Inflation targeting in context of ‘nationalisation’ debate

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What Reserve Banks do and what they should be doing has become a hotly debated issue in recent years. According to the authors, the Reserve Bank has a constitutional responsibility to manage monetary policy. Among the tools it uses to do this is inflation targeting.

The South African Reserve Bank has a constitutional responsibility for conducting monetary policy in South Africa. Sections 223 to 225 of the Constitution states that:

- the South African Reserve Bank is the central bank of the Republic and is regulated in terms of an Act of Parliament;
- The primary object of the South African Reserve Bank is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic and the South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters; and
- The powers and functions of the South African Reserve Bank are those customarily exercised and performed by central banks, which powers and functions must be determined by an Act of Parliament and must be exercised or performed subject to the conditions prescribed in terms of that Act.

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The Constitution, the South African Reserve Bank Act (No 90 of 1989) and the regulations framed in terms of this Act provides the framework for the structure and activities of the SA Reserve Bank. This Act provides, *inter alia*, for private shareholding in the central bank (SA Reserve Bank Act, 1989), a topic of current and sometimes heated debates in South Africa.

In December 2017 the ruling ANC took a decision that the SA Reserve Bank should be nationalised and instructed the government to institute such action (Hunter, 2017). The matter was raised for debate in Parliament in March 2018, but the motion was later withdrawn without any debate (Omarjee, 2018).

One of South Africa's opposition parties, the Economic Freedom Fighters (EFF), also has the nationalisation of the SA Reserve Bank in its sights. The EFF's position on the matter is that the "[t]he creation of a State Bank and the nationalisation of the Reserve Bank constitute an immediate task . . . essential to the development of the South African economy, as it can be progressively positioned to improve the existence of state-owned development finance institutions, in order to finance new industries" (EFF website). In this construct it is not clear whether a State Bank or the SA Reserve Bank or both should be "progressively positioned" to achieve the stated objectives.

The EFF went further and acted faster than the ruling ANC on the matter of nationalising the SA Reserve Bank in as much as the party tabled a Bill (The South African Reserve Bank Amendment Bill) which aims at eliminating private shareholders in the central bank. This Bill proposes expropriation without compensation (EWC) of SA Reserve Bank shareholders. This is clear from the explanatory memorandum tabled with the Bill, which states that "[t]he Bill seeks to amend the Act (the SA Reserve Bank Act) to make the State the sole shareholder of the shares in the Bank". The memorandum also states clearly that the financial implications of adopting the Bill are "none", thus confirming EWC. The Bill, however, is silent on the very important question of the aims and objectives of nationalisation, other than transferring ownership to the State.

If by nationalising the SA Reserve Bank the EFF intends to (also) bring it in line with most central banks in the world (which are state-owned) there would be some merit in this. But this objective is not explicit or even implicit in the Bill or the memorandum. The SA Reserve Bank is somewhat of an 'outlier' in this respect in contrast with most central banks, which switched from private shareholding (in full or part) to state ownership from the mid-1930s onwards. What needs to be understood is that state-ownership exists alongside and not in contradiction to 'independence'. State-owned banks have operational independence in the overwhelming number of cases, although this is not true in some command economies such as Cuba and North Korea.

So in short, shareholding by the state or private shareholders does not give control of the monetary policy objectives of the SA Reserve Bank to the owners – that responsibility is derived from the Constitution. Any attempt to nationalise the Bank, purportedly to get control of monetary policy or even to position the central bank "progressively" (EFF website), is simply misguided. A lot more would have to be changed to enable that and in every case the constitutionality of such changes would have to be tested.

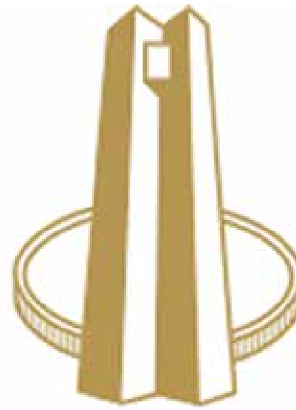
The EFF's Bill does not make any mention of the SA Reserve Bank's

inflation targeting monetary policy regime, which is the current mandate given to the SA Reserve Bank by the democratic government. If there is one aspect of the debate about the SA Reserve Bank which is within the powers of the current government to change, and which would entail neither any change to the Constitution, nor in the Bank's independence or its private shareholding, and which potentially does relate the broad yet vaguely stated macroeconomic policy objectives in the EFF Bill and memorandum, it would be to consider a change in the goal or target set by the government for the SA Reserve Bank to achieve. The inflation target can be replaced by a nominal target for the gross domestic product (GDP), an employment target, an exchange rate target or a money supply growth target, provided that the target supports in the South African context the constitutional mandate of the SA Reserve Bank.

The rest of this paper reviews the more technical narrative around the adoption, the once-off change and what we detect is the current effective inflation target of the SA Reserve Bank. The question we probe is whether the SA Reserve Bank, judged by its actual recent practice, has moved from an inflation target range to an inflation target point?

The SA Reserve Bank discharges its constitutional mandate of protecting the value of the currency by means of an inflation targeting policy framework. The inflation target is set at 3 to 6% per annum (South Africa, 2000; see also Van der Merwe, 2004). The inflation target is formulated by the South African government and announced by the Minister of Finance. The first announcement of the target was in 2000, for first achievement in 2002 (South Africa, 2000).

An inflation target is an explicit monetary policy anchor which leaves no doubt about the goal and objective of monetary policy. It can be contrasted to discretionary monetary policy, which implies ambiguity about the objective of monetary policy.



Mishkin (2001: 1) summarises the elements of a policy anchored in inflation-targeting policy as the announcement of the inflation target; the adoption of price stability (i.e. the agreed rate of inflation commensurate with the inflation target) as the overriding monetary policy goal; the use of many variables for decision-making on monetary policy instruments; improved communication to increase the transparency of monetary policy; and the accountability of the central bank for target achievement.

Mishkin (2001) explains that policy credibility enhances the successful implementation of inflation targeting. This is the advantage of rules-based monetary policy over discretionary monetary policy. In the latter instance central banks can aim to achieve anything (or even nothing in particular) in the implementation of monetary policy.

In a discussion of inflation targeting, it is necessary to point out that such a policy approach remains the subject of debate and its adoption by South Africa is questioned by some researchers (See for instance Comert and Epstein, 2011). However, a discussion of alternative policy approaches that South Africa can consider are outside the debate we want to solicit with this research, despite the fact that South Africa faces challenges such as low (or even negative) growth, rising unemployment and substantial inequality in income and wealth (See Padayachee, 2017).

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Inflation targeting is currently used by 28 countries. Examples of exclusions are the Euro Zone and United States of America, where attention is paid to the inflation rate, but where the authorities do not regard themselves as inflation targeters, and Switzerland (See for instance Allen et al., 2006: 5). ››

Seven countries specify a specific point as the inflation target, while 11 countries specify a specific point with a range around such a point. The remainder of the countries (10, including South Africa) specify an inflation target range.

The use of an inflation target range or an inflation target point with a range around it, as is the case in 21 countries, allows some flexibility in the application of monetary policy. This is not the case with a specific point. It is also evident that only one country (Thailand) includes zero in its inflation targeting range at the lower end. In terms of the specification as inflation targeters, no country has chosen zero as a target or the midpoint of its target range (Bernanke et al., 1999: 289), although Goodfriend and King (1997: 33) holds the view that " ... a central bank should target near-zero inflation".

In 1931 Sweden targeted price stability (i.e. a zero inflation rate) (Sveriges Riksbank, S.a.), but at that time such a policy was not called inflation targeting.

The use of an inflation target range or an inflation target point with a range around it, as is the case in 21 countries, allows some flexibility in the application of monetary policy.

A target range, rather than a target point, was chosen for South Africa, as a target point "... implies a degree of precision which cannot realistically be expected of monetary policy, especially in a small, open economy"(Casteleijn, 2001: 8). Nevertheless, at the time of the announcement of the inflation target range, the serving governor of the SA Reserve Bank, Mr Tito Mboweni, stated that "[t]he objective of the exercise is, after all, to achieve the target range" (Mboweni, 2000: 3). This leaves no doubt about the commitment to the inflation target, despite the choice of a target range rather than a target point.

The SA Reserve Bank has the *de jure* responsibility to set monetary policy for South Africa, but its *de facto* responsibility extends beyond the country's borders. South Africa's partners in the Common Monetary Area, namely Lesotho, Namibia and Swaziland (the LNS countries), peg their currencies to the South African rand. Although these countries have their own central banks, these institutions follow interest rate decisions of the SA Reserve Bank to maintain the peg.

South Africa's inflation target was specified at the outset as the rate of change in the CPIX, defined as changes in the CPI for metropolitan and other urban areas excluding changes in the interest costs of mortgage bonds (Mboweni, 2005; See also Van der Merwe, 2004). The main exclusion from CPIX (hence the "X") was the exclusion of changes in the interest costs of mortgage bonds to limit the impact of interest rate changes on the rate of inflation figure used for targeting purposes. The target was set for achievement as an annual average per calendar year from 2002.

In 2001 it was announced that "[t]he inflation target will remain an annual average increase of between 3 and 6% in CPIX in 2003. For the 2004 and 2005 year, the target will be 3 to 5%" (Manuel, 2001: 6). Despite this announcement, this change was not implemented as South Africa was subsequently exposed to considerable inflationary pressures owing to rising oil prices, a depreciating exchange rate of the rand and sharp increases in food prices. It was therefore announced in 2002 that the target will be retained at 3 to 6%, (Manuel, 2002: 4) the level where it still is today.

Since 2002, a number of other specification changes have taken place. In 2003 it was announced that the inflation target will be a monthly target, rather than an annual average for each calendar year (Manuel, 2003: 6). From January 2009, the inflation target was specified as the rate of change in the CPI for all urban areas. This change was necessitated by the fact that the inflation rate in terms of CPIX inflation was no longer calculated (SA Reserve Bank, 2009). Interest on mortgage bonds in the CPI was replaced with owners' equivalent rent to estimate housing-related costs.

With the exception of the re-specification of the target for the rate of change in the CPI, rather than the CPIX, and the goal of achieving it monthly rather than on an annual average, the formal inflation target has remained the same since its first announcement in 2000.

To the contrary, the application of the target has been subject to different emphasis. To restate: South Africa remained "on target", but it did not necessarily remain "on point".

While serving as Governor and subsequent to his period of service, Mr Mboweni made reference to the target as a range of 6 to 3%, rather than 3 to 6% as it is normally specified. Mr Mboweni used the 6 to 3% specification as confirmation that inflation (and presumably inflation expectations) should trend lower over time. As recently as 2016 (after his retirement from the SA Reserve Bank) Mboweni reiterated this viewpoint, stating that the SA Reserve Bank should ensure

that inflation "... stays within the 6 – 3% target range" (Mboweni, 2016).

The current Governor of the SA Reserve Bank, Mr L Kganyago, increasingly expresses a preference for focusing the inflation target on 4.5%, i.e. on the midpoint of the inflation target range (See for instance Ant and Lacqua, 2018 or Vollgraaff, 2018). This preference was expressed clearly at the 98th ordinary general meeting of shareholders of the SA Reserve Bank, i.e. "(t)he MPC[1] will maintain its vigilance and will react should there be second-round effects that take inflation significantly away from the midpoint of the target range" (Kganyago, 2018). It is noteworthy that Mr Kganyago states 4.5% as a target, but acknowledges the range around it.

This change in focus happened without any formal policy announcement, but moves South Africa from the group of 10 countries using a target range to the group of 11 countries using a specific point with a range around such point. The strategy behind this amendment in policy focus is to anchor inflation expectations at 4.5%, rather than at 6%, which will be beneficial to the South African economy. This focus "on point" rather than "on target" raises a number of important policy questions.

The first matter for consideration is whether the South African government should endorse this "on point" focus of the SA Reserve Bank and the question is whether this is appropriate for South Africa.

The second matter is the advisability of a formal target re-specification from 3 to 6% to 4.5% with a range of 1.5 percentage points on either side, as is mooted by Mr Kganyago, or even a point target specification of 4.5%.

The remaining issue is a debate on the suitability of an inflation target of 4.5% (with or without a range around it). Is 4.5% the appropriate level, or is it too high or too low? Finally, is the use of an inflation target (range or point) missing something bigger and more important? Should the government shift to another monetary policy target or goal entirely? To extend the metaphor, is the current debate 'off the mark'?

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ENDNOTES

1 The MPC is the Monetary Policy Committee of the SA Reserve Bank, entrusted with responsibility for setting monetary policy and the level of the interest rate. NA