 2003a: 3

The difference between the two clauses is unclear. According to the explanation clause the SARB has to fully inform the public of the nature of an exogenous shock, its anticipated impact on inflation and the response taken to ensure inflation returns to the target range. Accountability in South Africa is also effected by the SARB officials’ regular reports to Parliament. According to

Schaechter et al. (2000: 10), South Africa was among only four countries that had escape clauses to enhance the flexibility of their inflation targeting frameworks.

Lastly, the framework impacts on inflation expectations which should facilitate a reduction in inflation if the targets are seen as credible. The targets should, then, form the basis for future price and wage setting. According to Van der Merwe (2004: 13), inflation expectations have declined significantly since 2000 and during the last quarter of 2003 the overall figure for the various sectors was within the target range. This is positive for the inflation outlook.

The international context at the time was a compelling reason for the SARB to adopt a formal inflation targeting framework. Prior to the adoption of the inflation targeting framework, the SARB's monetary policy was aimed at promoting financial stability to create the conditions for economic growth in the medium to long term (Casteleijn, 1999: 63). This monetary policy objective was deemed to be a necessary but not sufficient precondition for economic growth and employment creation. However, with many countries pursuing price stability and successfully bringing down their inflation rates this left South Africa with "no alternative" but to do the same. As Casteleijn (1999: 64) explains low inflation is "almost universally accepted as the ultimate objective of monetary policy – not as an end in itself, but as the means whereby monetary policy can contribute to solid economic performance".

Aside from the general move by central banks around the globe towards an inflation targeting strategy, there was another reason why South Africa was left with little choice but to adopt an inflation targeting regime. Casteleijn (1999: 64) observes that market adjustments to compensate for inflation differentials between South Africa and its trading partners were inevitable if South Africa did not achieve price stability. These adjustments could include disruptive capital outflows, a weakening rand and high interest rates. Thus, from 2000 South Africa became a formal inflation targeting country, following the lead of a number of industrialised and developing countries.



In more general terms, it appears inevitable for South Africa not to have made the change. Van den Heever (2001: 169) observes that during the final decades of the 20<sup>th</sup> Century economists were gradually persuaded that the best contribution monetary policy could make to economic development and growth was by providing a stable financial environment. In South Africa this was reflected in the Constitution and in the South African Reserve Bank Act, No. 90 of 1989, which state that the SARB must protect the value of the currency in order to achieve balanced and sustainable economic growth. This requires the achievement of financial stability which encompasses both price stability and stable conditions in the financial sector. Price stability is achieved when changes in the general price level do not materially affect economic decision-making (Mboweni, 2000).

Apart from these reasons, the disadvantages of high and variable levels of inflation are well known. Inflation distorts investment and savings decisions, raises the risk premium in long-term interest rates and makes business decisions about the future difficult (Casteleijn, 1999: 63).

### **3.3 Framework design**

According to Mboweni (1999: 405-406), in order for South Africa to adopt the inflation targeting framework, a number of preconditions had to be met. The central bank should be free to pursue inflation targeting and to use any instrument to achieve this objective, despite the fact that the target is set jointly by the government and the central bank. This freedom to choose and set the policy instruments is referred to as instrument independence. However, given that the targets are set jointly with government, the SARB does not have goal independence.

Further, there needs to be a commitment by all authorities to the objective of price stability and a harmonisation of monetary policy with other policies. It is debatable whether, in the initial years, there were coordinated policies. On numerous occasions Mboweni has made mention publicly of the high increase of administered prices and public-sector wage settlements. However, in 2004

the government announced that it would look into administered prices, showing, perhaps, a greater commitment to the goal of inflation targeting.

It is equally important that there should be well-developed financial markets to ensure that the financial markets react quickly to the central bank's application of the instruments. On this point South Africa fares well. The country is known to be an emerging-market anomaly in that it has a well-developed banking system and financial markets.

Finally, according to Mboweni, the central bank must have sufficient resources, including human and technological resources. The sophisticated forecasting models required for inflation targeting necessitate the correct technological software and staff. In Mboweni's view, the SARB staff had the experience to implement the framework and refine the forecasting models. International experts were used where necessary. However, there was a feeling that the SARB wanted more time to test its forecasting and modelling procedures.

In implementing the inflation targeting framework, a number of operational decisions must be taken, as referred to in Chapter 2. A decision has to be taken on the target and the measure of the target. The practice among countries that have adopted inflation targeting is to specify the target in terms of the consumer price index or a variation of the consumer price index (Van der Merwe, 2004: 4). It is agreed that the index should be publicly accepted and include a range of products whose prices reflect changes in the cost of living. This is important as it affects the credibility of the conduct of monetary policy. The SARB opted for CPIX which is consumer price inflation for metropolitan and other urban areas excluding mortgage costs. According to Van den Heever (2001: 172) this measure was chosen to ensure as wide a geographical coverage of price information as possible. Mortgage costs were excluded because they are directly affected by the central bank's policy actions, i.e. interest rate movements.

Regarding the choice between setting the target as a single point or a range, the SARB chose a three-percentage-point target band. Mboweni (1999: 407) argues that a narrower band might be interpreted as indicating a stronger commitment to the inflation target. However, repeated breaches of the target may damage the central bank's credibility. Further, a single point is more difficult to reach than a band, which allows the central bank more discretion. Van den Heever (2001: 172) argues that a single point implies a degree of precision which "cannot realistically be expected of monetary policy. A degree of variation in inflation is to be expected, even under the calmest conditions".

The central bank also needs to decide on the level of the target. Mboweni posits that high targets may lead the public to believe that the central bank is not serious about containing inflation. It is, therefore, better to lengthen the period over which the target will be reached. The time horizon chosen by the South African authorities was designed to take cognisance of the time lags between a change in interest rates and their impact on inflation. In South Africa, according to Van den Heever (2001: 172) the typical lag is 1,5 to 2 years between a change in interest rates and its impact on inflation. Therefore, the target date must be at least 1,5 years in the future. Given these factors, the target was set in February 2000 for achievement in the year 2002.

Given the above considerations, when the adoption of inflation targeting was announced on 23 February 2000 the targets specified that the SARB must achieve an annual average for CPIX inflation of between 3 and 6 per cent for the year 2002. The same target was set for achievement in the year 2003 whereafter it was tightened to 3 to 5 per cent for 2004. However, in the October 2002 Medium Term Budget Policy Statement (MTBPS) the band was widened again to 3 to 6 per cent for 2004 and 2005, and in the November 2003 MTBPS the time period for this band was extended to 2006.

In order to fully implement the inflation targeting framework, the SARB engages in a continuous process of technical consultation with the National Treasury. To aid the formulation of monetary policy, a suite of econometric models is used to forecast inflation. However, Van den Heever (2001: 174)

emphasises that the monetary policy decisions are taken on the basis of “professional judgement” rather than “mechanical acceptance” of the models’ results.

Initially the SARB had an escape clause, whereby the central bank would be permitted to deviate from the target under certain “extraordinary” circumstances. In the 2001 MTBPS (Dykes, 2004: 94) these “extraordinary” events were fleshed out more fully and included international oil prices, drought and international financial contagion. The escape clause emphasised that an overreaction by the MPC could cause short-term damage to the economy and it required the MPC to explain how long it would take to bring inflation back on track.

However, the escape clause was deemed inappropriate and was then changed to an explanation clause. As Mboweni notes (2003b): “...the Reserve Bank generally views it inappropriate to resort to the escape clause, and would rather provide an explanation to any deviation from the target range once the final outcome of the CPIX average for that year had been published. This view is held so that the market has no doubt regarding the Bank’s vigilance and commitment to achieving its targets.”

The explanation clause obliges the SARB to inform the public of the nature of an exogenous shock, its anticipated effect on inflation, the monetary policy response and the time horizon over which inflation will return to the target range (Van der Merwe, 2004: 7). The difference between the two appears to be largely one of emphasis. An escape clause implies that the central bank is absolved of responsibility. An explanation clause, conversely, implies the continued long-term existence of the central bank’s responsibility to achieve the targets despite any deviations in the short term.

### **3.4 Operational instrument and decision-making process**

The operational instrument the SARB chose for implementing the inflation targeting framework is the repurchase rate or repo rate, as it is commonly

known. This is the rate at which the central bank lends funds to commercial banks and which directly influences the level of prime lending rates for consumers. All other interest rates are benchmarked to this rate. The SARB's monetary policy decisions or changes in the repo rate also have a direct impact on the exchange rate and decisions on investment and spending and therefore affect the demand for and supply of goods and services (Mboweni, 2001). Genberg (2002: 166) asserts that the choice of such a short-term interest rate may not be appropriate for developing countries since their money markets may be insufficiently developed and insufficiently liquid. South Africa, however, differs from many other developing countries in that its financial markets and banking system are well developed and are more akin to those in industrialised countries, albeit on a smaller scale.

Monetary policy decisions are made by an MPC. During the two-day meeting the members determine the appropriate level of the repo rate which impacts on the level of inflation with an 18 to 24 month lag period. The MPC's decision is made public on the second day, after the conclusion of the meeting. The MPC first met on 13 October 1999 and was constituted shortly before the adoption of a formal inflation targeting framework. The MPC comprises the Governor, the three deputy governors and a number of senior staff members at the SARB. The number of MPC members has changed over the years. Initially the MPC consisted of the Governor, the deputy governors and 10 senior staff members and met every six to eight weeks. At the beginning of 2002 MPC membership was scaled down to eight members and quarterly meetings were held to coincide with the release of the SARB's *Quarterly Bulletin*. In the middle of 2003, it was decided that four meetings a year was too infrequent and the meetings were rescheduled for every two months. In August 2004 MPC members numbered nine, including the vacant deputy governor position.

### 3.5 Institutional arrangements

Many of the institutional arrangements that accompanied the introduction of inflation targeting in South Africa concern the transparency and accountability the new monetary policy framework is meant to bring about. The adoption of inflation targeting has made the SARB a more transparent institution. Unlike previously where monetary policy decisions were essentially made by a single person, now the MPC sits for two days in deliberation. A detailed statement of the decision is released and a press conference held by the current governor, Mboweni, is broadcast live after each meeting. These are important steps forward in the history of the SARB and indeed in its transparency. It is in keeping with the intention of Mboweni, who declared that one of the focal points of his initial five-year term would be to increase the transparency of the central bank and to demystify it.

In keeping with this drive towards increasing transparency, the SARB initiated a series of regular Monetary Policy Forums (MPFs). These are held twice a year in major cities around the country. They provide an open forum for discussions on monetary policy and economic developments. Senior SARB staff members engage with key stakeholders from labour, business, and the community and other organisations. The forums reflect an earnest attempt on the part of the central bank to communicate monetary policy and economic developments to the broadest spectrum of South African society. In line with this the Governor also regularly gives public speeches.

The SARB publishes a bi-annual *Monetary Policy Review*, similar to the Bank of England's *Inflation Report*, twice a year to further enhance the understanding of the conduct of monetary policy. The inflation forecasts are published in the form of a fan chart, a technique used by many central banks. The fan chart illustrates the varying degrees of certainty for each expected level of inflation using confidence bands. As Mboweni (2002) explains the fan chart allows the MPC to assess the potential upside and downside risks to the inflation outcome and illustrates the probability of a particular inflation outcome.

Another aspect of the institutional arrangements under the inflation targeting regime is the regular consultation with the National Treasury on the conduct of inflation targeting. This technical consultation was formalised in 2004 with the conclusion of an MoU between the SARB and the National Treasury. This MoU provides a framework for a consultative process on macroeconomic, banking, financial and regulatory issues (Mboweni, 2004: 14).

The SARB is also accountable to parliament. The Governor appears regularly before the Portfolio and Select Committees on Finance to give detailed explanations of economic developments and the monetary policy decisions taken. The Bank is also required to submit an annual report on monetary policy to the Minister of Finance and must submit monthly statements of assets and liabilities as well as present its financial statements to the National Treasury once a year (Van der Merwe, 2004: 8).

### **3.6 Inflation expectations**

Most central banks use inflation expectation surveys in their conduct of monetary policy in an inflation targeting framework. In South Africa, the inflation expectation surveys are conducted by the Bureau for Economic Research at the University of Stellenbosch. They are conducted quarterly with four groups: households, business, analysts and labour (Kershoff & Smit, 2002: 448). Business executives, analysts and labour representatives are requested to forecast CPI and CPIX inflation for the current and subsequent two calendar years. They are also asked to estimate growth forecasts, the rand/dollar exchange rate, prime overdraft rate and wage increases.

Kershoff & Smit (2002: 455) also point out that inflation expectations and the actual level of inflation can diverge significantly at times, especially during the initial stages when the central bank has not yet gained credibility for its inflation targeting policies. In some countries inflation expectations declined to the target level after some time had passed and after the central bank had gained some credibility for its policies. In South Africa, the initial inflation

expectations surveyed in 2000 were all above the upper end of the target level. The average expectations for CPIX fluctuated between 6 and 8 per cent from 2000. By June 2002 expectations were creeping past the 8 per cent mark to reach more than 9 per cent by the November 2002 survey. By September 2003 expectations were below 8 per cent again and by the fourth quarter of 2003 expectations had fallen within the target range (Van der Merwe, 2004: 13). In South Africa's case, it would appear that the build-up of credibility among the public was initially slow.

### **3.7 Summary**

South Africa's adoption of the inflation targeting framework for monetary policy coincided with the opening up of the economy after the dawn of democracy. Over the years monetary policy took various forms which included the use of credit ceilings and credit controls, money supply targets, and an eclectic framework. Formal inflation targeting was adopted in 2000.

Headline consumer price inflation was already on a downward trend by the time the SARB formally adopted the inflation targeting framework. After peaking at 18 per cent year on year in the mid-1980s, headline consumer price inflation gradually fell to single-digit figures from 1993 onwards. The framework was adopted in order to maintain and lock in the lower inflation trend as well as for the other advantages afforded by the framework.

The other advantages include:

- the fact that the framework makes the intentions of monetary policy clear, unlike the SARB's experience with previous monetary policy frameworks;
- inflation targeting improves economic policy co-ordination; and
- it influences inflation expectations.

Another major factor which prompted the SARB to adopt inflation targeting was the concern that the inflation differentials between South Africa and its



trading partners would result in disruptive outflows of capital. Adopting the inflation targeting framework was, in a sense, inevitable. In adopting the framework, South Africa formally endorsed the global consensus of low inflation as the ultimate goal of monetary policy.

By all accounts, South Africa met the preconditions for the implementation of the inflation targeting framework. The SARB had the necessary formal independence as defined in the Constitution and the necessary instrument independence to conduct an inflation targeting policy. Although commitment to an inflation targeting policy and the co-ordination of policies were stated intentions on the part of the authorities, the extent of this is questionable given the consistently above-inflation administered prices and public-sector wage settlements. This will be discussed more fully in Chapter 4. South Africa is fortunate in that it has well-developed financial markets, which is necessary for the efficient operation of the inflation targeting framework. Finally, the SARB said it had the resources and skills to operate sophisticated forecasting and modelling procedures, although as will be seen again in Chapter 4, the readiness of these procedures is questionable.

In most respects, the SARB followed international practice in the design and implementation of its inflation targeting framework. South Africa's framework conforms to the basic tenets of a defined target range and level of the range, a specified time horizon, and the specified monetary policy tools to be used in pursuing the inflation target.

As a result of the adoption of the inflation targeting framework for monetary policy a number of institutional changes were implemented. The SARB is now characterised as a much more transparent institution than previously and certainly an effort is made to interact with a variety of stakeholder groups. Apart from trade unions, business groupings and the general public, the SARB regularly consults with the National Treasury on the conduct of inflation targeting. Transparency and accountability are enhanced through the introduction of an MPC, the publication of the twice-yearly *Monetary Policy*

*Reviews*, the regular reports to parliament and the introduction of the Monetary Policy Forums.

In line with international practice the SARB employs inflation expectation surveys as a way of monitoring inflation expectations and institutional credibility. Households, the business sector, analysts and the labour sector are surveyed quarterly. During the beginning stages of inflation targeting South Africa's experience confirmed a common trend where inflation expectations remain above the target range until central bank actions and policies acquire credibility.

It is evident that the SARB followed international norms and practices in adopting the inflation targeting framework for monetary policy. Its framework conforms to the basic principles of the theory and its reasons for adopting the policy were sound. There is no doubt that the adoption of the inflation targeting framework resulted in positive changes in the way the SARB conducts itself, in the form of heightened transparency and accountability.

## 4. South Africa's early experience with inflation targeting

### 4.1 Introduction

As indicated in Chapter 3, South Africa formally adopted inflation targeting in 2000 after an announcement by Finance Minister Trevor Manuel in his February Budget Speech. This followed months of public debate about the merits of inflation targeting for an emerging economy such as South Africa. In some respects the environment was conducive to the adoption of inflation targeting. Although South Africa was still in the throes of structural change Dykes (2004: 92) argues that a number of other countries, for example New Zealand and Poland, also adopted inflation targeting during times of structural change. The fact that a new governor, Mboweni, had taken office at the SARB in 1999 was also an advantage. Mboweni was a former labour minister and had political credibility. Armed with these credentials, Mboweni possibly could convince the economic role players of the SARB's commitment to inflation targeting and obtain their support and co-operation (Dykes, 2004: 92). Added to this, inflation had already fallen to relatively low levels and fiscal policy had remained disciplined since 1994.

However, a potentially problematic factor was government's sluggishness on privatisation and deregulation. This had left administered prices at a high level (Dykes, 2004: 92). Another concern was the SARB's credibility in forecasting and controlling inflation. This could not be tested before June 1999. Dykes (2004: 92) notes that there was a sense that the SARB wanted more time to test its models and forecasting capability. He elaborates: "This was not surprising, given the complexities of forecasting in a small, exposed economy undergoing enormous structural changes resulting from tariff reform, globalisation more generally, as well as social and political transformation. Other reservations centred on the SARB's ability to control inflation in an environment that is continually subjected to exchange rate and global price volatility." This is supported by Casteleijn (1999: 67) who writes in the *Quarterly Bulletin* that the SARB did not think South Africa was ready to adopt

a fully-fledged inflation targeting framework. The reasons ranged from the need for a comprehensive forecasting framework to the increased volatility in international financial flows. Casteleijn was also concerned that the policy credibility achieved by the monetary and fiscal authorities in the stabilisation process could be impaired by an “unsuccessful premature” adoption of inflation targeting.

In some respects these concerns were justified. It became clear early on that South Africa’s early experience with inflation targeting was difficult at best (Dykes, 2004; Woglom, 2003). The monetary authorities in South Africa had to contend with a number of stress tests to the framework, as shown in Table 3. Apart from the rapidly depreciating rand in 2001, high food and oil prices, persistent high wage settlements and consistent high inflation in administered prices complicated the task. This chapter will explore the early stress tests to the framework and the SARB’s responses to them.

**Table 3: South Africa’s early experience under inflation targeting**

Year	Target (CPIX)	Outcome	Shocks
2000		7.6%	
2001		6.6%	Rand collapse
2002	3 – 6%	9.3%	Oil and food price surge
2003	3 – 6%	6.8%	
2004	3 – 5% (subsequently changed to 3 – 6%)	Within target range; measured on a continuous basis	

Source: Marshall, 2002: 15

## 4.2 Oil prices

High international oil prices posed the first real test to the newly-adopted inflation targeting framework. Although oil prices increased rapidly only in 2000, the lag effect meant that this could impact on inflation in 2002, the year set for the achievement of the target. Brent crude oil prices increased swiftly

from a 25-year low of around \$10 a barrel in 1998 to over \$30 a barrel by the second half of 2000.

Much of the upward pressure in CPIX inflation until August 2000 was caused by higher food prices and the rise in transport costs as a result of the surge in crude oil prices (SARB, 2001). The CPIX measure of annual inflation in 2000 peaked at 8.2 per cent in August, falling to 7.6 per cent in December which was well above the upper end of the target range. Excluding energy prices, according to the SARB's calculations, CPIX would only have measured 7.2 per cent in August and 6.7 per cent in December.

In response, the SARB deemed it necessary to respond to expected inflation rather than to current inflation since the targets were set for 2002. The initial impact of a rise in energy prices on inflation is usually seen in the prices of petroleum products such as petrol and diesel prices which constitute approximately 4.1 per cent of the CPI and CPIX baskets (SARB, 2001: 11). What matters to policy-makers is whether these initial first-round effects (the rise in energy prices) become embedded second-round effects by feeding into other prices in the economy. If wages and other prices and inflation expectations rise as a result of the rise in energy prices, then policy-makers will respond (SARB, 2001: 12). Therefore, it was only in October at a special meeting that the MPC raised the repo rate by 25 basis points.

However, the SARB faced a dilemma. A large rise in interest rates to contain the impact of the oil price shock could have negatively impacted on an already subdued domestic economy. Towards the end of 2000 the SARB was under pressure to abandon or revise the inflation target and to use the higher oil prices as a justification for missing the target. According to the SARB: "In one sense, the whole inflation-targeting framework was being put to its first real test." However, the SARB (2001: 22) felt that abandoning or revising the target would have put the SARB's credibility at risk and would have complicated future successful monetary policy implementation.

### 4.3 The exchange rate

In addition to the rise in international energy prices, sustained pressure on the rand during 2000 imposed further strain on the inflation targeting framework. The rand is a notoriously volatile currency and, therefore, as Mboweni (2004) notes: “The exchange rate has proved central to the inflation outcome.”

The rand had declined almost continuously against most major currencies since the beginning of 2000. Towards the end of 2001 the weakening trend accelerated with the rand reaching a level of above R10 to the dollar for the first time at the end of November 2001. It then reached an all-time low of R13.84 to the dollar on 21 December 2001. The currency recovered somewhat and during January and February 2002 the rand fluctuated at levels of around R11.50 to the dollar. On a trade-weighted basis, the rand declined by over 34 per cent between June 2001 and 21 December 2001 (SARB, 2002: 12). After the initial shock exchange rate developments turned positive and the rand staged a dramatic recovery, contributing to the subsequent fall in inflation. The currency appreciated by 30 per cent against the US dollar and by 21 per cent against the trade-weighted basket since the beginning of 2002.

The depreciation of the rand in late 2001, combined with a sharp rise in international oil prices and domestic food prices, caused a surge in the annual rate of increase in CPIX from a low of 5.8 per cent in September 2001 to a peak of 11.3 per cent in October 2002 (Mboweni, 2004). Even in the second quarter of 2002 the SARB had strong doubts that it would achieve the inflation targets for that year because of the currency depreciation.

Similar to the spike in oil prices, monetary policy cannot be concerned with the so-called first-round effects of a depreciation in the currency but must try and mitigate the second-round effects of the exchange rate move. As indicated in the *Monetary Policy Review* of March 2001 (SARB, 2001: 21) the MPC was concerned about the second-round effects mainly resulting from the impact of the first-round effects on inflation expectations. The MPC (SARB,

2002: 1), therefore, raised interest rates by 400 basis points during the course of 2002 in order to pre-empt any second-round effects and to bring the inflation rate to within the target range.

The question of how best to deal with this challenge to attaining the target was a difficult one. As Mboweni (SARB, 2001a) observes there were a number of possible options for the SARB. One was to invoke the escape clause allowing for a deviation from the target in the event of a shock. However, this would have “admitted the immediate defeat” of the new monetary policy approach and might also have resulted in a loss of credibility. Another option would have been to tighten monetary policy to ensure the targets were met in 2002 and to demonstrate the clear determination of the SARB. However this would have incurred costs to the economy. Of the possible choices, the SARB opted to keep the repo rate unchanged for much of 2000. It was only in 2002 that the SARB began to raise the repo rate aggressively in order to contain any second-round effects arising from the rand’s depreciation.

The volatility of the rand puts South Africa in an unenviable position along with other emerging markets. Plenderleith (2003: 244) argues that exchange rate movements may have a larger impact on emerging-market countries, such as South Africa, than on their more developed counterparts. Emerging market currencies can be more exposed to volatility resulting from “shifts in sentiment unrelated to the country’s fundamentals”. While some argue that the central bank should try to smooth out the volatility in the exchange rate, Plenderleith argues that the appropriate remedy is to “stick to fundamentals, focusing monetary action determinedly on low inflation while taking into account impacts from the exchange rate as one amongst a range of relevant influences” (2003: 244).

Woglom (2003: 380) agrees, noting that in open economies with inflation targets, it is important not to react to temporary changes in the exchange rate. He notes that a flexible exchange rate within the framework of inflation targeting is a double-edged sword. Currency depreciations will result in an

increase in inflation which, in turn, may require a restrictive monetary policy response.

Apart from the inflationary impact of the rand's depreciation, the SARB was struggling with the fact that the South African public remained focused on the exchange rate rather than the inflation targets. Mboweni mentioned during a speech to the Institute of Bankers in July 2001 (Mboweni, 2001) that despite the central bank's efforts at creating and opening channels of communication on inflation targeting, the South African public was focused on exchange rate fluctuations rather than changes in inflation. Consequently, he argued, monetary policy decisions were often misunderstood. The problem for the SARB, despite its efforts, became communication.

#### **4.4 Food prices**

The rapid rise in food prices was the third stress test to South Africa's inflation targeting framework. Unfortunately the rise in food prices was combined with the two other stress tests, the rapid weakening of the currency and rising oil prices. Accelerating food prices were the main impetus behind the rise in CPIX inflation during 2002 and its fall in 2003 (SARB, 2003). The rise in food prices accounted for 0,7 percentage points of the total CPIX inflation of 6,4 per cent in June 2001; 3 percentage points of total CPIX inflation which reached 7,5 per cent in February 2002; and it accounted for 4,8 percentage points of the CPIX inflation of 10,8 per cent in August 2002 (SARB, 2002 & 2002a).

The price of maize, a staple food in South Africa, more than doubled between June 2001 and January 2002. This rapid price increase was partly a result of the depreciation of the rand, given that maize is a tradeable commodity and that its price is dollar-based. However, lower domestic production and high regional demand as a result of poor crops in the region also contributed to maize prices increasing to record rand price levels (SARB, 2002: 10).



As always, the SARB was concerned about the second-round effects. The rand's depreciation was felt primarily in food prices. The SARB viewed its role as guarding against further second-round effects from the food price rise. In other words, the SARB saw its function as preventing the food price inflation from impacting on inflation expectations and other wage and price decisions (SARB, 2002a: 1). However, the SARB's fears were confirmed when it became clear that inflationary expectations were becoming entrenched and wage settlements were trending higher. In response the MPC continued to raise interest rates. The repo rate rose by 400 basis points during 2002.

#### **4.5 Administered prices**

The last two factors affecting the success of the inflation targeting framework, administered prices and wage settlements, are better described as long-term obstacles rather than stress tests. Stress tests imply a severe external shock to the inflation targeting framework. Administered prices, those prices administered by the government or public sector agencies, such as electricity, water, education and certain medical costs, have long been a thorn in the side of the inflation targeting monetary policy regime. Constant criticism from Mboweni has been against administered prices and the state-owned enterprises that set them. While South Africa's parastatals are still in the midst of restructuring, the high increases in administered prices could on the surface indicate some lack of buy-in from certain sectors of government to the inflation targeting monetary policy.

A brief survey of the speeches and Monetary Policy Committee statements during the early years of inflation targeting implementation highlights the importance of administered prices and their effect on CPIX. The significance of administered prices lies in the fact that they are considered an exogenous factor that monetary policy cannot control. The MPC statement of 28 November 2002 (SARB, 2002b), contained a pointed assertion that "high increases in administered prices are clearly not desirable if we are serious about combating inflation. The public authorities need to place this matter high on their list of priorities. Discipline is necessary if we want to reach the

inflation targets.” In the MPC statement of 11 December 2003 (SARB, 2003c), reference is made to the “stickiness” of administered prices which was largely responsible for the persistence of higher service price inflation. In a speech given on 14 May 2004, Mboweni (2004b) refers to administered prices as a threat to the inflation target.

However, as time went on the government became gradually more willing to address the issue. The November 2003 MTBPS (National Treasury, 2003) noted that government commissioned a number of investigations into administered prices. Although at the time of writing no conclusions had yet been reached, the investigations showed that the government was now finally serious in its support of inflation targeting. As the MPC noted in its statement of 12 August 2004 (SARB, 2004b), “recent announcements by the government indicate a greater determination to moderate increases in administered prices as part of the co-ordination of policies to achieve the objective of price stability”.

While most commentators agree that price controls would be undesirable, because they distort the allocation of resources and lead to market distortion, Dykes (2004: 99) notes that the government appears to be leaning towards some form of market-driven solution through improved competition and improved regulation. This is encouraging. Whereas previously the only option for the SARB was to preach a gospel of low inflation and hope it was heard, now the government showed signs of backing its own policy.

The impact of administered prices on overall inflation is high. The administered price index (API) constitutes 21.64 per cent of the overall CPI and 23.9 per cent of CPIX. In the CPI, medical services, petrol and diesel, and communication services account for 54.6 per cent of total weight assigned to the API. The main components in the CPIX are medical services, petrol and diesel, and electricity; together they contribute 53.6 per cent of the total weight of administered prices (SARB, 2001). Given the weight of administered prices in both the CPI and CPIX, the effect of changes in administered prices is large. Overall administered prices increased by 11.1 per cent for the year

ending 2000 while the overall CPI rose by 7.0 per cent (SARB, 2001: 19). Administered prices recorded double-digit inflation rates until March 2001, according to the *Monetary Policy Review* (SARB, 2002a). In August 2002 API inflation was 7.8 per cent. Medical and education prices are often cited as the main contributors to API inflation.

Such is the impact of administered prices on inflation in South Africa that the SARB was prompted to note in the *Monetary Policy Review* (SARB, 2003: 23) that the pervasiveness of administered prices was a problem common to emerging markets. The Review noted that administered prices do not necessarily respond to monetary policy. These prices could also be a structural impediment to a sustainable low inflation rate in South Africa since it is easier to sustain low inflation in a competitive economy.

#### **4.6 Wage settlements**

The persistently above inflation wage settlements by the private and public sectors are the second long-run obstacle to the inflation targets. These wage settlements are closely related to the inflation expectations and thus the credibility of the SARB's monetary policy framework. In the *Monetary Policy Review* of November 2003 (SARB, 2003: 22) the following is noted: "Backward-looking behaviour, where wage and price setters assume that inflation will be similar to what it was in the previous period, arises when there is a lack of credibility in monetary policy. Simply put, in the absence of strong credibility, if people do not see inflation falling, they will not believe it will fall. This will result in inflation inertia...". The SARB (2003: 23) notes that forward-looking wage setting will help accelerate the decline in inflation and make the SARB's job easier.

The problem of backward-looking wage setting was part of a broader trend of backward-looking inflation expectations. Mboweni (2003b) observes that this constrains the gradual reduction of inflation and leads to what is termed inflation persistence. He noted that the SARB preferred wages and prices to be set on the basis of the expected inflation rate.

For inflation targeting purposes it is the unit labour costs that are important i.e. the increase in wages adjusted for changes in productivity. With public and private sector wage settlements over the years since inflation targeting was adopted being consistently higher than CPIX inflation (see Table 4 below), this means that productivity has to increase in order to prevent any upward pressure on inflation.

**Table 4: Average wage settlements compared with annual changes in CPIX (South Africa)**

Year	Annual change in CPIX (%)	Annual change in remuneration per worker (% for total non-agricultural sectors)	Annual change in nominal unit labour costs (%)
1999	6.9%	7.7%	3.1%
2000	7.8%	9.2%	1.9%
2001	6.6%	9%	4.2%
2002	9.3%	9.6%	6%
2003	6.8%	8.7%	4%
2004 (01)	7.6%	8.9%	5.4%
2004 (02)	5.0%	7.9%	6.8%
2004 (03)	2.6%	6.3%	4.9%

Source: SARB 2005: S158

By the first quarter of 2002 increases in unit labour costs had risen to levels above that of the targeted inflation rate. Year-on-year growth in unit labour costs accelerated from 2.4 per cent in the second quarter of 2001 to 7 per cent in the fourth quarter before slowing to 6.4 per cent in the first quarter of 2002. This was a result of rising wages and falling productivity. The annual increase in remuneration per worker rose from 7 per cent in the second quarter of 2001 to 10.7 per cent in the final quarter while productivity growth slowed from 4.5 per cent in the second quarter of 2001 to 3.4 per cent in the

third quarter, declining to 3 per cent in the first quarter of 2002 (SARB, 2002: 15).

However, Mboweni takes cognisance of the fact that for wage settlements and expectations to be set in a forward-looking fashion, there has to be confidence that the SARB will be able to achieve the inflation target. This kind of credibility can only be built up by the Bank achieving the inflation target and having a proven track record of maintaining low inflation.

#### **4.7 Outcomes**

Given these stress tests and challenges to the framework in the early years, how did South Africa actually fare? In 2002, the first year of inflation targeting, CPIX annual inflation averaged 9.3 per cent, well above the upper end of the target range. In 2003 CPIX averaged 6.8 per cent, only marginally above the upper end of the range. However, an important policy shift in November 2003 which changed the target from the calendar year average to a continuous target, i.e. the 12-month measure of CPIX must remain within the target on a continuous basis, means that ostensibly the SARB has achieved its targets since December 2003. Annual inflation on a monthly basis had fluctuated between 5 per cent and 3.7 per cent between December 2003 and August 2004.

The SARB summarised the reasons for missing the 2002 targets in the Monetary Policy Committee statement of March 2003 (SARB, 2003d). The reasons included the rand's depreciation, food price increases, oil price increases and increases in administered prices. The MPC concluded that the failure to achieve the 2002 targets was due to extraordinary events that fell outside the control of monetary policy. The SARB's responses were varied as it sought to respond to the second-round effects of the various shocks. As can be seen in Table 5, the SARB decreased interest rates systematically in 2001, raised them in 2002 and decreased interest rates again in 2003.

The SARB's initial failure in achieving its inflation targets contrasted with the success of some of the pioneering countries. The early failure, according to Dykes (2004: 96), was even more disappointing given the strong decline in global inflation over that period. However, in other respects South Africa is not unusual. South Africa is not alone in embarking on the inflation targeting framework in the midst of massive structural changes. When New Zealand adopted inflation targeting in 1990 it was undergoing significant structural change and it also did not have sophisticated econometric models or a clear understanding of how the transmission system worked (Dykes, 2004: 92). Similarly, Marshall (2002: 15) notes that South Africa's early failure is not unusual when compared with developing countries like the Czech Republic and Poland. These countries experienced undershoots and overshoots of their targets in the early years, as is explored further in Chapter 5.

**Table 5: SARB MPC's monetary policy responses**

<b>MPC meeting date</b>	<b>Monetary policy action</b>
<b>2000:</b>	
16 October	+25 basis points
<b>2001:</b>	
14 June	-100 basis points
20 September	- 50 basis points
<b>2002:</b>	
15 January	+100 basis points
14 March	+100 basis points
13 June	+100 basis points
12 September	+100 basis points
<b>2003:</b>	
12 June	-150 basis points
14 August	-100 basis points
10 September	-100 basis points
16 October	-150 basis points
11 December	-50 basis points

**Table 5: continued**

<b>MPC meeting date</b>	<b>Monetary policy action</b>
<b>2004:</b>	
12 August	-50 basis points
14 October	unchanged
9 December	unchanged

*Source: SARB, 2004c*

Both Dykes and Marshall argue that the failure in achieving the inflation targets should perhaps not be overemphasised as there is little to suggest that interest rates and inflation would have been lower under a different system. Significantly, Dykes (2004: 100) says that the capital markets have consistently reflected a belief in the downward trend in inflation. This belief could not have occurred in the absence of central bank and government credibility.

South Africa was, perhaps, unfortunate in the timing of its introduction of inflation targeting. The SARB (2001: 22) points out that other countries experienced a relatively stable international climate when they introduced their frameworks. In some cases the actual inflation rate was close to the target and monetary policy therefore had to attempt to maintain a low inflation rate. The SARB, on the other hand, had to contend with immediate challenges to the framework.

Key to South Africa's experience is that the SARB's failure to achieve the targets appears not to be due to errors in implementing the framework or incorrect policy responses. Woglom (2003: 403) argues that while macroeconomic conditions were somewhat tumultuous during the initial targeting period, the SARB acted flexibly and wisely in response to the shocks. He further asserts that this flexible response allowed the SARB to retain its credibility in terms of monetary policy, in spite of the fact that the targets were missed. Similarly Dykes (2004: 106) states that the framework is

“theoretically rigorous” and should lead to the desired outcomes in the longer term.

#### **4.8 Policy and operational adjustments**

There have been two major policy changes in the inflation targeting framework since its inception. Both policy changes were announced by the Minister of Finance, Trevor Manuel in November 2003 in the Medium Term Budget policy Statement.

The first policy change was the re-specification of the target. The 12-month measure of CPIX inflation would be targeted on a continuous (month-by-month) basis rather than on a calendar-year average basis (National Treasury, 2003). According to the *Monetary Policy Review* of May 2004 (SARB, 2004: 2), a continuous target is more forward looking and allows monetary policy to focus on the period of 18 to 24 months over which monetary policy operates.

Secondly, the Minister announced a change to the escape clause which then became an “explanation clause”. As noted previously, the difference between the two is unclear. The change was intended to give some flexibility to the Bank in the conduct of monetary policy within the new definition of the target (SARB, 2004a: 1). In the event of a serious supply side shock, such as an oil price shock, drought or financial contagion, the central bank is obliged to fully inform the public of the nature of the shock, the anticipated impact on CPIX and the monetary policy response to ensure that inflation returned to the target. This appeared to be an attempt to reduce the ambiguity surrounding the escape clause and its use (Dykes 2004: 98). At the time of writing, this explanation clause was untested in that inflation was contained within the inflation target range.

Apart from the two policy changes, there were other changes to the timing of MPC meetings as well as to the target range itself. The acknowledgement that the targets would be missed in the first two years of implementation led to an



upward adjustment for the 2004 target. The target was initially set at 3 to 6 per cent for the years 2002 and 2003. It was tightened for the years 2004 and 2005 to 3 to 5 per cent in the October 2001 MTBPS (National Treasury, 2001). However, in October 2002 the Minister announced that the 3 to 5 per cent target for 2004 and 2005 had been suspended until further notice. Given that CPIX inflation averaged 9.3 per cent in 2002 and 6.8 per cent in 2003, despite a rise of 400 basis points in the short-term interest rate, the target was subsequently widened to 3 to 6 per cent until further notice. Acknowledging the criticism from some quarters that this had been seen as indicating a lack of commitment to the inflation target, the *Monetary Policy Review* of April 2003 (2003b: 21) noted that it should be emphasised that the goal of inflation targeting is to achieve the target but not as quickly as possible or at all costs.

The implications of the change were positive (Dykes, 2004). The government implicitly released the SARB from trying to force an achievement of the targets in 2003, which would have been damaging to the economy. Judging by international experience, it would appear that the SARB had not acted incorrectly in adjusting the policy framework and making institutional changes when necessary. A consolidation of experience necessitates constant refinements to the framework in order to address changing circumstances. In this writer's view, the refinements and modifications to the framework have not been met with great opposition or concern. The fact that the policy refinements are announced during the MTBPS, when the targets are set for the following period, has come to be expected and lends some certainty to the process.

#### **4.9 Credibility**

The key question is whether the SARB's credibility, through the policy refinements and missing the targets, has been damaged in any way. In this regard, Du Plessis (2002: 47) notes that the credibility of the SARB at that time had not been conclusively established. In an interview conducted with Brian Kahn, Senior Deputy Head of the SARB's Research Department and a member of the MPC (Kahn, 2004), he observes that the reasons for the

deviation from the target were so obvious that it did not irreparably damage the SARB's credibility. This is shown in the fact that CPIX fell to within the target fairly quickly. Although there were calls for the authorities to abandon the framework as a result of the severe oil price and exchange rate pressures, Marshall (2002: 15) notes there were few viable alternative strategies that could be implemented without the SARB suffering a severe loss of credibility. The SARB had to weather the storm, and it did.

The credibility of the central bank's ability and commitment to reaching the target is a nebulous issue. If credibility is taken to mean that the public believes the targets will be adhered to because it is convinced of the central bank's ability and commitment then, theoretically, inflation and inflation expectations should converge.

Judging the credibility of inflation targeting monetary policy from the inflation expectation surveys provides some interesting insights. In a discussion in the *Monetary Policy Review* of March 2001 (SARB, 2001), the expectation of the finance, business and labour sectors was that the target would be missed in 2002. In fact, the expectations of the inflation outcome for 2001 were on average above the actual CPIX outcome of 6.6 per cent for 2001. It is interesting to note that the expectations of the financial sector were generally accurate since they are generally more forward looking while the expectations of the business and labour sectors were higher than the actual outcome. This underlines the inertia of inflation expectations. The Bureau of Economic Research, which conducts the surveys, notes that the initial higher-than-target expectations are consistent with other inflation targeting countries' experience where inflation expectations gradually moved to within the target range as the central banks' credibility increased.

The depreciation of the rand and the increase in food prices in late 2001 pushed inflation expectations in the first quarter of 2002 above the target range for 2002 (SARB, 2002: 24). These higher inflation expectations were mirrored by the steeper yield curve, reflecting an expected increase in interest rates as a result. By the first quarter of 2003 inflation expectations continued

to rise, following the actual upward movement of inflation throughout 2002 (SARB, 2003b: 25). By the first quarter of 2004 inflation expectations for all groups declined but those of business and labour remained outside the target range. However, a positive development was that the expectations of the business and trade union sectors fell sharply in the course of 2003 to the first quarter of 2004. The trade union sector's expectations declined from 10,4 per cent in the first-quarter survey of 2003 to 6,1 per cent a year later (SARB, 2004a: 29).

The above scenario underlines Dykes' (2004: 104) assertion that inflation expectations are difficult to adjust. The business, consumer and labour sector reluctantly accept that inflation is low and declining. The inertia of inflation expectations could, therefore, be due to the public's reluctance to be convinced that the central bank is intent on maintaining low levels of inflation.

However, it is simplistic to view the labour sector's initial inertia as simply not believing the SARB's commitment or capability of reaching the inflation targets. The labour movement in South Africa has been especially vocal in its consistent opposition to inflation targeting principles. This is chiefly because it sees inflation targeting as preventing job creation.

A key credibility issue concerns the SARB's response to the exchange rate depreciation. Although the financial sector has reflected a consistent belief in the downward trend in inflation, Woglom (2003: 382) notes that the financial markets appear to be uncertain about the SARB's response to exchange rate shocks. The SARB's policy response of not trying to completely offset the real depreciations of the rand in 2000 and 2001 appeared to surprise the financial markets. This probably meant that the inflation targets would not be met during 2003.

Many commentators agree that while the SARB appears to have weathered the early years fairly well, certain changes need to be made to entrench the credibility of monetary policy. Woglom (2003: 403) argues that more transparency is needed to communicate how policy regarding the exchange

rate will be guided. While on the surface the SARB espouses a focus on the inflation targets, there is the proviso that a number of factors, including the exchange rate, are taken into account. This could be the source of ambiguity and uncertainty for the financial markets. However, there have been consistent accusations that the SARB does not communicate well. Du Plessis (2002) argues that the SARB needs to implement a “more sophisticated” communications strategy.

It has been noted in Chapter 3 that the inflation targeting framework needs a supportive context in order to achieve success. This is also borne out by the South African experience. Governments need to show support of the targets in order to lend credibility to the process. As already discussed administered prices have been problematic but are being addressed. Dykes (2004: 101), however, argues that wage policies also need attention.

Both Dykes (2004) and Du Plessis (2002) argue that the SARB could boost its credibility further by introducing some technical changes. The SARB should make known its forecasts, release details of its econometric models and the assumptions underlying its fan chart. In this respect the SARB is different to other central banks. The Brazilian central bank, for example, details the assumptions behind its so-called baseline scenario as well as the risks to this outcome. It also details assumptions for regulated prices, the exchange rate and interest rates.

Secondly, Du Plessis (2002) also argues that the MPC meetings must be made more transparent with the publication of minutes and a voting record, a detailed inflation report and the appearance of the MPC members before parliament. He refers to the practice of the MPC to reach a decision by consensus as “eccentric” and argues that the MPC meetings are “scarcely transparent”, despite the televised press conferences. Instituting these changes would allow the public to monitor the process (Du Plessis, 2002: 10). However, Mboweni has often argued that the MPC is as transparent as its international counterparts. The SARB is certainly not the only central bank to reach monetary policy decisions by consensus. This technique is employed

by Switzerland, Thailand, Australia and Canada. Further, a detailed statement is released immediately after the SARB's MPC meeting is concluded, which is arguably an improvement on the Bank of England's practice of releasing minutes two weeks after the conclusion of the interest rate meeting. Du Plessis also appears to misunderstand the workings of the MPC. The committee members do not vote but engage in discussions until they reach consensus. A record of the voting patterns is, therefore, not possible.

It would appear, then, that for all the SARB's efforts, patience is needed on the credibility front. Du Plessis (2002: 12) quoting Blinder, says: "There do not appear to be any shortcuts to credibility, rather ...central banks get their credibility the old-fashioned way; they earn it by building a track record for honesty and inflation aversion."

#### **4.10 Summary**

At the outset, the timing of the introduction of inflation targeting in South Africa appeared both favourable and unfavourable. The new monetary policy framework coincided with a change of leadership at the SARB. It was felt in certain quarters that a new governor at the helm, Mboweni, with his impeccable political credentials could perhaps spread the word of inflation targeting and gain acceptance for the new policy better than his predecessor. However, the government's sluggishness with privatisation and deregulation meant administered prices remained at a high level. Coupled with this were concerns about the SARB's forecasting and modelling capability and its ability to control inflation in the face of volatile currency movements.

In hindsight it has become clear that South Africa's timing in introducing inflation targeting was perhaps more unfortunate than advantageous. The international economy was far from benign due to rising oil prices, rising international interest rates and rising US growth. In the light of this, South Africa's inflation targeting framework was subjected to three stress tests and also had to contend with two long term obstacles.

In 2001 and 2002, the combined effects of the rapid collapse in the rand and the oil and food price spike contributed to the failure to achieve the targets in the first two years of operation. The two long-term obstacles – high administered prices and high wage settlements – were ongoing problems that significantly impacted on the achievement of the inflation targets during the first two years. A policy change towards the end of 2003 meant that the SARB had consistently achieved its targets since November 2003 to August 2004.

In the case of all three stress tests, the SARB followed international practice by remaining focused on the primary goal of low inflation and responding only to the second-round effects of the shock. In the case of the oil price spike, the SARB responded to inflation expectations and signalled its concern by raising the repo rate by 25 basis points. The exchange rate was another forceful test to the framework with the rand weakening by 34 per cent in the last six months of 2001 alone. The MPC had to concern itself with the second-round effects of the shock. The SARB kept monetary policy unchanged and in so doing indicated that low inflation was not being pursued at all costs. Most commentators agree that it is best for central banks not to respond to temporary changes in the exchange rate. The third test, in the form of food prices, was the main impetus behind the rise in inflation during 2002 and its fall in 2003. The SARB raised interest rates when it became clear that inflation expectations were becoming entrenched and wage settlements were trending higher.

The two long-term obstacles to inflation targeting present more of a credibility and communication problem for the SARB. The high rise in administered prices can be interpreted as a lack of government support and buy-in to the policy. However, some progress was made with the government announcing a number of investigations into the issue. As is noted, these prices are generally not responsive to monetary policy decisions and therefore cannot be countered with a monetary policy response. However, the SARB's continued public statements about the issue appear to have been heard. The second obstacle, the high wage settlements, is related to inflation expectations and the credibility of the SARB's monetary policy framework. Once again the

SARB embarked on a strong campaign by issuing public statements about the subject.

Although South Africa did not achieve its inflation targets for the first two years, this was evidently not due to errors in the policy framework, implementation of the framework or incorrect decisions. For all intents and purposes the SARB followed generally accepted best practice in that it maintained its focus on the second-round effects of the various shocks and did not overreact to the initial shocks.

As a result of the early experience, the SARB made various changes to the framework and operational procedures. With the benefit of hindsight and experience, the target for 2004 and 2005 was widened from 3 to 5 per cent to 3 to 6 per cent; the target was re-specified as a continuous target rather than a calendar-year average and the escape clause was changed to an explanation clause. Refinements like these should not be regarded as unusual, as noted in Chapter 2 (see Mishkin 2000a: 220). Other changes were made to the timing of the MPC meetings and the composition of the MPC. These refinements did not appear to create credibility problems for the SARB.

The SARB's credibility in the early years also appears to be in line with the experience of other countries where credibility is built up only after the central bank has proved itself. Average inflation expectations, a measure of credibility, initially diverged from the target range and only fell within the target range during 2004. South Africa is, therefore, not different from other countries which have battled with expectations based on historical levels of inflation rather than a belief in the central bank's commitment to the inflation targets.

Some commentators argue that the SARB could boost its credibility by introducing some technical changes. Among the suggested changes are releasing its forecasts, details of its econometric models and publishing the minutes and voting record of the MPC. However, the SARB appears to be as

open and transparent as it can be without laying itself bare to unwarranted criticism. Still, as the SARB gains further experience it could make further changes to the institutional arrangements.

In conclusion, then, the question that arises is should the early years be regarded as the years when teething problems are bound to occur? Should some allowances be made for central banks in missing the targets in the early years? If one of the aims, and it most certainly is, is to ensure that the monetary authorities retain the necessary credibility in order to conduct monetary policy within an inflation targeting framework, then this kind of latitude is undesirable. However, if it is agreed that inflation targeting should be implemented flexibly rather than rigidly at all costs, then a highly sophisticated and more transparent communication strategy is necessary.

