South Africa's Monetary Policy Framework

Continental Seminar of the AACB on Monetary Policy Frameworks in Africa in a a Changing Financial Landscape

Nairobi Kenya 13-15 May 2015

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Structure of the presentation

- South Africa's Monetary Policy Frameworks before Inflation Targeting
- Key aspects of Inflation Targeting in South Africa
- Assessment of the Inflation Targeting Monetary Policy Framework

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Table 1: Evolution of South Africa's monetary policy framework

Years	Monetary policy framework
1960 – 1981 ………………….	Quantitative controls over interest rates and credit
1981 – 1985 ………………….	Mixed system during transition
1986 – 1998 ………………….	Pre-announced monetary targets (M3)
1998 – 1999 ………………….	- Securities repurchase system (omo) - Pre-announced M3 targets - Informal targets for core inflation
2000 ………………………….	Formal inflation targeting

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Monetary Aggregate Targeting

- Assumes stable and predictable money demand function
- Advantage is that monetary aggregates are easily measurable and observable.
- With financial liberalisation, stable relationship broke down.

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The eclectic approach

- Included focus on a broad range of intermediate targets
- bank credit extension, overall liquidity in the banking sector
- yield curve and interest rates
- exchange rate, bop and reserves
- prices of financial assets

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Problems encountered

- Objective of monetary policy unclear, seemed to change
- No clear accountability
- Informal inflation target 1-5 %
- No specified time frame
- High degree of real interest rate variability

Table 2: Money supply growth and inflation outcomes from 1986 - 2005

Percentage change

Year	Money Growth Guidelines	Money Growth Actual	Inflation CPI	Inflation CPIX[3]
1986	16-20	9,3	18,6	
1987	14-18	17,6	16,1	
1988	12-16	27,3	12,9	
1989	14-18	22,3	14,7	
1990	11-15	12,0	14,4	
1991	18-12	12,3	15,3	
1992	7-10	8,0	13,9	
1993	6-9	7,0	9,7	
1994	6-9	15,7	9,0	
1995	6-10	15,2	8,7	
1996	6-10	13,6	7,4	
1997	6-10	17,2	8,6	
1998	6-10	14,6	6,9	7,1
1999	6-10	10,2	5,2	6,9
2000	6-10	6,8	5,4	7,8
2001		16,3	5,7	6,6
2002		19,5	9,2	9,3
2003		13,0	5,8	6,8
2004		14,2	1,4	4,3
2005 Nov		16,2	3,4	3,9

Source: South African Reserve Bank Quarterly Bulletin, various issues

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Target announced by Government

- South Africa formally adopted an inflation-targeting monetary policy framework on 23 February 2000 when the Minister of Finance announced an inflation target.

Key aspects of Inflation Targeting in South Africa

- Instrument independence
- Accountability and transparency
- Dimensions of the inflation target
- The monetary policy decision-making process

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Instrument Independence

- Inflation targets set by Treasury in consultation with the Reserve Bank.
- SARB has the necessary degree of instrument independence granted under the Constitution read together with the SARB Act.

Accountability and Transparency

- The inflation-targeting framework has substantially improved the accountability and transparency of monetary policy.
  - A clearly stated inflation target .
  - Governor reports quarterly to Parliament, where any target misses would be explained at sessions of the Governor with Parliamentary Portfolio Committee on Finance
  - Monetary Policy Review twice a year
  - Monetary Policy Statements
  - Monetary Policy Forums held twice a year in 9 provinces around the country
  - Interaction with various groups

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Dimensions of the Inflation Target

- 12-month CPIX measure of inflation must remain in the 3 to 6 per cent target range at all times
- CPIX measure excludes mortgage interest cost from the overall CPI measure
- CPIX was replaced by CPI headline inflation for all urban areas effective January 2009
- New CPI is based on the Classification of Individual Consumption by Purpose (COICOP)
- The new CPI introduced the owners' equivalent rent as a measure of owner occupied housing, replacing the mortgage interest rates

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The Monetary Policy Decision-making Process

- An 6-member MPC
- 6 scheduled meetings annually
- Bank analyses all available relevant data
- Intensive preparatory process
- Risks and uncertainties reviewed during meeting
- Monetary Policy Statement read by the Governor and published electronically

Review of the monetary policy process

Government sets inflation target (3-6%)

Reserve Bank has to keep inflation in target range

Bank's Monetary Policy Committee assesses inflation outlook

- Inflation likely to fall below 3% → Reduce repo rate
- Inflation likely to remain between 3 and 6% → Keep repo rate unchanged
- Inflation likely to exceed 6% → Raise repo rate

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Inflation “forecast” targeting

- The inflation target is the goal of policy rather than an intermediate target
- The intermediate target is the inflation forecast
- If the forecast is above the target, then it implies a tightening of policy and vice versa.

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Important requirements for IT

- A reasonable degree of credibility (including mutual commitment from central bank and fiscal authorities)
- Understanding of the transmission mechanism
- well developed forecasting models

Assessment of the Inflation Targeting Framework

- Initial target was for 3-6% for 2002 and has been unchanged
- CPIX inflation was on an upward path when the IT regime was introduced (at 7 %)
- Two major shocks since framework was adopted
  - A currency shock in year 2001
  - The global financial crises in 2007/8

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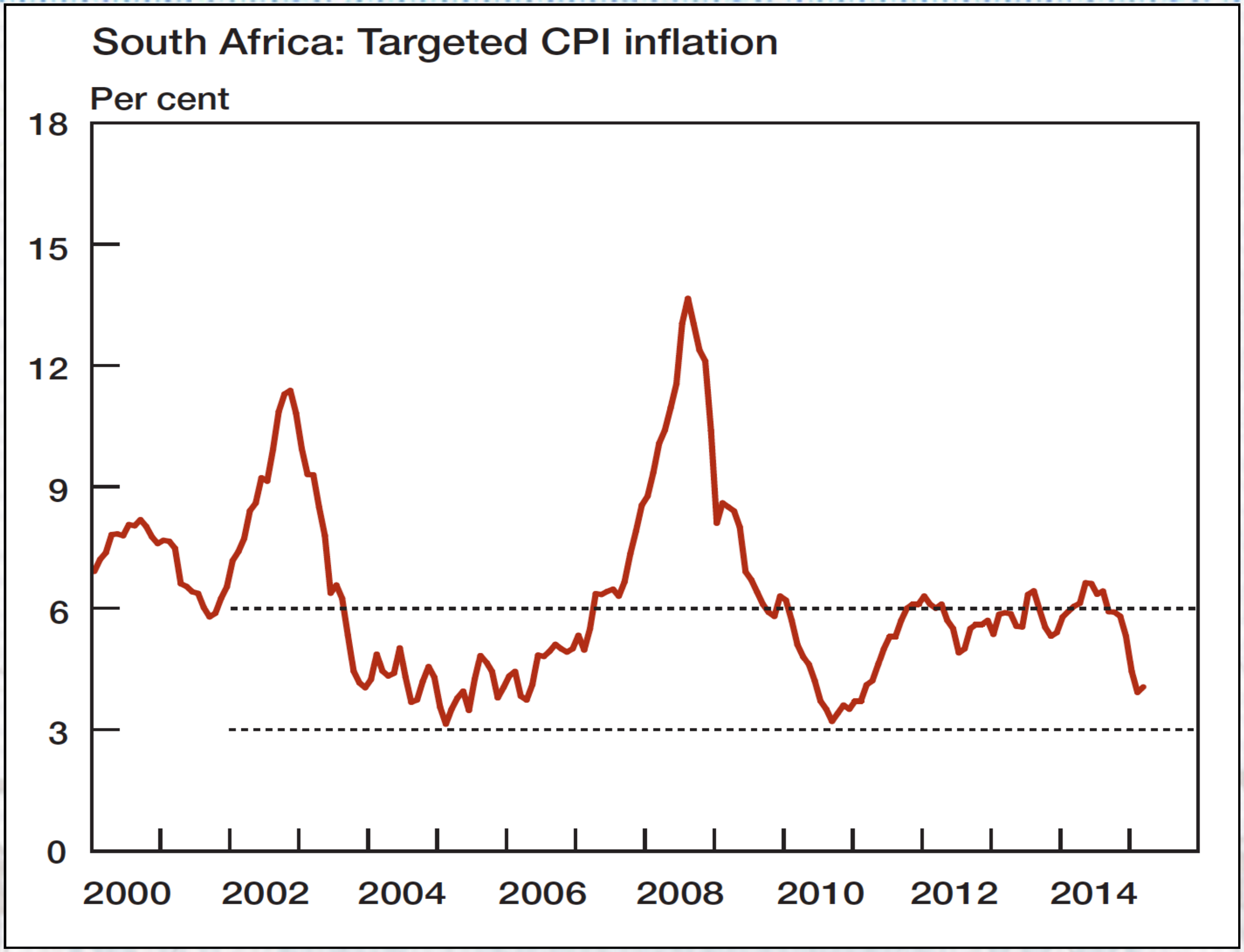

South Africa: Targeted CPI inflation
Per cent
18
15
12
9
6
3
0
2000
2002
2004
2006
2008
2010
2012
2014

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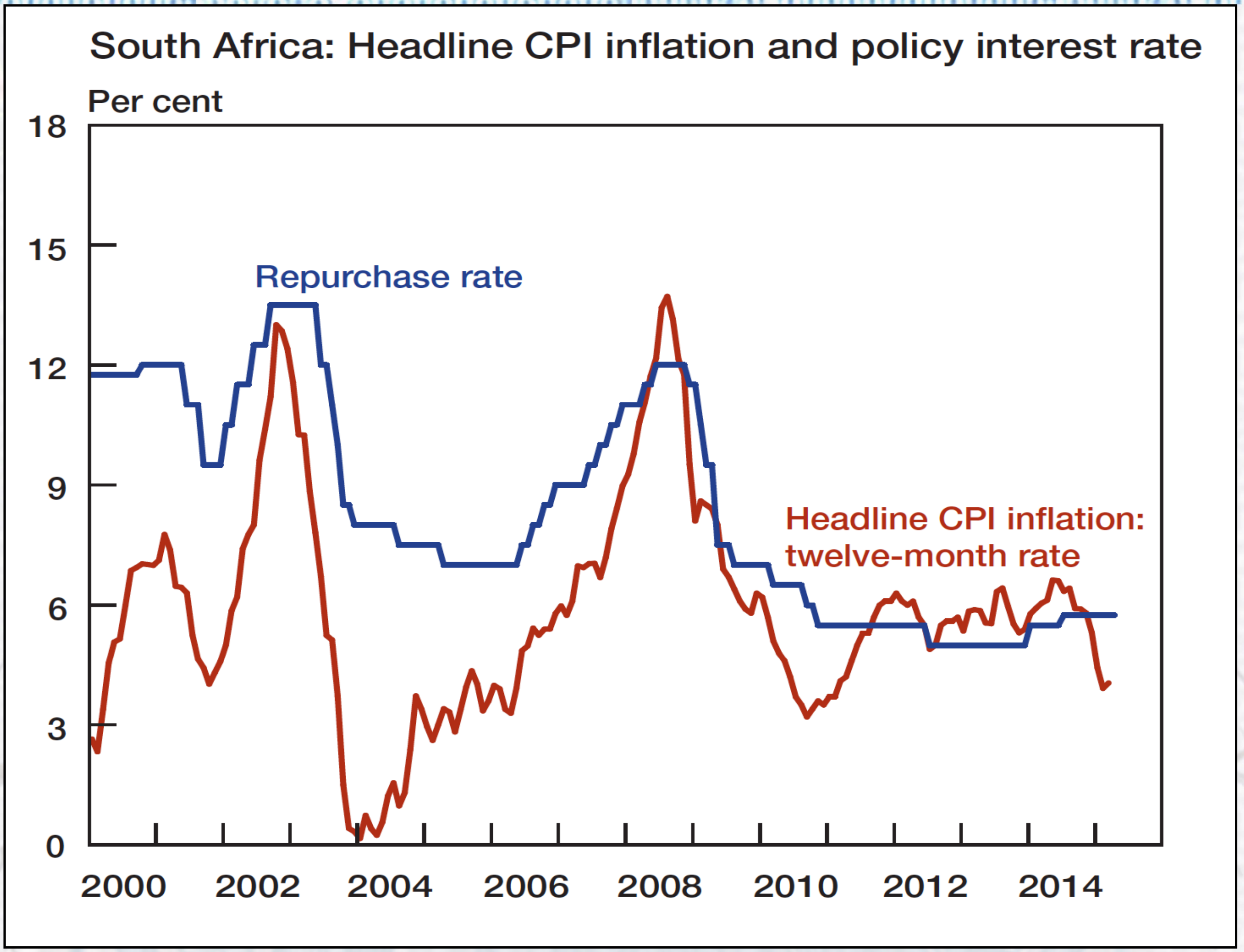
South Africa: Headline CPI inflation and policy interest rate
Per cent
18
15
12
9
6
3
0
Repurchase rate
Headline CPI inflation:
twelve-month rate
2000
2002
2004
2006
2008
2010
2012
2014

Assessment of the Inflation Targeting Framework

- Since February 2000, monetary policy has been forward looking.
- The policy allows for some discretion in the case of serious supply shocks to avoid costly losses in terms of output and jobs.
- Public acceptance of the price stability target has grown significantly and inflation expectations have become better anchored.

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Assessment of the Inflation Targeting Framework

- Inflation targeting has undoubtedly already reinforced the longer-term focus of monetary policy.
- The immediate effects of shocks are discounted by reverting to the question of what their consequences will be for inflation 18 to 24 months into the future.

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Advantages of IT

- More easily understood
- Enhances transparency
- Improves co-ordination between fiscal and monetary policy: budget targets have to be consistent with a projected inflation path.
- Increased co-ordination helps build credibility of macroeconomic frameworks
- Forward looking, avoids stop-go policies and should achieve smoother cycles.

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Policy Challenges

- Global financial integration has brought the problem of coping with movements in financial asset prices, including exchange rates.

- Central banks will have to continuously improve their forecasting procedures and their research on how monetary policy instruments affect inflation and economic activity.

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Policy Challenges

- Strict inflation targets could lead to output instability
- Could lead to excessive reliance on forecasting models

Final Remarks

- The best monetary policy choice implies pre-commitment, time consistency, transparency and accountability.

- South Africa's monetary policy framework now encompasses all these important factors.

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