CHAPTER ONE - INTRODUCTION

1.1 Context of the study

In 1990 New Zealand was the first country to adopt inflation targeting as a monetary policy framework (Svensson, 2006). Many industrialized countries, as well as emerging-market economies have followed their example. The primary concern of monetary policy is to pursue price stability. South Africa first adopted an inflation targeting monetary policy framework in April 2000 (Van der Merwe, 2004).

The primary objective of the South African Reserve Bank (SARB) is to achieve and maintain price stability by keeping inflation within the range outlined by the inflation targeting framework (3% - 6%). The interest rate is the only mechanism used by the Monetary Policy Committee (MPC) to curb inflation. The great benefit of using inflation targeting is to control inflation expectations so that people adjust their behaviour accordingly (Black Management Forum, 2008).

There were four reasons for the SARB's decision to abandon their conservative approach and adopt a new transparency stance to target inflation.

1. "Greater transparency.
2. Better co-ordination between monetary policy and other economic policies.
3. Increased accountability of the SARB with regard to monetary policy.
4. Greater credibility of monetary policy in the eyes of the public"
   (Van der Merwe 2004 cited by Mitchell-Innes, 2006: 23).

Inflation targeting has the tendency to lead to politicized debate with regard to the central bank's capabilities in the long run (i.e. its ability to control inflation) compared to the fact that it cannot raise the output and decrease the unemployment (Mishkin, 2000).

The effect of inflation targeting on the interest rate is very significant. Interest rate hikes always raise questions about inflation targeting, particularly from the ANC Alliance partners (the SACP and COSATU). Their concerns are that the range is too narrow, too low. They believe that it hampers economic growth and increases the unemployment level (D.A. Discussion Document, 2008).

After the ANC National Conference, held at Polokwane in December 2007 there were speculations that the inflation range would be revised. Such a move was, however, quickly denied by the ruling party. The ANC indicated that they would entertain suggestions on inflation targeting from the SACP and COSATU, but warned that the complete abandonment of inflation-targeting was not an option (Rossouw and Letsoalo, 2008).

The political interference in SARB operation should be discouraged and MPC should be allowed to make decision based on their mandate. According to Bernanke, et al. (1999: 13)

> "Politicians (and politically influenced central bankers) tend to override and manipulate the levers of monetary policy in an attempt to control the economy".

Mishkin (2000: 105) argues that inflation targeting is not the only solution and, although it can be useful for a number of them, it may not be suitable for many emerging-market countries. Economists and academics suggest that any form of political interference with the SARB will compromise the bank's credibility and tarnish South Africa's reputation in international financial markets (Black Management Forum, 2008). From a financial market perspective, any changes in the inflation targeting range will have an adverse effect on the market.

The reality is that the SARB uses the interest rate to contain inflation and ignores other internal factors (such as distorted food prices, the high cost of telecommunications, the government electricity blunder and so on) that are within our control. The SARB argues repeatedly that external factors (like the price of oil, the global economy slow down and volatile currency) are the main culprits driving inflation above its range and that the bank has no control over it. By increasing interest rates, “the poor become poorer” and the unemployment level increases.

Inflation is presently far above the upper band of the target range, in other words, maintaining CPIX between 3% and 6%. This means that the SARB has failed to control inflation expectations. There is conflict brewing between price stability and “national priorities” in the form of economic growth, job creation and poverty alleviation. The SACP and COSATU suggest that inflation targeting has put the brakes on these national priorities (African Leader, 2008) and cause more harm than good to the economy overall.

1.2 Objectives and methodology of the study

The main objectives of this study include soliciting perspectives on inflation-targeting from various political parties, trade unions, businesses, the SARB and academics. In addition, case studies from other countries will be investigated. The study will ultimately contribute to the ongoing debate about inflation targeting. In pursuing this journey, data will be gathered from participants by conducting interviews. The approach used in this study is qualitative. The statically data on the inflation are published by the SARB and interview data were sourced from the inflation targeting experts.

This study will also discuss the relationship between interest rates and inflation.

> “The Fisher hypothesis argues that nominal interest rates move on a one-to-one basis with expected inflation, leaving the interest rate unaffected. The Fisher hypothesis has enjoyed wide-spread empirical support and remains one of the cornerstones of monetary economics” (Mitchell-Innes, 2006: 1)

The SARB is using interest rates as a tool to contain inflation. The impact of the internal and external factors affecting inflation will also be examined.

It will be interesting to see when the Government led by Jacob Zuma comes to power in 2009 and how they will respond to inflation targeting challenges. Zuma enjoys more support from the left than former President Mbeki. The study also seeks to identify inflation targeting policy shifts that may be promulgated by the tripartite Alliance.

1.3 Document structure

The dissertation is structured as follows.

- Chapter 1 provides a context for the study. It presented the objectives and overview of this study.

- Chapter 2 is mainly a literature review, and as such, it outlines the meaning of inflation targeting and interrogates the rationale behind the adoption of it. This chapter also investigates cases studies from developed and emerging market countries that have adopted this monetary policy.

- Chapter 3 focuses on the research methodology employed by this study. It also unpacks similarities and differences between a qualitative and quantitative research approach.

- Chapter 4 presents the data that was gathered from participants through semi-structured interviews. The primary data from interviews and secondary data are discussed in depth and further analysed in this chapter.

- Chapter 5 presents the main findings of this study. It discusses the limitations that were revealed and suggests areas for future research. It further summarizes perspectives that were gathered from participants and a conclusion of this study.

CHAPTER TWO - LITERATURE REVIEW

2.1 Introduction

Monetary policy, whether determined solely by central a bank or in conjunction with other officials, has emerged as one of the most critical areas of government responsibility. Bernanke, et al. (1999: 3) states that "A stable inflation is important for market-driven growth and monetary policy is the most direct determinant of inflation". Monetary policy is the most widely used tool to achieve medium-term objectives, however, the fiscal policy has a number of objectives. The fundamental difference between the two is the flexibility of the monetary policy and its immediate reaction to macro-economic development. When the SARB reacts to fluctuations in output and employment, monetary policy is usually the preferred tool.

According to Green (1996: 780) "inflation targeting is a framework for conducting monetary policy under which policy actions are guided by expected future inflation relative to an announced inflation target".

The purpose of this chapter is to establish whether is there empirical evidence to support the adoption of inflation targeting as the country's main monetary policy. This dissertation gathers and analyses different perspectives from monetary policy experts. Section 2.2 provides a background of inflation targeting and Section 2.3 deals with definition, while Section 2.4 unpacks various inflation targeting regimes. Section 2.5 identifies specific criteria that have to be met before the implementation of inflation targeting. Section 2.6 reviews inflation targeting in the developed countries. Section 2.7 reviews inflation targeting in the emerging market countries. Section 2.8 examines the Fisher effect and takes a closer look at the effect of the interest rate on the inflation targeting. Section 2.9 investigates the relationship between unemployment and inflation by looking at the Phillips Curve. Section 2.10 examines the impact of the exchange rate on inflation by taking a closer look at Chile's monetary policy. Section 2.11 reviews the transparency and accountability of Central Banks on issues pertaining to inflation targeting. Section 2.12 deals with the escape clause in the monetary policy, that comes to effect when the target is "missed". Section 2.13 brings conclusion remarks together on the inflation targeting.

2.2 The rationale for inflation targeting

According to Bernanke, et al. (1999: 10) "macroeconomic policy has many goals besides low inflation, i.e. high real growth, low unemployment, financial stability and not too excessive trade deficit". The ultimate objective of monetary policy is to create a favourable environment that will increase output and reduce unemployment levels.

Bernanke & Mishkin (1997: 210) argue that

> "The rationale for treating inflation as the primary goal of monetary policy is clearly strongest when medium to long-term horizons are considered, as most economists agree that monetary policy can affect real quantities, such as output and employment, only in the short run".

The rationale for inflation targeting is that price stability should be the primary long-term goal of monetary policy. "When monetary policy-makers set a low rate of inflation as their primary long-run, to some significant extent they are simply accepting the reality of what monetary policy can and cannot do". (Bernanke, et al., 1999: 10).

Empirical studies suggest that even reasonable rates of inflation are detrimental to economic growth if there is not a concerted effort to maintain low and stable inflation in order to achieve macroeconomic goals.

2.3 What is inflation targeting?

Bernanke (1999: 14) discussed and explained inflation targeting as a

> "framework for monetary policy characterized by the publication announcement of official quantitative targets (or target range) for the inflation rate over one or more horizons and explicit acknowledgement that low stable inflation is monetary policy's primary long-run goal".

The clear distinction between inflation targeting and other monetary policies is transparency. Among the important features of inflation targeting are enthusiastic endeavors to communicate with the public about the plans and objectives of the monetary authorities and also to influence inflation expectations.

Svensson (1997) mentions that inflation targeting is a monetary policy framework that was introduced in New Zealand in 1990. It has been very successful in stabilizing both inflation and the real economy. The system has been adopted by more than 20 industrialized and non-industrialized countries (see Table 2.2) (Bernanke & Woodford, 2005). It is characterized by the announcement of a numerical inflation target and a high degree of transparency and accountability.

Van der Merwe (2004) explained that the fundamental reasons why the SARB abandoned it previous monetary policy framework was to ensure transparency and accountability. If the public is aware of the intentions of the SARB that would render monetary policy framework credible, it is much easier to influence the inflationary expectations. In essence, a credible policy would consequently bring stable inflation over the long run.

Svensson (1997: 1128) defined it as follows:

> "Inflation targeting in terms of an objective of the central bank that depends only on squared target misses. A target regime in which the central bank cares only about meeting its target for inflation is consistent with legislative reforms in which price stability or low inflation is identified as the sole objective of monetary policy".

According to Mitchell-Innes (2006: 35) the SARB considers its primary goal to be "the achievement and maintenance of the price stability". The adoption of an inflation targeting monetary policy framework paved the way towards ensuring significant price stability and achieving monetary policy credibility, thus enabling the SARB to guide the public's inflation expectations.

According to Bernanke & Mishkin (1997: 102) the achievement of inflation targeting requires the realignment of both fiscal and monetary policy frameworks. Perceptions created thereafter suggest independence of central bank is subjected to administrative arrangement between central bank and Treasury department. The choice of instrument setting is the prerogative of the central bank with no interference from any party.

Van der Merwe (2004) argues that, the ideal inflation targeting is not rigid but flexible to accommodate macro-economic objectives.

Van den Heever (2001: 170-171) suggested advantages and disadvantages for inflation targeting.

The advantages:

- "Transparent, it is comprehensible with the ultimate policy objectives translated into an explicit target value;
- Enhanced clarity about the objectives of monetary policy which is conducive to sound planning in both private and public sectors;
- Improved accountability and increased co-ordination helps build credibility of macroeconomic framework;
- Elimination of the need to rely on a stable relationship between the money stock and inflation, which has become increasingly difficult to identify;
- Enhanced economic policy coordination with government and the central bank publicly committed to the same inflation target. In other words improves co-ordination between fiscal and monetary policy. Budget targets have to be consistent with projected inflation path; and
- Providing an anchor for inflation expectations and price and wage setting, thus reducing the friction which arises from widely divergent inflation expectations".

The disadvantages:

- “It is a complicated approach, relying heavily on forecasts in an uncertain economic environment;
- It runs the risk of inefficient output stabilization; and
- Significant change in the oil price could require very large monetary policy adjustments to bring inflation back inside the target range”.

Van den Heever (2001) argued that for any inflation targeting regime to succeed, requires measurement, time horizon, target range, width of the range, and the level of the target.

2.4 Inflation targeting regimes

Carare and Stone (2003) suggested a broader definition of inflation targeting, listing what they saw as three inflation targeting regimes:

- Fully-fledged inflation targeting;
- Eclectic inflation targeting;
- “Inflation targeting elite”.

2.4.1 Fully-fledged inflation targeting (FFIT)

According to Mishkin (2000: 1) fully-fledged inflation targeting is characterized by the five main elements below.

- “The public announcement of medium-term numerical targets for inflation;
- An institutional comment 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 plan, objectives and decisions of the monetary authorities; and
- Increased accountability of the central bank for attaining its objectives.”

South Africa is a typical example of a fully-fledged inflation targeting country.

2.4.2 Eclectic inflation targeting (EIT)

Carare & Stone (2003: 3) suggested that eclectic inflation targeting countries are those countries that can maintain price stability (low inflation) without disclosing details about their intended monetary policy. This could be attributed to their integrity and in these cases, transparency and accountability are not essential for this inflation targeting. One example of an EIT economy is the USA.

2.4.3 Inflation targeting elite (ETL)

According to Carare & Stone (2003: 3), the inflation targeting elite make their intention known by disclosing their monetary policy objectives. However, less attention is paid to achieve this objective because of economic instability and because their central bank lacks credibility. This definition is most relevant to certain emerging-market economies, for example, Indonesia.

2.5 The implementation of inflation targeting

Van der Merwe (2004: 3) highlighted four critical questions that have to be answered prior to the implementation of inflation targeting.

- "Who sets the target?
- How will the target variable be defined?
- How will the target be set?
- How will monetary policy decisions be made"?

2.5.1 The determination and announcement of the target

In responding to the above questions, the independence of the central bank is paramount when defining and announcing the target range or single target. "The independence of the South African Reserve Bank (SARB) is set by the Constitution; however most countries preferred to spell out the independence of their central banks through an ordinary Act of Parliament" (Van der Merwe 2004: 3). The relationship between treasury and central bank is essential for any successful state.

> "In countries such as Spain, Sweden, Mexico and Poland the inflation target is set and announced by the central bank. In countries such as Brazil, Israel, Korea, Peru and Thailand it is set by Government in consultation with the central bank. In some other countries like Australia, Canada, Columbia and New Zealand the target is set jointly by government and the central bank" (Van der Merwe, 2004: 3).

The SARB operates within the Constitution Act of 1996 (Act No 8) and the South African Reserve Bank of 1989 (Act No 90). In South Africa the inflation target is set by government in consultation with the SARB. However, the tool used to attain the target is selected by the monetary policy committee under the chairmanship of the SARB governor (Van der Merwe, 2004). This empowers central banks with the authority to dictate the interest rates or repurchase rate with the intention of keeping inflation within the required target range.

2.5.2 The definition of the target variable

There are three measures of consumer price inflation in South Africa:

- "The headline consumer price index;
- The core consumer index; and
- The overall index excluding the effects of changes in mortgage costs" (Van der Merwe, 2004: 4).

2.5.3 Setting the target

The target varies in the form of range, single point and ceiling. It should be stressed that a single target point is difficult to achieve in comparison to a range or ceiling. Single point targeting provides a realistic focus for inflation expectations whereas a range gives central banks leeway to react to any possible price shocks as a result of exogenous factors. In setting the target, sufficient consultation is paramount to ensure buy-in from all the stakeholders. In South Africa, the central bank, in consultation with the government, opted for the range of 3% – 6% CPIX.

Van der Merwe (2004: 5) suggested that if the target is too high, it could defeat the entire purpose of combating inflation and the role of central bank would not be taken seriously. However, if the target is too low, the end result would be strict policy measures to support the intention of central bank, consequently impacting negatively on domestic production, consumption, saving and investment. A decision about the target presents a serious problem to the central bank with regard to the width of the band. "A wide range reduces the credibility of the target because it acts less as an anchor of inflation expectations".

2.5.4 The decision-making process

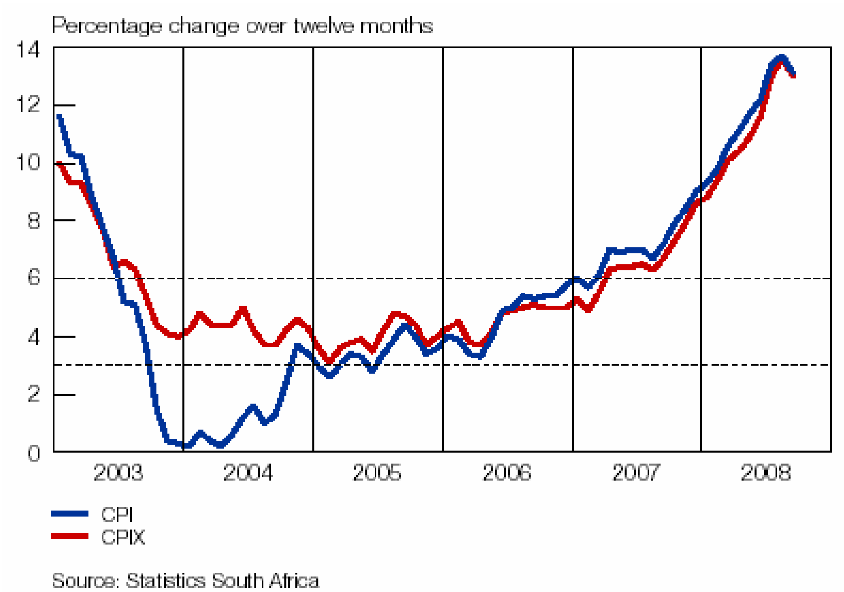
The following forecasting inflation models are critical for the decision-making process

- "A core model;
- Small scale model;
- Vector autoregressive model;
- Phillip-curve model; and
- Disaggregated inflation forecasting model".

Van der Merwe (2004) argued that there is empirical evidence to suggest that in some instances, forecasting is detrimental to the inflation targeting framework. The MPC relies less on the forecasting because forecasts are built on hypotheses and the findings are only used to support policy makers.

Figure 2.1 below illustrates that from the last quarter of 2003 till the first quarter of 2007, the SARB has been successful in keeping inflation within the target range of 3%-6%. However, in the second quarter of 2007 the inflation rate exceeded 6% and rose to 7, 2% in September 2007 and then jumped to 10, 6% in March 2008. This escalation has been accompanied by regular interest hikes which were used in an attempt to reduce the inflation rate. Unfortunately, this has vilified the role of the SARB and has also drawn attack mostly from the left of the political spectrum.

Figure 2.1 Consumer price inflation: CPIX and CPI



Source: Monetary policy review, (2008: 2)

Table 2.1 shows the determinants of the consumer price index and their weights. This table focuses mainly on the 2008 consumer price index. The impact of the increased food prices on the consumer basket is seen as the main driver of inflation rate. In second place, transport costs claim a significant portion in consumer baskets. This is attributed to certain exogenous factors that the SARB has no control over. From March to September 2008 the inflation rate escalated from 10, 1 % to 13%.

Table 2.1. Contributions to CPIX inflation

Percentage change over twelve months* and percentage points

	2008						
	Mar	Apr	May	Jun	Jul	Aug	Sep
Total*	10,1	10,4	10,9	11,6	13,0	13,6	13,0
Of which:							
Food	4,4	4,5	4,7	5,1	5,1	5,3	5,0
Housing	0,9	0,9	0,9	0,9	0,9	0,9	0,9
Medical care and health expenses	0,5	0,5	0,5	0,6	0,6	0,6	0,7
Transport	2,1	2,1	2,3	2,6	3,2	3,1	2,7
Education	0,4	0,4	0,4	0,4	0,4	0,4	0,4
Fuel and power	0,4	0,4	0,4	0,4	1,1	1,3	1,3
Other	1,4	1,6	1,7	1,6	1,7	2,0	2,0

Source: Statistics South Africa

Source: Monetary Policy Review, (2008: 2)

2.6 Inflation targeting in the industrialized countries

In 1989 New Zealand was the first country to announce an inflation target as part of that country's economic reform and restructuring effort. There is sufficient evidence to suggest that developed countries enjoy both low inflation and low levels of unemployment. Inflation targeting in its various forms have been adopted by a number of industrialized countries including Canada, the UK, New Zealand, Sweden, Australia, Finland, Spain and Israel (Mishkin, 2001)

Green (1996: 782) suggested that following the UK's exchange rate crisis in September 1992, a call was made to abandon the exchange rate as an anchor and inflation targeting was then adopted. It was not that long before Sweden and Finland dumped their exchange rates and also adopted inflation targeting.

According to Mishkin (2000) empirical evidence suggests that inflation targeting in industrialized countries recorded lower inflation rates in comparison to their counterparts who did not use inflation targeting. They have also experienced less "pass through" into to the inflation rate which is normally as result of foreign shocks.

Bernanke & Mishkin (1997: 102) state that

> "In most inflation targeting regimes, the central bank publishes regular, detailed assessments of the inflation situation, including current forecasts of inflation and discussion of the policy response that is needed to keep inflation on track".

A typical example is the Bank of England quarterly inflation reports.

2.7 Inflation targeting in emerging markets

Inflation targeting adoption by industrialized countries has set a new precedence and as a result, a noticeable number of emerging market economies has increasingly adopted this monetary policy. Amongst these emerging market countries that have opted for inflation targeting are Chile, Brazil, the Czech Republic, Hungary, Poland and South Africa (Mishkin, 2000: 105).

A list of criteria for inflation targeting regimes in the emerging market economies include:

- “A strong fiscal position;
- A well understood transmission mechanism between monetary policy instruments and inflation;
- A well-developed financial system;
- Central bank independence and a clear mandate for price stability;
- A reasonably well-developed ability to forecast inflation;
- Absence of other nominal anchors than inflation; and
- A transparent and accountable monetary policy” (Jonas & Mishkin, 2003: 5).

It is always not possible to state categorically that a country satisfies all of the above requirements or to what extent the country makes progress towards achieving the above requirements (Bernanke & Woodford, 2005: 356)

The table below illustrates emerging market countries that have adopted inflation targeting as a monetary policy. It further shows the adoption date and also whether these countries are using a target range or a single point strategy. The last two columns specifically show the period from January 2005 to March 2008. In March 2008, it is noticeable that South Africa has the highest inflation rate in comparison to other emerging market countries.

Table 2.2. Inflation-targeting adoption dates and targets for emerging market economies

Country	Adoption date	Target range % & pp	Point %	January 2005 (%)	March 2008 (%)
Israel	1992	1 – 3	-	1,2	3,7
Czech Rep	Jan 1998	+\- 1pp	3	1,7	7,1
Poland	1999	+\- 1pp	2,5	4,0	4,1
Brazil	Jun 1999	+\- 2pp	4,5	7,4	4,7
Chile	Sep 1990	+\- 1pp	3	2,3	8,5
Colombia	Sep 1990	3,5 – 4,5 (2008)	-	5,4**	5,9
South Afr.	Feb 2000	3 – 6	-	3,6	10,1
Thailand	May 2000	0 – 3,5	-	0,7	1,7
Korea	1998	+\- 0,5pp	3	3,1	3,9
Mexico	Jan 2001	+\- 1pp	3	4,5	4,3
Hungary	Jun 2001	+\- 1pp	3	4,1	6,7
Peru	Jan 2002	+\- 1pp	2	3,0	5,5
Philippines	Jan 2002	+\- 1pp	4	8,4	6,4
Indonesia	Jul 2005	+\- 1pp	5	7,3	8,2
Romania	Aug 2005	+\- 1pp	4	9,0	8,6
Turkey	Jan 2006	+\- 2pp	4	9,5	9,2

* A number preceded by a (+\-) indicates the tolerance level for a point target (in percentage points)

** Colombia's target for 2005 was 4, 5 – 5, 5 percent

Sources: International Financial Statistics (2006) cited by Mishkin (2000)

According to Bernanke & Woodford (2005: 398)

> "It has been recognized that the large degree of openness of some emerging market economies, in combination with specific characteristics of their financial systems, create additional challenges for the implementation of inflation targeting".

All the inflation targeting countries have introduced credibility enhancing measures including more policy discussion and interpretation of economic data. Chile is one of the emerging markets that adopted inflation targeting in September 1990. Mishkin (2000: 105) argued that inflation targeting is not the only solution and while it can be useful for a number of them, it may not be suitable for many emerging market countries.

2.8. Fisher Effect

According to Mitchell-Innes, et al. (2007: 693)

> "Irvin Fisher after whom the Fisher Effect and the International Fisher Effect were named, the Fisher hypothesis states that nominal rates move one for one with expected inflation, leaving the real interest rate unaffected".

This hypothesis has been used extensively by monetary policy authorities in most central banks.

The Fisher equation is a relevant instrument to ascertain whether the inflation expectations have been matched with sufficient significance for the SARB to use them to determine the long-term real interest rate (Mitchell-Innes, 2006: 35).

Hawtrey (1997) cited by Mitchell-Innes, et al. (2007) identified areas that elevated the Fisher hypothesis to be the most often considered yardstick for monetary policy in the economic literature. First of all, the real interest rate is crucial in determining economic growth, savings and investment. Fama (1995) cited by Mitchell-Innes, et al. (2007) stated that, secondly it contributed to trade and capital inflow through its influence on the exchange rates. Finally, Payne & Erwing (1997) cited by Mitchell-Innes, et al. (2007stated that the Fisher hypothesis is the most relevant instrument when a central bank makes decisions on monetary policy which uses the interest rate as a tool to contain inflation.

Mitchell-Innes, et al. (2007: 694) argued that a "Fisherian link exists between nominal interest rates and expected inflation in South Africa during inflation-targeting regime, from 2000 henceforth".

The rationale behind this theory yields two implications. Firstly, it determines that the interest rate includes an inflation premium on top of the real rate of interest. Secondly, it suggests that the real interest rate will have no impact on monetary policy following the adoption of inflation targeting.

2.8.1 The effect of the short-term interest rates

"The South African Reserve Bank's key operational variable within its monetary policy framework is the level of short-term interest rates" (Mitchell-Innes 2006: 25).

To comprehend the interconnection between money, inflation and interest rate, one needs to have a clear definition of nominal interest rate and real interest rate. The nominal interest rate does not take into account the impact of the expected inflation rate. However, the real interest rate adjusts nominal interest rate in relation to the expected inflation rate. In other words, the real interest rate focuses on the purchasing power of your savings.

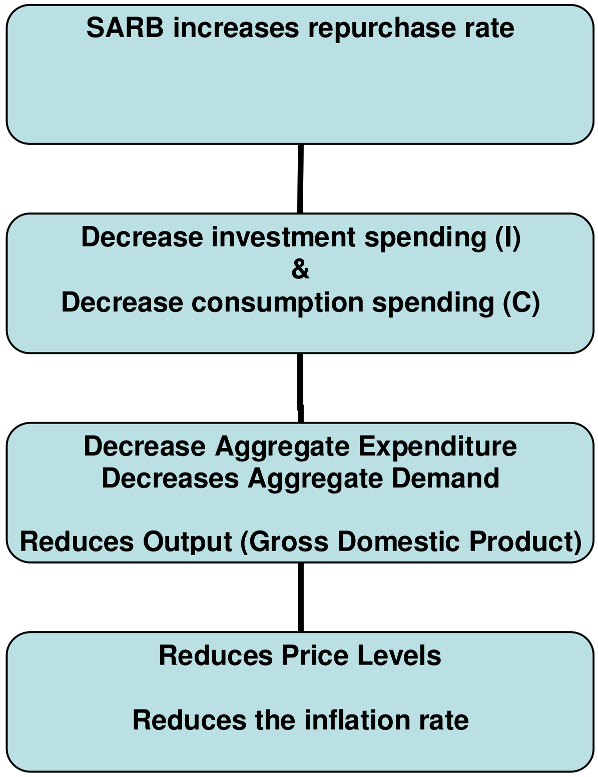
Real interest rate= Nominal Interest Rate - Expected Inflation Rate

Nominal Interest Rate= Real interest Rate + Expected Inflation Rate

According to Mitchell-Innes, et al. (2007: 695) the SARB authorities impose the level of interest rate to be charged through its monopoly as a central bank. The SARB is therefore able to dictate the terms of the repurchase rate to other banks. For the SARB to make it presence felt, it interferes with the money market with the intention of causing scarcity that will drain surplus liquidity. By doing this, it ensures that commercial banks are within its grip and they will remain constantly indebted to the SARB to maintain their liquidity requirement.

The figure below adapted from Chasomeris (2008) illustrates the impact of an increase in the repurchase rate. The increase results in a decrease in consumer spending and capital investment. Ultimately, aggregate expenditure and demand shrink and output will be reduced. Reduced price levels and a low inflation rate will ultimately be achieved. In conclusion, the repurchase rate is a direct determinant of the price level and inflation rate. This also demonstrates that the interest rate can be used as a tool to control inflation.

Figure 2.2. From interest rates to inflation



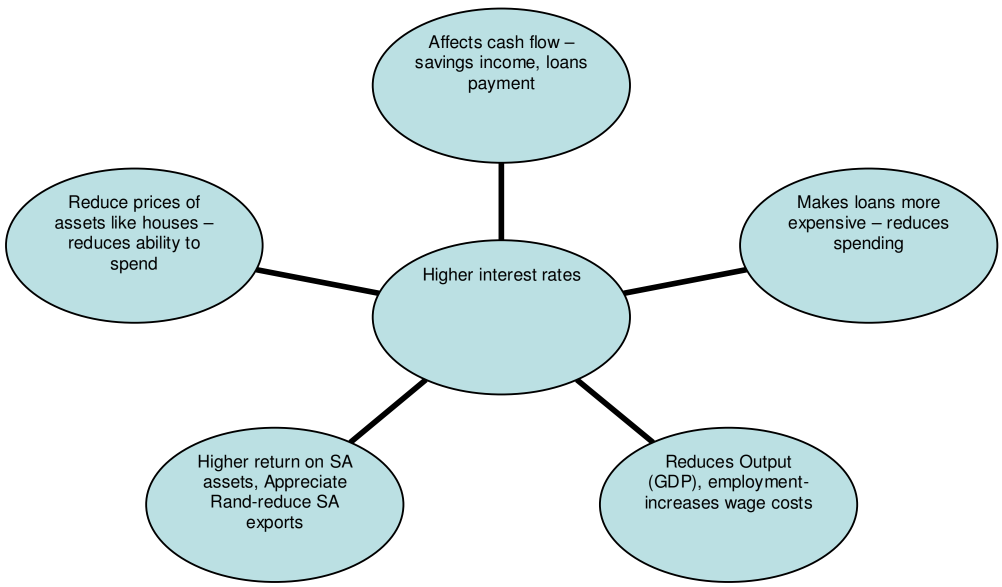
Source: Adapted from Chasomeris 2008.

> "In the interest channel, the real interest rate influences aggregate demand and finally inflation. If, for example, the SARB increases the repurchase rate, then the real short-term interest rate will also increase. This will prompt both firms and individuals to alter their investment and spending behavior. Higher real interest rates stifle consumer spending (*C*) and investment spending (*I*) and ultimately lead to lower real output (GDP)" (Mishkin, 2004: 617).

Figure 2.3. Adapted from Chasomeris (2008), illustrates clearly the impact of the higher interest rate and exactly how it affects the economy, it reduces the output (GDP) and employment. For investors, a higher interest rate ensures

higher return on local assets. While the local currency becomes stronger in comparison to foreign currency, that impacts negatively on those industries that export goods and services abroad. With higher interest rates, loans become more expensive and this reduces spending. Cash flow is also affected in the form of savings income and loan repayment.

Figure 2.3. Summary of the economic impact of higher interest rates.



Source: Adapted from Chasomeris 2008

A high inflation scenario contributes immensely to the expectation of the inflation and a series of increases in the rep rate by 50 basis points on numerous occasions has made the situation worse (Monetary Policy Review, May 2008).

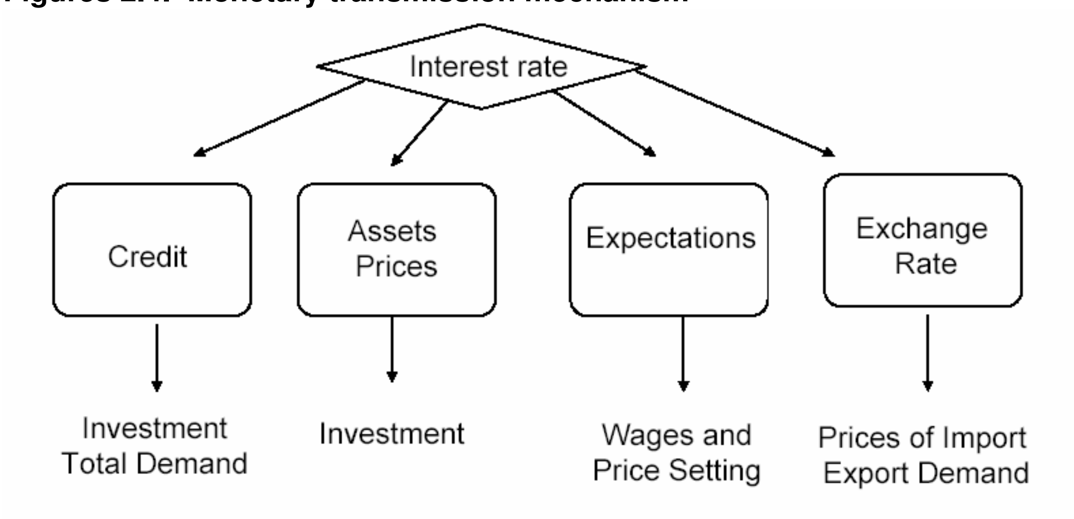
Mishkin and Simon (1995) and Esteve, et al. (2003) cited by Mitchell-Innes (2006: 25) suggested that nominal short-term interest rates turn out to be less important if the Fisher effect is definite.

2.8.2 The long-term interest rate

Mishkin (2004) stated that an "important feature of the interest rate transmission mechanism is that it is the real rate of interest rather than nominal interest rates that affect general economic activity".

Figure 2.4 below shows the various monetary transmission mechanisms which react to changes in the interest rate. Through these mechanisms the SARB is able to use the interest rate as a tool to "manipulate" the credit, assets prices, expectations and exchange rates. The exchange rate therefore becomes a very useful instrument to control inflation expectations.

Figures 2.4. Monetary transmission mechanism



Sources: Viegi (2006)

The impact of the real long-term interest rate is significant on consumer and investment in comparison to the changes in nominal short-interest rates.

> "The real short-term rate can be artificially decreased through its influence over the short-term interest rate, but this will only have a long run positive impact on the economy, if the induced decrease in the short-term rate filters through to real long-term rate of interest" (Mitchell-Innes, et al. (2007: 696)

Table 2.3. Real long-term interest rates

	SA	UK	Japan	Australia
1980-89	0.0	3.7	4.0	5.0
1990-2000	5.7	4.0	2.4	5.6
2000-2003	4.3	2.6	1.8	2.2

Source: Kahn (2004).

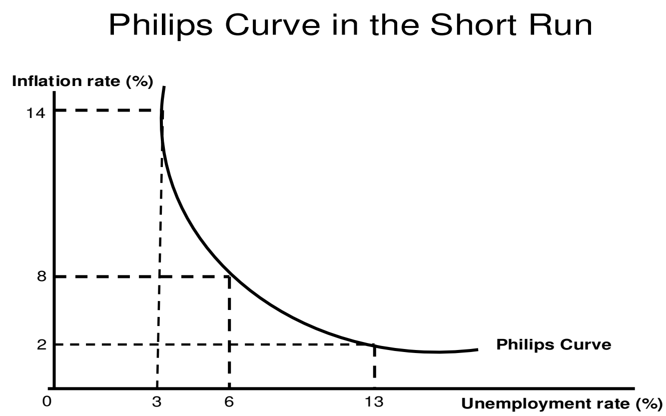
2.9 Phillips Curve

Phillip curve suggests that there is a relationship between inflation and unemployment. It further argues that unemployment level can be reduced by allowing a slightly higher inflation rate and the opposite is true (Van der Merwe, 2004: 11).

There is empirical evidence that in the short run a trade-off exists between inflation and unemployment. However, in the long run Phillips curve becomes vertical.

Figure 2.5 illustrates Philips curve, along with the trade-off between the inflation rate and the unemployment rate. The unemployment rate is 13%, while the inflation rate sitting at 2%. However, if the inflation rate rises to 8%, the unemployment declines to 6%. In an extreme case there is the suggestion that if the inflation rate increases to a two digit figure i.e. 14% then the unemployment rate will drop to 3%. In other words this graph depicts that the two economic variables move in opposite directions. Inflation would be allowed to escalate to a two digit figure (14%) with the intention of reducing the unemployment level (3%).

Figure 2.5. Phillips curve



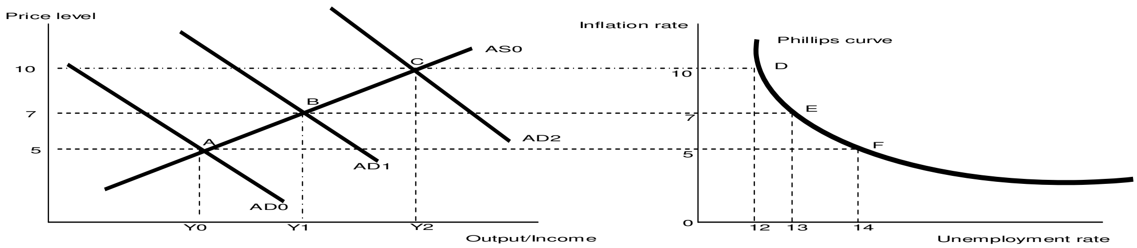
Source: Tendai Gwatidzo (2005)

Van der Merwe, (2004: 12) states that

> "Acknowledgement of a short-run trade-off between inflation and economic growth has probably contributed to the application of inflation targeting in a flexible rather than strict manner. Strict inflation targeting is applied when the central bank attempts to reach the long-term inflation objective as quickly as possible. However, central banks following a flexible approach will attempt to reduce inflation gradually to the desired long-term level taking the effect of its action on other economic variables into consideration".

Figure 2.6 below illustrates the impact of increase on aggregate demand from A to B that results in a shift from AD0 to AD1 (this could be attributed to changes in any of the determinants of aggregate demand). This shift results in an increase in output to Y1 and a price level increase from 5 to 7. On the other hand, it will produce the required output Y1 that will create more jobs. As a result of this, the unemployment level will decrease from 14 to 13. The aggregate demand increases further from B to C (Y2), the demand curve shifts from AD1 to AD2 and the price level also increases from 7 to 10. As a result of these changes, more jobs will be created and the unemployment level will drop further from 13 to 12.

Figure 2. 6. Phillips curve



Source: Tendai Gwatidzo (2005)

2.10 The effect of the exchange rate on inflation targeting

Van der Merwe (2004: 9) raised a valid point by stating that the exchange rate has a definite impact on the economy since it "affects inflation, aggregate demand, economic growth, employment creation and income". The Monetary Policy Committee should consider the impact of the exchange rate if it aims to make informed decision with regard to monetary policy.

According to De Gregory, Tokman & Valdes (2005)

> "A flexible exchange rate regime should be consistent with the inflation targeting framework and acknowledge that keeping inflation in check would be very difficult with two nominal anchors i.e. the exchange rate band and inflation target".
>
> In other words, although monetary policy considers inflation target as it primary objective, for that to be achievable, it needs to have a free floating exchange rate regime.

De Gregory, Tokman & Valdes (2005) suggests that those economies which are often engulfed by foreign shock have to adopt a flexible exchange rate to cushion them. The worst case scenario is when the country's currency is devalued as a result of exaggerated real shock and there is no exchange rate, alteration guide. When there is a floating regime, the currency is allowed to float, which will allow the central bank to focus on its inflation target.

2.11 The transparency and accountability of monetary policy

Svensson (1997) argued that the transparency that accompanied inflation targeting restored the credibility and reputation of the central bank. The regular publication of monetary policy reports is imperative to ensuring the integrity of the central bank. Svensson (1997) states, if a central bank succeeds in achieving credibility, a good part of the battle to control inflation are already won.

As the custodian of monetary policy framework and the inflation target, the central bank is accountable to the public through it public pronouncements (Van der Merwe, 2004: 8). As a state entity, the SARB is required by law to ensure that it accounts for its function. The Governor of the SARB is mandated to submit his report to the Minister of Finance on the progress made in terms of the inflation targeting policy framework. The Act (Section 32 of the Reserve Bank Act) that governs the existence of the SARB, stipulates that reports must be submitted on a monthly basis. The report should be accompanied by the statement of assets and liabilities. Financial statements of the SARB have to be submitted annually to the National Treasury. (Van der Merwe, 2004: 8).

Green (1996) suggests that transparency is an essential tool for inflation targeting, because it influences the expectations that in turn affect the behavior patterns of the society.

2.12 "Escape clauses" or "explanation clauses"

According to Van der Merwe (2004: 7) an inflation targeting framework takes cognizance of the impact of exogenous shock that might result in the central bank missing its target. In response to those challenges, central bank came up with an escape clause solely aimed at protecting its credibility in circumstances that it has no control over. In the South African context, the escape clause was perceived as a “fire escape” for the Monetary Policy Committee and that conveyed the wrong message to the public. Therefore, proper wording was suggested, namely “explanation clause”. This clause provides the Monetary Policy Committee with the platform to reveal the underlying determinants which caused the target not to be met (Van der Merwe, 2004)

Mishkin (2000) identified the international crude oil price as the main source of aggregate supply shocks that affect targeters directly. To drive inflation back closer to the original target, may prove to be a cumbersome exercise with respect to lost output and employment. The escape clause comes handy under these circumstances, since it provides a leeway for the central bank to alter its medium-term target.

According to Svensson (2007), the central bank of England is required to reveal the exact reasons that led to any deviation which is more than one percent point. In addition, these reasons must be accompanied by an action plan which will address the reasons for deviation. In countries like New Zealand, UK, Norway and Sweden, monetary policy is often subjected to review by a panel of well-informed independent specialists.

2.13 Concluding remarks

There is no evidence to suggest that inflation targeting has been detrimental to growth, productivity, employment or any other measure of economic performance. To support that, no country has abandoned inflation targeting for another form of monetary policy. For both industrial and non-industrial countries inflation targeting has proved to be a most flexible and resilient monetary policy strategy (Svensson 1997).

Inflation targeting emerged as monetary policy in an attempt to find a way for both industrialized and non-industrialized countries to maintain and achieve price stability. This chapter presented a topical and thematic review of the literature available on monetary policy with the focus on inflation targeting.

First of all, past studies acknowledged that, as one of the macro economic objectives, inflation targeting ensures that price stability is maintained. The mandate of central bank is to achieve and maintain price stability.

Secondly, accountability and transparency are essential ingredients for any form of inflation targeting regime. However, there are certain hurdles that many, but not all, emerging-market countries have to overcome before they can be acknowledged as fully fledged inflation targeters. Whether the decision in terms of the band or single point inflation target is made jointly between central bank and treasury or central bank alone, the consultation between the two is very important.

Thirdly, the interest rate plays a crucial role in managing a country's inflation. While it has a direct influence on the credit, assets price expectation and exchange rate, there little or nothing it can do to address the challenges imposed by exogenous factors.

Finally, despite taking precautionary measures, the escape clause serves to protect the credibility of the central bank in the event of missing the target as a result of exogenous factors that are beyond its control.

CHAPTER THREE - RESEARCH METHODOLGY

3.1 Introduction

This chapter will focus on the research methodology and data collection techniques employed in this study. The primary sources of data were interviewees. It was imperative for this study to select interviewees who were in a position to contribute effectively to the inflation targeting debate. The interviewees ranged from politicians, bankers (including the SARB), academics and economic analysts.

Inflation has a direct bearing on both South African citizens and foreign investors because it affects the value of the currency. The interest rate is currently being used as a direct instrument to control inflation. The primary objective of the SARB through inflation targeting is to achieve and maintain price stability which it is mandated by law to achieve. However, many questions have been asked in terms of whether the interest rate is the only mechanism or tool available to control inflation. This study will give insight on the critiques of the inflation targeting.

The chapter proceeds as a follows:

- Section 3.2 examines both qualitative and quantitative research methodologies.
- Section 3.3 reviews the data collection techniques applied to this study.
- Section 3.4 reviews the qualitative content analysis and provides insight on data analysis.
- Section 3.5 focuses mainly on the semi-structured interviews as a relevant tool to source primary data.
- Section 3.6 reviews the research instrument which was designed for this study.
- Section 3.7 examines the sample size, as the response is imperative for any study.
- Section 3.8 identifies shortcomings of this study and
- Section 3.9 brings research methodology to a conclusion.

3.2 Qualitative and quantitative research

Rudestam & Newton (2001:36) suggested that,

> "Qualitative implies that the data are in the form of words as opposed to numbers. Whereas quantitative data are generally evaluated using descriptive and inferential statistics, qualitative data are usually reduced to themes or categories and valuated subjectively".

This study's intention is to gather views/opinions on inflation targeting in South Africa by conducting semi-structured interviews.

According to Buber, Gardner & Richards, (2004: 142)

> "qualitative and quantitative approaches have been distinguished on the basis of the type of data used (textual or numeric, structure or unstructured) logic employed (inductive or deductive), the type of investigation (exploratory or confirmatory), the method of analysis (interpretive or statistical), the approach to explanation (variance theory or process theory) and the presumed underlying paradigm (positivist or interpretive/critical, rationalistic or naturalistic)".

A qualitative method of analysis changes in relation to the data to which the various analytical methods are applied. Qualitative studies always seek to explore and investigate specific cases; therefore the data analysis tool should be relevant. The distinction between qualitative and quantitative research is not about the quality of the results, but about the techniques used to achieve those results.

Secondary data was collected by means of a literature review and primary data was collected by conducting semi-structured interviews. Ritchie & Spencer (1994) suggest that the data from qualitative studies are in the form of words so it imperative that interviews be recorded and later transcribed. This exercise is time-consuming and requires extra effort from the researcher. This study typifies this aspect of a qualitative study, although there were only eight interviewees, transcribing the data from the interviews was a time-consuming task.

Research may vary between the two approaches (qualitative and quantitative) or may be a combination of the two. The decision about which approach to use, could be informed by the nature of the study. While the approach in this study is qualitative, inflation rate information is of a quantitative nature. The purpose of this study is to analyse people's perspectives on inflation targeting which is informed by the inflation rate therefore a mixed approach was selected.

3.3 Data collection

Keller (2006: 142-157) suggested that the simplest methods of obtaining data are direct observations, experiments and surveys. The most common method of sourcing data is through the use of a survey, particularly in a study that deals with people and factors like income, family size and opinions on certain issues. In summary, there are three commonly used techniques of data collection personal interviews, telephone interviews and self-administered questionnaires.

According, Rudestam & Newton (2001: 97)

> "…data recording may be described along two dimensions, fidelity and structured. An open-ended interview, when properly recorded, has high fidelity and low structure, whereas standardized paper and pencil test has both high fidelity and high structure".

A tape recorder is ideal for interviews and researchers can take notes for follow up questions for the sake of clarity.

Ghauri, et al. (1995: 84) postulate that qualitative research is very complex, because it mixes "rational, explorative and intuitive" and the skills of the researcher play an important role in the data analysis.

According to Cooper and Schindler (2003: 69) the gathering of data ranges from basic trouble free observation to a massive survey which is conducted in different parts of the world. The preferred method will dictate how the data is gathered.

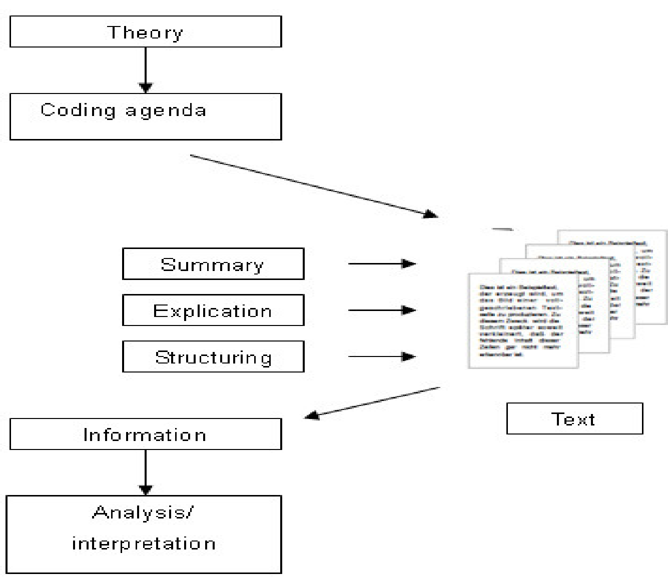
According to Ghauri, et al. (1995: 54), many research students undervalue the quality and quantity of data available from secondary sources. It is advisable for researchers to commence with secondary sources before embarking on collecting raw data as this might be time consuming exercise. It was critical for this study to gather data both from primary and secondary sources.

3.4 Qualitative Content Analysis

According to Mayring (2003: 42-46), the objective of qualitative content analysis is to take recorded data, be it a transcript of interviews or written documents, and analyze it. This analysis is done systematically and is strictly monitored step-by-step.

The diagram below illustrates qualitative content analysis. It shows the basic steps of qualitative analysis that has to be followed if you applied this technique, starting with theory and filtering down to coding agenda. There are three distinct analytical procedures which can be applied autonomously or concurrently, depending on the particular research question i.e. summary, explication or structuring. The final stage of content analysis is the interpretation of data.

Figure 3.1. The basic steps of qualitative content analysis



Source: Mayring (2003: 46)

3.5 Semi-structured interviews

Rudestam and Newton (2001: 95) suggested that the researcher has to prepare the questions in advance and also be prepared to modify them if the need arises during the interview process. Most empirical studies suggest that the personal face-to-face interview is the best technique to collect data because it presents an opportunity for the researcher to clarify the intention of the study. Keller (2006) concurred and further stated that the semi-structured interview has the advantage of having a higher expected response rate than other methods of data collection. The researcher should guard against putting "words in the interviewee's mouth" that would result in a biased response.

According to Ghauri, et al. (1995: 64) research interviews can be divided into two categories i.e. structured and unstructured. During structured interviews, a standard format is applied with all interviewees whereas during unstructured interviews, the format is not standardized. Semi-structured interviews seek to breach the gap between the two, although it differs from both structured and unstructured interviews on a topic to be covered and sample size. Semi-structured interviews were conducted successfully with all participants in this study.

3.6 Research instrument design

The interview questions in this study were tailor-made specifically to assist the researcher to gather perspectives from participants with minimum effort. It was imperative to design an effective and efficient tool, which would convince keen participants to allocate time for interviews. Although questions were not ambiguous or double-barreled, follow-up questions were allowed where further clarity was needed. The questions that were used for interviews are presented below.

1. What do you understand by the term inflation targeting?
2. Is inflation-targeting appropriate for South Africa's developing economy?
3. Is the interest rate or repurchase rate the only mechanism to control or fight inflation?

4. What would you consider as more important: economic growth (and job creation) or price stability (keeping inflation within the range)?

5. What is the realistic inflation-targeting range for South Africa?

6. How do you think financial markets would react to a 6% to 10 % inflation-targeting range?

7. What is the position of the tripartite alliance (ANC, SACP & COSATU) with regards to inflation-targeting?

8. The alliance's feeling is that South Africa should follow the example of South Korea which 'manipulated' interest rates according to industrial policy. Would you support this idea?

9. What do international economists think of South Africa's inflation-targeting?

10. What range is considered relevant for a developing economy and can also stimulate economy growth?

11. Is the South African Reserve Bank experiencing any pressure from the newly appointed ANC leadership with regard to inflation targeting?

12. When the new government comes to power next year, do you think the inflation-targeting range will be reviewed or completely abandoned?

13. How does the exchange rate impact on inflation-targeting?

3.8 Sample size and group

The sample group in this study included politicians, bankers (including SARB), academics and an economic analyst (from provincial treasury). According to Ghauri, et al. (1995) the necessary sample size will also depend on the research design. The sample in this study was limited to participants who were monetary policy expects and were also keen to participate. It is worth mentioning that the political interviewees were limited to those from the tripartite alliance i.e. ANC, SACP and COSATU members because they are in a position to influence decisions on monetary policy.

Keller (2006: 146) argued that "a self-selected sample is almost always biased, because the individuals who participate in them are more keenly interested in the issue than other members". The sample group was made up of individuals who were identified by the researcher based on their knowledge of monetary policy. Personal interviews were conducted with the following participants (see Table 3.1).

Table 3.1: list of interviewees

Name of the Institution or Organization	**Title**	**Participants**
SARB	Monetary policy Researcher	Ph.D.(Econ)
Dept. of Econ. KZN	Economic Analyst	M. Com (Econ)
KZN Treasury Dept.	Economic Analyst	M .Com (Econ)
COSATU	PEC member	
ANC	PEC member	
SACP	PEC member	
DUT	Senior lecturer	Ph.D. (Econ)
KZN Treasury Dept.	Economic analyst	M. Com (Econ)

The methods and techniques applied in this study were informed by the research problem and its purpose. An important aspect of any research is the response rate. The response rate is based on the percentage of the people who were responded to the questions. A low response rate renders the collection and analysis of the data insignificant and affects the outcome of the study. The onus is on the researcher to ensure that the data is collected and is reliable.

3.9 *Shortcomings and sources of error*

The qualitative method is complicated since the sourcing and analysis of data are frequently done concurrently. The data analysis in quantitative research is more challenging than in qualitative research. Qualitative research purely take numbers and pordices statistics whereas quantitative attempts to quantify feelings and attitudes. Weaknesses associated with personal interviews, is that they are costly, particularly when the study requires a researcher to travel long distances to conduct the interviews.

Of all the participants, only the SARB's participant was reluctant to respond to those questions that were politically motivated. Efforts were made to re-phrase the questions, but still he would not give answers. He also preferred to do the interview on-line (e-mail) which presented a problem, because he could not respond to the follow up questions.

3.10 Conclusion

This chapter outlined the research methods and data collection techniques applied in this study. It also unpacked the research instrument, sample size and the response rate. Semi-structured interview questions (attached) were used to collect primary data. The data that was gathered will be presented, analyzed and discussed in Chapter 4.

CHAPTER FOUR - PRESENTATION AND DISCUSSION OF RESULTS

4.1 Introduction

Chapter 4 presents the data that was gathered from various participants through semi-structured interviews. All the interviews were recorded on a tape recorder to ensure accuracy and effective data collection. It was critical that the interview questions were directed to relevant individuals in order to receive informed responses. The questions were designed to encourage participants to qualify their reasoning behind the answers they had given. All the questions were about inflation targeting, a technique which has a direct impact on all South African citizens. This study acknowledges the exogenous forces of rising energy and food prices that the central bank has no control over.

In order to measure and compare the differences and similarities in the opinions of the participants, the data is presented in such a manner that all the participants' response are tabulated below the question posed. This chapter aims solely to reflect the views of the participants and presents a complete analysis and discussion of the data. The participants responses are discussed in conjunction with the insight gained from the literature review as presented in Chapter 2. Letters of informed consent were signed by all participants and are presented in the appendix.

The chapter proceeds as follows:

Section 4.2 reviews the profile of all interviewees and their relevance to this study.

Section 4.3 presents the data that was collected using semi-structured interviews.

Section 4.4 discusses the results from all the interviewees in depth.

Section 4.5 reflects on discussion from the previous section as a conclusion of this chapter.

4.2 Sample profile

The researcher is compelled to adhere to certain ethical clearance requirements and not divulge the names of interviewees on this study. The sample profile of the participants is imperative to outline the background of all interviewees. It was important that the 'handpicked' interviewees were able to contribute effectively to ensure that the study achieved its goal. The economic analysts from Provincial Treasury made it clear that their responses reflected personal views, not those of the institution they worked for.

Table 4.1 The list of interviewees

Name of the institution or organization	**Title**	**Qualification**
SARB	Monetary policy researcher	Ph.D.(Econ)
Dept. of Econ. KZN	Economic analyst	M. Com (Econ)
KZN Treasury Dept.	Economic analyst	M. Com (Econ)
COSATU	Provincial office bearer	
ANC	National executive member	
SACP	Provincial executive member	
DUT	Senior lecturer	Ph.D. (Econ)
KZN Treasury Dept.	Economic analyst	M. com (Econ)

The DUT senior lecture is an experienced academic and researcher with more than 10 years lecturing experience at various tertiary institutions in South Africa. She has presented papers at national and international conferences. She has a PhD in Economics. She is also supervising more than 10 Masters and two Doctoral students. The monetary policy researcher is from the South African Reserve Bank and has a PhD in Economics. He is an experienced researcher and has presented many papers locally and abroad on monetary policy. Both Economic analysts from the KZN Provincial Treasury Department have Masters Degrees. They have co-authored a number of papers for provincial government.

The Economic analyst from the KZN Provincial Department of Economic Development has a Masters Degree in Economics and is currently working towards completing his PhD. His area of expertise is local economic development and he has authored and co-authored papers on economic development.

The SACP interviewee is a member of the Provincial Committee and he sits on the National Executive Committee of the ANC. Furthermore, he also sits on the Economic Committee that deals with socio-economic challenges and monetary policy. To a certain extent the position of the SACP towards inflation targeting, is well known given the fact they are calling for abandonment of the strategy.

The COSATU interviewee is the KZN Provincial office bearer. He sits on the Economic Committee of COSATU and is a regular guest on various radio talk shows, particularly those on worker related issues. Through Patrick Craven, COSATU has maintained that interest rates should not be used to control inflation and have stated that they believe the inflation targeting band is too narrow and too low (Black Management Forum, 2008). The ANC representative is a member of the KZN Provincial Executive committee and also a member of the National Executive Committee of the ANC. ANC National Secretary General of the ANC (Gwede Mantashe) has made it very clear that they are prepared to engage with their Alliance partners on the monetary policy issue.

4.3 Presentation of results

The first question required that interviewees provide a brief personal understanding of inflation targeting as a monetary policy framework.

Table 4.2. What do you understand by the term 'inflation targeting'?

No	Respondent	Response
1	Provincial executive member for SACP	It is the monetary policy adopted by the South African Reserve Bank (SARB) to maintain price stability.
2	Economic analyst From KZN Treasury (1)	It is more concerned about price stability as a primary objective of the monetary policy and it keeps checks and balances on the price fluctuation.
3	DUT senior lecture	Is the official policy of the SARB, to make decisions to change the repurchase rate, secondly they see it as a publicity mechanism to inform the general public what their stance is on monetary policy.
4	Monetary policy researcher from the SARB	Inflation targeting is a monetary framework to control a pre-specified rate of inflation in the context of an economy that uses fiat money. This is money, not backed by gold but is issued by a central bank with the monopoly to print notes and issue coins.
5	Provincial office bearer for COSATU	It is the monetary policy adopted by the South African government.
6	Economic analyst From KZN Treasury (2)	It is the monetary policy designed to ensure that inflation is kept within the desired band.
7	National executive member for ANC	It is the monetary policy adopted by South African Reserve Bank to maintain price stability.
8	Economic analyst from KZN Department of Economic Development	Inflation targeting is a monetary policy strategy that was introduced in New Zealand in 1990, has been very successful in terms of stabilizing both inflation and the real economy.

The second question aimed to establish whether inflation targeting is appropriate for South Africa, taking into account that it is still an emerging market economy. Much has been said about the fact that inflation targeting is ideal for the First World countries but not necessarily for emerging market economies.

Table 4.3. Is inflation targeting appropriate for South Africa?

No	Respondent	Response
1	Provincial executive member for SACP	The SACP stand by its argument that inflation-targeting is not ideal for emerging markets, because the bulk of the society is poor. It is appropriate for the First World countries, certainly not for South Africa because it ignores the challenges of poor people and plays a minimal role in stimulating economic growth.
2	Economic analyst From KZN Treasury (1)	Inflation targeting is appropriate, because it reflects sound economic principles. One of the key objectives of macro economic is the price stability, hence the SARB's inflation-targeting seeks to maintain that, irrespective of SA being emerging market economy.
3	DUT senior lecture	It is appropriate, because it clearly defines the intentions of the SARB.
4	Monetary policy researcher from the SARB	Inflation targeting is appropriate for South Africa because it has reduced the volatility of real output and inflation.
5	Provincial office bearer for COSATU	COSATU does not support inflation-targeting, because is too rigid, considering our challenges as a developing country.
6	Economic analyst From KZN Treasury (2)	Inflation targeting is appropriate, because it seeks to address one of the key macro economic objectives i.e. to maintain price stability.
7	National executive member for ANC	Inflation targeting is appropriate. It has created conditions that are suitable for sustainable long-term economic growth.
8	Economic analyst from KZN Department of Economic Development	Inflation-targeting is appropriate,

The SARB is using the interest rate to control inflation. Every time the Reserve Bank's Monetary Policy Committee meets to determine whether the interest rate should go up or not, consumers hold their breath. “Will this mean another hike and more belts tightening” (Black Management Forum, 2008)? Question 3 asked “Is the interest rate or repurchase rate the only mechanism to control or fight inflation?

Table 4.4. Is the interest rate the only mechanism to control or fight inflation?

No	Respondent	Response
1	Provincial executive member for SACP	It is not the only tool. In fact, SACP has questioned the MPC decision to use repurchase rate as a mechanism to fight inflation. SACP has called on the SARB on numerous occasions to abandon inflation targeting. The SARB should adopt a monetary policy that will protect our domestic products and fast track industrial growth.
2	Economic analyst From KZN Treasury (1)	The interest rate is a direct instrument that can be used to fight inflation head on. However, open market systems could also be used and the SARB can sell shares to the public to “dampen” inflation.
3	DUT senior lecture	If high inflation is caused by demand factors or if it is demand driven (demand pull inflation), high interest rates should be used to fight inflation.
4	Monetary policy researcher from the SARB	A short-term interest rate hike is one of the indirect methods used by monetary policy to curb inflation as opposed to direct methods such as credit ceilings.
5	Provincial office bearer for COSATU	COSATU is totally against the use of the interest rate as mechanism to fight inflation.
6	Economic analyst From KZN Treasury (2)	The interest rate is the one direct policy instrument that can be used to fight inflation head on.
7	National executive member for ANC	The interest rate should be used, but to the extent that is does not impact negatively on the well-being of poor people.
8	Econ analyst from KZN Dept of Eco Dev	The interest rate is the one direct policy instrument that can be use to fight inflation directly.

The primary purpose of inflation targeting is to maintain price stability. The underlying rationale of controlling inflation is that low inflation will provide the basis for sustainable economic growth. There is a growing perception that, in the short run, inflation targeting ignores economic growth. This leads to the theory of Phillip's curve and the need to answer the next question: "What would you consider as more important between economic growth (and job creation) and price stability (keeping inflation within the range)?"

Table 4.5. What is more important: economic growth or price stability?

No	Respondent	Response
1	Provincial executive member for SACP	Sustainable economic growth requires price stability with a low interest rate.
2	Economic analyst from KZN Treasury (1)	Low inflation increases economic growth.
3	DUT senior lecture	In the short-term, inflation targeting does not complement economic growth, but in the long-term it brings about price stability and creates a conducive environment for economic growth.
4	Monetary policy researcher from the SARB	Both are important. The central bank in South Africa does not have the mandate to target any kind of economic growth rate. However, economic growth is taken into account when interest rate decisions are made.
5	Provincial office bearer for COSATU	Inflation targeting is only concerned with price stability.
6	Economic analyst From KZN Treasury (2)	Low inflation stimulates economic growth in the long-term.
7	National executive member for ANC	The mandate of the SARB is price stability and economic growth is the government's responsibility. It is critical that price stability complements other macro economic objectives.
8	Economic analyst from KZN Department of Economic Development	Low inflation stimulates economic growth, so it is imperative that inflation is kept within the band.

There is concern that the inflation range is too narrow, too low and hampers economic growth as well as increases the unemployment level. There is a growing perception amongst the Alliance partners that the current band is too narrow for South Africa, considering that it is still an emerging market economy. After the Polokwane ANC conference, there were speculations that the range will be revised. The next question asks: “What is a realistic inflation-targeting range for South Africa”?

Table 4.6. What is a realistic inflation-targeting range for South Africa?

No	Respondent	Response
1	Provincial executive member for SACP	Since South Africa is an emerging market, any range that will stimulate economic growth is desirable.
2	Economic analyst From KZN Treasury (1)	It is very difficult to give a specific answer. Emphasis should be on the fiscal policy to expand without negatively impacting on the inflation.
3	DUT senior lecture	The current inflation targeting band is perfect; however it needs to be sustainable.
4	Monetary policy researcher from the SARB	The current inflation targeting band is perfect.
5	Provincial office bearer for COSATU	6% to 10%
6	Economic analyst From KZN Treasury (2)	The current inflation targeting band of 3% to 6% is perfect, irrespective being emerging market.
7	National executive member for ANC	The current inflation-targeting range is perfect.
8	Economic analyst from KZN Department of Economic Development	South Africa is a role model for other African countries because of its sound monetary policy. The current inflation targeting band is perfect.

South Africa is regarded by many foreign investors as a country of opportunities, given the sound economic policies and political stability. The next question asked: “How would financial markets react to a 6% to 10 % inflation-targeting range?”

Table 4.7. How would financial markets react to a 6% to 10 % inflation-targeting range?

No	Respondent	Response
1	Provincial executive member for SACP	There is not likely to be any major reaction from the financial markets, because South Africa’s economic policies are sound.
2	Economic analyst From KZN Treasury (1)	This would have a major impact on our financial markets. Foreign investors would be likely to consider pulling their money out of South Africa.
3	DUT senior lecture	We can only speculate, but there is no straight answer to this question.
4	Monetary policy researcher from the SARB	This is an empirical matter. No prophet or a sangoma can give you a precise answer to this question. We know that any change in the inflation target band will influence the anchoring of inflation expectations.
5	Provincial office bearer for COSATU	More jobs will be secured and sustainable economic growth will be achieved.
6	Economic analyst From KZN Treasury (2)	Foreign investors are more skeptical and financial markets are very fragile. In short, any upward movement will have a negative impact.
7	National executive member for ANC	In the short-term this will have a negative impact, but in the long run, it will return to normal.
8	Economic analyst from KZN Department of Economic Development	There is no precise answer, but if the ANC eventually succumbed to the pressure of its Alliance partners, an effort would have to be made to assure investors that South Africa is still a “safe haven” for their money.

With the latest developments on the political landscape of the country, one of the Alliance Economic Summit objectives will be to give all stakeholders the opportunity to air their opinions and further “iron out” any differences. The result of this will ultimately determine the position of the alliance. “What is the position of the tripartite alliance (ANC, SACP & COSATU) with regards to inflation targeting?”

Table 4.8. What is the position of the tripartite alliance with regards to inflation-targeting?

No	Respondent	Response
1	Provincial executive member for SACP	The position of the SACP is that the range has to be revised. They have agreed with COSATU in principle that 3% to 6% is too narrow, too low and hampers economic growth.
2	Economic analyst From KZN Treasury (1)	The alliance has more pressing issues (the election) to deal with it right now. Monetary policy is last on the list of their problems at this point in time.
3	DUT senior lecture	They have agreed to disagree around the issue of inflation targeting.
4	Monetary policy researcher from the SARB	Please ask them.
5	Provincial office bearer for COSATU	The Economic Summit will define the position of the alliance on inflation targeting.
6	Economic analyst From KZN Treasury (2)	The reality is that the ANC differs with their alliance partners on this issue. However, they all agreed to find a workable solution.
7	National executive member for ANC	The ANC supports inflation targeting, but the challenge that faces the ANC is to convince its alliance partners.
8	Economic analyst from KZN Department of Economic Development	They have an obligation to support government policies, irrespective of whether there has been sufficient consultation. The economic summit will tone down any confrontation around the subject.

COSATU has repeatedly called for an interest-rate strategy based on targeting economic growth, job creation and poverty eradication. The recent interest hikes have adversely affected the sustainable growth of the economy. The alliance feels that South Africa should follow the example of South Korea which "manipulated" interest rates according to industrial policy. Would you support this idea?

Table 4.9. Would you support the alliance that SA should follow South Korea and 'manipulate' interest rates to suit industrial policy?

No	Respondent	Response
1	Provincial executive member for SACP	Monetary policy should be in line with industrial strategy in terms of interest rates.
2	Economic analyst From KZN Treasury (1)	Clear industrial policy is required to accompany inflation targeting.
3	DUT senior lecture	I support this idea.
4	Monetary policy researcher from the SARB	I have no answer to this question.
5	Provincial office bearer for COSATU	It will encourage small business and create job opportunities.
6	Economic analyst From KZN Treasury (2)	Monetary policy is the central bank's responsibility and industrial policy is government's responsibility.
7	National executive member for ANC	Our economy is not in a strong enough position to manipulate interest rates in favour of industrial policy.
8	Economic analyst from KZN Department of Economic Development	I support this idea.

South Africa has sound economic policies in place which have been built on a stable political foundation. The Johannesburg Stock Exchange (JSE) has played a crucial role in attracting foreign investors. Many international investors are using South Africa as a vehicle to enter Africa. The next question asks what international economists think of South Africa's inflation targeting?

Table 4.10. What do international economists think of South Africa's inflation-targeting?

No	Respondent	Response
1	Provincial executive member for SACP	They are comfortable with current the status quo, because inflation-targeting is pro-capitalist.
2	Economic analyst From KZN Treasury (1)	They see it as an emerging market with great economic potential and political stability.
3	DUT senior lecture	South Africa has a sound monetary policy.
4	Monetary policy researcher from the SARB	Please ask them. Which international economists are you referring to? This question is not helpful.
5	Provincial office bearer for COSATU	South Africa's economic policies are friendly to any potential investors. However, industrial action as a result of the MPC insisting on using interest rate to fight inflation might prove other wise.
6	Economic analyst From KZN Treasury (2)	They see it as a country with great potential.
7	National executive member for ANC	South Africa is one of the emerging markets with low inflation.
8	Economic analyst from KZN Department of Economic Development	They perceive the Central bank to be independent.

The Alliance partners of the ANC have made it very clear that a 3% to 6% range of inflation targeting is too narrow and too low. In South Africa, with its high unemployment levels, inflation should not be a priority. The interest rate should be lowered to encourage economic growth and to create jobs. The next question asked the interviewees what range they considered best for an emerging market economy that can also stimulate economy growth?

Table 4.11. What inflation range is best for a developing economy and can also stimulate growth?

No	Respondent	Response
1	Provincial executive member for SACP	6% to 10%
2	Economic analyst From KZN Treasury (1)	3% to 6%
3	DUT senior lecture	6% to 8%
4	Monetary policy researcher from the SARB	3% to 6%
5	Provincial office bearer for COSATU	6% to 10%
6	Economic analyst From KZN Treasury (2)	3% to 6%
7	National executive member for ANC	3% to 6%
8	Economic analyst from KZN Department of Economic Development	5% to 8%

With the inflation rate breaching the upper band of the inflation targeting in April 2007, a spate of unpopular interest hikes (more than 200 basis points) has placed South African Reserve Bank, Tito Mboweni, and the Monetary Policy Committee (MPC) under increasing pressure (Sharondavis.co.za).

There are noticeable numbers of leftists in the ANC hierarchy who cannot hide their dissatisfaction on inflation targeting. The interviewees were asked whether the South African Reserve Bank was experiencing any pressure from the newly appointed ANC leadership.

Table 4.12. Is the South African Reserve Bank experiencing any pressure from the newly appointed ANC leadership?

No	Respondent	Response
1	Provincial executive member for SACP	Pressure will always be there, one needs to only consider the recent interest rate hike to see it.
2	Economic analyst From KZN Treasury (1)	No comment.
3	DUT senior lecture	High unemployment levels, steep increases in food prices, fuel and interest rate hikes would put pressure on any government, not pnly on the central bank.
4	Monetary policy researcher from SARB	No comment.
5	Provincial office bearer for COSATU	SARB has to abandon inflation targeting.
6	Economic analyst From KZN Treasury (2)	No comment.
7	National executive member for ANC	No comment.
8	Economic analyst from KZN Department of Economic Development	No comment.

Media speculation suggested that when a newly government comes to power next year, Polokwane and the Alliance Economic Summit resolutions will be implemented. However, the ANC has issued a statement that there will be no policy shift through its President. The next question asked: "When the new government comes to power next year, do you think the inflation targeting range will be reviewed or completely abandoned?"

Table 4.13. When a new government comes to power next year will the inflation targeting be reviewed or completely abandoned?

No	Respondent	Response
1	Provincial executive member for SACP	The range will be revised.
2	Economic analyst From KZN Treasury (1)	There will be no policy shift.
3	DUT senior lecture	They have indicated that there will be no major shift in terms of economic policies.
4	Monetary policy researcher from the SARB	Inflation targeting will remain as the main monetary policy framework.
5	Provincial office bearer for COSATU	The current range is too narrow and has to be revised after the election.
6	Economic analyst From KZN Treasury (2)	Inflation targeting will remain within the same band.
7	National executive member for ANC	The monetary policy will be kept the same and Polokwane resolutions will be implemented.
8	Economic analyst from KZN Department of Economic Development	There will be no major shift.

The weak rand has exacerbated the situation for South Africa with regard to the Rand/Dollar exchange rate. The weak rand has resulted in South Africa importing inflation. The interviewees were asked how the exchange rate impacts on inflation targeting.

Table 4.14. How does the exchange rate impact on inflation-targeting?

No	Respondent	Response
1	Provincial executive member for SACP	What happens in First World countries, has direct bearing on the third world countries. The dollar: rand exchange has impact on the inflation, for example South Africa imports crude oil and pays in dollars.
2	Economic analyst From KZN Treasury (1)	The dollar: rand exchange (importing crude oil) impacts negatively on inflation targeting.
3	DUT senior lecture	Our weak rand has resulted in south Africa “importing inflation”.
4	Monetary policy researcher from the SARB	If our currency continues to weaken, it might a have negative impact.
5	Provincial office bearer for COSATU	Our government needs to protect our economy e.g. If America sneezes, other countries catches the flu.
6	Economic analyst From KZN Treasury (2)	The volatility of the currency impacts negatively on our imports.
7	National executive member for ANC	Inflation targeting protects the value of the currency in order to sustain price stability.
8	Economic analyst from KZN Department of Economic Development	Exchange rate movements directly affect domestic inflation, as a result of external shocks.

4.4 Discussion of results

4.4.1. The understanding of inflation targeting

All the participants interviewed seemed to be familiar with South Africa’s monetary policy framework. This question aimed to set the tone for the study and afforded the participants an opportunity to divulge their understanding of the subject matter. Their responses portrayed knowledge and rationale behind the adoption of inflation targeting in South Africa. They stated that the primary objective of inflation targeting is to achieve and maintain price stability so it is imperative to control a pre-specified rate of inflation. The success of inflation targeting is based on three pillars: transparency, accountability and the independence of the central bank. It is also characterized by a public announcement of a numerical target range which in South Africa is 3%-6%.

4.4.2. Is inflation targeting appropriate for South Africa?

Not all participants agreed that inflation targeting is appropriate for South Africa. There were two participants (from COSATU and SACP) who felt that inflation targeting is not appropriate for South Africa. They raised arguments such as the fact that South Africa is an emerging market so price stability should not be a priority and also suggested that inflation targeting was hampering national priorities such as economic growth and job creation. They further argued that inflation was too rigid, pro-capitalist and ignored the challenges facing poor people. A follow up question revealed that they believed that inflation targeting was not ideal for South Africa because the priorities and challenges facing this country (with its high unemployment level) are not the same as those of the First World countries.

However, the rest of the participants felt that inflation targeting was appropriate, because it reflected sound economic principles and also because one of the key macro economic objectives was price stability. Low inflation encourages sustainable economic growth and job creation in the long run. Since the inception of inflation targeting by New Zealand in 1990, a number of industrialized and non industrialized countries have also adopted inflation targeting. The evidence is that none of those countries (including emerging market countries) has abandoned inflation targeting for any other form of monetary policy (see Table 2.2).

4.4.3 The interest rate as a mechanism to fight inflation

What transpired from this question was that there are mechanisms, other than interest rates, that the SARB could employ to fight inflation, but how viable or effective these would be, remains untested. The SACP participant could not hide his disapproval of using interest rates to curb inflation; he went as far as stating that about 6000 houses are repossessed by banks every month as a result of interest rates hikes. The COSATU participant stated that the SARB has recently increased interest rates 10 times within a short space of time with the intention of bringing inflation to within the desired range i.e. 3% to 6% and they have failed. He concluded by saying that this demonstrated the arrogance and short-sightedness of the MPC, which appeared to ignore the fact that rising of inflation was often the result of exogenous price factors.

However, other participants saw interest rates as a relevant tool to curb inflation. They argued that the SARB did not raise the interest rate to control prices of exogenous factors it did so with the intention of controlling the secondary effects of inflation expectations. What the SARB is trying to do is to prevent the relative rise in price from becoming entrenched as an inflation expectation. The interviewee from the SARB differed with other participants. His response was that the short-term interest rate is the indirect method used by to curb inflation as opposed to direct methods such as credit ceilings. The theory gleaned from the literature review in Chapter 2 suggested that the real long-term interest rate, rather than changes in the short-term nominal interest rates, has a potent impact on consumer and investment spending.

4.4.4. Economic growth and price stability

The Phillips Curve suggests that there could be a trade-off between inflation and unemployment (which is often accompanied by economic growth). The theory indicates that a short-term Phillips Curve would exist, however in the long run the curve becomes vertical. The mandate of the SARB is clear: to achieve and maintain price stability.

There was some agreement amongst the participants, that a low inflation rate is imperative for sustainable economic growth. COSATU and SACP participants, however, thought differently. The SACP participant argued that theoretically speaking the above statement is true or is only applicable in the First World countries. Inflation could be allowed to increase slightly and the interest rate could also be lowered to kick start small businesses and ensure debt repayment. These two interviewees noted that there is a conflict between price stability and national priorities such as economic growth, job creation and poverty alleviation. The SACP and COSATU suggested that inflation targeting hindered these national priorities (Black Management Forum, 2008).

The COSATU participant stated that interest rates are meant to curb inflation but it is doing the opposite because of the high interest rates on debt repayment. He suggested the SARB's ten .50 basis point increases since July 2006, have only served to increase inflation. The participant from the SARB argued repeatedly that, irrespective of the leftist element in the ruling party and trade unions, the underlying purpose for price stability is to allow maximum sustainable economic growth.

4.4.5. Inflation targeting range

There is a concern that the 3%-6% inflation targeting range is too narrow, too low and hampers economic growth as well as increases the unemployment level. What then is a realistic range for South Africa? It was a difficult question for participants to answer and they were not prepared to give a specific range (see Table 4.10). However, the general response was that a single digit upper band of inflation is acceptable. For more than 24 months inflation has remained outside the target range, the question arises about why the SARB has opted for an unrealistic range. One could argue that their intention is to influence inflation expectations, but realistically speaking, it is not attainable given the fact that the SARB has no control over exogenous price factors. In the literature review, an escape clause is meant to cater for any events that are likely to occur as a result unforeseen circumstances e.g. the exorbitant escalation of exogenous prices.

COSATU and the SACP interviewees suggested that a 6% to 10% range would not compromise long-term sustainable economic growth. They took it to the extreme by suggesting that even a range below 14% is acceptable and significant and sustainable economic growth would still be realized. The unemployment would also decrease significantly.

4.4.6. Financial market reaction to a 6% to 10% target range

Most interviewees differed on this question. The SARB and DUT interviewees agreed that there is no straight answer, only speculation. The chief reasoning behind speculation is that financial markets are volatile. Any change in the inflation target band will influence the anchoring of inflation expectations. A slightly upward shift of the band would have a negative impact on the primary objective of the SARB which is to achieve and maintain price stability in the short run and the financial markets are likely to feel the pinch.

The SACP interviewee stated that the likelihood is that a reaction to a higher inflation target range will be less significant because South Africa has sound economic policies. The series of interest hikes will not be necessary and the dream of 6% economic growth per annum will be realized. The COSATU interviewee argued that there will not be any major reaction in the financial market because South Africa is politically stable. Monetary policy should not aim at pleasing capitalists, but it should be seeking to eradicate poverty. The Treasury economic analyst who was interviewed thought this would scare investors, but once the “dust has settled” the situation would return to normal.

4.4.7. The position of the tripartite alliance with the regard to inflation targeting

The position of the tripartite alliance is that the SACP and COSATU differ with the ANC on the monetary policy issue. The SACP participant stated his organization’s position that the range has to be revised because a 3% to 6% band is too narrow, too low and hampers economic growth. COSATU’s position is that inflation targeting should embrace industrial policy to be adopted by the Economic Summit. The DUT interviewee suggested that members of the Alliance probably agreed to disagree on monetary policy, so for her it would be slightly difficult to predict their position.

The ANC interviewee suggested that the Alliance has more pressing issues to deal with (for example disgruntled ANC members forming a new political party

(COPE) just ahead of the upcoming election). However, the Economic Summit is set to define their position in this regard and pave the way for the implementation of the Polokwane resolutions. The SARB interviewee opted not to entertain this question. The conclusion drawn from his silence was that he does not want to comment on the political landscape of the country.

4.4.8. Should SA follow the example of South Korea?

It is important to note that, in order for economic growth to occur; small businesses need to be supported by government. Government has to develop "tailor-made" packages for small businesses. A reasonable fixed interest rate (i.e. below prime) could be one of those packages. In other words, small businesses should not be affected by constant interest rates hikes. Empirical evidence suggests that small businesses are the ones which suffer the most followed by home owners, while larger companies are able to cushion themselves for any shock.

Additionally, the manipulation of interest rates has to complement industrial policy. There should be a formal document that seeks to ensure that cooperation and coordination exists between the central bank and government as far as industrial policy is concerned. However, the independence and integrity of the central bank should be paramount. Government should consider rescuing those industries that are currently experiencing hard times, for example the mining and automobile industries, to avoid retrenchments.

COSATU has repeatedly called for an interest-rate strategy based on targeting economic growth, job creation and poverty eradication. Most of the participants in this research also called for clear industrial strategies that will be in line with the macro economic objectives of the country.

4.4.9 International investors

There is empirical evidence to suggest that most foreign investors irrespective of their dissatisfaction with trade unions and the SACP have called for inflation targeting to be abandoned South Africa would remain a blue-chip country for investment because its political stability has played a significant role in assuring foreign investors. The adoption of inflation targeting has actually set the precedence for other African states that single digit inflation is possible. South African statistics suggested that there is sufficient evidence that foreign capital (investment) has increased substantially, thanks to inflation targeting. Most analysts agreed that any debate around the subject has to be delicately handled to avoiding tarnishing the integrity and reputation of the central bank.

Most interviewees suggested that South Africa is an emerging market economy with great potential, a sound monetary policy and political stability. The SACP interviewee felt that international investors are capitalists who seek to enrich themselves at the expense of poor people. He went on to state that inflation targeting was deliberately "geared" to attract foreign investors and "jobless growth". The COSATU interviewee argued that inflation targeting is pro-capitalist and anti-working class.

4.4.10. The desired inflation range for South Africa

The literature review outlined a number of emerging market countries that had adopted inflation targeting (see Table 2.2). However, most of these countries have "flexible" inflation targeting, to accommodate foreign shocks. In terms of range, it was obvious that they are operating slightly below 5%. South Africa is not far from other emerging markets with an upper band of 6%.

Most interviewees argued that the emphasis should not be on the target range, rather on how that range translates into impacting positively on sustainable economic growth and reducing unemployment. Although most interviewees were prepared to commit themselves by stating their desired range, the SACP and COSATU participants suggested double digits as an upper band (10%).

Although most of the interviewees opted for single digit upper band, it was interesting that the ANC, the SARB and both treasury economic analysts agreed with the current inflation target range of a 3% - 6%. On the other hand, the economic analyst from the Department of Economic Affairs suggested an inflation target range of a 5% - 8%. The DUT interviewee suggested that, given circumstances, an inflation target range of a 6-8% would be realistic and attainable.

4.4.11. South African Reserve Bank experiencing pressure from Political head

Pressure would always be there from any government if there is a high level of unemployment. The SARB has come under enormous pressure recently from the ANC Alliance partners. Finance Minister Trevor Manuel has strongly defended the government's inflation targeting policy which came under attack on many occasions from the left in the ruling party. One of his arguments is that it provides an anchor in the context of financial market turmoil. Treasury and the SARB have agreed that they should ensure continued commitment to inflation targeting, a flexible exchange rate, a well capitalized and prudently regulated banking system, low external debt, deep domestic capital market, higher foreign exchange reserves and sustainable fiscal policy as the “key anchors” for improved economic performance (Creamer, 2008)

Most of the interviewees opted not to respond to this question that tried to establish whether the SARB was under pressure from the ANC’s new leadership. However, the SACP, COSATU and DUT interviewees did respond. The DUT interviewee suggested that the SARB’s failure to meet their target was due to circumstances beyond their control and this is bound to attract pressure from the political arena. The COSATU participant made it clear that they would continue debating this subject matter, but whether that would amount to applying pressure on the SARB, he could not comment further. The SACP participants state that, they would continue exerting pressure, until inflation targeting is revised or completely abandoned.

4.4.12. New government will come to power in 2009

When a “new” Government (pro left) comes to power they would seek to implement Polokwane policies and the Economic Summit resolutions. It is an open secret that the new government would lean more towards the left, given the number of SACP and COSATU members rising to senior positions in the government. There have been assurances made by the ruling party that there would be no policy shift. Foreign investors are more concerned about the influence of the left wing on the ruling party. In essence, international investors are skeptical about what is likely to happen after the election. Many investors have opted for a cautious strategy to wait and see what emerges in terms of monetary policy after the election.

4.4.13. The impact of the exchange rate on the inflation targeting

In the literature review (Chapter Two), many countries opted a for flexible exchange rate rather than fixed exchange rate that has become less viable and less successful in stabilizing inflation targets. This has led to many countries pursuing inflation targeting. Many central banks are facing difficulties in defending misaligned fixed exchange rates against speculative attack.

All the interviewees agreed that foreign exchange does have an impact on inflation in various ways. This is the only question that all the interviewees agreed that a weak currency would result in South Africa importing inflation.

4.5. Conclusions

This chapter met the objectives of the study that is to analyse the various perspectives on inflation targeting. All the perspectives from the participants were tabulated and analyzed by the researcher. This has enabled the researcher to strategically analyse rationale that prompted the South African government to adopt inflation targeting as monetary policy. There have been outcries from the left within the ruling party that seek to suggest that, the ruling party has actually made a blunder or there was not sufficient consultation prior to the adoption. Another key objective of this study was to attempt to pre-empt, any possibility that might lead to a radical policy shift.

The main important insight that emerges from the analysis firstly was that all the participants agreed on the definition of the inflation targeting. The objective of SARB is to achieve and maintain price stability in order to ensure sustainable economic growth. While the SACP and COSATU participants argued that inflation targeting is not appropriate for South Africa. The analysis further revealed that interest rate as the only the direct instrument used by the SARB to fight inflation. The resent interest rates hikes have actually fuelled the already existing tension on the subject matter within the tripartite Alliance partners. There is an assumption that suggests a role for the SARB is not clearly understood by the Alliance partners.

Secondly, the constitution draws a clear distinction between the SARB mandate and other government departments. There is no clear coordination between monetary and fiscal policies, hence the conflict between the two was highlighted by participants. These policies should complement each other, as low and stable inflation is critical for sustainable economic growth. The inflation targeting does not ensure the job creation and economic growth but it create favourable environment to stimulate economic growth. On the other hand inflation targeting influences inflation expectations and the inflation targeting range act as a catalyst on salary or wage negotiations. There is no empirical evidence to suggest that price stability is putting brakes on national priority (economic growth, job creation and poverty alleviation).

More so an inflation targeting ranges of 3%-6% is in line with other emerging market economies; however it has remained outside the band for more than 24 months. That ignites the question of whether a 3%-6% is attainable and attracted negative criticism from SACP and COSATU. Any topic that seeks to debate the challenges of inflation targeting in South Africa is easily drawn to politics. In most cases all monetary policy debates are easily politicised by various stakeholders.

Thirdly to a large extend financial markets are known to be fragile and volatile, if a decision is taken by the new administration to revised the range, it should be diligently crafted to minimize possible damage, that might suggest the influence of the left on the ruling party. South Korea has set precedence on manipulation of the interest rate to address objective of the industrial policy. COSATU is calling for similar approach an i.e. interest –rate based strategy to be adopted.

Fourthly, since the inception of inflation targeting, South Africa has attracted international investors, hence foreign capital has escalated significantly. Unfortunately the SARB has been under enormous pressure as a result of interest hikes perpetuated by politics of the day. The SARB should be commended for executing delegated authority without fear or favor on pursuing low and stable inflation. It became evident on the response from participants not to single out ANC Alliance partners. Fig. 2.2 clearly illustrated as to how does interest hikes eventually reduce inflation through interest rates channel. The interest rate is the instrument that talks directly to inflation; however the impact of exogenous factors rendered the role of interest rate insignificant.

Finally, flexible foreign exchange is crucial fro inflation targeting. Also inflation targeting has to be flexible to accommodate foreign shocks. The volatility on the market dictates that inflation targeting not to be rigid. It became obvious that SARB has one instrument, irrespective whether it relevant to current situation. The reality is that the recent interest hikes have actually did not do justice to the people on the street.

CHAPTER FIVE - CONCLUSION

5.1 Summary of findings

The main objectives of this study are to gather perspectives on inflation targeting from various political parties, trade unions, businesses, the SARB, academics as well as to investigate case studies from other countries. The ultimate intention is to take the inflation targeting debate to another level. This journey is guided by the limited number of interviews designed to entice participants to share their perspectives on inflation targeting.

The secondary objective of this study is seeking to pre-empty fundamental policy shifts post election. The relevance of this study is important as inflation targeting debates are always politicized particularly in South Africa (within the ruling party and its Alliance partners). A debate that seeks to undermine the integrity of the SARB should be condemned and also the monetary policy committee should not think they are operating on an island.

Inflation targeting puts price stability as the primary objective of monetary policy. The key rationale of inflation targeting is to provide an anchor for expectations of future inflation to influence prices and wage setting. Inflation erodes the value of the currency and reduces the buying power of money. It is generally the case that the poor are most vulnerable to inflation. The current escalation of inflation has been primarily driven by food and energy prices. The empirical evidence suggests that food has more weight particularly in the baskets of poor people.

The consequence of inflation is uncertainty which makes economic decision-making more difficult. High inflation is always accompanied by price variability and the result is lower levels of investment and growth. Therefore, monetary policy can be used a as tool to provide a low and stable inflation environment that is conducive for sustainable long-term growth. In essence, growth in the long run is determined by real variables and other supply-side factors, however monetary policy can speed up growth rates by lowering interest rates. Empirical evidence suggests that, this will work in the short run, but this will contribute to high inflation, a weak currency and lower growth. A stable monetary policy will contribute to a stable environment of low inflation and low interest rates but it does not guarantee a high growth which is associated with real factors in the economy.

Sound monetary policy is critical to ensure sustainable economic growth; however, there are various schools of thought as to how economic growth can be sustained. The SACP and COSATU participants have different opinions in comparison to the other participants in this regard. The views of all participants were analyzed to establish degrees of similarities and differences amongst them. Of the 13 questions presented to participants, only the SARB participant was reluctant to answer certain questions particularly those that were politically motivated.

The interview questions were strategically set to begin with general questions and gained momentum as it progressed. In the first question, participants were asked to briefly explain and define their understanding of inflation targeting. Most participants responded by saying it is monetary policy set to achieve and maintain price stability which is the objective of the SARB.

The second and third questions were intended to create a platform for participants to expand on the appropriateness of inflation targeting in South Africa. The SACP and COSATU participants did not think that inflation targeting is ideal for South Africa. Their arguments were merely informed by political ideologies, that inflation targeting is too rigid and put brakes on the economic growth. Other participants were of the view that inflation targeting is sound irrespective of whether South Africa is a developing state or not, it is appropriate.

The forth question wanted to establish whether the interest rate is the only mechanism to fight inflation, while the fifth question looked at the relationship between economic growth and inflation. The conclusion drawn from the analysis of the response from the participants particularly on these two questions suggested that low interest rate fuel economic growth, however high inflation does the opposite.

There was consensus amongst the participants that suggested that the interest rate is not the only tool. A short-term interest rate is the indirect method used by monetary policy to curb inflation as opposed to direct methods such as credit ceilings. If inflation is demand driven i.e. demand pull inflation, high interest rate would be a relevant tool to dampen the demand.

Consequently interest rates hikes contribute to the reduction of demand for money, hence further cut supply of money and reduce inflation. Alternatively cut in interest rates, raises demand for money, hence raises supply of money and boost inflation.

There is a perception that seeks to suggest that interest rates hikes impact negatively on economic growth. The SARB mandate is clearly stated in the Constitution i.e. to protect the value of the currency with intention to ensure equilibrium and sustainable economic growth (Van der Merwe, 2004).

Therefore price stability or low inflation protects the value of the currency. There are views that portray the wrong image about inflation targeting such as those suggesting that it slows down economic growth. However, the underlying rationale for controlling inflation is that low inflation will provide appropriate basis for economic growth. The reality is that the Phillips curve trade-off between unemployment and inflation is not possible in the long run; however, there is a trade-off between inflation variability and output variability in the short run.

The sixth question takes a close look at the range of 3%-6%. Since the SARB has failed to bring inflation with this range, that has drawn unnecessary criticism of the central bank. Most of the inflation targeting debates dwells on the range as opposed to fundamentals of inflation targeting. Table 2.2, looks at inflation targeting range of emerging-market economies and South Africa is inline with its counterparts.

A 3%-6% inflation targeting might appear to be inappropriate for a number of reasons. The current target is an arguably low one, too low to stimulate economic development. The COSATU participant argued that we could have a rate of 6% to 10% and still not compromise on long-term sustainable economic growth. The consensus view among economists worldwide is that inflation higher than 14% is not desirable and detrimental to the economic growth (Black Management Forum, 2008).

Inflation has been above the target band for the very long time and still there is no sign of reducing soon. This has led to many people questioning inflation targeting as well as interest rate hikes. If a 3%-6% is not attainable, Government needs to consider other options. A realistic inflation target band should strive for balance between macroeconomic objectives and monetary policy.

The seventh question wanted to ascertain, what would likely to happen in financial markets if the range is revised or changed to 6%-10%. Analysis drawn from the response on this question is that low inflation is desirable; however it is not possible under the current economic climate. On the same breadth high or double digit inflation is not ideal for sustainable economic growth for obvious reasons.

The financial markets are fragile, so any change in the band has to be careful guarded. The underlying rationale that could lead to the shift has to be thoroughly explained and whether it is temporal or it is permanent. The Metropolitan chief economist suggested that, if the target is moved it will no longer serve its purpose to control inflationary expectations and the SARB credibility would be undermined (Black Management Forum, 2008: 31).

The eighth question view tripartite Alliance holistically as one entity that exists outside government, yet it plays significant role in policies decision making. In essence this question seeks to ascertain the position of tripartite Alliance with regard to monetary policy. The conclusion drawn from the analysis of the response suggests that there is a rift within the Alliance on this matter. However there is a notion to “agree to disagree” on this matter. On the other hand the position of the tripartite Alliance on the inflation targeting is not clearly stated on the economic summit document, other than saying that monetary policy should complement industrial policy.

The ninth question looks at the possibility of manipulating interest with the view to accommodate industrial policy. Industrial policy suggests low interest rates to stimulate economic growth. The analysis from this question is that the mandate of SARB does not address the objectives of industrial policy. In essence both monetary policy and industrial policy are not talking to each other. The leftist stance is that the SARB should manipulate interest rate according industrial policy and the Finance Minister appears to be a threat to this approach.

The tenth question, wanted to gather opinions of the participants as to how international community views South Africa’s monetary policy. It is evident that South Africa took a bold step toward achieving and maintaining price stability through inflation targeting. To sum up the views of participant excluding SACP and COSATU on this question, inflation targeting assures foreign investors that SARB is independent. International economists applauded South Africa for being the first African state to adopt inflation targeting. In other words South Africa has actually set the trend for other African state. SACP participants argued that a 6% -10% inflation targeting band might be relevant for South Africa and without impacting negatively on economic growth.

The eleventh question focuses on inflation targeting for emerging market countries. Table2.2 provided a detailed breakdown on the range pursued by various emerging market states. This question seeks to establish ideal range for emerging market, although there was no straight answer, but what was important is that these countries are making great strides toward attracting investors.

The twelfth question was set to determine whether there is any political interference on the SARB. The analysis indicates that the SARB has been under enormous pressure after the Polokwane conference. Overall South Africa has demonstrated political maturity and also the constitution is being adhered to. There was a probability that suggested a policy shift after the elections. There is great possibility that inflation will not be scrapped but the band might be revised to accommodate industrial.

The final question was systematically set to view the impact of exchange rate in relation to inflation targeting. The analysis drawn from responses suggests fixed exchange rates have been tried by many countries to fix the exchange rate relative to a centre country with an independent monetary policy. However it has become less viable and less successful in stabilizing inflation. This could be one of the reasons that many countries opted for inflation targeting with flexible exchange rate.

When the SARB increases the repurchase rate, short-term real interest rates also increase causing the rand to strength, the rand become more attractive compared to foreign currency. This led to capital inflows and also the stronger rand makes domestic goods relatively more expensive to foreigners and foreign goods become relative cheaper for domestic importers.

5.2 Conclusion

The conclusion drawn from the analysis of the perspectives of inflation targeting brought a variety of views as to how participants view inflation targeting. On the first question it was critically important for participants to first define inflation targeting and provide briefly explanation on the rationale behind the adoption. Their responses portrayed knowledge and rationale that prompted South Africa to adopt inflation targeting. They stated that the primary objective of inflation targeting is in line with the mandate of the SARB to achieve and maintain price stability.

On the appropriateness of the inflation targeting, there was no consensus amongst the participants. SACP and COSATU participants sighted inflation targeting as too rigid, pro capitalist and ignores challenges facing poor people. However other participants supported inflation targeting. On the interest rate as a tool to curb inflation, participants argued that interest is not the only solution to fight inflation. Although there are various methods but the mandate of SARB does not dictate as to which instrument to be used therefore it remains prerogative for MPC to decide on the relevant tool.

Looking at economic growth and price stability, in essence sustainable economic growth requires low and stable inflation. There was some agreement amongst participants with COSATU and SACP have some reservations in this regard. They reservations emanated from the notion that suggests a brewing conflict between price stability and national priorities (economic growth, job creation and poverty alleviation). Surprisingly, a suggestion emerged that inflation targeting literally put breaks on these national priorities.

It is evident that for the last 24 months, inflation has been above the ceiling of 6%. That prompted the researcher to pose a question on the participants to ascertain whether a 3%-6% range is relevant for South Africa. It was a difficult question to answer for participants and they were not prepared to put their head on block and give a specific range (see Table 4.10). But the general response was that a single digit upper ceiling of inflation is acceptable. The question as to how would the financial market reacts if a range of 6%-10% is adopted. The concerns from the participants were that financial markets are fragile and volatile. Also this might the send wrong signal to investors about South Africa and that the SARB is not independent. Any changes in the range would likely have adverse an effect on the central bank.

With regard to the position of the tripartite Alliance on the inflation targeting based on the response from the participants, it was clear that the alliance is divided. On the question as to whether the central should manipulate interest rate, COSATU participants called for an interest-rate strategy based on the economic growth, job creation and poverty eradication. Other participants were of the view that interest could be manipulated to complement industrial policy.

On the question as to how international community views South Africa's monetary policy. There is empirical evidence to suggest that most foreign investors consider South Africa as an emerging market with great potential, sound monetary policy and political stable. Based on the data from South African statistics, there is sufficient evidence that foreign capital increased substantially after the adoption of inflation targeting.

To further look at the desired range, it was interesting to establish that the effectiveness of the range should be measured with the impact it has on the macro economic objectives. In other words the emphasis should not be placed on the range but how that range does affect other economic variables. On the question that seeks to ascertain whether the SARB does experience any pressure from the alliance partners. SACP & COSATU participants insisted that they will continue debating about inflation targeting, but whether that amount of pressure will continue, they would not comment further.

With new administration which is perceived to be pro-left, the writing is on the wall that they would seek to implement Polokwane policies and Economic Summit Resolutions. There is a huge possibility that the inflation band might be revised. When looking at the impact of the foreign exchange on the inflation, weak currency results to South Africa importing inflation.

The study observed that current global economic meltdown has shown clear indication that economic performance today does not guarantee good performance in the future. In conclusion, this study has achieved what is set to achieve i.e. an analysis of perspective of inflation targeting with the view to contribute on the ongoing debate of inflation targeting. Inflation targeting transparency has attracted unnecessary attack to the central bank. Where platform is provided to debate inflation targeting related matters, it is imperative that such a platform is not used as a tool to discredit central bank. Amongst the key imperatives of inflation targeting includes effort to communicate with public about plan and desired outcomes of monetary policy makers, thus increases accountability of the central bank.

This analysis will contribute in channeling inflation targeting debates to a constructive one. It also suggests fundamental policy shift to support industrial policy. The manipulation of interest rates is vital to ensure that industrial policy does achieve its goals. The interest rate through the monetary transmission mechanism has s direct influence over credit, asset price expectations and exchange rates.

5.3 Limitation and future research

The study suffered from at least two limitations, Firstly although inflation targeting is ideal for South Africa, but any inflation targeting debate is easily politicized, that turn to raised concerns about political maturity of this country. Academics and analysts that were interviewed were particularly uncomfortable to answer certain questions and the researcher had to rephrase those questions. Secondly the study suffered from inflation targeting bias that is to a large extent all the materials consulted was in favour of inflation targeting.

Among the findings of the study, it was found that the SARB does not have mandate to target any kind of economic growth rate other than striving to achieve and maintain price stability. However that does not mean that economic growth is not taken into account when interest rate decisions are made. Most of the participants suggested that the interest rate is not the only variable to control inflation.

There were few questions that might lead to future research such as to what extent do the political forces from the left have on the tripartite Alliance with regard to monetary policy. Another question that might suggest a complete scrapping of inflation targeting could be what is the alternative monetary policy that the SARB should pursue?

Another area which can prompt future study is to look at assigning price stability as the single policy objective or by assigning dual target for inflation and output provided they are consistent as it is argued in the Democratic Alliance document 2009 (DA Discussion Document, 2008).

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Appendix A: Selected central bank interest rates

Countries	1 Jan 2008	27 Oct 2008	Latest decision (change in percentage points)	
United States	4,25	1,50	8 Oct 2008	(-0,50)
Japan	0,50	0,50	14 Oct 2008	(0,00)
Euro area	4,00	3,75	8 Oct 2008	(-0,50)
United Kingdom	5,50	4,50	8 Oct 2008	(-0,50)
Canada	4,25	2,25	21 Oct 2008	(-0,25)
Denmark	4,25	5,50	24 Oct 2008	(+0,50)
Sweden	4,00	3,75	23 Oct 2008	(-0,50)
Switzerland	2,75	2,50	8 Oct 2008	(-0,25)
Australia	6,75	6,00	7 Oct 2008	(-1,00)
New Zealand	8,25	6,50	23 Oct 2008	(-1,00)
Israel	4,25	3,50	27 Oct 2008	(-0,25)
China	7,47	6,93	8 Oct 2008	(-0,27)
Hong Kong	5,75	2,00	9 Oct 2008	(-0,50)
Indonesia	8,00	9,50	7 Oct 2008	(+0,25)
Malaysia	3,50	3,50	24 Oct 2008	(0,00)
South Korea	5,00	4,25	27 Oct 2008	(-0,75)
Taiwan	3,375	3,25	9 Oct 2008	(-0,25)
Thailand	3,25	3,75	8 Oct 2008	(0,00)
India	7,75	8,00	20 Oct 2008	(-1,00)
Brazil	11,25	13,75	10 Sep 2008	(+0,75)
Chile	6,00	8,25	9 Oct 2008	(0,00)
Mexico	7,50	8,25	17 Oct 2008	(0,00)
Czech Republic	3,50	3,50	25 Sep 2008	(0,00)
Hungary	7,50	11,50	22 Oct 2008	(+3,00)
Poland	5,00	6,00	24 Sep 2008	(0,00)
Russia	10,00	11,00	11 Jul 2008	(+0,25)
Turkey	15,75	16,75	22 Oct 2008	(0,00)
Iceland	13,75	12,00	15 Oct 2008	(-3,50)

Source: National central banks

Appendix B: IMF projections of world growth and inflation for 2008 and 2009*

	Real GDP		Consumer prices**	
	2008	2009	2008	2009
World	(3,7) 3,9	3,0	(4,7) 6,2	4,6
Advanced economies	(1,3) 1,5	0,5	(2,6) 3,6	2,0
United States	(0,5) 1,6	0,1	(3,0) 4,2	1,8
Japan	(1,4) 0,7	0,5	(0,6) 1,6	0,9
Euro area	(1,4) 1,3	0,2	(2,8) 3,5	1,9
United Kingdom	(1,6) 1,0	-0,1	(2,5) 3,8	2,9
Other advanced economies	(3,3) 3,1	2,5	(3,0) 4,4	3,3
Other emerging-market and developing countries	(6,7) 6,9	6,1	(7,4) 9,4	7,8
Africa	(6,3) 5,9	6,0	(7,5) 10,2	8,3
Central and eastern Europe	(4,4) 4,5	3,4	(6,4) 7,8	5,8
Commonwealth of Independent States	(7,0) 7,2	5,7	(13,1) 15,6	12,6
Developing Asia	(8,2) 8,4	7,7	(5,9) 7,8	6,2
China	(9,3) 9,7	9,3	(5,9) 6,4	4,3
India	(7,9) 7,9	6,9	(5,2) 7,9	6,7
Middle East	(6,1) 6,4	5,9	(11,5) 15,8	14,4
Western hemisphere	(4,4) 4,6	3,2	(6,6) 7,9	7,3

* IMF projections for 2008 as at April 2008 in parentheses
** Zimbabwe excluded

Source: IMF *World Economic Outlook*, October 2008