Commentary: Challenges of inflation targeting for emerging-market economies: The South African case

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For inflation to be outside its target range for 18 consecutive months, amid a cycle of monetary tightening, suggests that there are shortcomings in the price mechanism; either in its application by monetary policy-makers, or in the mechanism itself, for example, the designated range being too ambitious for the South African economy to reach. Indeed, there is strong criticism that the cycle of monetary tightening, first embarked on in June 2006, has pushed interest rates up by 500 basis points, but that the desired result of lowering the consumer price index excluding mortgage interest cost for metropolitan and other urban areas (CPIX) to within its 3–6 per cent target range has not been achieved. When viewed in this context, inflation targeting may be considered a failure.

Since its implementation in 2001, changes have only been made once to the inflation target and that was in 2003. Firstly, to the range, which was widened from 3–5 per cent to 3–6 per cent and, secondly, to the target being monitored not against an annual average of CPIX, but against where CPIX is each month. Since these changes were implemented, the dynamics in the economy have changed considerably:

- South Africa is in the midst of its most ambitious infrastructural spending programme on record, with some R600 billion intended to be spent over the next three to five years.
- Between 2005 and 2007, some 2,3 million consumers have migrated from low-income Living Standards Measure (LSM) categories to higher-income, middle-class categories. In many instances, these consumers have reduced their asset deficits, accumulated pursuant to a number of legacy issues, and relied on credit to facilitate such consumption. (Refer to Table 1.)

With dynamics as intense as these, the inflation-targeting mechanism has become something of a straightjacket for the economy, where gross domestic product (GDP) growth and job creation are compromised. If these changes are to be more sustainable, it would be prudent to widen the inflation band to 3–7 per cent, and then, once these effects of consumer migration and infrastructure spending come off their highs, to revert to the previous band of 3–6 per cent.

Table 1: Migration of households in Living Standards Measures (LSM) categories

Living Standard Measure	Household income per month (R)	2005	2003	Change 2005 versus 2003	2007	Change 2007 versus 2005
LSM 1	1 028	2 317 000	2 828 435	(728 735)	1 287 000	(1 030 000)
LSM 2	1 275	3 745 000	3 900 263	(315 980)	3 034 000	(711 000)
LSM 3	1 638	3 979 000	4 287 312	(169 001)	3 366 000	(613 000)
LSM 4	2 141	4 582 000	4 168 220	579 034	4 290 000	(292 000)
LSM 5	2 952	4 132 000	3 810 944	506 125	4 516 000	384 000
LSM 6	5 096	4 451 000	3 930 036	796 118	5 379 000	928 000
LSM 7	8 320	2 174 000	1 935 245	433 580	2 885 000	711 000
LSM 8	11 227	1 609 000	1 756 607	(73 406)	2 096 000	487 000
LSM 9	14 741	1 971 000	1 637 515	404 622	2 359 000	388 000
LSM 10	20 902	1 695 000	1 518 423	215 643	1 898 000	203 000
Migration						
LSM 1–3		10 041 000	11 016 010	(1 213 716)	7 687 000	(2 354 000)
LSM 4–7		15 339 000	13 844 445	2 314 857	17 070 000	1 731 000
LSM 8		1 609 000	1 756 607	(73 406)	2 096 000	487 000
LSM 9–10		3 666 000	3 155 938	620 265	4 257 000	591 000

Source: South African Advertising Research Foundation, Brait

Early in its implementation, the inflation-targeting mechanism faced criticism in that monetary authorities were felt not to be passing the full extent of interest rate cuts to the economy. This kept the high-yield attraction of the rand strong between 2003 and 2005. The South African Reserve Bank (the Bank) may not have been explicitly targeting a strong rand, or for that matter, any level in the local exchange rate, but the perception was that a “strong rand policy” was allowed to operate, which kept imported inflationary pressures at bay and made the inflation target easier to reach. The criticism, that such a policy risked pushing interest rates higher than they should be, and therefore compromised GDP growth and job creation, is entirely valid, as is the criticism that exogenous food and fuel price shocks should not be responded to with monetary tightening. Monetary policy has no control over prices of commodities set on international markets. This highlights the tenuous trade-off between flexibility and credibility the Monetary Policy Committee (MPC) must strike. The price mechanism is inflexible in handling the exogenous prices, which prompted interest rates higher, to the extent that the MPC faces criticism for maintaining a restrictive monetary route, which did not deliver the intended goal of bringing prices within the 3–6 per cent range. A different approach is now needed to protect what economic growth there is.

While inflation targeting handles demand pressures well, the same cannot be said for supply-side shocks. Oil price spikes and drought, which affect fuel and food inflation respectively, and in the current environment, financial contagion, are issues over which consumers, and monetary and government authorities have no control. A somewhat different response is required under such circumstances. This raises the matter of the explanation clause and why it has not been invoked.

South African Reserve Bank Governor Tito Mboweni has said that the clause would not be invoked and that he would not operate in a way similar to that where Mervyn King, Governor of the Bank of England, wrote to the then Chancellor of the Exchequer Gordon Brown, explaining why the British central bank was missing its inflation target. In South Africa there is no point in having a clause if it will not be invoked. However, as with exchange control regulations, which are formulated by government, but implemented by the Bank, amendments to the inflation target need to come from the National Treasury.

Why should central banks push interest rates any higher, when monetary tightening will have a negligible effect on these price pressures? Put more simply, commodity prices are set on international markets. Monetary tightening will therefore be little more than a blunt instrument. The duration of such shocks may not be known, but if the central bank is as forward-looking on monetary policy as it says it is, then on a balance of probabilities the effect of financial contagion the world economy is now experiencing will be reflected in disinflation/deflationary pressures over the next 12–18 months. A monetary response under such conditions suggests aggressive accommodation from the Bank, similar to that undertaken by most G-20 central banks over the past few months. The question therefore asked is why is it taking the MPC this long to cut interest rates?

An answer can probably be found in the application of the new inflation target – consumer price index (CPI), which includes owner equivalent rent – the first data of the reweighted and rebased data released by the time the MPC meets in the new year (2009). The MPC is likely to wait for the new inflation data before making its move on interest rates.

If there is a problem created by having a high interest rate environment and, in particular, high interest rate differentials, it must be the bubble created in the balance of payments, when carry-trade-type transactions are created. The mismatch between short-term, speculative capital flows and long-term, foreign direct investment inflows is that speculative flows are susceptible to the fickle ebb and flow of sentiment. Carry-trade positions, which are accumulated over many months, are often unwound over much shorter time frames, creating disruptive patterns of volatility for the rand, at times inviting a restrictive monetary response to a rising inflationary environment. The challenge for monetary authorities is therefore to monitor an interest rate differential attractive enough to boost portfolio inflows, but not sufficient to attract abnormally large amounts of speculative, carry-trade-type transactions. It must be stressed, however, that a monetary response is insufficient on its own to address the mismatch between short- and long-term capital flows through the financial account. A less stringent regulatory environment, more flexible labour legislation and incentives for exporters are all issues that must be handled by government, if longer-term foreign direct investment is to be attracted.

Another challenge for inflation targeters has been the lack of control it has over administered prices, such as the series of price hikes in electricity and property rates. Verbal intervention from the central bank is generally not effective, yet the MPC has to flex its monetary policy around price hikes over which it has no control.

While the aforementioned may be viewed as criticisms that highlight a need to fine-tune the mechanism, inflation targeting has had its successes. Among these are an important anchor being created for price adjustments, a useful benchmark against which wages and prices can be adjusted, and an efficient signal for when rate changes are pending.