South African Reserve Bank
90th
Anniversary

A perspective on monetary policy in South Africa

Remarks by Dr Monde Mnyande, Chief Economist and Adviser to the Governor, at a presentation hosted by the Institute for Futures Research at the Protea Hotel, Midrand, 21 June 2011

Introduction

This year, the South African Reserve Bank (the Bank) celebrates nine decades of existence. Having been established in December 1920, the country and the Bank have observed different levels of economic growth and have, as such, witnessed much economic turbulence.

The recent turbulence in international financial markets and the concomitant credit squeeze and impaired access to credit have once again amplified the role of monetary policy, globally and in South Africa.

Historically the core functions of the Bank, like that of most central banks, have essentially remained that of control over currency and maintaining the purchasing power of the monetary unit. In other words, the Bank's principal objective remains that of achieving and maintaining price stability – defined by Alan Greenspan, as "an environment in which inflation is so low and stable over time that it does not materially enter into the decisions of households and firms."

The Bank has used different monetary policy frameworks over time, such as credit ceilings and credit controls in the 1960s and 1970s, money supply growth targets from the middle of the 1980s, money supply growth guidelines by the early 1990s, an eclectic approach from the mid-1990s, and an inflation-targeting regime since February 2000.

The philosophy, style and methods of monetary policy formulation and implementation have undergone various changes since the Bank commenced operations in June 1921. The purpose of this presentation is to review monetary policy in relation to inflation, economic growth, the business cycle and ongoing economic debates from 1999.

Review of inflation targeting monetary policy approach

The Bank is one of some 27 countries that adopted an inflation-targeting framework after New Zealand had become the first inflation targeter in 1990. The first target set in South Africa was specified in terms of an average for a particular calendar year, 2002 in that instance. In November 2003 the Minister of Finance announced that the calendar-year averaging would fall away and that the target would apply continuously, while the “escape clause” was renamed an “explanation clause”, to help clarify the degree of flexibility given to the Bank in the conduct of monetary policy. Although the Bank has always accepted co-responsibility for preserving financial stability in the country, the Minister of Finance, during February 2010, reaffirmed the Bank’s role in overseeing and ensuring the strong prevalence of financial stability in the country in the interest of well-balanced long-term economic growth and development.

South Africa follows a “constrained discretion” flexible-inflation-targeting approach to monetary policy formulation. This implies that the Bank takes account of short-run output effects when deciding how rapidly inflation should return to within the official inflation target range.

The countries that have followed this approach in recent years have achieved greater stability of long-run inflation expectations and have achieved significant advantages in having clear objectives and targets in formulating monetary policy. In addition, inflation targeting implies a responsibility on the part of the Bank to achieve the predetermined inflation outcome rather than a direct emphasis on stabilising the business cycle – although monetary policy actions may contribute to the business cycle. The Bank aims to create monetary stability that, in turn, facilitates economic growth and much-needed development.

The inflation-targeting framework has generally been found to perform well as it tended to reduce levels of volatility in inflation, interest rates and output while the exchange rate pass-through moderated somewhat.

Broad trends in inflation since the introduction of inflation targeting

Since the inception of inflation targeting in South Africa, the targeted measure of CPI inflation has mostly remained within the inflation target range. However, there have been two periods of notable exception.

The first of these occurred during 2002 – the first year for which the inflation target was set. CPIX inflation picked up notably throughout 2002, due to an increase in international crude oil prices, a steep increase in domestic food prices and, in particular, imported goods prices, following the marked depreciation in the exchange rate of the rand in the second half of 2001.

The second period when inflation breached the upper limit of the inflation target range was from April 2007 until the end of 2009. The sharp depreciation in the exchange rate of the rand from May 2006 and sustained high and rising international crude oil prices, together with sharply rising international food prices, caused consumer price inflation to accelerate from about the middle of that year.

More recently, international food and crude oil prices have, once again, started to increase ominously. The effect of these increases on domestic inflation has been shielded somewhat by the continued strength in the exchange value of the rand, with headline CPI inflation picking up gradually and amounting to a year-on-year rate of 4,2 per cent in April 2011 – still well within the inflation target range. However, inflation expectations, as measured by the inflation expectations survey conducted by the Bureau for Economic Research at Stellenbosch University, point to an expected increase in targeted inflation to an average rate of 5, 3 per cent in 2011 and 5, 7 per cent in 2012.

The Bank's CPI forecast expects inflation to reach the upper limit of the target range during the final quarter of 2011 and to peak at 6, 3 per cent in the first quarter of 2012, before returning to within the target range by the second quarter of 2012 and remaining close to the upper limit of the range for the rest of that year. Inflation is expected to average 5, 1 per cent in 2011 and 6, 0 per cent in 2012.

Broad trends in the business cycle and economic growth since the introduction of inflation targeting

Owing to the complex developments in the global economy and collaborative measures taken by policy-makers of different economic clusters in response to the prevailing economic climate, it is almost impossible to discuss monetary policy in isolation. In addition, monetary policy is in many countries expected to play an increased role, especially during this period where the fiscal policy stance, for sustainability reasons, often reflects austerity measures. Nonetheless, the impact of monetary policy in minimising the fluctuations in economic activity or rather the relationship between monetary policy and the business cycle remains a focal point of today's deliberations.

Beryl. W Sprinkel (1986) describes a three-phased lagged approach in which policy reactions interact with the economic cycle. The first is the "observation lag" which is normally associated with uncertainty about contemporaneous economic activity. Data on activity initially contains mixed signals not allowing precise judgement on appropriate policy measures required to respond to economic conditions. Secondly, the “execution lag” where policy decisions are taken and implemented. This lag is usually shorter for monetary policy than that of fiscal policy due to the frequent meetings convened by the monetary policy authorities and relative ease with which monetary policy settings can be changed. Thirdly, the “impact lag”, which describes the lapsed time between a change in monetary policy and its ultimate influence on the economy. Thus, uncertainty about these time lags and the effects of monetary policy, and the magnitude and duration of economic cycles reflect the complexities in dealing with economic cycles.

The broad views about the effects of monetary policy on economic cycles can be addressed by reviewing, firstly, the role of monetary policy in stabilising output by minimising the deviations from the long-term growth trend. The biggest challenge for monetary policy, particularly in advanced economies, is to prove its effectiveness in stabilising output fluctuations in an environment of low inflation and financial crisis. Secondly, its ability to influence aggregate output and demand without compromising its primary objective of price stability. Lastly, the manner and transparency of implementation of monetary policy, for the sake of public information and influencing inflation expectations.

Preliminary indications are that the conduct of monetary policy under these considerations has generally led to, in addition to reduced output volatility, recession episodes becoming shorter and milder. Prudent macroeconomic policies are, of course, not solely responsible for this outcome. The improvements in technology, globalisation, deepened financial markets and financial liberalisation have also played a significant role in fostering higher productivity.

The aforementioned influences of monetary policy on the business cycle have indeed been observed in the South African economy and can be illustrated by comparing the growth and contractionary phases experienced during the period from 1990 to the first quarter of 2011 with those that occurred prior to the 1990s.

Prior to 1990, especially in the 1970s and 1980s, growth in real gross domestic product has been unduly volatile, leading to visible variations in the economic cycles that discouraged investment in South Africa. Over that period foreign direct investment into South Africa was virtually insignificant while portfolio flows almost dried up due to political sanctions and limited access to international capital markets. The lack of stable long-run economic growth partly reflected the absence of an appropriate domestic monetary policy strategy to deal with the economy.

As a result of short-lived monetary policy strategies prior to 1990, the real economic growth cycles tended to be short and somewhat volatile. However, as the monetary authority gradually gained a firmer footing on monetary policy strategies, especially towards the mid-1990s, the expansionary phases of the domestic economic cycles tended to have an extended duration while the contractionary phase, although sharp and painful at times, was relatively short.

Since the adoption of inflation targeting, the domestic economy has experienced one downward phase, which lasted for only 21 months from December 2007 to August 2009. During the two years prior to this downward phase the monetary policy stance was more restrictive in response to higher domestic prices. However, as the downward cycle resumed, the monetary authority eased the policy rate to minimise the impact of the global financial crisis and the subsequent reduced demand.

Turning to the upward phases of domestic economic cycles, the country has undergone three expansionary phases since 1990. These upswings were typically extended for a longer period and at a gradual pace. Both the first and second upward phases were accompanied by an average real economic growth rate of around 3, 5 and 4, 4 per cent respectively and a reduction in official policy rates. The first prolonged upswing that started in 1993 lasted for 36 months as the monetary policy authority developed better policy strategies. As monetary policy implementation improved with the adoption of inflation targeting in 2000, the second expansionary phase lasted even longer, 99 months from 1999 to 2007. In this phase, quarterly GDP growth rates reached 7, 4 per cent in the second quarter of 2005 and growth rates of above 6 per cent were recorded in several quarters between 2004 and 2007; evidence that the 7 per cent growth rates in the current economic growth debate are not with out precedent, although the challenge is to achieve them on sustain basis. The 2007/08 global financial crisis, which brought this cycle to an end, instinctively reminded us that despite our efforts and needs for a stable economic growth environment, we live in a world of booms and busts of economic activity.

During most of this phase, domestic monetary policy has been largely accommodative amid stable and gradually declining inflation. The sustained long-run growth alongside accommodative monetary policy was further encouraged by other complementary policies, including expansionary fiscal policy and enhancement of trade policies.

The current or third upswing is by now nearly 22 months long and its duration is largely dependent on, among other factors, sustainability of demand, capacity utilisation and employment levels. This phase is characterised by some structural supply-side constraints and, despite an extraordinary rise in international commodity prices, the volume of mining production has remained disappointingly unresponsive.

Infrastructural and capacity constraints coupled with the persistently high levels of unemployment continue to limit the growth potential of our economy in this cycle. These are critical issues that we should address jointly as households, business, labour, policy-makers and government.

As mentioned earlier, this era seems to be challenging for most monetary authorities, as monetary policy, amid the fiscal austerity measures taken by most governments, is expected to play a more visible role in reviving the economic activity in an environment of already low interest rates and mixed signals from short-term economic data. This scenario has led to some authorities leaving the economic cycle to be influenced by what we referred to earlier as the “observation lag”.

In exercising that option, the interest rates of most advance economies were left unchanged at low levels. In some emerging-market economies, the threat of a narrowing output gap has forced authorities to opt for the “execution lag” where policy rates were raised to avoid overheating of their domestic economies. In South Africa, although inflationary pressures are starting to set in, the Bank has kept the repo rate unchanged at its lowest level in 30 years. This stance has thus far been supportive to the real economic growth rate which has been increasing firmly since the rebound from the recession in early 2009.

Monetary policy is not conducted in isolation from ongoing economic debates in the country. The Bank, through its Outreach Programme, continuously engages stakeholders in the economy on a wide range of economic issues that are pertinent to monetary policy. Some of the issues covered include, but are not limited to, the level and volatility of the rand, the country’s reserves, growth and unemployment issues, national savings, administered prices, financial sector architecture, primary sector production capacity and architecture (e.g., nationalisation), as well as issues of resources and capacity (land, water, electricity, etc). These are important matters that the Bank takes into account in its policy-making and implementation processes.

Conclusion

In conclusion, allow me to summarise a number of points relevant to the present and likely future course of monetary policy:

- It is mostly agreed that stable monetary policy and the subsequent price stability, achieved through inflation targeting, are prerequisites for sustained long-run economic growth with less cyclical volatility as envisaged in the government's New Growth Path.

- The world space has changed tremendously over the past two decades; whereas double-digit rates of inflation were common in the 1970s and 1980s, discipline has been restored as far as inflation is concerned.
- South Africa is fortunate to be part of that more disciplined process, since there are no lasting benefits in embracing inflation, but many costs and frictions.
- Our world of lower inflation is also our world of lower nominal interest rates.
- Monetary policy now has clear, explicit objectives – inflation targeting has made this government policy transparent – and policy-makers are always mindful and conscious of the broader challenges of the economy and of financial stability considerations.
- The Bank participates vigorously in the ongoing economic debates to ensure its relevance and effectiveness in the macroeconomic policy space. Low inflation is in the interest of sustainable quality growth and development. What the Bank does – combating inflation – is in fact necessary in order to have a strong platform

from which growth and job creation by households and firms can take off materially and gain momentum.

Thank you