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INFLATION TARGETING: THE IMPLICATIONS

The government has just adjusted its inflation target for 2004 upwards after acknowledging that inflation will miss its target range in the first two years of implementation. This came in the wake of calls to abandon the regime altogether. This feature looks at the rationale and practice of inflation targeting, assesses the latest changes and examines the implications for interest rates and the economy.

Background

In early 2000 the government set the Reserve Bank a 3% to 6% target range for CPIX inflation in 2002. The targeting framework was then extended further in the October 2001 Medium Term Budget Policy Statement (MTBPS), with the range tightened to 3% to 5% for 2004 and 2005.

The scorecard has so far been unflattering. This year CPIX is likely to average around 10%, some four percentage points above target. Current expectations for next year centre on an average figure of about 7,5%. This despite a four percentage point rise in prime to 17% since the start of the year. The lack of success has resulted in some questioning the effectiveness of the framework, but calls for its abandonment normally come from those who implicitly believe in some tradeoff between growth and inflation and who therefore consider the current monetary stance as being inappropriately tight.

This latter argument is flawed, as both South Africa's past experience and the international scorecard demonstrate. Both the theory and the empirical evidence suggest that such a tradeoff exists at best in the very short term as so-called money illusion fools individuals and businesses into making poor decisions on the basis of incorrect price signals. This is hardly a compelling argument to reduce interest rates.

A further argument against targeting that has gained popularity is that, as most of inflation is due to cost-push factors, for example, rand-induced increases, higher food prices and administered prices, interest rates are an inappropriate tool. The strict theoretical answer to this would be that the source of inflation is unimportant. Relative price changes are there to send signals and general accommodation just leads to higher inflation with increased inefficiency. If, for example, the rand falls by 10%, this represents a loss

of the country's wealth and should force cutbacks on imported goods and services. The market mechanism makes South African goods and services relatively cheap and exports and tourist arrivals rise, forcing corrective forces to move into motion. However, if the reality is denied and all prices, wages and money supply adjust to the same extent, then no one is better off, but inflation moves to a higher plane. Ultimately, a higher price is paid in the longer term as the authorities try to work inflation lower once again.

Even more dangerous are the conclusions that can flow from the cost-push school. If the sources of higher prices are the exchange rate and food prices, then by simply controlling these directly inflation can be addressed. Unfortunately, these were the same arguments that applied in command economies and the evidence of their past failures is abundantly clear. The success rate of less extreme income and wage policies is, at best, chequered over the short term, but invariably poor over the longer term.

There is, however, one area where cost-push factors could be addressed more directly. Administered prices have consistently boosted overall inflation and are often linked to public sector monopolies whose goals are partly to increase social spending. The government's objectives are therefore contradictory. In such cases direct subsidies offer a more transparent solution that would not jeopardise government's own inflation objectives.

Once it is accepted that higher inflation cannot result in sustained higher growth and that therefore a goal of lower or relatively low inflation is accepted, inflation targeting as a framework should not be controversial. More serious debate centres on the appropriate level of inflation, how long the monetary authorities should be given to achieve this, what latitude in terms of bands and exclusion clauses is appropriate and what measure of inflation should be adopted.

There are few that would argue with the goal of achieving a sustained low level of inflation. High levels of inflation distort the signals sent by the market system and normally impact disproportionately on the poor as the value of cash relative to hard assets is eroded. An important reward of a more stable price regime should be reduced interest rate volatility and consequently lower real interest rates.

However, just how low inflation should be is more debatable. Although there is substantial evidence that

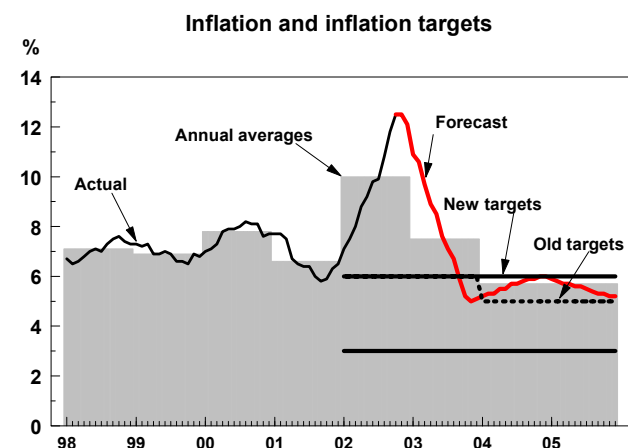
high inflation should be avoided at all costs, there is little to suggest that substantial rewards in terms of economic growth can be reaped from a reduction to low single-digit inflation from high single-digit territory. In contrast, the short-term costs of trying to achieve this quickly in an economy where inflationary expectations adapt only slowly can be significant. This should, however, not detract from a longer-term goal of bringing inflation down into the low single-digit territory. Inflation is rarely static and in an economy such as South Africa's tends to drift higher rather than lower. Ultimately, correcting the end result of a slow upward drift back into double digits would prove costly as inflationary expectations would have shifted and the central bank's credibility would be in question.

The ability of the monetary authorities to forecast inflation and influence its direction should determine how much latitude in terms of bands and escape clauses is appropriate. A narrow range without exclusion clauses in a small open economy with a volatile exchange rate such as South Africa's would be inappropriate as the recent past clearly demonstrates. However, too much flexibility could start to impact on credibility. Finding the right tradeoff is difficult as those who determine prices and wages in the economy should be influenced by the government's objectives and success. Financial markets also take their cue from these targets and the cost of ambiguity can be higher interest rates.

On the final issue, that of which measure of inflation should be targeted, the most inclusive measure possible is normally the most appropriate, particularly if the escape clause provides some flexibility. Too narrow a measure, with exclusions for various key items, risks making the exercise irrelevant for the person in the street. The government's original choice of CPIX – headline inflation minus interest service costs – makes sense as it excludes only the monetary control variable itself (leaving interest costs in the measure means that raising interest rates increases inflation).

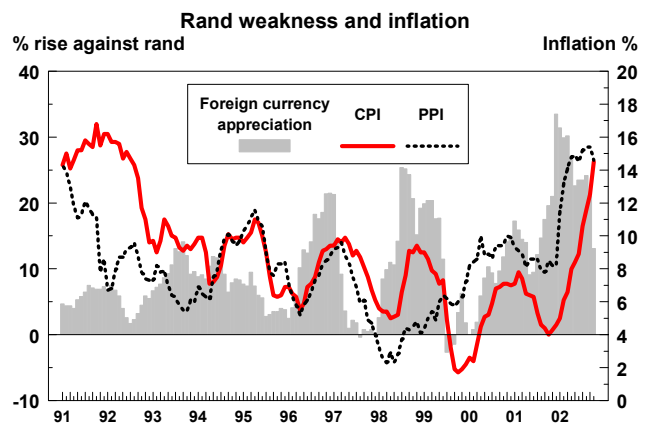
Implications of the recent changes

The changes announced in the October MTBPS appear minor at first. The 2004 and 2005 targets rise to 3% to 6% from the previously set 3% to 5% and the government implicitly releases the Reserve Bank from the 3% to 6% target for 2003 by acknowledging that there is little chance that inflation will fall into the range.



Although relatively modest, the changes significantly reduce the dangers of higher interest rates in the short to medium term. The Reserve Bank is freed from having to try and force average inflation back below 6% in 2003, which was always going to be difficult given the high levels that will prevail at the start of the year.

Instead, the Reserve Bank's decisions will now more likely be guided by their view of inflation in 2004 and beyond, where the move in the upper bracket to 6% will structurally be easier to achieve. In 'Prospects for inflation' (Guide to the Economy, 2 May 2002) we argue that most of the gains of economic restructuring forced by lower tariff barriers have already been reaped. A drive to achieve sub-5% inflation in too short a period would probably be only possible by inappropriately high interest rates, particularly in view of the damage to inflationary expectations over the last year.



Other recent developments will also lighten the Reserve Bank's task. Key among these is the dramatic recovery in the rand. The currency has appreciated by 30% against the US dollar and by 21% against the trade-weighted basket since the beginning of 2002, following the 37% and 34% tumble against the dollar and the basket in 2001. Apart from a bounce back from a severely undervalued situation, several factors have supported the currency. Most important has been high interest rate differentials in its favour, which has made it more and more costly to speculate against the currency and has led to exporters bringing receipts back more quickly, helping to reverse the negative leads and lags situation that developed in late 2001.

Also helping have been more positive perceptions over the economy, a reduced net open forward position, expected privatisation receipts in the first quarter of next year and hopes that the global economy will gain momentum and boost commodity prices.

The rand's comeback will provide evidence on how critical the pass-through effects have been over the past year, that is how much rand-related increases retailers and wholesalers have been able to pass on to consumers and whether they have used the opportunity to extend margins. Inflation should fall

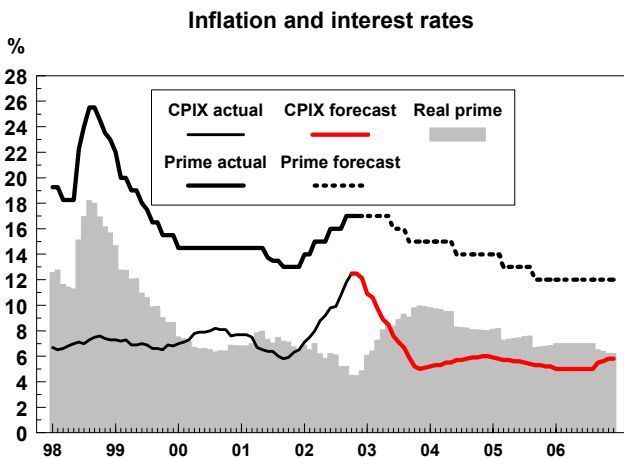
quickly in response to the rand's appreciation, but may prove sticky, particularly if demand conditions remain firm.

At the same time food prices internationally are showing early signs of easing, although unfortunately drought conditions in the region could offset some of these gains.

Finally, certain areas of credit extension are starting to respond to the hikes in nominal interest rates. Growth in total private sector credit slipped back into single-digit territory in September for the first time since 2001.

Conclusion

The recent changes to the inflation-targeting regime are positive. The authorities have avoided the temptation of making dramatic and unnecessary changes, but have at the same time acknowledged the reality of disappointingly high inflation in the short term without losing credibility in the process. As a result interest rate prospects have improved in the short to medium term. The recent strength of the rand has further helped the situation, with two interest rate cuts likely in 2003 and the possibility of more to follow in 2004.



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