Appropriateness of inflation targeting in South Africa

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Abstract

In 2001, South Africa adopted inflation targeting as the monetary policy framework. The principal of the framework is to maintain inflation within the target band of 3% to 6%. However the policy has been heavily criticised. The purpose of this research is to contribute to the debate as to which monetary policy framework is the most appropriate for South Africa. This research intends to examine the inflation targeting framework advocated by government against the alternatives to inflation targeting. The research will assess monetary policy frameworks of inflation targeting, flexible inflation targeting with a wider target band, real targeting, exchange rate targeting and non-inflation targeting, within the context of international and local best practices and lessons of experience.

The methodology in the research mainly followed a qualitative design principle. The main methods of data collection were personal interviews, literature review and secondary data from institutions such as South African Reserve Bank and Statistics South Africa. The data collected was analyzed using content analysis and then tabulated.

The studies main recommendation is that South Africa adopts a real targeting approach in place of the current monetary policy of inflation targeting, while keeping inflation constant. The study further recommends South Africa impose capital controls, tighten the escape clause as well as implement a clear and coherent macroeconomic economic framework eliminating any contradiction between fiscal and monetary policy

The study found that the current monetary policy of inflation targeting is inappropriate and argues that a more relaxed monetary policy is more appropriate to the economic and development challenges in South Africa

Dedication

To Africa; for all her People, potential and Passion

"God Bless Africa

Guard her children

Guide her leaders

And give her peace, for Jesus Christ's sake.
Amen."

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Declaration

I Duma Walter George Sisulu, declare that this research report is my own work, submitted in partial fulfilment of the requirements for the course Masters of Management in the area of Public and Development Management (MM-P&DM) in the University of the Witwatersrand, Johannesburg. It has not been submitted for any degree or examination in any other University

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Chapter 1

1.1 Introduction

Inflation Targeting is a relatively new policy tool. In December 1989 New Zealand became the first country to officially adopt inflation targeting (van der Merwe, 2004). During the 1990`s inflation targeting quickly gained popularity and became the monetary policy framework of choice for many countries. The popularity of the inflation targeting framework has two sources according to Mishkin F. S (1998). Firstly, central banks around the world, the South African Reserve Bank included, agree that price stability should be the number one concern of monetary policy. This arises from understanding of the negative effect high inflation has on economic growth (Pollin, Eptein, Heintz, &Ndikumana, 2006). Secondly, the other approaches to monetary policy, such as exchange rate targeting and monetary aggregate have not succeeded (Mishkin F. S 1998).

According to Van der Merwe, South Africa has opted for a flexible exchange rate rather than a fixed rate for three reasons. Firstly, attempts in the past have failed as the currency experienced large swings (Van der Merwe, 2004). Secondly, in a global economy of floating exchange rates it is virtually impossible to obtain exchange rate stability and lastly, monetary policy flexibility and independence is abandoned with the use of various forms of exchange rate regimes (Van der Merwe, 2004). Mishkin (2001) also points out that many countries have to adopt inflation targeting because it has advantages such as transparency, a clearly understood target and accountability.

There is a need to control inflation and create a stable economy with a high degree of price stability which will lead to sustainable economic growth. The South Africa constitution states that "the primary objective of the South African Reserve Bank (SARB) is to protect the value of the currency in the interest of balanced and sustainable economic growth in the republic"(South African Reserve Bank, 2010).The Reserve Bank has chosen a monetary policy of inflation targeting to achieve this objective and in February 2000, the Reserve Bank announced it would pursue a policy of explicit inflation targeting and a band of between 3% and 6% was selected. Monetary policy is the process undertaken by a government agency to control the supply, availability, cost of money or interest rates to promote broad economic goals of the country (ForexTraders, 2011).Current monetary policy is neo classical based, with price stability its primary goal in order to create an enabling environment for economic growth and development (Interview C). There is now worldwide agreement that the ultimate goal of monetary policy is price stability, employment, economic growth and stable exchange rate. (South African Reserve Bank, 2009)

There is general consensus that inflation targeting has been successful in bringing down inflation. However there is a large debate around its effect on the rest of the economy. South Africa's largest, most powerful trade union federation, the Congress of South African Trade Unions (COSATU) believes inflation targeting prioritises inflation over growth and employment. COSATU argues that monetary policy should focus primarily on employment. It calls for the removal of inflation targeting frameworks as the efforts made "to contain inflation have kept interest rates too high, adding to job losses during last year's recession" (COSATU, 2010). COSATU argues that the primary economic challenge is to increase growth and cut unemployment and poverty and that the only way these challenges can be addressed is with the removal of inflation targeting in its current form (COSATU, 2007).COSATU further argues that inflation targeting is not pro-poor but in actual fact, favours retainer groups and the financial sector (COSATU, 2008). According to COSATU the high interest caused by inflation targeting result in a overvalued rand which attracts unstable foreign capital (COSATU, 2007).COSATU argues that inflation targeting reduced economic growth by raising the cost of capital and thus slowing business expansion rate (COSATU, 2008).

Given South Africa's poverty and unemployment, the Minister of Finance, Pravin Gordhan acknowledges the concerns of COSATU and business and has called for a shared vision of inclusive growth (Gordhan, 2010). However Government is firm about maintaining the current monetary policy of inflation targeting and the current band. Gordhan sees no need to change the South African Reserve Bank's existing inflation target band, saying the bank had new flexibility to tolerate inflation out of the range (South African Reserve Bank, 2009)

1.2 Problem Statement

In 2001, South Africa adopted inflation targeting as the monetary policy framework. The principal of the framework is to maintain inflation within the target band of 3% to 6%. However, recently there have been contrary views from COSATU and in some academic circles, that there is a need to review the monetary policy framework. COSATU criticised the current monetary policy of inflation targeting as too narrow, calling for it to be removed or target expanded to support job creation efforts in the South African economy (LOURIE, 2009). Stieglitz believes inflation targeting is an inappropriate framework, arguing that developing countries need to abandon the framework. Stieglitz points out that continually raising interest rates to combat inflation will certainly result in economic slowdown and high unemployment (Stiglitz 2008).

The main alternatives to inflation targeting will be considered briefly. Widening of the inflation target band compliments inflation targeting. **Widening of inflation target band** involves moving the target band from 3 % - 6% to a higher level. Khan & Senhadji (2001) provide empirical evidence showing that the negative growth threshold for developing countries is between 11% and 12%. On the other hand a study conducted by Burdekin, Denzau, Keil, Sitthiyot, & Willett (2004) found that the negative inflation/ growth threshold for developing countries was 3%.

Alternatives such as real targeting as advocated by Epstein (2003) replace inflation targeting altogether. Epstein (2003) argues that South Africa is ill-suited to inflation targeting because of its high unemployment rate, advocating instead a **real targeting framework**. In this framework the central bank chooses a real target appropriate for the country- in South Africa's case it would be unemployment. The central bank then chooses a set of monetary policy instruments to achieve the target (Epstein 2003).**Real exchange rate targeting** is the "maintenance of a stable and competitive real exchange rate, by managing the real exchange rate" (Epstein & Yeldan, 2011, p 4). However this alternative was shown to be less favourable than inflation targeting by Frankel (2006) as South Africa is prone to supply shocks. The Reserve Bank Governor, Gill Marcus, stated that any intervention to hinder the appreciation of the rand is costly and not always effective (Marcus, 2010).

The discussion presented indicates that there is considerable difference in opinion in deciding on the required monetary policy framework. In the case of South Africa, the appropriate monetary policy framework should ensure that the developmental economic objectives of job creation are met. The problem is that there is a need to contribute to the debate as to which monetary policy framework is appropriate for South Africa –inflation targeting or the alternatives to inflation targeting and the reasons for making the recommendations.

1.3 Purpose Statement

The purpose of this research is to contribute to the debate as to which monetary policy framework is the most appropriate for South Africa. The debate takes place in the context of encouraging job creation and economic growth. This research intends to examine the inflation targeting framework advocated by government against the alternatives to inflation targeting. The theoretical discourse is further reflected in the debates between government and labour in South Africa, advocating monetary policy frameworks that will achieve specific economic transformational objectives. The research assesses monetary policy frameworks of inflation targeting, flexible inflation targeting with a wider target band, real targeting, exchange rate targeting and non-inflation targeting, within the context of international and local best practices and lessons of experience. In addition, the research compares local and international evidence to inform the argument as to which monetary policy framework is most appropriate for South Africa.

1.4 Research Questions

1. What are the current theoretical frameworks informing monetary policy?
2. What is the nature and content of the debate in South Africa with respect to monetary policy frameworks?
3. What are the main alternatives to inflation targeting in South Africa? What is international experience and best practice?
4. What are the main recommendations with respect to the appropriate monetary policy framework for South Africa?

1.5 literature review

In 2001 The SARB chose inflation targeting as the monetary policy framework to achieve its objective to "protect the value of the currency in the interest of balanced and sustainable economic growth in the republic "(South African Reserve Bank, 2010).The principal of the framework is to maintain inflation within the target band of 3% to 6%. However COSATU argues that the focus of monetary policy should be employment and that inflation targeting harms job creation. COSATU proposes real targeting where inflation targeting is put alongside equally well defined targets for employment, growth, investment and skill development (COSATU, 2008). The literature considers the advantages and critiques of inflation targeting, empirical evidence supporting it, as well as international examples and best practice. The literature further covers the debates on the best alternatives to inflation targeting; looking at the pros and cons of exchange rate targeting, real targeting and expanding the inflation targeting target band.

1.6 Methodology

The methodology in the research mainly followed qualitative design principles to gain an understanding of the process and issues relating to inflation targeting and its alternatives. The main methods of data collection were personal interviews, reviews of literature and existing statistical research from institutions such as Statistics South Africa and SARB. Semi- structured interviews with open-ended questions were used to gain a deep understanding of the topic. This allowed for two-way communication where the respondents were able to give feedback and express themselves. Content analysis followed by tabulation methods were used to analyze the data collected.

1.7 Conclusion

The purpose of this research study was to evaluate inflation targeting, the alternatives to inflation targeting and to assess the most appropriate policy for South Africa. The research followed qualitative design principals to gain an understanding of the process and issues relating to inflation targeting and its alternatives. The main method of data collection was personal interviews, review of literature and existing statistical research from institutions such as Statistics South Africa and SARB.

There is general consensus within the literature that inflation targeting brings down inflation rates and output volatility. However there is much debate on its impact on the rest of the economy and economic activity. COSATU argues that inflation targeting is not pro-poor but benefits retainer groups and brings job creation is at a standstill. Several authors argue that the inflow of international capital attacked by the high interest rates, caused by inflation targeting, pushes up the price of the rand.

Inflation targeting cannot be blamed all of South Africa's economic problems (Kahn, 2008). According to Mohr and Fourie, stringent labour laws hamper employment creation and this, coupled with very poor performance in most South African industries causes' huge unemployment (Mohr, Fourie, & Associates, 2008). The lack of skilled labour compounds the problems of unemployment (Hodge 2002).

There are several alternatives to inflation targeting and the main ones examined in this study are widening target band, exchange rate targeting and real targeting. COSATU calls for the removal of inflation targeting, arguing that it has had a disastrous effect on the South African economy. It recommends that inflation targeting is put alongside equally well defined targets for employment, growth, investment and skill development (COSATU, 2008). It further calls for the target band`s expansion to allow for higher growth rates and to stimulate job creation. Government has advocated maintaining the current monetary policy of inflation targeting and the current band, arguing that "There are new tools and flexibility that we have created for the Reserve Bank, which helps it to achieve whatever it is that it, wants to achieve" (South African Reserve Bank, 2009).

Chapter 2

Literature Review

2.1 Introduction

This review considers the arguments for and against inflation targeting as defined by the literature, as well as empirical studies of inflation targeting and its effect on other variables, such as, economic growth (GDP), unemployment and inflation. Attention is given to the alternatives to inflation targeting, including exchange rate targeting, widening of the target band and real targeting, as well as some international experience and the effect inflation targeting has on the poor.

2.2 Theory of monetary policy

There are many different varying definitions of monetary policy. Monetary policy is the process undertaken by a government agency (in South Africa that agency is the South African Reserve Bank) to control the supply of money, availability of money, cost of money or interest rate to promote broad economic goals of the country e.g. economic growth, price stability, employment and stable foreign exchange rate (ForexTraders, 2011). The Central Bank of Kuwait noted that it is a stabilizing policy adopted by government to correct economic imbalances (Central Bank of Kuwait, 1988)

The major trend in monetary policy over the last 20 years has been its focus on price stability (Tobin, 1998). Central banks all over the world, South Africa included, have committed to price stability (Tobin, 1998). Interestingly no country that has adopted this mandate has abandoned it in favour of another. There is now worldwide agreement that the ultimate goal of monetary policy at present is price stability, employment, economic growth and stable exchange rate. (South African Reserve Bank, 2009)

The monetary policy instruments used by a central bank depend largely on the development of the economy and particularly the development of the financial sector. In established capitalist economies such as South Africa, monetary authorities commonly use one or more of the following instruments: change the reserve requirement, change in the “discount rate or official bank rate” (Central Bank of Kuwait, 1988 p.7), exchange rates and open market operations (Central Bank of Kuwait, 1988).Current monetary policy is neo-classical based in that it is concerned with providing an enabling enviroment for economic growth. It is based on the assumpion that price stability in itself is enough to provide this enabling enviroment (Interview C)

2.3 Inflation targeting, its advantages and critiques

South Africa adopted inflation targeting as a monetary policy framework in February 2000 (South African Reserve Bank, 2009). According to Mishkin (July 2001:1), "inflation targeting is a recent monetary policy strategy that encompasses five main elements: The public announcement of medium-term numerical targets for inflation; an institutional commitment to price stability as the primary goal of monetary policy, to which other goals are subordinated; an information inclusive strategy in which many variables, and not just monetary aggregates or the exchange rate, are used for deciding the setting of policy instruments; increased transparency of the monetary policy strategy through communication with the public and markets about the plans, objectives, and decisions of the monetary authorities; and increased accountability of the central bank for attaining its inflation objectives". Inflation targeting is more than just the announcement of inflation targets over a specific time period (van der Merwe, 2004).

The main advantages of inflation targeting pointed out by its advocates are

- Reduce the rate of inflation (Mboweni, 2004)
- Enhance the credibility of monetary policy (Mboweni, 2004)
- Easily understood by the public and thus highly transparent (Mishkin, 2001)
- Help to attract foreign investment by making SARB intentions clear and provide transparency giving investors' confidence (Mboweni, 2002)
- Improves harmonisation between SARB and monetary policy (Mboweni, 2004)
- Future oriented framework where decisions are based on the systematic assessment of the future. (Mishkin, 2001)

From the above discussion, it is clear that advocates for inflation targeting regard this monetary policy framework as providing an effective nominal anchor for monetary policy and inflation expectations (EconomyWatch, 2010).

The main critiques of inflation targeting as pointed out by the authors.

Although inflation has dropped in countries that have adopted inflation targeting, on average it has been accompanied by higher unemployment (Debelle, Masson, Savastano, & Sharma, 1998). In Mishkin (2001) it is noted that according to Bernanke, Laubauch, Mishkin & Posen (1999) and Mishkin (1998) four of the main critiques of inflation targeting –that inflation targeting is too rigid, that it allows for too much discretion, that it has the potential to increase output instability, and lastly that it will lower economic growth—are in reality not serious critiques to a properly designed inflation targeting strategy, which can be characterised as "constrained discretion" (Mishkin, 2001). However Mishkin (2001) points out that there are other solid critiques of inflation targeting. The flexibility of the exchange rate required by inflation targeting may cause instability in the financial market (Mishkin, 2001). Inflation targeting can only produce weak accountability, because of the difficulties in controlling inflation, and the long lag times between the action of raising the intrest rate and the desired outcome of lower inflation (Mishkin, 2001). Lastly inflation targeting cannot prevent fiscal dominance. Governments can still persist with irresponsible fiscal policy with inflation targeting in place, however it would help if government set out clear targets (Mishkin, 2001).

There is general consensus among the authors considered that inflation targeting brings down inflation rates (Pollin, et al., 2006; Walsh 2008).However there is much debate on its impact on the rest of the economic activity in the economy. Pollin states that inflation targeting has been broadly successful in the sense that it has met its primary goal of reducing inflation (Pollin, et al.,2006). Kahn agrees and his findings show that inflation targeting has decreased inflation levels and variability in South Africa and at the same time increased economic growth (Kahn 2008).

2.4 Empirical evidence

There is general consensus among the authors considered that inflation targeting does in fact bring down inflation. On the other hand (Ball & Sheridan, 2003) in Kahn (2008) point out, that there is no fundamental link between lower inflation and inflation targeting, as all OECD countries, regardless of their monetary policy realised lower inflation. The Ball &Sheridan (2005) study did lend some support to inflation targeting, as they concluded that the implementation of the inflation targeting framework "did not make any countries worse off in terms of output volatility" (Kahn, 2008, p. 140). Kahn (2008) further notes, the general evidence shows that inflation and economic variability are lower during inflation targeting periods as opposed to pre-targeting periods, the performance of targeting nations is not significantly better than that of non-targeting nations (Kahn, 2008). However, using a contested method where they compare inflation targeting nations to non-inflation targeting nations of similar economic makeup and structure, Lin &Ye (2007) find that inflation targeting is not a statistically significant cause of low inflation. Walsh (2008) pointed out that the method used by Lin &Ye (2007) is inaccurate and problematic because they compare inflation targeting nations with countries that already have low levels of inflation. For emerging market economies such as South Africa, the evidence is more convincing. Studies such as Walsh (2008) show that, for these economies inflation targeting has been associated with lower inflation as well as lower real output volitility.

There is a big debate around the relationship between inflation and economic growth. The majority of the studies show that a negative relationship between inflation (CPIX) and economic growth (GDP) exists but only at high levels of inflation (Pollin, et al.,2006 ;Khan &Senhadji, 2001). The debate continues particularly around the threshold at which inflation begins to have a negative effect on GDP. Some argue that the current inflation band of 3% and 6% is too low for sustainable economic growth. However the findings of a study conducted by Burdekin, Denzau, Keil, Sitthiyot, & Willett (2004) disputed those of Khan &Senhadji (2001), finding that the negative inflation/ growth threshold for developing countries was 3%, as opposed to Khan &Senhadji (2001) where it was found to be between 11% and 12%. In contrast, others argue that higher inflation targets are needed for developing countries to accommodate exogenous shocks. This is particularly true for developing countries which are prone to some supply shocks such as South Africa (Selassie, Clements, Tareq, Martijn, & Di Bella 2006).Thus raising interest rates in response to an exogenous supply shock makes inflation targeting pro-cyclical rather than anti-cyclical. This can be accommodated for using the explanation clause in a more flexible framework which allows for temporary deviations.A study conducted by Jose Antonio Cordero (2007) it was found that countries that adopted inflation targeting, should tolerate higher inflation levels to avoid excessive appreciation of the real exchange rate. Excessive appreciation of the exchange rate may harm exports. Calls for a wider target band are discussed in the next section.

In conclusion, empirical evidence shows that inflation targeting has been successful in South Africa. The general consensus is that inflation targeting has brought down inflation and inflation variability without affecting output volatility. There is still a large debate on the appropriate range for developing countries to target. Many authors argue that the current band of between 3% and 6% is too low for sustained economic growth. Studies show tolerating a higher band of anything less than 15% does not negatively impact growth, as the negative growth threshold as shown by Khan(2001) to be from 11%. However there is a counter argument form Burdekin et.al (2004) where it was found that the negative inflation/ growth threshold for developing countries was 3%.The renewed focus on flexibility by the SARB ensures that the range of 3% to 6% is not too narrow and can accommodate any exogenous shocks.

2.5 Inflation and the Poor

Is inflation targeting really in the best interest of the poor? COSATU argues that contrary to media reports the high interest rates caused by inflation targeting are in actual fact in the best interest of the retainer groups, financial sector and not the poor (COSATU, 2008). The real question that should be asked is what is the price paid by the poor and society as a whole, for government's pursuit of low inflation policies, and who are the main benefactors of such policies? (COSATU, 2008). According to COSATU international evidence shows that the poor tend to receive a higher share of income when inflation is higher and that recent experience in South Africa shows that low inflation has coincided with rising inequality (COSATU, 2008). Countries that have had sustained long term growth and job creation have had to do so in an environment of rising inflation because growth, investment and employment all put upward pressure on inflation (COSATU, 2008). Thus having inflation targeting means any chance of a period of sustained growth and job creation is cut short, because inflation will quickly move out of the target band forcing South Africa Reserve Bank to raise interest rates (COSATU, 2008). The literature supports this argument and suggests that growth increases as inflation rises from low levels to about 15% - 20% (Epstein 2003). South Africa therefore has a simple choice - either accommodate a moderate level of inflation or hike interest rates, thus slowing growth and development to keep inflation within the target band. COSATU argues that, contrary to media indications, inflation targeting is not pro-poor but instead favours the rich to the detriment of the poor, since it slows growth and raises inequality.

2.6 Other factors effecting economic performance

Economic growth is determined by a range of real variables (Kahn, 2008). Many authors such as Bowes, Lundy, & Pennington (2004) and Pringle (2010) point to the fact that there are other factors which are responsible, not just inflation targeting. There is consensus among the authors that South Africa labour laws are too stringent and are partly to blame for the high level of unemployment in the country. Several authors argue that because laws on dismissals, strikes and bargaining are too stringent, they tend to hurt the employer, who then switches to more capital-intensive means of production (Mohr, Fourie, & Associates, 2008).

Under- performing industries remain a problem in South Africa. Apart from the booming services sector of the economy, South African industries have been performing poorly with low growth rates. Bowes et al (2004) points out the underperformance in low technology sectors such as footwear and textile, arguing that the result of this has been a steady decline of South Africa's world export share from 1.5% in 1980`s to 0.4% in 2004. There is a lack of innovation in South Africa, with many pointing to poor quality of human capital as a result of poor education. Gouwer calls for more investment in education (Pringle, 2010). His words are echoed by most of the literature. Gouwer states that "slow economic growth and unemployment could not be blamed on inflation targeting" (Pringle, 2010), pointing out that this is instead a shortcoming in terms of skills development, human capital and infrastructure. Some authors blame inflation targeting for high and increasing levels of unemployment pointing out that low inflation and high interest rates hamper job creation. However Hodge (2002) and many others find no relationship between inflation and employment. The literature also points out that unemployment in South Africa is deeply structural in nature (Hodge 2002). External factors like terms-of-trade swings are also relevant. This is particularly true for emerging economies (Kahn, 2008).

Inflation targeting has been criticised for much of the problems in the South African economy. However from the above discussion we see that it is not the only possible cause for South Africa's poor economic condition. There are many other factors such as stringent labour laws which hamper employment creation, coupled with very poor performance in most South African industries causing huge unemployment. The lack of skilled labour compounds the problems of unemployment

2.7 Alternatives to inflation targeting

The literature reviewed indicates that while there are many alternatives to inflation targeting, only a few are considered viable. These are discussed briefly in the next section. There are alternatives that compliment inflation targeting such as widening of inflation target band, and the rest which replace it as a monetary policy framework such as exchange rate targeting as well as real targeting

Widening of inflation target band

The acceptable band for inflation cannot be the same for both developed as well as developing countries. Empirical evidence suggests that for developing countries the acceptable band should be substantially higher than the 2% -4% for developed countries. The majority of the studies show that a negative relationship exists between inflation and economic growth, but only at high levels of inflation (Pollin, et al.,2006). Bruno & Easterly (1996) analyzed the relationship between economic growth and inflation between 1960 and 1992. His findings show that on average, rates fell only significantly as inflation rates rose to 20% – 25% (Epstein 2003). Bruno and Easterly (1996) further found that "on average growth increased as inflation rose from negative or low rates to 15% - 20%"(Epstein 2003: p 10). Moderate rates of inflation are not associated with "slower growth, less investment, foreign direct investment or any other important real variable" (Epstein 2003: p 10)

Exchange rate targeting

A fixed or pegged exchange rate is one in which the Reserve Bank sets the official exchange rate and then intervenes in the market to ensure that the rate remains the same (Heakal, 2009). The price of the currency is pegged against a major world currency (Heakal, 2009).To maintain the exchange rate the Reserve Bank buys and sells its own currency on the foreign exchange market in return for the currency against which it is pegged (Heakal, 2009)

Fixing the exchange rate or pegging has a number of pros and cons. The main advantages include reducing the inflation rates, reducing transaction costs as well as exchange rate fluctuations. With reduced currency fluctuations, uncertainty is also reduced and thus trade is increased (PÉTURSSON, 2000). It also serves as an anchor for monetary policy and increases transparency (PÉTURSSON, 2000). The expectations of those who determine capital flows, wages and prices are positively affected by convincing them that they need not worry about inflation or depreciation.

However, maintaining a fixed exchange rate has a number of disadvantages. Speculative attacks are more likely. Shocks are harder to deal with as the Reserve Bank cannot use monetary policy to respond to such shocks (PÉTURSSON, 2000). Economic shocks in the country against which the currency is pegged will filter through into the local economy and reflect in the domestic interest rates (PÉTURSSON, 2000).Exchange rate targeting is not ideal for South Africa as we are prone to supply shocks as pointed out by Reserve Bank Governor Gill Marcus (South African Reserve Bank, 2010). Van der Merwe (2004) further points out that in the current global economy of floating exchange rates it is relatively impossible to have a fixed exchange rate.

Real targeting framework

An important factor to consider is whether there is too much emphasis being placed on inflation by inflation targeting at the expense of the other monetary policy objectives such as employment and growth

South Africa unemployment level was between 26.5% (narrow definition) and 40.5% (wide definition) depending on which definition used (Pollin, et al.,2006). The old

South African economic policy framework ASGISA targeted halving the unemployment rate by 2014 (Pollin, et al.,2006). The average growth rate in South Africa post-apartheid is only 3.1% which is only 1% higher than the average rate of population growth (Pollin, et al.,2006). Thus by itself the GDP growth cannot raise the living standards substantially by significantly reducing unemployment. For the government to reach its target of a 50% reduction in unemployment by 2014, it will require an aggressive employment targeting programme (Pollin, et al.,2006).

Epstein (2003) criticized inflation targeting, stating that in many countries it has generated significant costs such as slowing growth, sluggish employment generation and high interest , while yielding small benefits. Epstein (2003) points out that inflation targeting's biggest disappointment is its inability to reduce the sacrifice ratio, the unemployment cost of fighting inflation. Epstein (2003) proposes real targeting, stating that it is a superior alternative to the costly inflation targeting policy

In this framework the central bank chooses a real target appropriate for the country - in South Africa's case it would be unemployment. The central bank then chooses a set of monetary policy instruments to achieve the target (Epstein 2003).

Real targeting prioritizes economic variables which contribute directly to the social welfare of the majority of the population (Epstein 2003). The advantage of real targeting is that the central bank is required to clearly identify its goals/targets and reach them and if it fails to do so, explain why it failed and how it will reach them in future (Epstein 2003). This will increase the accountability of the bank to the general public. Real targeting takes into account the negative effect of high inflation. Thus under the new targeting approach the central bank must achieve its target, subject to an inflation constant (Epstein 2003). This means the central bank will have two targets e.g. employment and to a lesser extent inflation

Conclusion

Widening of inflation target band involves moving the target band from the current 3 % - 6% to a higher level. The empirical evidence suggests that having a moderate level of inflation does not result in slower growth, less investment, foreign direct investment or any other important real variable.

Targeting of the exchange rate looked to be a viable alternative to inflation targeting. Successful implementation of this policy may yield lower levels of inflation, transaction costs as well as reduced exchange rate variability. However targeting of the exchange rate is not suitable for South Africa because the country does not have the required reserves to maintain an exchange rate targeting policy. South Africa is also prone to shocks and would suffer heavily under speculative attacks

South Africa suffers from severe unemployment with levels at 40.5%. Coupled with this GDP, growth is too slow to have any real impact on unemployment. Real targeting offers a solution by putting first the economic variables which contribute directly to the social welfare of the population (Epstein 2003).With real targeting the central bank chooses a real target appropriate for the country, in South Africa's case it would be unemployment or economic growth. The central bank then chooses a set of monetary policy instruments to achieve the target (Epstein 2003).

2.8 International Experience and best practice

The experience of countries that have adopted inflation targeting seems to be a positive one. The countries managed to reduce inflation and inflation expectations to levels below what would have been possible had inflation targeting not been adopted. Internationally there has been a move towards inflation targeting. This is confirmed by Bernard (2005) "In recent times, many countries have moved towards monetary policy frameworks with a more or less specific inflation targeting" (Bernard, 2005).

According to (PÉTURSSON, 2000) Canada attempted to implement monetary targeting but had very limited success. This may be due to the fact that "Innovations in the financial market had created an unstable relationship between money supply and inflation" (PÉTURSSON, 2000, p. 40). Consequently Canada adopted inflation targeting as they saw it as being more likely to bring about low inflation (PÉTURSSON, 2000). Other countries such as Poland and Israel had a lot of success bringing down inflation and saw inflation targeting as the best way to maintain their success.

Lessons of experience

There are many lessons that can be learned from inflation targeting nations; the literature highlights a few of these. International evidence seems to suggest that there is no incompatibility between inflation targeting, growth and unemployment (Portugal, 2007). In fact when inflation targeting is perused in a flexible framework, taking into consideration short term effects on output, inflation targeting can bring down inflation considerably without any real cost to growth (Portugal, 2007). The evidence further suggests that for both developed and developing nations low inflation is good for long term growth (Portugal, 2007).

International evidence also shows that of all inflation targeting nations, none follow a strict form of inflation targeting that only focuses on inflation (Portugal, 2007). Rather, they follow a flexible form of inflation targeting where short term conflicts between growth and inflation caused by negative supply shocks are resolved in favour of lower output and employment volatility (Portugal, 2007)

Inflation targeting ensures that external financial disturbances, exchange rate volatility and other influences do not trigger an inflationary process that could negatively affect long term growth (Portugal, 2007). However inflation targeting does not insulate countries from these influences.

Best practice

Inflation targeting should be in the form of target bands rather than point estimates (Saxton, 1997). Bands allow for measurement errors as well as unexpected shocks. In addition some nations such as South Africa and New Zealand have explanation clauses which allow for inflation to fall outside of the band in certain special circumstances e.g. oil shocks (Saxton, 1997)

Multi-year objectives are crucial as they increase the chances of successful inflation targeting by slowly conditioning expectations. It also takes into account the long lags between action (raising/reduce the interest rates) and the effects (drop/raise in domestic demand). (Saxton, 1997)

Inflation targeting should be consistent with other macroeconomic policies, and not contradictory as in South Africa's case with contractor monetary policy and expansionary fiscal policy (interview B)

Challenges facing emerging economies

Developing nations experience more challenges in relation to inflation targeting than developed nations (Kahn 2008). This is true for South Africa as well. In this section we will discuss some of the challenges facing emerging market economies in relation to inflation targeting. Kahn (2008) presents data up to 2002 which suggests inflation targeting in emerging-market economies does not perform as well as in developed countries.

However they point out that inflation targeting is more challenging, and regarded as inappropriate for emerging economies as very few of these countries are able to comply with the prerequisites for its successful introduction (Kahn 2008). Thus it is not a result of lack of commitment to the targets (Kahn 2008). There are many prerequisites which are essential to the successful introduction of inflation targeting namely: Central bank independence, Fiscal Dominance, the Structure of the economy and Technical infrastructure (Kahn 2008).

Central bank independence is a key institutional requirement for the success of inflation targeting, the central bank must have instrument independence (Kahn 2008). There should also be public and political commitment to inflation targeting or independence is irrelevant (Kahn 2008). Independence is key as it prevents undue political influence such as government changing the target each time the Reserve Bank has to implement unpopular measures (Kahn 2008). This would undermine the advantages of inflation targeting, of building credibility & predictability and the anchoring of expectations (Kahn 2008).In South Africa institutional independence of the Reserve Bank is constitutionally guaranteed (Kahn 2008). This ensures that the bank maintains credibility (South African Reserve Bank, 2009)

Fiscal Dominance: Another challenge facing emerging economies is the amount fiscal dominance in the economy (Batini & Laxton, 2007). Demand for social expenditure is normally higher in developing countries along with smaller tax base

(Kahn 2008). If the central bank is forced to monetise the debt of the government, the ability of the monetary policy to focus on inflation targeting will be undermined and reduced (Kahn 2008). However adoption of inflation targeting can help promote fiscal and financial reforms, making it harder for governments to push forward policies that are not coherent with the inflation target (Kahn 2008).

Structure of the economy: Kahn (2008) identifies economic structure as a key requirement for inflation targeting success. Kahn (2008) noted that prices should be deregulated, and not very sensitive to commodity and exchange rate fluctuations. Also noted is that if prices are generally administered inflation control is not very effective (Kahn 2008).

Technical infrastructure: International experience shows that the inflation forecast and good technical infrastructure is of key importance to any inflation targeting regimes, as well as quality data and modelling capabilities (Kahn 2008). A lack of technical capabilities can be overcome with training and the aid from other central banks (Kahn 2008). When South Africa adopted inflation targeting as its monetary policy, the South African Reserve Bank got assistance and peer review from many central banks, including the UK, Canada and Sweden (Kahn 2008).

In concluding, we see emerging economies that adopt inflation targeting face a number of challenges, such as technical infrastructure, structure of the economy, fiscal dominance and central bank independence. If these challenges are not adequately addressed inflation targeting will most likely fail. However the experience of emerging market countries as well as the industrialized nations that have adopted inflation targeting, suggests that inflation targeting can be successful even if not all of the desirable conditions are met (Portugal, 2007)

Internationally there has been a move towards inflation targeting, interestingly no country that has adopted inflation targeting has dropped it in favour of another policy. South Africa has overcome all of the challenges discussed, allowing it to successfully implement and maintain an inflation targeting monetary policy.

2.9 Summary of literature, lessons of experience and best practice from literature

The literature review looked at arguments for and against inflation targeting as well as debates on its effect on the rest of the economy, looking at its relationship with GDP and unemployment. This is followed by a discussion on the alternatives to inflation targeting, namely exchange rate targeting, real targeting and expanding the inflation targeting band. Lastly we looked at the international experience, best practice and lessons of experience

Inflation targeting is a monetary policy adopted by the SARB in February 2000, it is designed to reduce inflation and maintain it at a low level through the use of the interest rate. The main advantages of inflation targeting pointed out by its advocates are: reduce the rate of inflation (Mboweni, 2004); enhance the credibility of monetary policy (Mboweni, 2004); help to attract foreign investment by making SARB intentions clear and provide transparency giving investors' confidence (Mboweni, 2002); improves Harmonisation between SARB and monetary policy (Mboweni, 2004).The main disadvantages of inflation targeting are; that inflation targeting is too rigid, that it allows for too much discretion, that it has the potential to increase output instability, and lastly that it will lower economic growth. However these critiques were proven not serious to a properly designed inflation targeting strategy. There are other major critiques of inflation targeting, such as inflation targeting inability to prevent fiscal dominance, also the flexibility in the exchange rate needed by inflation targeting may cause instability in the financial markets. Lastly inflation targeting may only produce weak accountability

There is general consensus within the literature that inflation targeting brings down inflation rates and output volatility. However there is much debate on its impact on the rest of the economy and economic activity.

There is much debate about the threshold at which inflation negatively affects economic growth. The literature shows that a negative relationship exists but only at high levels of inflation. Moderate rates of inflation below 20% are not associated with slower growth, less investment or any other important real variable.

Widening target band: The acceptable band for inflation cannot be the same for both developed as well as developing countries. Empirical evidence in the literature suggests that for developing countries the acceptable band should be substantially higher than the 2% -4% for developed countries. However the SARB opposed this view arguing that the renewed focus on flexibility ensures that the range of 3% to 6% is not too narrow and can accommodate any exogenous shocks

Exchange rate targeting: A fixed or pegged exchange rate is one in which the Reserve Bank sets the official exchange rate and then intervenes in the market to ensure that the rate remains the same (Heakal, 2009). However SARB does not have the reserves needed to maintain exchange rate targeting. Speculators would severely harm the economy through speculative attacks. The literature points out that in the current global economy of floating exchange rates it is relatively impossible to have a fixed exchange rate.

Real targeting: With real targeting the central bank chooses a real target appropriate for the country in South Africa's case it would be unemployment or economic growth. The central bank then chooses a set of monetary policy instruments to achieve the target (Epstein 2003). Real targeting focuses on economic variables most important to the majority of the population. The main advantage of real targeting is that it forces the central bank to give explicit targets and justify any failure to reach such targets.

From the literature we see emerging economies that adopt inflation targeting face a number of challenges such as technical infrastructure, structure of the economy, fiscal dominance and central bank independence. If these challenges are not adequately addressed inflation targeting will most likely fail. South Africa has overcome all of the challenges discussed, allowing it to successfully implement and maintain an inflation targeting monetary policy.

From the lessons of experience we see that; no incompatibility between inflation targeting, growth and unemployment; no inflation targeting nation follows a strict inflation targeting policy they prefer a more flexible form; and lastly Inflation targeting ensures that external financial disturbances and exchange rate volatility do not trigger inflationary processes.

From best practice we noted that inflation targeting should be in the form of target bands rather than point estimates; Multiyear objectives increase the chances of successful inflation targeting; Inflation targeting should be consistent with other macro macroeconomic and not contradictory.

From the literature we see inflation targeting is not the only cause of South Africa's economic woes, as some would argue. Stringent labour coupled with very poor performance in most South African industries hampers employment creation and contributes to unemployment. The lack of skilled labour compounds the problems of unemployment. Globally, inflation targeting has gained much popularity, so much so that no country that has adopted inflation targeting has dropped it in favour of another policy.

The literature review looked at advantages and disadvantages of inflation targeting followed by its effect on the rest of the economy. It was found that inflation targeting had been successful, with the consensus it that brings down inflation rates and output volatility. The review also looked at alternatives to inflation targeting and found that exchange rate targeting was not possible in South Africa as it was too costly. Widening the band of inflation targeting posed possible solutions but it was real targeting that seemed to be the most promising and best option for South Africa. Lastly the review looked at the international scene and found that inflation targeting had been successful. It was noted that no country that had adopted inflation targeting had dropped in favour of another policy.

Chapter 3 Research Methodology

The chapter describes the research design, data collection and data analysis strategies as well as the assumptions and limitations of the study. The main aim of this research study is to evaluate inflation targeting, the alternatives to inflation targeting and find out what is the most appropriate policy for South Africa.

The research was predominantly qualitative in design to gain understanding of process and issues relating to inflation and inflation targeting. Qualitative methods were chosen as they help in gaining a deeper understanding of the process as opposed to the outcome (Bogdan&Biken, 1998). By using qualitative research design we can explore how the inflation targeting process works. Qualitative design techniques are very useful when the subject is too complex, as with monetary policy, to be answered by a simple yes or no hypothesis (experiment resources, 2011)

3.1 Data collection strategy

Data was collected from multiple sources for triangulation in order to enhance the reliability and credibility of the findings of the research (Merriam & Associates, 2002). Following scientific methodology is essential to the credibility of the research report. The main methods of data collection were personal interviews, review of the literature and secondary data collected from institutions like Statistics South Africa and SARB, who have a wealth of information on the South African economy. Initially the research aimed to conduct interviews with economists from COSATU, SARB, ANC and other leading economists. However, due to unavailability and difficulties in arranging meetings, the research reverted to reading of literature which contained extensive quotes by the economist's on their views on inflation targeting. In addition to the literature, two prominent academic economists, two economists from COSATU as well as economists from the private sector were interviewed. These organisations were selected as the main sources for the following reasons:

1. ANC is the ruling party in South Africa with a large majority in parliament. Therefore ANC`s economic policy is in effect the economic policy of south Africa

2. Interviewing economists who are outside of government and the ANC, such as COSATU who tend to have some opposing views which will enrich the quality and reliability of the findings of the research. Providing an outside view to inflation, inflation targeting and what is the most appropriate solution for South Africa.
3. Statistics South Africa and South African Reserve Bank are the two institutions charged with the mandate of recording inflation (statsSA) through the CPI & CPIX and controlling inflation and inflations expectations (SARB) with the REPO Rate
4. Secondary data from Statistics South Africa and South African Reserve Bank will be used as it is easily available and highly reliable. Also the cost of conducting independent time series studies would have been excessive and unnecessary as the data is already available

Getting economists from both ANC and COSATU provides both views of the prevailing economic thinking within South Africa. This combined with economists from academia and South African reserve bank provides triangulation of information enhancing the credibility of the findings.

Overall 6 economists were interviewed. All interviews were recorded and transcribed for analysis. The interviews took place over a four week period, and were on average 30 minutes long. A semi structured interview style was employed where open ended questions where used exclusively. This style aims to encourage full and meaningful responses, more than a yes or no answer could provide (mediacollege). Open= ended questions allow the respondents the opportunity to express their views in their own terms (Qualitative Research Guidelines Project, 2008). Semi- structured interviews allow for two-way communication and thus build understanding (FOA, 1990). The main advantages of semi structured interviews are that they provide not just the answer but also the reason for the answer (FOA, 1990).

The results of the interview were made readily available to the respondents. Anonymity was agreed to, as requested by the respondents. The respondents were very willing and open with their answers, and in general seemed interested in the study. Many of the respondents provided additional information and literature to assist with the research. The writer found the responses interesting and enjoyed the interviews as well as enthusiasm of the respondents.

Most of the data for the study was attained through the use of secondary sources. Secondary sources included books; chapters in books on inflation targeting, inflation, employment, economic growth, and international experience on inflation; journal articles, websites and lastly from institutions like stats SA and SARB. Secondary sources provide a very strong overview of the topic and combined with the primary source of interviews, provide a deep understanding giving valid and reliable results to the study. A framework was created to capture and tabulate data to ensure a clear and focused presentation of results. However the tabulated data was made up solely of primary data gathered from the interviews.

The methods of data collection and presentation of the study were informed, and guided by the objectives of the study. The data collection methods were both interview-based which helped with gathering data over a short period of time, and literature-based which provided an overview of the topic. Interviews were semi-structured to allow for two-way communication as well as the opportunity for the interviewees to express themselves in their own way.

3.2 Data analysis strategy

Data analysis is the search for and interpretation of patterns (Neuman, 2011). Qualitative data analysis is a very personal process with few rigid rules and procedures (Dadar College , 2005). Thus it was of great importance that the research went through a process of content analysis. Content analysis is the process of analysing interviews in order to identify the main overriding themes that emerged from the interviews (Dadar College , 2005). This process involves a number of steps. The steps followed in the research are listed below:

1. Identifying the main themes: this step involves going through the transcriptions of each interview question by question, to fully understand the meaning conveyed by the respondent (Dadar College , 2005). From these responses the main themes could be identified. This took considerably longer than expected as the respondents used different language and examples to

express themselves. The main disadvantage of content analysis is the fact that it is extremely time consuming (Palmquist, 1990)

2. Assign codes to the main themes: once the main themes were identified a keyword was assigned to each theme.
3. Classify responses under the main themes: Having identified the themes, last step in the content analysis was to go through the transcripts of all the interviews and classify the responses under the different themes.

Interviews were analyzed through content analysis followed by tabulation. This process was time consuming but ensured that the results of the research were valid and reliable.

3.3 Scope and Limitations of Research

The study of monetary policy and inflation targeting is an extremely broad topic. The decision was made to reduce the scope of the research because of time constraints. The focus was thus narrowed to what monetary policy framework is most appropriate in South Africa, inflation targeting or the alternatives to it.

There are many alternatives to inflation targeting, however from a review of the literature it is clear there are only a few which are seen as viable. Therefore only the main alternatives to inflation targeting are looked at in this research as they are the most relevant.

3.4 Interview Question

1. Is current monetary policy in South Africa appropriate given the debate over inflation targeting versus jobs?
2. What policy alternatives would you give for targeting of jobs or growth and why do you recommend these alternatives?

3.5 Conclusion

The purpose of this research study was to evaluate inflation targeting, the alternatives to inflation targeting and find out what is the most appropriate policy for South Africa. The research mainly follows qualitative design principles to gain an understanding of the process and issues relating to inflation targeting and its alternatives. The main method of data collection was personal interviews, review of literature and existing statistical research from institutions such as Statistic South Africa and SARB. Semi-structured interviews were used to gain a deep understanding of the topic and allow for two-way communication. Content analysis followed by tabulation methods were used to analyze the data collected. Only the main alternatives to inflation targeting where looked at in the study as a result of time constraints

Chapter 4

South African Case Study

This section is a case study of South Africa. beginning with a brief history of the South African monetary policy history and success of inflation targeting. Attention is then paid to the current monetary policy environment and inflation targeting. The debates, critiques and alternatives to inflation targeting are examined

South African monetary policy history

South Africa has a rich monetary policy history. According to Aron & Muellbauer (2000) the first regime, a liquid asset ration based system with quantitative controls on interest rates and credit, was in effect from 1960 to 1981. This system was gradually refined into a cash reserve system by 1985 (Aron & Muellbauer, 2000). From 1986 onwards a cost of cash reserves based system was employed, with pre-announced monetary targets. in the early 1980`s financial liberalization began and by 1990 a more open capital account, which rendered monetary targets of little use (Aron & Muellbauer, 2000). Starting in 1998 , a new monatery policy was introduced, whith the REPO system along with M3 targets and targets for core inflation (Aron & Muellbauer, 2000). South Africa underwent a rapid transition moving away from monetarist views that assume a simple connection between money supply and inflation (Aron & Muellbauer, 2000). International and local evidence did not support this monetarists view causing a move away from these ideas (Aron & Muellbauer, 2000).

Recently there has been a shift to a regime with an explicit target. In 2001 South Africa adopted inflation targeting as its monetary policy. “The primary objective of the SARB is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic “(South African Reserve Bank, 2010). The South Africa Reserve Bank selected a target band of between 3% and 6%. The South Africa Reserve Bank sees inflation targeting as the most appropriate way to achieve its objective. However recently there have been contrary views from COSATU and in some academic circles, that there is a need to review the monetary policy framework. COSATU and others have criticised the current monetary policy of inflation targeting as too narrow calling for it to be removed or target expanded to support job creation efforts in the SA economy (LOURIE, 2009)

South African Experience of inflaton targeting so far is shown in Kahn (2008). The success of inflation targeting can be seen from Table 2 which compares the inflation targeting period (1st quarter of 2000 until the 4th quarter of 2008) with the pre tagetting period in the 1990`s (1st quarter of 1991 until the 4th quarter of 1999).

Table 2: South African inflation and growth in the pre-targeting and targeting periods

Inflation	Mean (per cent)	Standard deviation
Pre-targeting period	9,7	3,5
Targeting period	6,5	2,2
Gross domestic product growth		
Pre-targeting period	1,6	2,3
Targeting period	4,3	1,1
Real policy rate		
Pre-targeting period	5,7	4,1
Targeting period	3,3	1,3

Note: The pre-targeting period is 1991Q1–1999Q4
The targeting period is 2000Q1–2008Q2

Source: (Kahn, p143. 2008)

From Table 2 we see that the average inflation rate (CPIX) dropped from 9.7 in the pretargeting period to 6.5 in the targeting period. The average GDP improved raising from 1.6 in the pre-targeting period to 4.3 in the targeting period. These statistics show that inflation targeting has been consistent with higher growth rates but not necessarely the cause of it.

Standard deviation is a measure of variability, the lower the standard deviation the lower the variability. The Standard deviation of inflation dropped from 3.5 to 2.2, while the standard deviation of output growth also declined from 2.3 to 1.1.

So not only has inflation and inflation variability declined, but so too has output growth variability, while output growth has increased

South African current monetary policy environment

There have been significant gains in the performance of monetary policy since South Africa adopted inflation targeting (Mnyande, 2007). As shown in the last section inflation targeting has been successful and has brought about not only a reduction in inflation and inflation variability, but so too a reduction in output growth variability, while output growth has increased. It has brought about greater stability in the real and nominal interest rates (Mnyande, 2007). Monetary policy credibility has also greatly increased, currently on average inflation expectations have converged to the target (Mnyande, 2007)

Employment or rather unemployment remains a huge challenge in South Africa, possibly the biggest one faced by government (COSATU, 2008). South Africa's unemployment level was between 26.5% (narrow definition) and 40.5% (wide definition) depending on which definition used (Pollin, et al.,2006). The average growth rate is too low to create sufficient jobs and significantly reduce unemployment (Pollin, et al.,2006). Monetary policy and specifically inflation targeting cannot solve the problem of unemployment (Pollin, et al.,2006). To address this government needs to embark on an employment targeting economic program (Pollin, et al.,2006). Monetary policy is merely a tool that creates an environment conducive to growth and job creation (interview respondent C)

The rand is currently grossly overvalued, largely due to inflow of international capital attracted by high interest rates as a result of inflation targeting (COSATU, 2010). These short term capital inflows do not add to productive investment but rather add to instability (COSATU, 2003). Manufacturing and other sectors of the economy which are sensitive to the exchange rate have suffered a large drop in output. Growth in the manufacturing sector fell from 4,7% to a mere 0,5% (COSATU, 2010). Mining, one of South Africa's largest and most significant sectors, suffered a loss in output for the consecutive quarter which means it is officially in recession (COSATU, 2010)

According to Mnyande (2007) South Africa has to ensure that SARB is up to date and comparable with international best practice (Mnyande, 2007). Secondly the country has to bring inflation down to level of its trading partners (Mnyande, 2007).

Conclusion

In closing South Africa's current monetary policy environment has been characterised by the success of inflation targeting in bringing down inflation, However there is still high unemployment and jobless growth. The rand is overvalued as a result of high interest rates, resulting in large capital inflows which cause instability. Other sectors of the economy which are sensitive to the exchange rate have also suffered, particularly exports. Monetary policy still has many challenges it must overcome. Inflation needs to be reduced to levels similar to South Africa's trading partners, and the SARB needs to be comparable with international best practice.

South African Current debates, alternatives and critiques on inflation targeting

This section examines the debate on inflation targeting as opposed to its alternatives. COSATU and SACP both call for non-inflation targeting as they believe the current inflation targeting policy has had a disastrous effect on the South Africa economy. However the South Africa Reserve Bank believes the new flexible inflation targeting is the best monetary policy framework for South Africa

COSATU

COSATU along with SACP believe that the current monetary policy of raising interest rates has had a disastrous effect on the South Africa economy. COSATU believes that inflation targeting prioritises inflation above growth and employment (COSATU, 2003) and that inflation targeting reduces economic growth by raising the cost of capital and thus reducing business expansion rate. SMME`s are hit hardest by this (COSATU, 2003). This has a negative effect on job creation as well as putting existing jobs in danger as businesses struggle to meet rising repayments on loans as a result of increasing interest rates (COSATU, 2003). COSATU points to IMF data that shows that internationally reduced inflation is generally associated with lower growth (COSATU, 2003).

COSATU argues that contrary to media reports inflation targeting is not pro-poor but rather benefits the retainer groups and the financial sector, which are able to multiply the value of their investments leading to greater inequality (COSATU, 2008).

COSATU states that job creation is almost at a standstill. At the current rate the ASGISA goals of halving unemployment by 2014 cannot be achieved (COSATU, 2010). COSATU blames conservative monetary policy for this, particularly the relentless hikes in interest rates (COSATU2010). COSATU views the government's inflation targeting policy as disastrous and argues that it is at the heart of the country's economic problems (COSATU, 2007).

COSATU argues that the primary economic challenge is to increase growth and cut unemployment and poverty. COSATU points out that the only way these challenges can be addressed is with the removal of inflation targeting in its current form (COSATU, 2007). COSATU (2003) proposes that: inflation targeting is put alongside equally well-defined targets for employment, growth, investment and skill development; cabinet defines the responses of failure to meet inflation targets, not only the South African Reserve Bank; the inflation target band is raised to more moderate levels to allow for higher growth rates; tighten the escape clause so that interest rates are only raised significantly where there is a problem with aggregate demand; instruct the South African Reserve Bank to justify all decisions regarding interest rates in terms of short-run effects on job creation/employment and growth. (COSATU, 2008)

Government: Flexible inflation targeting

On the 9th of November 2009 Gill Marcus replaced Tito Mboweni as governor of the South African Reserve Bank (South African Reserve Bank, 2010). With the change in regime at the SARB there is now a renewed focus on flexibility with regards to inflation targeting (South African Reserve Bank, 2010). This can be seen by the actions of the Finance minister Pravin Gordhan in his letter to the Governor of the Reserve bank in which he states "there was no need to change the South African Reserve Bank's existing inflation target band, saying the Bank had new flexibility to tolerate inflation out of the range for some time if need be (Mapenzauswa, 2010). There are new tools and flexibility that we have created for the Reserve Bank, which helps it to achieve whatever it is that it, wants to achieve," (South African Reserve Bank, 2009). According to Kahn (2008) the part of the framework that allows for temporary deviations are known as the explanation clause which is defined as:

> When the economy is buffeted by a supply side shock similar to those envisaged by the original escape clause that will take CPIX inflation outside the target range (e.g. an oil price shock, a drought, a natural disaster, or financial contagion affecting the currency), at the subsequent meeting of the Monetary Policy Committee, the SARB will fully inform the public of the nature of the 'shock', the anticipated impact on CPIX inflation and the monetary policy response to ensure that inflation returns to the target and the time frame over which this will occur. (Republic of South Africa, 2003: 31.)

Emerging markets such as South Africa are more susceptible to external shocks and thus require more flexibility in dealing with these shocks. (Kahn, 2008)~~.~~ Kahn (2008) further states that the flexibility of the framework offers distinct advantages compared to other alternatives. However, the challenge is often to balance this flexibility with monetary policy credibility. Too much flexibility may detract from the predictability of the framework (Kahn, 2008).

Both COSATU and the SACP welcome the new flexible policy of inflation targeting but still call for more emphasis on job creation and "move away from the narrow inflation targeting approach" (SACP, 2010)

Government feels strongly about maintaining the current monetary policy of inflation targeting and the current band. This was clear in the 2010 budget speech in which Minister Pravin Gordhan stated "there was no need to change the South African Reserve Bank's existing inflation target band" (Mapenzauswa, 2010). However the other members of the tripartite alliance namely COSATU and SACP believes that the Reserve Bank's policy on inflation-targeting is destroying jobs and calls for review of monetary policy in South Africa (SACP, 2010)

Conclusion

COSATU along with SACP believe that the current monetary policy of raising interest rates affects the South Africa economy negatively. COSATU argues that government has wrongly prioritised inflation above more important socio-economic objectives such as job creation. COSATU argues that inflation targeting reduces economic growth and job creation and that at the current rate South Africa cannot achieve its goal of halving unemployment by 2014. They further point out that inflation targeting is in fact not pro-poor but benefits a retainer group.

Government has advocated maintaining the current monetary policy of inflation targeting and the current band.

Summary of South African scene and debate

South Africa`s rich monetary policy history is summarised in table 1 below

Table 1. Sequence of Monetary Policy Regimes in South Africa

Years	*Monetary Policy Regime*
1960-81	Liquid asset ratio–based system with quantitative controls on interest rates and credit
1981-85	Mixed system during transition (see appendix for details)
1986-98	Cost of cash reserves–based system with preannounced monetary targets (M3)
1998-99	Daily tenders of liquidity through repurchase transactions (repo system), plus pre-announced M3 targets and targets for core inflation
2000-	Repo system with inflation targeting (CPI-X)

Source: adapted from (Aron & Muellbauer, 2000, p. 429)

In 2001 South Africa adopted inflation targeting as its monetary policy and targeted an inflation band of between 3% and 6%. Empirical evidence in Kahn (2008) shows that in South Africa inflation targeting has been successful in its mandate of reducing and maintaining inflation to within the target band of between 3% - 6%. It has not only reduced inflation and inflation variability but increased economic growth while reducing variability in growth. South Africa's current monetary policy environment has been characterised by the success of inflation targeting in bringing down inflation, however there is still high unemployment and jobless growth.

COSATU criticised inflation targeting calling for its scrapping as it is bad for the economy and job creation. They believe inflation targeting prioritises inflation over growth and employment. COSATU argues that contrary to media and public perception inflation targeting is in fact not pro-poor but rather favours retainer groups and the financial sector. The Federation further points out that the rand is currently overvalued as a result of the high interest rates, causing large inflows of unstable foreign capital adding to instability in the economy.

Government feels strongly about maintaining the current monetary policy of inflation targeting and the current band. Finance minister Pravin Gordhan stated that there is no need to change the South African Reserve Bank's existing inflation target band, saying the bank had new flexibility to tolerate inflation out of the range. Within the Reserve Bank there is a renewed focus on flexibility this can be seen with the explanation clause.

From the literature it is clear that inflation targeting in South Africa has been successful in relation to inflation and economic growth but has failed to create sufficient jobs. However inflation targeting is merely a tool government uses to address economic issues. It creates the environment conducive to growth and employment but cannot solve South Africa`s economic challenges alone. Government needs to set in and fill the gap where the market has failed.

Chapter 5

Analysis and assessment of interviews

Interviews and people interviewed

As stated in the methodology of this paper, the initial intention of this research was to conduct interviews with economists from COSATU, SARB, ANC and other leading economists. However, due to availability issues and time constraints this was not possible. Thus the research reverted to reading of literature which contained extensive quotes by the key economist's on their views on inflation targeting. Along with the literature, six economists were interviewed - two prominent academic economists, two economists from COSATU as well as two economists from the private sector.

The respondents were very open with their answers, and in general seemed very interested in the research. Many of the respondents provided additional information and literature to assist with the research. The writer found the responses of great interest and enjoyed the interviews as well as enthusiasm of the respondents. The respondents requested anonymity.

Analysis of interviews

There was consensus across all the individuals interviewed that current monetary policy is not appropriate for South Africa, as inflation targeting is not in favour of developing countries. The overwhelming view was that there is a need for a more relaxed monetary policy, which is more appropriate to the economic and development challenges in South Africa.

Respondent C argues that monetary policy has no control over job creation, it can only influence growth through the transmission mechanism with aggregate demand. Respondent A agreed with this assertion, further noting that monetary policy alone cannot achieve growth as monetary policy is merely a tool. They (interviewees A, B and C) agreed that the state would have to play a key role, "Market mechanisms are not going to work given the experience over the last couple of years. Therefore the state would have to intervene, number one put in place the kind of instruments that are going to drive economic growth. There has to be a clear macro-economic framework and not a contradictory macro-economic framework where we have on the one hand expansionary fiscal policy and on the other a narrow monetary policy"

Respondents B and E stated that monetary policy was biased towards inflation targeting, prioritizing inflation over economic development and job creation. "Growth has to be the primary goal given South Africa's economic challenges. We should be concerned with inflation but not obsessed with it"

Respondent E noted that economic upturn causes upward pressure on inflation, forcing SARB into raising interest rates to ensure that inflation does not move outside of the target band. This has a dampening impact on growth and as a result does not allow for sustained growth and economic take off. "The growth process is inherently inflationary, we need to understand what are the inflationary pressures and if we respond to those pressures are we going to slow down economic growth?" Respondent E pointed out that the SARB`s explanation clause did not help the situation. The explanation clause allows for temporary inflation outside of the band, which is a result of shocks and not inherent processes.

Respondent C pointed to skills shortage as a major contributor to South Africa's unemployment problem "South Africa suffers from structural unemployment resulting in jobless growth. This is a problem that inflation targeting and monetary policy cannot solve". There is a mismatch between what the economy wants and what the labour market is providing. The key intervention needed would be to address the issues of skills development. Government needs to look at strengthening education and aligning education to what the market actually needs, thus closing the gap.

South Africa imports a vast number of intermediary goods and capital equipment as we are very dependent upon them. The result is imported inflation. The majority of the respondents agreed that responding to this inflation by raising interest rates is inappropriate.

However respondent B argued that Inflation targeting has seen some positive results such as bringing down inflation as well as assisting with the relocation of investment, and the price stability helps attract investment by reducing risk to investors.

All respondents were of the view that current inflation targeting framework is inappropriate and they advocate a number of revisions and alternatives such as real targeting, expanding the target band and exchange rate targeting.

Respondent A pointed out that as a result of inflation targeting real interest rates are relatively high compared to the rest of the world. This causes a significant inflow of unstable foreign capital attracted by the high interest rates. He called for the implementation of capital controls to prevent capital flight thus stabilizing the foreign capital

Real Targeting

The majority of the respondents called for the targeting of growth or employment: “we first need to establish what the developmental and economic needs of the country are, and then set targets (real targets) to achieve these needs. Each target will have a specific instrument to achieve it, all the while inflation should be kept constant”

However respondent C disagreed, arguing that targeting growth and unemployment would be fruitless, arguing that first the skills mismatch needs to be solved “Targeting growth or employment to solve unemployment would be a waste of time in South Africa because of the structural unemployment problem.”

Widening of the target band

There was consensus that target Inflation band of 3% - 6% is too low for developing economies. However the respondents did not call for expansion of the target band but rather its scrapping all together. They argued that inflation should not be ignored but rather tolerated at higher rate provided it remains constant.

Exchange rate targeting

All the respondents agreed targeting the exchange rate would be the best solution for South Africa “targeting the exchange rate would be better for development, employment, alleviating poverty and inequality”. However they also agreed that South Africa cannot afford such a policy. Noting that South Africa does not have the reserves and speculative attacks are more likely. Furthermore shocks are harder to deal with as the Reserve Bank cannot use monetary policy to respond to such shocks.

In concluding it is clear that fixing the economy is not possible through monetary policy alone. Below is a tabulated summary of the interviews

Summary of interviews main ideas

Respondents	**Is current monetary policy in South Africa appropriate?**	*Exchange rate targeting*	**Alternatives** *Widening of the target band*	*Real Targeting*
Respondent A	Not appropriate: need a more relaxed monetary policy	-	-	-
Respondent B	Not appropriate: biased towards inflation rather than towards job creation and growth	Too costly south Africa does not have the reserves	Expanding the band by 2% - 3% would be a considerable benefit to growth	Target growth and tolerate higher levels of inflation
Respondent C	Not appropriate:	Advocates targeting of the exchange rate to boost exports	Remove the band and monitor inflation	Real targeting cannot solve South Africa's structural unemployment problem
Respondent D	Not appropriate	Targeting exchange rate would be better for development, employment and reducing inequality	Band is too narrow the 3% - 6% is for developed economies not emerging economies like South Africa	Advocates the targeting of growth
Respondent E	Not appropriate: Economic upturn causes upward pressure on inflation forcing SARB into raising interest rates to ensure that inflation dose not move outside of the target band. Thus dampening growth		Does not support the target band. However advocates that moderate rates of inflation of up to 25% do not negatively affect growth	Advocates real targeting by focusing on the developmental and economic need of the country, making them the primary concern of monetary policy

There was general consensus that current monetary policy of inflation targeting is not appropriate for South Africa. Furthermore the respondents agreed that exchange rate targeting is the best solution for South Africa, however such a policy is not possible as it is too costly and South Africa does not have the required reserves. There was consensus that current inflation targeting band was too narrow all the respondents called for an expansion or its removal all together.

Chapter 6 Conclusion and recommendation

South Africa adopted inflation targeting in 2001 selecting an inflation target band of 3% to 6%. However the policy has been heavily criticised with some calling for a review of monetary policy framework. COSATU criticised the current monetary policy of inflation targeting as too narrow calling for it to be removed or target expanded to support job creation efforts in the South African economy. However government was of the view that the current monetary policy is appropriate and have no plans to change it. The purpose of this study was to evaluate inflation targeting, the alternatives to inflation targeting and find out what is the most appropriate policy for South Africa.

The study concludes that current monetary policy of inflation targeting is inappropriate and there is a need for a more relaxed monetary policy, which is more appropriate to the economic and development challenges in South Africa. A brief overview and recommendations are made in the following sections.

Overview

The main research questions which the study aimed to answer were:
What are the current theoretical frameworks informing monetary policy?
What is the nature and content of the debate in South Africa with respect to monetary policy?
What are the main alternatives to inflation targeting in South Africa based on, international experience and best practice?
What are the recommendations with respect to the appropriate monetary policy framework for South Africa?

The literature review discussed the theoretical background to as well as empirical evidence on inflation targeting. It is from these studies and discussions that the research intended to evaluate inflation targeting and its appropriateness in South Africa.

The literature made a strong case for inflation targeting with empirical evidence showing that it does in fact bring down inflation and improve economic growth. However the debate around the threshold where inflation begins to negatively affect growth was less clear with no complete consensus. However most of the literature supported the argument that the current band of 3% to 6% was too low for sustained economic growth. The literature showed that a negative relationship exists but only at high levels of inflation of 15% or more.

The literature review highlighted three alternatives to inflation which are seen as viable, namely exchange rate targeting, widening the target band and real targeting. The interviews found that the most viable alternative to inflation targeting was real targeting where employment was the target, provided South Africa was able to solve its skills mismatch. It was also found that the current monetary policy of inflation targeting in its current form is inappropriate and South Africa requires a more relaxed monetary policy. The interviews pointed out that South Africa needs a monetary policy which focuses on the country's most pressing economic needs such as unemployment and growth. Real targeting accomplishes this by putting front and centre economic variables which are linked to the economies most pressing concerns such as employment.

International experience and lessons were in favour of inflation targeting. Internationally there has been a move towards inflation targeting and interestingly no country that has adopted inflation targeting has dropped it in favour of another policy. If inflation targeting is perused in a flexible framework it can significantly reduce inflation without any real cost to growth (Portugal, 2007). International evidence suggests that no country follows a strict inflation targeting policy but rather a flexible one (Portugal, 2007).

The South African experience of inflation has been a positive one with empirical evidence showing that since adoption of inflation targeting not only has inflation and inflation variability declined, but so too has output growth variability, while output growth has increased. COSATU still criticises inflation targeting pointing out South Africa's high unemployment as a key shortcoming. However Government feels strongly about maintaining the current monetary policy of inflation targeting and the current band, arguing that the renewed focus on flexibility with the explanation clause enables the bank to deal with inflation outside of the band.

The methodology of this study focused on qualitative and to a lesser extent quantitative methods. Quantitative techniques were used for the analysis and interpretations of inflation targeting in South Africa. Qualitative techniques such as personal interviews were triangulated with literature review.

Summary of the main debates in South Africa and the interviewee's main ideas

The main ideas brought to light in the interviews are discussed next. All the respondents agreed that the current form of monetary policy in South Africa is inappropriate. All called for a change in the current monetary policy advocating one or more of its alternatives such as expanding the target band, real targeting and exchange rate targeting. The interviewees further argued that monetary policy is merely a tool and cannot alone solve South Africa's socioeconomic problems. It was also noted that monetary policy was biased towards inflation targeting to the detriment of other important socioeconomic goals such as employment and growth.

The growth process is inherently inflationary; as growth increases it puts upwards pressure on inflation. However responding to this by raising interest rates may hamper growth.

Unemployment was a key discussion point. All respondents agreed that it was a critical problem in South Africa. However it was noted that unemployment in South Africa is deeply structural in nature, there is skills shortage and this cannot be solved by monetary policy. Government would have to intervene to correct the market failure.

Lastly all the respondents agreed that inflation targeting has had some positive gains, noting that it has lowered inflation and inflation variability.

The case study highlighted the main debates in South Africa which were concentrated around governments support for inflation targeting, COSATU`s criticism and the success of inflation targeting in south Africa to date. COSATU criticised inflation targeting calling for its removal, stating that monetary policy was biased focusing on inflation instead of more important socioeconomic such a growth and unemployment. COSATU further stated that inflation targeting is not pro poor as reported in the media, but rather favours retainer groups and the financial sector. However Government on the other hand feels strongly about maintaining the current monetary policy of inflation targeting and the current band, as they believe it to be a successful monetary policy. Finance Minister Pravin Gordhan stated that there is no need to change the South African Reserve Bank's existing inflation target band, saying the bank had new flexibility to tolerate inflation out of the range. The success of inflation targeting in South Africa is clearly shown in the literature particularly Table 2 and its subsequent discussing. However inflation targeting has failed to create sufficient jobs and resolve South Africa's unemployment issues.

Conclusion

The main ideas and themes from the interviews were unemployment, alternatives to inflation targeting, growth and its relationship with inflation targeting and lastly the inappropriateness of the current monetary policy. The key debates in South Africa covered in the case study were governments support for inflation targeting, COSATU`s criticism and the success of inflation targeting in south Africa to date.

Locally there has been a move towards flexible inflation targeting, this is reflected in SARB stance on the escape clause (Mapenzauswa, 2010). The same can be said internationally where central banks around the world have adopted more flexible monetary policy. The overwhelming view from the interviews was that there is a need for a more relaxed monetary policy, which is more appropriate to the economic and development challenges in South Africa.

Recommendations

This report evaluated inflation targeting, the alternatives to inflation targeting to assess what is the most appropriate monastery policy for South Africa. The study showed that the current monetary policy of inflation targeting is inappropriate; here several proposals and recommendations are given based on the findings of the study.

The study is proposing the adoption a real targeting approach in place of the current monetary policy of inflation targeting. In this framework SARB would chooses a real target appropriate for the country either employment or growth. However given South Africa's extremely high levels of unemployment, targeting employment would be the best option. However South Africa suffers from structural unemployment and skill shortage, the misalignment between the market`s demands and what is provided need to be resolved through re-skilling for the real targeting approach to have an effect. Real targeting puts front and centre economic variable which contributes directly to social welfare of the majority of the population.

The study further proposes the removal of the inflation targeting band and keeping inflation constant while targeting growth or employment. However it is important not to ignore inflation but rather monitor it and tolerate a higher level of inflation. This prevents the kind of hyperinflation seen recently in Zimbabwe. The literature shows that a negative relationship between inflation and growth does exist but only at high levels of inflation, inflation only really become a problem when it turns into hyperinflation. Moderate rates of inflation below 20% are not associated with slower growth, less investment or any other important real variable. Tolerating a higher level of inflation is necessary to allow growth as higher growth rates will inherently put pressure on inflation. Reacting to such inflation by raising interest rates would dampen growth. From the study it was shown that high interest rates are needed to attract foreign capital for the balance of payments. However this foreign capital tends to be unstable and causes volatility in the exchange rate. Capital controls should be implemented to stabilize capital flows preventing capital flight.

There should be tightening of the escape clause so that interest rates are only changed significantly when there is a problem of aggregate demand. As higher interest rates can only effect aggregate demand and have no effect on imported inflation and supply shocks. Reacting to supply shocks by raising interest rates would make inflation targeting pro-cyclical rather than anti-cyclical.

Lastly the study proposes that macroeconomic policy needs to be aligned. South Africa needs to resolve its contradictory macroeconomic policy of having a tight monetary policy and expansionary fiscal policy. The state must implement a clear and coherent macroeconomic economic framework. International experience showed that in order for inflation targeting to be successful there is a need for a coherent macroeconomic policy.

Conclusion

The main recommendation was that South Africa adopt a real targeting approach in place of the current monetary policy of inflation targeting in conjunction with the removal of the targeting band while keeping inflation at a constant level. High interest rates which may cause instability are needed to attract foreign capital for the balance of payments, thus it was recommended South Africa impose capital controls and tighten the escape clause so that interest rates are only changed significantly when there is a problem of aggregate demand

Lastly the state must implement a clear and coherent macroeconomic economic framework eliminating any contradiction between fiscal and monetary policy

7. Chapter outline

Chapter 1

Introduction

Chapter 2

Literature review

Chapter 3

Methodology

Chapter 4

South African Case study

Chapter 5

Analysis and assessment

Chapter 6

Conclusion and recommendation

Chapter 7

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