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Would the Criticism of the Inflation Targeting Framework Pursued by South Africa be Justified?

The deviation of the observed inflation rate from the inflation target since 2007 could raise concerns that this monetary policy framework pursued by South African Reserve Bank (SARB) is deficient……..

Introduction

The history of inflation targeting (IT) dates as back as late 1980s. It was first adopted by New Zealand in 1989 and the ultimate objective of the monetary policy framework was cited as attainment of price stability. Since its introduction, a growing number of industrialised and emerging market economies adopted IT as a monetary policy framework *inter alia* Canada, Chile, United Kingdom, Australia, Brazil etc. Similarly, in February 2000, South Africa (SA) adopted this monetary policy framework. IT is characterised by a public announcement of an official target for the rate of inflation and an acknowledgement that low and stable inflation is the primary goal of monetary policy. A 3-6 percent inflation target range was adopted by SA in the year 2002 as stipulated in the budget speech of 2000. However, inflation rate has remained above the upper limit of the 3-6 percent from April 2007 to date. Therefore this could lead to severe criticism of IT. Many could therefore argue that IT is deficient. But the question is: would that argument be justified? The objective of this discussion is to provide answers to this question. In answering this question the justification for adoption of this monetary policy framework and the possible explanatory factors for the recent performance would be provided.

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Further, it would also be important to assess whether (and how) the CMA countries have been affected by the implementation of this monetary policy strategy. Such an evaluation is very useful since any policy change or reversal would have a direct bearing on economies such as Lesotho, through the fixed exchange rate regime.

Pros and Cons of Inflation Targeting

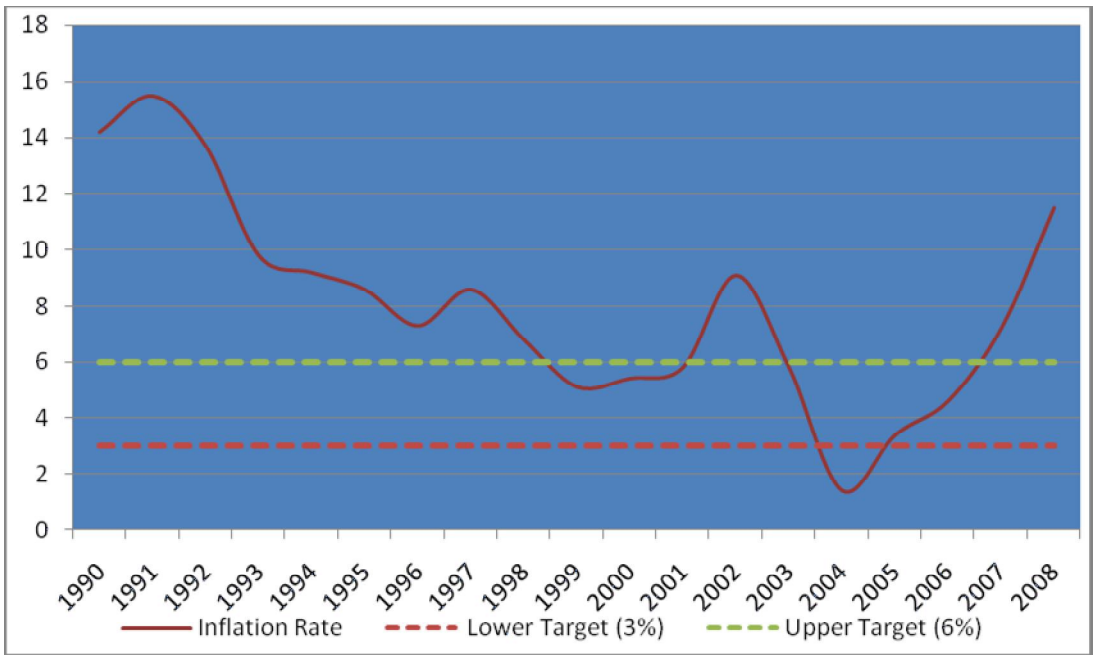
Adoption of IT has both benefits and costs, as evidenced by the experience of countries that adopted IT thus far. Experiences of emerging market economies that adopted IT would be used to gauge the benefits vis-à-vis costs of IT. For instance, the experience of Brazil since the adoption of IT showed mixed signals. The targets for inflation were met in 5 out of 8 years of IT. However, although inflation was met in most of the periods, the inflation targets were frequently altered in line with the shocks that hit the economy. Further, IT led to a drop in real interest rates which put an expansionary pressure on net public debt. Economic growth did not improve much compared with the period prior to adoption of IT, and this did not happen despite favourable environment for economic growth in era following adoption of IT. Chile is also one of the emerging market economies that adopted IT in the early 1990s. Chile has been able to lower inflation rates from 20 percent to around 2 percent presently (Mishkin, 2004). Over the same period, output growth has also been very high averaging 6 percent per year from 1991 to 2002.

Other economists (Fraga, 2003) argue that average inflation in both emerging market and developed economies is lower after adoption of IT than before its adoption. However, it is argued that emerging market economies have had a relatively worse performance in comparison with developed countries as evidenced by more volatile output and inflation. The relatively weaker performance by emerging market economies is attributed to more volatile macroeconomic environment coupled with weaker institutions.

South African Performance since the Advent of IT

The above-stated prons and cons of IT are used as a yardstick of the success or otherwise of IT in SA. The discussion will be guided by the following array of questions: i) has inflation been low and stable with the advent of IT? ii) Has there been any transparency and accountability in the conduct of monetary policy? Has output become more volatile with the advent of IT? As Figure 1 below depicts, the rate of inflation has remained relatively low and stable since the introduction of IT framework. Since 2000 when this framework was adopted, inflation remained on a single digit except on a few occasions. Figure 1 clearly shows that the conduct of monetary policy has been credible. The deviation from the target in 2001-2002 was driven by the severe depreciation of the rand vis-à-vis other currencies. Further, the deviation of inflation from the target since 2007 was a result of the impact of exogenous shocks which the SARB had no direct control over. For instance, in July 2008, the price of Brent Crude Oil was above $145 per barrel. With regard to accountability, the SARB has been communicating the factors that led to the failure to achieve the set target through several of its monetary policy statements and press releases, monetary policy reviews, and holding of forums which reflect accountability. Kahn (2008) argues that despite the challenges that have been posed by supply-side and exchange rate shocks, the variability of both output and real interest rates has declined during the IT period.

Figure 1: SA Average Inflation Rate

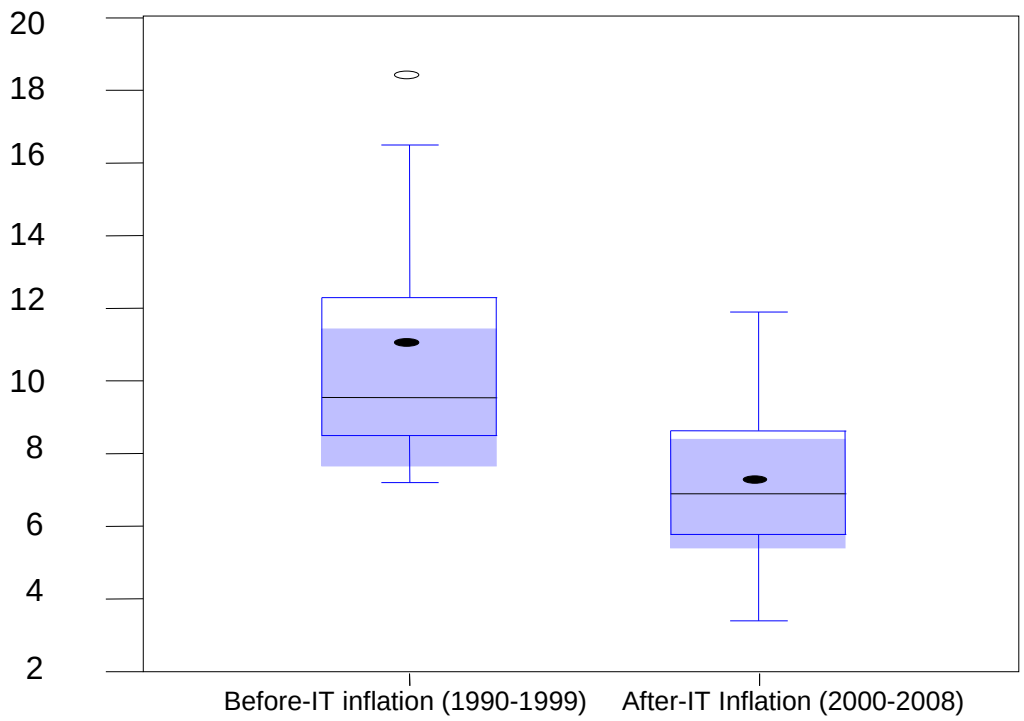


Data Source: *Statistics South Africa*

What has been the Impact on Lesotho?

There are both benefits and costs to Lesotho of the move to IT as a monetary policy framework. The decision by Lesotho (prior to adoption of IT) to peg the loti to the rand was based on the close trade linkages and the history of low inflation in South Africa. Has the picture changed with the advent of IT? Has adoption of IT brought more costs than benefits to Lesotho? As indicated earlier, since the adoption of IT, inflation has remained relatively low and stable in comparison with the era prior to adoption of IT. As a consequence, this has translated into a lower price level through the fixed exchange rate system. Average inflation was roughly 7 percent since the adoption of IT. In turn therefore, the lower price level has benefited the poor in Lesotho who lack assets to hedge against high inflation. Due to their very low incomes, inflation tends to erode the purchasing power of their incomes. However, there are costs to Lesotho. Lesotho's economy is driven largely by the export sector and since there is an inherent preference for a stronger rand under IT, this might have impacted negatively on Lesotho's export sector.

Figure 2: Lesotho's Inflation Performance Before and After Adoption of IT



Data Source: *Bureau of Statistics*

Conclusion

As the above discussion shows, since the adoption of the inflation targeting framework, South Africa has managed to achieve relatively low and stable inflation. However, the deviation from the target over the period was due to exogenous factors which SA has little control over. Thus it can be concluded that the criticism of this framework would be unjustified as evidenced by low inflation in the era after adoption of IT.

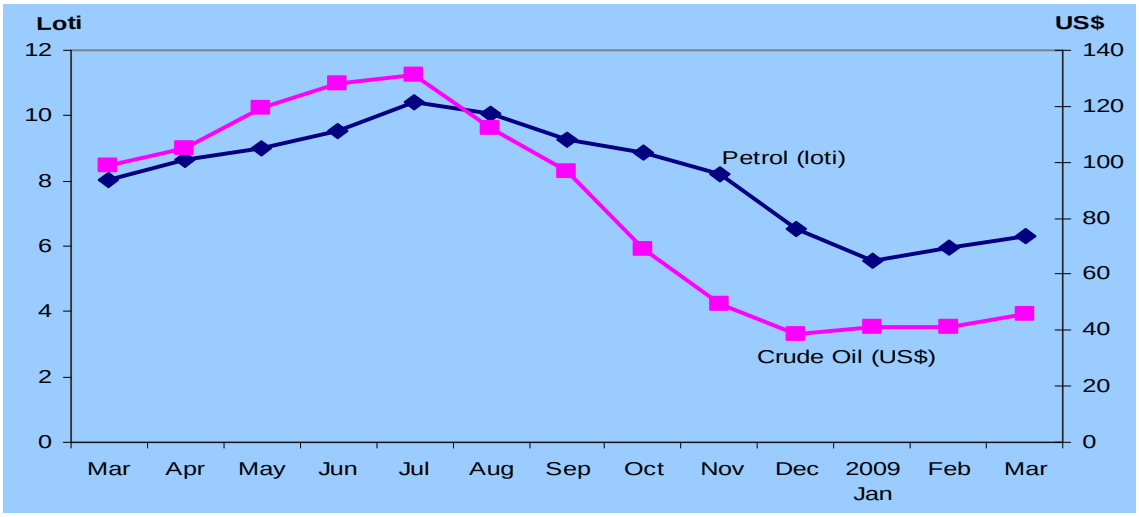
International Oil Price Movements

The international price of oil reached a peak at $140 a barrel in July 2008. However, it declined significantly in the months that followed, recording the lowest end of day closing price of $33.36 on 24 December 2008. It began to growth steadily afterwards, registering an average of $50.21 a barrel in April 2009 (see Figure 3).

The movements in the oil price in the last twelve months were influenced by a number of factors. The rise to the peak in 2008 was attributed to inertia driven by speculative investments in

commodities, strong demand in China and other emerging economies as well as subdued production. Increased use of commodities, other than gold for investment and speculative purposes, was widespread prior to the emergence of the subprime mortgage problem due to rising commodity prices. It was based on the premise that crude oil supply could decline, going forward, due to depletion of existing reserves, low discovery of new large oil fields and an expected freeze on global refinery capacity. As markets start to respond to the subprime problem, funds liquidated from investments such as stocks were channelled to the commodity markets, raising demand for oil and its price further. However, the credit crunch that followed the emergence of the subprime crisis forced many investors to cash on their commodity holdings to meet liquidity needs. This prompted the decline in the oil price, which was aggravated by signs that global economic activity and oil consumption could be adversely affected towards the end of 2008.

Figure 3: Crude Oil and Lesotho Petrol Prices



Data Sources: *Bloomberg and Bureau of Statistics*

The price of oil began to show an upward bias early in 2009 and continued to increase in April. The low price of oil created opportunities for stock-piling by major consumers such as China. In addition, renewed hopes for an economic upswing improved the attractiveness of oil as an investment on expectations that the price would increase further as demand recovers. This is reinforced by the expectation that supply of crude oil will continue to dwindle in the coming years and credible alternatives to oil will take a while to emerge. The world's capacity to convert crude oil into usable fuels is also expected to remain restrained. Significant construction of new refineries is not anticipated due to uncertainties on the return of such investments given the relatively short lifespan of existing oil fields, and possible changes in environmental laws which may require changes in refinery technology and oil demand.

Implications

The rising international price of oil could lead to an improvement in market sentiments if viewed as an indication of early recovery of global economic performance. A more positive economic outlook by the market would lead to higher global financial flows and more active credit markets necessary for stronger economic recovery. Increasing price of oil could also improve the attractiveness of oil exploration; act as an incentive to pursue further efficiency gains in the use of oil and innovations on new substitutes for oil.

However, the increase in the price of oil occurred against a background of depressed economic activity and stubbornly high inflation in the Southern African region. Economic activity slowed down in both South Africa and Lesotho in 2008 to real annual growth rates of 3.1 and 3.4 per cent, respectively, and indicators for first quarter of 2009 implied possible economic contraction in both countries. Conversely, inflation eased slightly in the recent months but remained high at 8.5 per cent in South Africa (versus a target of 6 per cent) and 10.1 per cent in Lesotho in March. These creates a monetary policy dilemma in the region that is not experienced by most developed countries where inflationary pressures are abating in tandem with falling economic activity.

Thus, the higher oil price could fuel higher inflation pressures which would erode incomes and depress consumption and investment expenditure. As Figure 3 demonstrates, domestic prices of fuel follow the price of crude oil closely resulting in a direct effect on prices of other goods and services in the economy. Inflation concerns emanating from rising crude oil prices could also restrain the magnitude of interest rates cuts. This would subdue economic activity though a squeeze on credit, increases in credit defaults and slowdown of exports as currency appreciates.

Monetary Policy Operations for April 2009

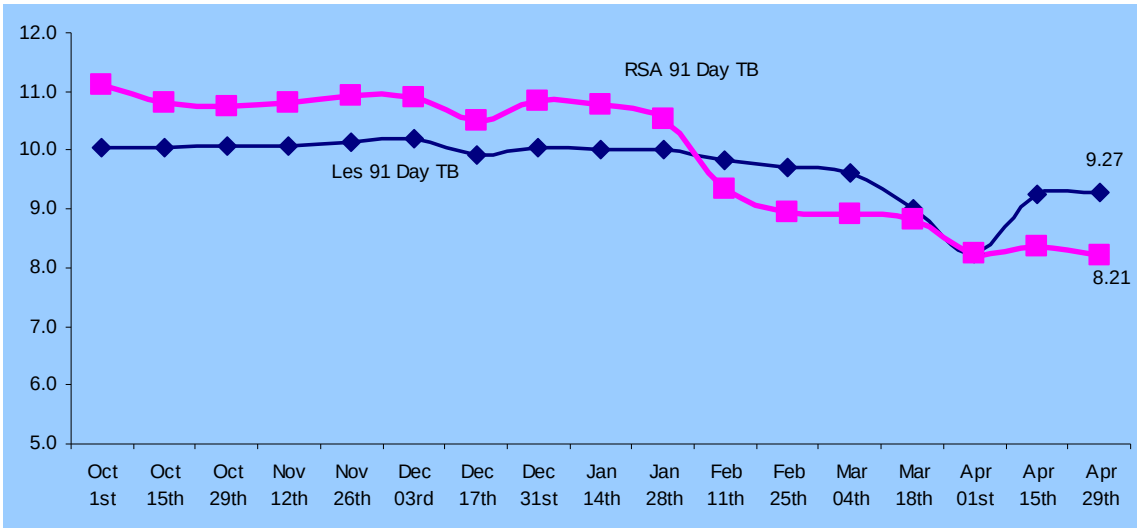
The key objective of the Central Bank of Lesotho is to maintain price stability which is achieved through maintenance of an adequate level of Net International Reserves (NIR). An adequate level of NIR ensures that the parity between the loti and the rand is maintained. CBL uses Open Market Operations (OMO) to achieve this objective. Table 1 below shows the amount auctioned and the corresponding discount rates that prevailed for each of the auctions during the review month. The level of competiveness in the treasury bills market is estimated by the number of participants in an auction. Competiveness of the 91-day treasury bills auction, as measured by number of bids, improved during the review period. The number of bids received during the auction conducted on the April 29 increased from 6 to 10 on April 15. The number of bidders also increased from 3 to 7 participants with only one participant partially successful while the rest were fully successful.

Table 1: Treasury Bills Auction

Type of Security	Auction Date	Maturity Date	Action Amount (Million Maloti)	Amount Issued (Million Maloti)	Discount Rate (%)	RSA Discount Rate (%)
91-day	01-April-09	01-July-09	M8.0	M8.0	8.24%	8.24%
182-day		30-Sep-09	M8.0	M8.0	7.35%	7.13%
273-day		30-Dec-09	M5.2	M5.2	8.21%	7.56%
364-day		31-Mar-10	M5.0	M5.0	8.16%	6.63%
91-day	15-April-09	15-July-09	M9.0	M9.0	9.25%	8.36%
182-day		14-Oct-09	M9.0	M9.0	7.30%	7.29%
273-day		13-Jan-10	M6.0	M6.0	8.14%	6.93%
364-day		14-April-09	M6.0	M6.0	8.00%	6.81%
91-day	29-April-09	29-July-09	M12.0	M12.0	9.27%	8.21%
182-day		28-Oct-09	M12.0	M12.0	9.27%	8.21%
273-day		27-Jan-10	M8.0	M8.0	8.14%	6.93%
364-day		28-April-10	M8.0	M8.0	7.99%	6.89%
Total for reporting period			**M96.2**	**M96.2**	**-**	**-**

Success of the CBL in achieving its monetary policy objectives could also be assessed by monitoring the movement of the intermediate target against trends in the region. A successful policy would result in a treasury bill rate that moves in line with comparable rates in the region, given the free movement of funds within the CMA region, to avoid undesirable capital flight or costly accumulation of foreign funds.

Figure 4: Performance of the Lesotho 91-Day T-Bill Rate vis-à-vis SA 91-Day T-Bill Rate



As figure 1 shows, the 91-day treasury bill rate in Lesotho remained above the South African counterpart rate. The margin between the two rates was 106 basis points.

Table 2: Selected Monetary and Financial Indicators

	2009		
	January	**February**	**March**
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	*16.58*	*15.17*	*14.50*
1.2 Prime Lending rate in RSA	*15.00*	*14.00*	*14.50*
1.3 Savings Deposit Rate	*4.61*	*3.98*	*3.64*
1.4 Interest rate Margin(1.1 – 1.3)	*11.39*	*11.19*	*10.86*
1.5 Treasury Bill Yield (91-day)	*10.67*	*9.35*	*9.00*
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	*5494.34*	*5412.82*	*5488.95*
2.2 Net Claims on Government by the Banking System	*-4606.27*	*-4319.72*	*-3645.69*
2.3 Net Foreign Assets – Banking System	*12408.45*	*11907.63*	*11392.76*
2.4 CBL Net Foreign Assets	*8949.13*	*8577.37*	*8191.19*
2.5 Domestic Credit	*-3090.42*	*-2748.22*	*-2087.90*
2.6 Reserve Money	*613.76*	*643.05*	*749.96*
3. Spot Loti/US$ Exchange Rate (Monthly Average)	***9.9250***	***9.8640***	***9.9469***
4. Inflation Rate (Annual Percentage Changes)	***10.7***	***10.2***	***10.1***
5. External Sector (Million Maloti)		***2008***	***2009***
	QIII	***QIV***	***QI***
5.1 Current Account Balance	*330.86*	*414.37*	*422.36*
5.2 Capital and Financial Account Balance	*1079.61*	*-184.20*	*132.85*
5.3 Reserves Assets	*-704.65*	*-558.82*	*67.28*

+Preliminary Estimates.

**Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities*

Table 3: Selected Economic Indicators

	2005	***2006***	***2007***	***2008+***
1. Output Growth(Percent)				
1.1 Gross Domestic Product – GDP	*0.7*	*8.1*	*5.1*	*3.4*
1.2 Gross National Product – GNI	*-1.9*	*12.0*	*3.0*	*5.0*
1.3 Per capita –GNI	*-1.9*	*12.0*	*2.2*	*4.2*
2. Sectoral Growth Rates				
2.1 Agriculture	*-12.4*	*14.9*	*-8.6*	*1.8*
2.2 Manufacturing	*-10.2*	*6.0*	*9.9*	*-4.5*
2.3 Construction	*5.4*	*3.5*	*6.9*	*7.7*
2.4 Services	*2.8*	*6.5*	*3.1*	*2.4*
3. External Sector – Percent of GNI				
3.1 Imports of Goods	*83.5*	*77.6*	*82.0*	*86.8*
3.2 Current Account	*-5.8*	*3.4*	*9.8*	*9.5*
3.3 Capital and Financial Account	*3.7*	*0.7*	*5.5*	*5.1*
3.4 Official Reserves (Months of Imports)	*5.5*	*6.7*	*7.6*	*7.4*
4. Government Budget Balance (Percent of GDP)	*5.0*	*11.6*	*7.5*	*-1.0*

+Preliminary Estimates