NATIONAL COUNCIL OF PROVINCES

QUESTION FOR WRITTEN REPLY

QUESTION NUMBER 627 [CW772E]

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Mr K A Sinclair (COPE-NC) to ask the Minister of Finance:

Whether the Monetary Policy Committee's focus on inflation targeting is stifling economic growth; if not, what is the position in this regard; if so, what are the relevant details?

CW772E

REPLY:

No, the focus on inflation targeting is not stifling economic growth.

Lower inflation helps to protect the poor from price shocks and helps improve the purchasing power of households' income. Lower inflation reduces interest rates which in turn lower the cost of investment for firms and borrowing for government. By lowering inflation and interest rates in the long run and smoothing the cycles of economic growth in the short term, inflation targeting helps to boost long run growth rates.

South Africa's current inflation targeting regime requires that the Monetary Policy Committee adjust interest rates so that the CPI inflation rate in 18 months time will fall within a target band of 3 to 6 per cent.[1] This policy was designed to support economic growth.

Firstly, **the inflation targeting regime has helped to provide a stable macroeconomic framework.** Since its introduction, inflation and interest rates have been lower and interest rates have been less volatile. This is largely due to the increased transparency and accountability of monetary policy, which helps to contain inflation expectations around the target band.

In the decade after inflation targeting was introduced, the real repo rate fell to an average of 3 per cent between 2000 and 2009, compared to rates of 5.7 per cent between 1990 and 1999. In 2011, the real repo rate has averaged 0.7 per cent and is just -0.5 per cent at present. At the same time, households' real income grew at 3.7 per cent, nearly double the average rate of 2.1 per cent in the 1990s, while the rate of expansion of gross fixed capital formation surged from only 1.4 per cent in the 1990s to an average of 8.9 per cent in the 2000s.

[1] Lower rates tend to support borrowing and investment in the short term, which increases the pace at prices increase, whereas higher interest rates tend to produce the opposite effect.

Secondly, **the inflation targeting band of 3 to 6 per cent was designed to support South Africa's competitiveness**. The upper band was set to ensure that inflation in South Africa did not exceed the inflation rate of emerging market economies whose products we compete with internationally – if prices rise in South Africa faster than these countries, we lose competitiveness.

Thirdly, **the inflation targeting regime is implemented in a flexible manner**. This means that monetary policy is set after due consideration of all the factors impacting on inflation as well as the performance of a range of macroeconomic variables including growth and issues affecting financial stability. The inflation targeting framework stipulates that in the presence of large external shocks, a temporary overshoot of the target may be tolerated in order to avoid sharp movements in interest rates that would unnecessarily harm growth. This limits the impact of inflation shocks on interest rates, employment and growth.

The current stance of the Monetary Policy Committee provides a good example of how flexibly the inflation targeting is implemented. The Committee expects CPI inflation to breach the upper band of the inflation target range in the fourth quarter of 2011 and then fall gradually to within the target range towards the end of 2012, but has left interest rates unchanged - because the likelihood of much weaker economic growth has risen.

There has been much criticism of the high cost and limited availability of credit in South Africa due to inflation targeting. However, bank lending rates are determined not only by macroeconomic policy but also an assessment of the risks of lending to a particular firm or individual. The level of the prime rate together with the policy rate has declined along with inflation over the past decade. The cost of capital for small firms and entrepreneurs should be addressed directly by reviewing lending conditions imposed by banks and development finance institutions rather than an alteration of the inflation targeting framework.