

Chapter 6

South Africa's experience with monetary policy within an inflation-targeting policy framework

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This chapter discusses the South African experience with inflation targeting (IT). The author describes the institutional underpinnings of monetary policymaking in South Africa, including the instruments that have been put in place since introduction of IT to strengthen the central bank's communication with market participants and the public in general. On discussing the main features of the South African regime, he contends that monetary policy has become more forward-looking following the introduction of IT.

Introduction

The evidence in favour of choosing inflation targeting (IT) as the framework for monetary policymaking has become very persuasive in the case of industrialised, non-industrialised and emerging-market/developing economies. There is increasing consensus that central banks that adopt an IT-based monetary policy framework contribute to improving their countries' economic performance by reducing uncertainty about economic policies. Many countries, including South Africa, have in recent years questioned what should replace monetary aggregates or exchange rates as anchors for monetary policy, hence IT has been the flavour of numerous central banks in recent times. This chapter will briefly outline how IT has worked in South Africa and the extent to which this monetary policy framework has lived up to expectations since it was introduced in February 2000.

The inflation target in South Africa

The monetary policy framework of the South African Reserve Bank (SARB) comprises an inflation target that is set by the government. A target range was announced by the Minister of Finance for the first time in February 2000. At that time actual inflation fluctuated around 7%. An important decision that had to be taken in setting the targets for the years subsequent to 2002 was whether a target for one year should be announced, or whether a multi-year path should be specified instead. It was decided to set annual targets without a specific indication of the full disinflation path. This would allow policymakers slightly more flexibility in setting the monetary policy stance. The objective was to bring inflation down to acceptable levels, while implicitly recognising that an excessively fast reduction in inflation to within the target range through high interest rates, would have had high costs in terms of output foregone.

The target has been altered several times since February 2000. The initial target range was set as an annual average rate of increase in the CPIX (the consumer price index excluding mortgage interest costs) of 3-6% for the calendar year of 2002. This range was maintained for 2003, while a range of 3-5% was announced for 2004 and 2005. In October 2002, when it became clear that the inflation target would be missed for a fairly protracted period due to a sharp depreciation of the exchange rate and a number of other exogenous shocks, it was agreed that the target range would once again be 3-6% for 2004. In February 2003, the target range for 2005 was maintained at 3-6%. In November 2003 it was decided to discontinue the average calendar-year specification for the target, because it complicated the implementation of IT and could lead to inconsistencies in monetary policy, adding to interest-rate

volatility and leading to ineffective management of inflation expectations. The annual average was then replaced by a continuous target of 3-6% for the period beyond 2006. This revision potentially reduced the interest-rate volatility that might have ensued from de facto progressively shortening the target horizon towards the end of each year in a dispensation where annual average inflation is targeted.

Autonomy of the South African Reserve Bank

Subsequently to the introduction of IT, a joint National Treasury/SARB Inflation Targeting Technical Committee was established to maintain regular contact and to consult on technical issues relating to the monetary policy framework. This committee serves as an advisory body to both the Minister of Finance and the Governor of the Bank. The final decision on the inflation target regime is reached at cabinet level. Decisions relating to the implementation of monetary policy remain under the purview of the SARB; in other words, full instrument independence is maintained by the Bank.

The Monetary Policy Committee (MPC)

The MPC currently has seven members: the SARB Governor, two Deputy Governors and four senior central bank officials. The MPC will be expanded again to eight members when the vacant position of a Deputy Governor is filled. Meetings are held on even months of the year, but there is continuous monitoring of economic developments, particularly those that impact on monetary policy. Unscheduled meetings may be called if the need arises, as it was the case in January 2002.

The MPC cycle begins in earnest, approximately two to three weeks prior to the scheduled meeting, when MPC members meet with the Macro Models Unit of the Bank's Research Department and provide inputs to be used in generating economic forecasts. The first day of the scheduled MPC meeting starts with presentations on items of topical interest that are prepared on an *ad hoc* basis, usually at the request of the MPC. A review of economic and financial developments then follows, which entails presentations on different aspects of the economy prepared by various departments of the SARB and presented by senior staff members. The following morning begins with a summary of the discussions of the previous day, followed by a discussion of the monetary policy stance by the committee members only. In general, decisions are taken by consensus or with a majority view, without a formal vote. Once the decision is taken, the statement to be issued is finalised and is released to the press at the same time as the Governor reads the statement live on national television.

The inflation forecast

An important implication of the introduction of IT in South Africa was that monetary policy had to become more explicitly forward-looking. Like in most inflation targeters, monetary policy decisions in South Africa are made on the basis of current and expected developments in a number of variables, which are also the main drivers of the SARB's forecasting models. The MPC monitors a number of factors that influence inflation, including changes in wage settlements, productivity and unit labour cost; the output gap; money supply and credit extension; exchange-rate developments and the prices of imports including oil; and administered prices. There is no target for any of these variables other than CPIX, which is the benchmark for monetary policy decisions. Clearly, greater emphasis is now placed on the inflation forecast than before the introduction of IT.

The MPC uses a fan chart to assess the risks inherent in the forecast and to communicate to the public the uncertainties that lie ahead. The SARB publishes the current fan chart in the six-monthly *Monetary Policy Review*. The fan chart allows the MPC to focus its discussions on the potential future upside and downside risks and, more particularly, on the possible effect of these risks on inflation.

The explanation clause

A letter to the Governor of the SARB from the Minister of Finance at the inception of IT contained an "escape clause" suggesting that failure to meet the inflation target would not be considered in breach of the central bank's commitment, if it were due to an uncontrollable ("exogenous") shock of a temporary nature. It would nevertheless require a full explanation on the part of the SARB. Such a deviation from the target could occur, for example, due to the first-round effects of a sudden rise in oil prices or a drought affecting food prices, over which monetary policy has little immediate influence. The escape clause was designed to create more transparency about the discretion the central bank must use in these circumstances.

In November 2003, the SARB in consultation with the National Treasury rephrased the escape clause to achieve greater flexibility and clarity into a forward-looking "explanation clause" that reads as follows: "When the economy is buffeted by a supply side shock similar to those envisaged by the original escape clause that will take inflation outside the target range (*e.g.* an oil price shock, a drought, a natural disaster, or financial contagion affecting the currency), at the subsequent meeting of the Monetary Policy Committee, the SARB will fully inform the public of the nature of the 'shock', the anticipated

impact on CPIX inflation and the monetary policy response to ensure that inflation returns to the target and the timeframe over which this will occur” (Medium Term Budget Policy Statement, 2003).

Assessing the performance of IT in South Africa

In assessing the current policy framework, it is important to ask whether or not it has made a difference. Mishkin and Schmidt-Hebbel (2007) show that IT does indeed make a difference, as inferred from panel evidence for IT countries and a control group of high-achieving industrial countries that do not target inflation. They also acknowledge the importance of controlling for various factors when comparing these countries. It is important to acknowledge at the outset that other important factors also need to be taken into account when assessing the performance of IT in South Africa. For example, government has established a sound and sustainable macroeconomic platform over the past decade by improving tax administration, steadfastly abiding by expenditure limits and moderating the level of government debt. The greatly improved government finances and better co-ordination between monetary and fiscal policies have provided the solid foundations required for the favourable evolution of key macroeconomic indicators in South Africa.

The evolution of key macroeconomic indicators

The explicit forward-looking nature of IT has resulted in far greater stability in real and nominal interest rates in South Africa. This is reflected in their less vigorous response to events, such as the oil price shocks in recent years, and sizeable exchange-rate movements in 2000 and 2001. Excessive focus on or targeting of these variables would probably have resulted in greater variability in interest rates.

Recent analysis of whether IT has reduced interest rate and output volatility also examines how policy has reacted to external and domestic shocks. Indeed, South Africa could not escape the inflationary consequences of the sharp depreciation of the rand at the end of 2001 or the impact of high international crude oil prices. In their findings, Aron and Muellbauer (2006) argue that, since the introduction of IT in South Africa in February 2000, the volatility of headline CPI inflation initially rose substantially, given the weight of the mortgage component of the CPI and the decrease in the volatility of nominal interest rates. Although the volatility of output growth remained very similar to that observed in the four-year period prior to introduction of IT, the growth rate improved significantly. This can be regarded as a significant achievement, given the shocks that hit the economy during the IT period: the tail-end of the 1998 exchange-rate shock and the policy response to it, and the

exchange-rate shock of 2001, as well as shocks to South Africa's most important trading partners.

The credibility of monetary policy

An analysis of inflation expectations before and after adoption of IT reveals that there has been convergence to the target, and that monetary policy credibility has improved significantly. The survey of inflation expectations that is conducted on behalf of the SARB by the Bureau for Economic Research (BER) of the University of Stellenbosch asks households, trade unions, businesses and financial analysts what their expectations are for average CPIX and CPI inflation in the forthcoming calendar year and for the year thereafter. Examining these expectations since the introduction of the survey of inflation expectations reveals that they have generally remained within the target range over time, and agents' expectations have indeed converged. This is encouraging evidence in favour of improved monetary policy credibility in South Africa.

Monetary policy transparency

In recent years governments have increasingly granted independence to central banks but have also been requiring more accountability for their actions. At the same time, the trend towards greater transparency and openness of central banks has improved accountability. In its experience with IT, South Africa has observed that greater policy transparency has positively influenced the effectiveness of monetary policy by assisting in anchoring agents' inflation expectations around a credible target. The view is that this in turn assists in increasing the predictability of interest rate policy, as well as lowering interest rate volatility, and therefore uncertainty in the economy.

The Bank's transparency has improved greatly under IT. The SARB has placed increased emphasis on transparency, since the adoption of the IT framework.¹ In previous policy regimes in South Africa there was no explicit benchmark against which the performance of the central bank could be assessed objectively, but under IT the government sets a specific target range for a particular price index to be achieved within a specific timeframe. Adoption of IT has been accompanied by major improvements in the SARB's communication with the public and markets. Examples are the biannual Monetary Policy Review, the monetary policy statements and the national and regional Monetary Policy Forums. The Governor holds regular consultations with the Minister of Finance, as directed by the Constitution and required for sound macroeconomic policy co-ordination. He also has periodic discussions with members of the Parliament Portfolio and Select Committees on Finance.

Inflation forecast errors

The Bank's forecasters regularly examine their performance in order to improve their forecasting capacity, models and modelling techniques, and to examine their understanding of the workings of the South African economy. This practice is followed by most inflation tagerters, since monetary policy is in essence forward-looking, and models and forecasts play an important role in the policy formulation process. The accuracy of the forecasts of CPIX inflation, when using the Bank's models, is compared with alternative forecasts; including a naive forecast, forecasts by individual agencies and the Reuters Consensus Forecast.

The SARB forecast on the basis of its core model has consistently performed better than those of the other 22 individual agencies included in the Reuters Consensus Forecast with respect to the one-, two- and three-quarter-ahead forecast period. SARB forecasts rank fourth with respect to the four-quarter-ahead forecast period. Comparisons of the inflation forecast errors across the different horizons reveal that, on average, no other forecasting agency has consistently produced more accurate inflation forecasts than the SARB in the period May 2003 to December 2005. Furthermore, the analysis shows that the Reuters Consensus Forecast performs generally better when compared to most individual forecasters.

Remaining policy challenges

CPIX inflation remained within the 3-6% target range from September 2003 to March 2007. In April 2007 the CPIX inflation rate breached the upper limit of the inflation target range and remained above the upper limit in subsequent months. It is projected to return to within the inflation target range in the course of 2008; currently monetary policy is relatively tight to ensure this outcome, leading to discomfort of and criticism by interest rate sensitive debtors. Review of the target range may be necessary; ultimately, the inflation rate will have to approach the level of inflation in South Africa's major trading partners. As Van der Merwe (2004) argues: "If a country's inflation rate is significantly higher than those of its most trading partners or competitors it could result in a loss of price competitiveness over time and generally unstable economic conditions".

A number of aspects have been proposed by Aron and Muellbauer (2006) as being important to further improving IT in South Africa, including publishing more detailed economic forecasts and annual evaluations of forecast errors; publishing (non-attributed) minutes of Monetary Policy Committee (MPC) meetings; giving a more detailed assessment of future economic

conditions in the MPC's monetary policy statement; and explicit future policy inclinations in MPC statements. Central banks in emerging-market economies and developing countries most certainly have to ensure that the conduct of monetary policy is entirely consistent with international best practices. Although some of the aforementioned proposals and/or challenges are still deemed quite controversial in certain countries, a few of these proposals have already been, or are in the process of being, scheduled for review and consideration by the MPC.

Monetary policy challenges were debated at a seminar on IT held at the SARB in 2006 in the context of regional integration in the Southern African Development Community (SADC). Studies and important themes that were discussed included macroeconomic convergence in the SADC region, SADC country experiences with different monetary policy regimes, and IT in theory and practice. There was a large measure of agreement that sound monetary, fiscal, financial and structural policies are all essential pillars of economic success, with the effective conduct of monetary policy critical to every country's economic performance and prospects.

Conclusion

There have been important gains in the performance of monetary policy in South Africa since adoption of IT. The SARB's targeted measure of inflation remained within the inflation target range of 3-6% for 43 successive months to March 2007 before breaching it. Despite the fact that the past few years have been characterised by significant volatility and external shocks, inflation and output volatility have declined, with a substantial improvement in the growth rate of the South African economy since 2002. The elimination in 2003 of its large oversold international liquidity position has also reduced the vulnerability of the Bank. The SARB continued to accumulate foreign-exchange reserves for reducing short-term exchange-rate instability, and thus inflation and interest rate volatility.

Increased macroeconomic stability in South Africa will contribute to sustained financial stability and, if an increasing number of individual developing-country governments and their central banks succeed in delivering greater macroeconomic and financial stability in the years ahead, the performance of the global economy as a whole will improve significantly.

Note

1. For further discussion see Arora (2007).

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List of acronyms

ADF	Augmented Dickey-Fuller Test
AR	Autoregressive Model
BCB	Central Bank of Brazil (<i>Banco Central do Brasil</i>)
BER	Bureau for Economic Research
BI	Bank Indonesia
BIS	Bank for International Settlements
BRSA	Banking Regulatory and Supervisory Agency
CBC	Central Bank of Chile
CBT	Central Bank of Turkey
CDT	Colombian Interest Rate (<i>Certificado de Depósito a Término</i>)
CETES	Mexican Interest Rate (<i>Certificados de la Tesorería de la Federación</i>)
CMN	Brazilian National Monetary Council (<i>Conselho Monetário Nacional</i>)
CNB	Czech National Bank
COPOM	Brazilian Monetary Policy Committee (<i>Comitê de Política Monetária</i>)
CPI	Consumer Price Index
CPIX	Consumer Price Index (excluding mortgage interest costs)
DSGE	Dynamic Stochastic General Equilibrium
EMBI	Emerging Market Bond Index
FAVAR	Factor-Augmented Vector Autoregressive Model
FDI	Foreign Direct Investment
FIML	Full Information Maximum Likelihood
FPAS	Forecasting and Policy Analysis System
FTO	Fine-Tuning Operations
GDP	Gross Domestic Product
GNP	Gross National Product
IGP-DI	Brazilian General Price Index (<i>Índice Geral de Preços - Disponibilidade Interna</i>)

IMACEC	Chilean Monthly Economic Activity Index (<i>Indicador Mensual de Actividad Económica</i>)
IMF	International Monetary Fund
IMT	Inflation Management Team
INPC	Mexican Consumer Price Index (<i>Índice Nacional de Precios al Consumidor</i>)
IPC	Chilean and Colombian Consumer Price Indices (<i>Índice de Precios al Consumidor</i>)
IPCA	Brazilian Consumer Price Index (<i>Índice Nacional de Preços ao Consumidor</i>)
IRF	Impulse Response Functions
IT	Inflation Targeting
M-GARCH	Multivariate Generalised Autoregressive Conditional Heteroskedasticity Model
MPC	Monetary Policy Committee
MPR	Monetary Policy Report
OMO	Open-Market Operations
PP	Phillips-Perron Test
QPM	Quarterly Projection Model
SADC	Southern African Development Community
SARB	South African Reserve Bank
SBI	Bank Indonesia Certificates (<i>Sertifikat Bank Indonesia</i>)
SDIF	Savings Deposit Insurance Fund
SEE	Survey of Economic Expectations
SELIC	Brazilian Policy Interest Rate
SIC	Schwarz Information Criterion
TJLP	Brazilian Long-Term Interest Rate (<i>Taxa de Juros de Longo Prazo</i>)
TPM	Chilean Policy Interest Rate (<i>Tasa de Política Monetaria</i>)
TR	Brazilian Reference Interest Rate (<i>Taxa Referencial de Juros</i>)
UF	Chilean <i>Unidad de Fomento</i>
VAR	Vector Autoregressive Model
VMA	Vector Moving Average

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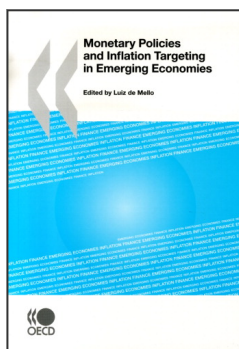
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