COSATU's call for the review of the Inflation Targeting policy framework; the success or not of the policy; possible results on its removal; alternatives to Inflation Targeting and recommendations to the Finance Minister

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Abstract

The South African reserve bank's adoption of inflation targeting policy as a flagship monetary policy framework has received mixed feelings across many sections of South African society. The first time this framework was institutionalized in 2000 (Budget speech; 23 February), eventually resulting with formal inflation target of 3-6%, taking effect from the year 2004. This paper aims to critically argue against this policy framework. Approximately six years since the inception of this inflation targeting policy framework, very little can be said about its successes, especially when one looks at the plight of ordinary citizens. Epstein (2003) clearly attacks this framework when he says the adoption of formal "inflation targeting" that focuses on low level of inflation, to the exclusion of other important economic variables such as employment generation, increasing investment or reducing poverty, despite the widespread evidence that moderate levels of inflation have few or no costs, is unnecessary and ineffective. Cosatu (2007), correctly said, "the policy is seriously jeopardizing the prospect of achieving the government's modest but necessary Accelerated and Shared Growth Initiative for South Africa (ASGISA) target of halving the 2004 levels of unemployment and poverty by 2014". I firmly believe that reviewing the policy could be a major step towards an improved macro-economic stability. I believe that the subtle macro-economic evidence that i provide in this essay bears testimony to my firm assertion that reviewing the policy will not be suicidal as monetary policy conservatives believe. This essay covers a comprehensive close-knit, easy-to understand recommendations on alternatives.

1. Introduction

The essay begins by briefly discussing the arguments for both the continuation of inflation targeting and against its continuation. It will draw various attestations from the impact this policy has had on the citizens. I will do all this through what many economists call the "Sacrifice ratio"-

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the unemployment costs of fighting inflation. The other aspects I will touch will be on whether the removal of this policy will result in lower or higher nominal interest rates and also the alternative to this policy. The essay is constructively and partially arguing for such proponents in the society as COSATU, who calls for the policy's reviewing, but my own opinions might and will overlap COSATU's, since I do not entirely agree with the workers union's stance on the matter.

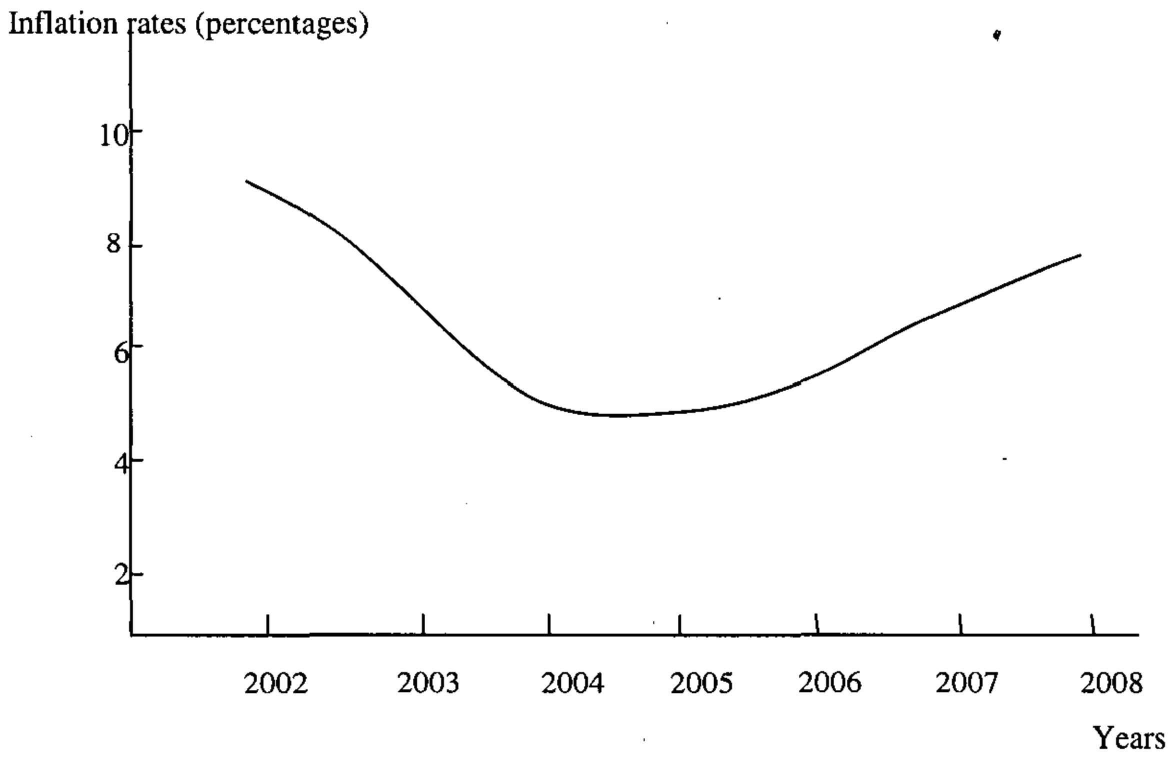
1.1 Background to South African Inflation Targeting policy framework

Since the early 1990's, there has been an increasing number of central banks across the globe adopting inflation targeting as their flagship framework for monetary policy. This inflation targeting is simply an economic policy framework in which a central bank estimates and makes public a projected, or "target" inflation rate and then attempts to steer actual inflation towards the target through the use of interest rate changes and other monetary tools. Since interest rates tend to be inversely related to inflation, the likely moves of the central banks to raise or lower interest rates become more transparent under the policy of inflation targeting. According to Svensson (2006), this high level of transparency is exceptional in view of history of central banking, since, traditionally, central bank objectives, deliberations, and even policy decisions have been subject to considerable secrecy. The countries in the developing world were lured by relative success of inflation targeting in achieving low levels of inflation in the industrialized world, and also because, as Epstein (2003) correctly puts it, "Even when countries do not put formal inflation targeting, many of them, under pressure from the International Monetary Fund and other organizations- still orient policy almost exclusively to fighting inflation". South Africa became an adherent to the policy in 2000, and from then there has been more contrasting views on whether this approach has been a success or economic travesty. Countries such as South Africa have failed to succinctly keep the inflation rate at the set range of 3-6%, drawing criticisms for whether this policy is viable for the country, given its multi-faceted macro-economic commitments such as curbing spiraling rate of unemployment- which has proven to be a thorny issue to the economy.

Table 1 South Africa's inflation rate: Annual average figures:[1]

Year	Annual % percentages
2002	9.3%
2003	6.8%
2004	4.3%
2005	4.3%
2006	4.6%
2007	7.1%
2008	7.4%

Source: StatsSA (statistical bulletins for various issues)



[1] *Table 1 shows that the success in South Africa's inflation targeting has not been consistent, inflation having been contained within the target range of 3-6 percent only during three years in seven years.

1.2 Arguments for the use of inflation targeting in South Africa

South African Reserve Bank, as the custodian of the monetary policy, argues that the adoption of the inflation targeting policy framework serves as an institutionalized commitment to price stability as the primary goal of the monetary policy, to which other goals are subordinated (Mboweni;2000). The bank argues that by setting inflation targeting as the main goal of the monetary policy, it ensures sustainable price stability which will positively spill-off to other variables in the economy, thus maintaining sound economic and monetary outlook. The argument is that inflation targeting-as a monetary policy target, anchors the public's inflation expectations, thereby improving planning for the economy. According to Gowland (1991-277), the argument for inflation targeting as monetary target is that they are necessary to constrain or discipline governments.

The bank attributes that increased monetary policy transparency is ensured through better communication with the public and the markets about the objectives of the monetary policy and the rationale for the decisions taken by the monetary authorities. It is believed that the policy makes it easier for all players in the economy to make effective future economic decisions, hence their confidence on the financial stability.

The defence of this policy is that a low rate of inflation is generally justified as the ultimate goal of the monetary policy.

The SARB argues that the policy makes it easy for investors to know what the central bank considers the target inflation rate and therefore will more easily factor in likely interest rate changes in their investment choices, which is viewed as leading to increased economic stability.

The bank asserts that the inflation targeting policy creates an atmosphere in the economy where financial stability is a certainty as a result of low inflation. Inflation targeting proponents advocate that the stability in prices is the cornerstone to fulfilling many of the country's socio-economic ills, among others, the relentless unemployment, poverty, low economic growth, etc. Nevertheless, more convincing is needed in view of the disturbing macro-economic failures that are crippling South Africa compared to the developed world.

1.3 Arguments against the use of inflation targeting

Much as I opinionate my discomfort with this rather "dogmatic" inflation targeting by our reserve bank, I am not entirely comfortable with COSATU's argument.

The current approach to inflation targeting is indeed not bearing enough fruits for our relatively strong emerging economy. I think the approach, since when it was officially adopted as the flagship goal of monetary policy, has depressed and in fact undermined many of our macro-economic policy objectives such as sustainable economic growth, job creation, and because so much is concentrated on price stability, the citizens have been subjected to cumulative increases in interest rates- which for most is unfortunate and unbearable. It has to be noted with absolute shrewdness that inflation is usually measured as the change in prices for consumer goods, called Consumer Price Index. Inflation targeting on the other hand assumes that this figure accurately represents growth of money supply, which is not always the case. The exception occurs when factors external to a national economy are the cause of price increases (Epstein; 2002). An example in this regard could be the recent oil price surges and the 2007-2008 world food crises which caused sharp increases in the prices of food and consumer goods, which in turn resulted in a sharp increase in CPI. Under such conditions increases in inflation (CPI) is not necessarily coupled to any factor internal to a country's economy and adjusting interest rates (which is what SARB did) is ineffectual and will reduce economic growth unnecessarily.

Another criticism which I hold dearly is that inflation targeting does not really comprise a specific set of monetary policy recommendations- as traditional monetarism, for example, does- but constitutes just an explicit statement of the aims of the monetary authority.

This policy is also prone to rigidity as too little flexibility is given to stabilizing growth and employment, particularly when there is an exogenous economic shock. The proponents backing for reviewing of this policy such as COSATU have cried foul over this lack of wholesome commitment by the government on employment stability. Epstein(2002) has particularly challenged this "narrow-mindedness" by saying " This focus of fighting inflation to the exclusion of other ills is particularly puzzling in light of the well known evidence that, assuming inflation is within moderate levels, less than 20%, there are no negative consequences of inflation on real variables". Limiting monetary policy solely to price stabilization cannot guarantee economic growth since low inflation does not necessarily lead to high and sustainable economic growth. For this reason, the United Nations World Summit in 2005 and United Nations Economic and Social Council (ECOSOC) Ministerial Declaration in 2006 stressed the need to place "productive employment and decent work into economic policy making, recognizing that employment can no longer be considered a derivative of economic policy". Annan, (2006 July).

I challenge the absolute advantages of this inflation targeting framework because by contrast, the costs of large scale unemployment and slow growth are high and well understood, why compromise on all of these important macro-economic policy objectives that by far outweigh the inflation targeting. To further attest to this problem that South Africa finds itself in, Epstein (2003) says "Among the greatest disappointments for proponents of inflation targeting has been its apparent inability to reduce the so called 'Sacrifice ratio',- the unemployment costs of fighting inflation". More identically to South Africa, Van der Merwe et al (1991-118) say, "A desire to tighten monetary policy severely so as once and for all to make an end to inflation, may, for example, have to be tempered in the light of prevailing slackness in the economy's already unimpressive employment record".

King (1997), Governor of the Bank of England and erstwhile adherent to inflation targeting correctly said "An explicit target might turn central bankers into 'inflation-nutters' i.e. -central bankers who concentrate on the inflation target to the detriment of stable growth, employment and exchange rates". The assertion by monetary authorities that by virtue of pursuing low inflation, there will be positive spill-over economic benefits is very questionable, especially since that will imply high interest rates- which depresses investment capacity, particularly that of private employers as the lending rates become unattainable (Mishkin;2007). COSATU (September 2007) is correct when saying these deliberate surging of interest rates to curb inflation is frustrating government's efforts of halving unemployment rate by 2014 as many investors will exercise a conscious approach to investment capacity when interest rates are high, since most of investment is funded through borrowing. The monetary authorities may argue against this assertion but the reality is that under such circumstances, potential new jobs are not realized because firms prefer to borrow when interest rates are lower due to cost-reducing reasons.

In agreeing with COSATU, I also explicitly challenge their remarks that government must replace this policy of inflation targeting with employment-targeting because once more, other macro-economic variables that are necessary, including inflation, might be detrimentally ignored. COSATU must acknowledge that as an important member of the civil society, they have the capacity to influence policies in this regard. Nevertheless it must equally realize that South Africa is living in a global context which economically cannot cater for dogmatic assertions such as that of adopting so called employment targeting policy. COSATU is too excessive and infact too political in their demands, because the SARB's monetary policy ought to be multi-faceted and should cater for such macro-economic objectives as price stability (inflation rate), economic growth and employment.

Stringent inflation targeting on the other hand tends to undermine and frustrate the economic growth targets, and this is evident for South Africa. By virtue of unemployment being high (Epstein;2002) and even potential new employment opportunities being suppressed as a result of high interest rates, the economy will be nowhere closer to functioning at its fullest potential.

Table 2: A need for monetary policy intervention in South Africa: Facts[2]

On poverty	On unemployment
Very high despite the country's status as an upper middle class country.	Of the 4.2 million officially unemployed South Africans, 1.6 million have been looking for a job for over 3 years.
Extent of marginalization of poor people from mainstream economy immense, and there can be no cheap and painless quick-fix.	StatsSA has ceased to report on the category of discouraged work seekers, at least estimated around 3.6 million in 2005.
At least 29% of South Africans live in severe poverty, largely due to pre-democracy policies, hence a need to redress the imbalance.	2.5 million of the officially unemployed people have never worked before.
Chronic poverty has transferred across generations in South Africa.	Within 31-46 years category, the engine of the labour force- 46.0% have been unemployed for in excess of 3 years.

Source for Data: National Labour Force survey: 2005

[2] Table 2 summarizes the arguments against the use of inflation targeting, with particular reference to startling evidence on the state of South African poverty and unemployment severity.

1.4 Resultant rates from removal of inflation targeting policy framework

These are nominal interest rates and refer to the rates before adjustment for inflation and they are in contrast with real interest rates. The removal of inflation targeting will definitely result in lower nominal interest rates because South Africa, with unemployment hovering around 40%, is, as Epstein (2002) explicitly puts it, "singularly ill for such a policy". It is a well known fact across the conservative economic orthodoxy that this policy of targeting inflation has generally lowered the levels of inflation in those countries that adopted it, (maybe debatable with South Africa), but it is also unrivalled to note that the policy tends to heighten interest rate levels- often severely affecting the employment and economic growth prospects. This approach has unconvincing successes in developing countries as compared to developed ones, and much of that has to do with its inverse relationship to employment-the more the success of inflation targeting, the worse the unemployment levels. For its removal, South Africa's monetary authorities will be better positioned not to adversely and unnecessarily hike the interest rate (i.e. as they did during oil and world food crisis period recently) as there will be no pressure to achieve set inflation targets.

1.5 Alternative to inflation targeting

The search for alternative to inflation targeting, I have to admit, is a very contentious aspect of this and many other monetary policy discussions, and this is not only in South Africa, but the world over. For starters, there seems to be sweeping messages that inflation targeting is the best option by many economists and economic policymakers, including leading institutions such as International Monetary Fund, etc, and maybe this is more so since the developed world i.e. USA,U.K etc seem to dictate to the global economic world what to and not to do. As much as I cannot challenge the relative success of this policy in the developed world, for example, in Canada, U.S.A, I cannot say the same for the rest of the developing world, including, among others, Mexico, Chile, Argentina, Brazil and South Africa. Mexico was asymmetric with respect to exchange rate movements -tightening when exchange rates depreciated, but not loosening when exchange rates appreciated and this lent a bias in favour of over-valued exchange rates, leading to contractionary effects on output, and it was left with no choice but to find alternatives

(Galindo; 2007); Brazil did the same, and South Africa, though reluctant at national level, is under severe pressure from mostly the civil society (COSATU, SACP) to do the same.

Given the above, I believe our monetary authorities should not let this policy unchecked and unmodified. I strongly support the assertion that we move to a more flexible approach to monetary policy, and in my mind that approach is the "real targeting" model (Epstein, 2003). The reason why I do not necessarily support COSATU on an outright removal of the inflation targeting model is that some aspects of it are only suicidally ignorable. To put it bluntly, I think a relook at the centrality of our monetary policy objective is necessary (currently too narrow), since I believe inflation targeting should be coerced into a multi-faceted policy obligations of our monetary authority with equal attention being given to decent employment, sustainable economic growth, etc. I think South Africa should take an eclectic approach to inflation targeting, and that we shouldn't pursue it to an extent of dispositioning our other equally important macro-economic objectives, particularly in inculcating to our monetary policy, a more developmental agenda.

The approach I propose is "real target" approach. It will imply that our central bank chooses a "real target" that is appropriate for our country i.e. poverty levels, employment growth, real economic growth, and thereafter choose a set of monetary policy tools to achieve the chosen target, and of course there will be other economic constraints that must be confronted, including, most notably, inflation and balance of payments or even exchange rate constraints.

The advantages of the real targeting policy framework are immense:

It places in front and center, the economic variables that have the most immediate and clearest association with social welfare and the central bank will be forced to identify this target and then reach it. If the central bank does not reach it, it will both explain why it failed and how it plans on improving it in the next period. Given the public pressure to reach the target, the central bank will have significant incentives to invest in research and other activities to improve its understanding and tools to reach this "real" target. Another incentive is that given that it'll need to reach this target and other constraints, it will find incentives to develop new tools of monetary policy, further enhancing its positioning. Another plus factor for this real targeting approach to be adopted is that it lends itself naturally to a more democratic, transparent and accountable central bank policy that serves genuine needs of the majority of the country's citizens, rather than the minority that typically benefit from a combination of slower growth, low inflation, and high real/nominal interest rates under stringent inflation targeting.

1.6 Recommendations to the Minister (Concluding Remarks)

I recommend that the minister takes cognizance of the fact that since the adoption of this stringent inflation targeting, poor ordinary South Africans(especially the unemployed) have found it even harder than ever before to cope with their socio-economic lives (i.e. skyrocketing consumer prices) - which I firmly believe has deteriorated partly as a result of this rigid and inflexible policy which hinder new possible employment opportunities as investors narrow their investment capacity when interest rates are high.

I propose that the minister, together with the monetary authority, adopt a more multi-faceted monetary policy where all of the macro-economic policy objectives such as employment, sustainable economic growth, price stability, financial stability are equally prioritized and dealt with. Inflation targeting as a primary objective of our monetary policy has failed ordinary South Africans; hence, equally, if not, more contentious issues such as relentless unemployment, low economic growth have subjected most of us into deepening levels of poverty never witnessed before, and as such I propose for immediate review of inflation targeting as a primary goal of the central bank.

That the minister engages the civil society organizations, on consultation terms, on an all-round monetary policy reform where among others, critical thorny issues of employment, real economic growth, economic stability and inflationary pressures are discussed with an eye on a possible multi-faceted macro-economic policy reform.

That the ministry improves relations and consultations with the civil society organizations (i.e. COSATU) as I believe they are indeed the voice of the people and as such should not be marginalized. Indeed to every ordinary South African's liking, important decisions such as monetary policy position of our central bank should not be monopolized- not even at consultation level because there seems to be a serious stand-off between COSATU and the monetary authority on a suitable policy framework.

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