Recent Performance and Challenges for Monetary Policy in South Africa

Stan du Plessis
Department of Economics
University of Stellenbosch

Plan

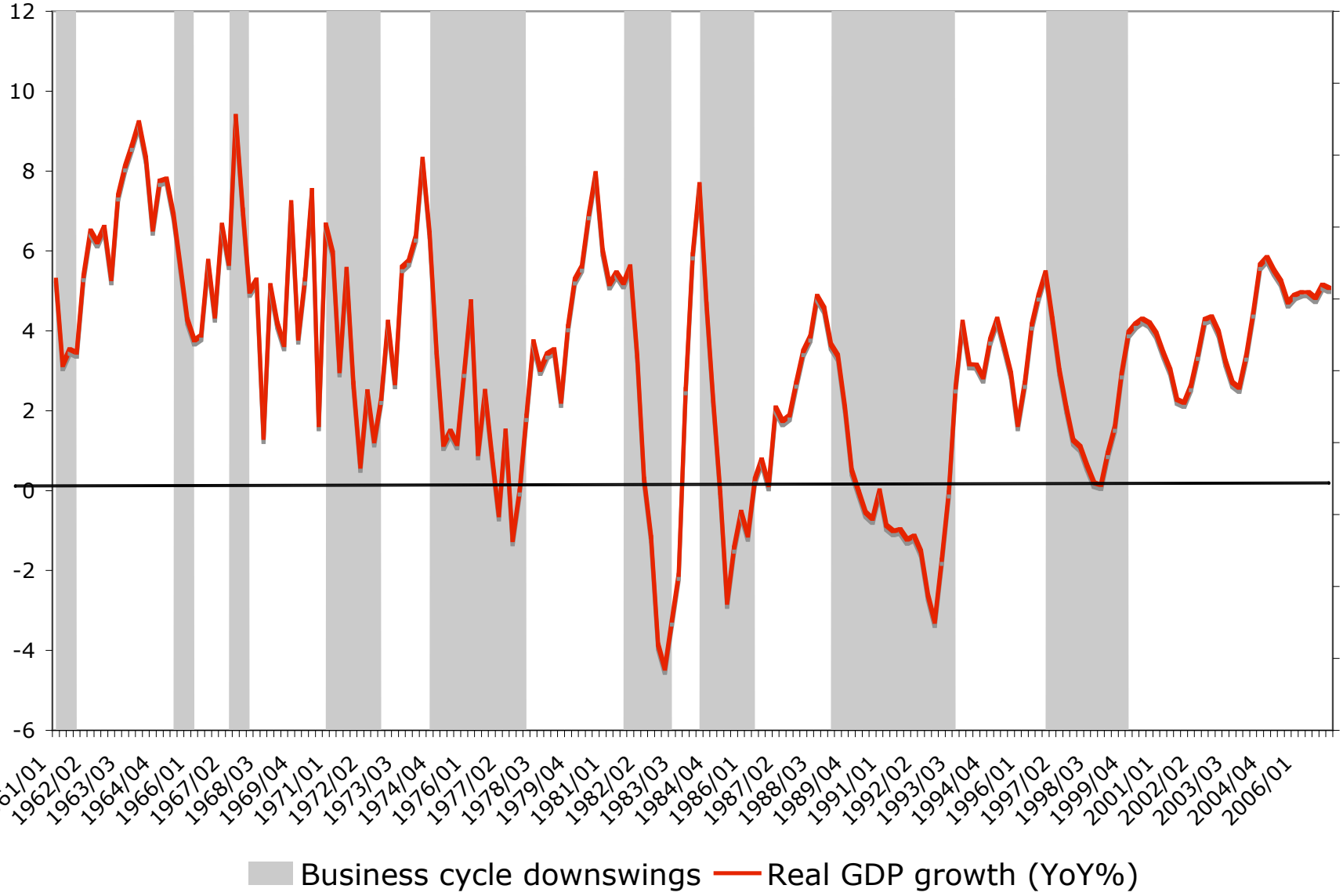
- Overview of policy performance
    - Data
    - Academic research
- Recent challenges
    - Local and international conditions
    - Flexibility and credibility
- New ideas

Data

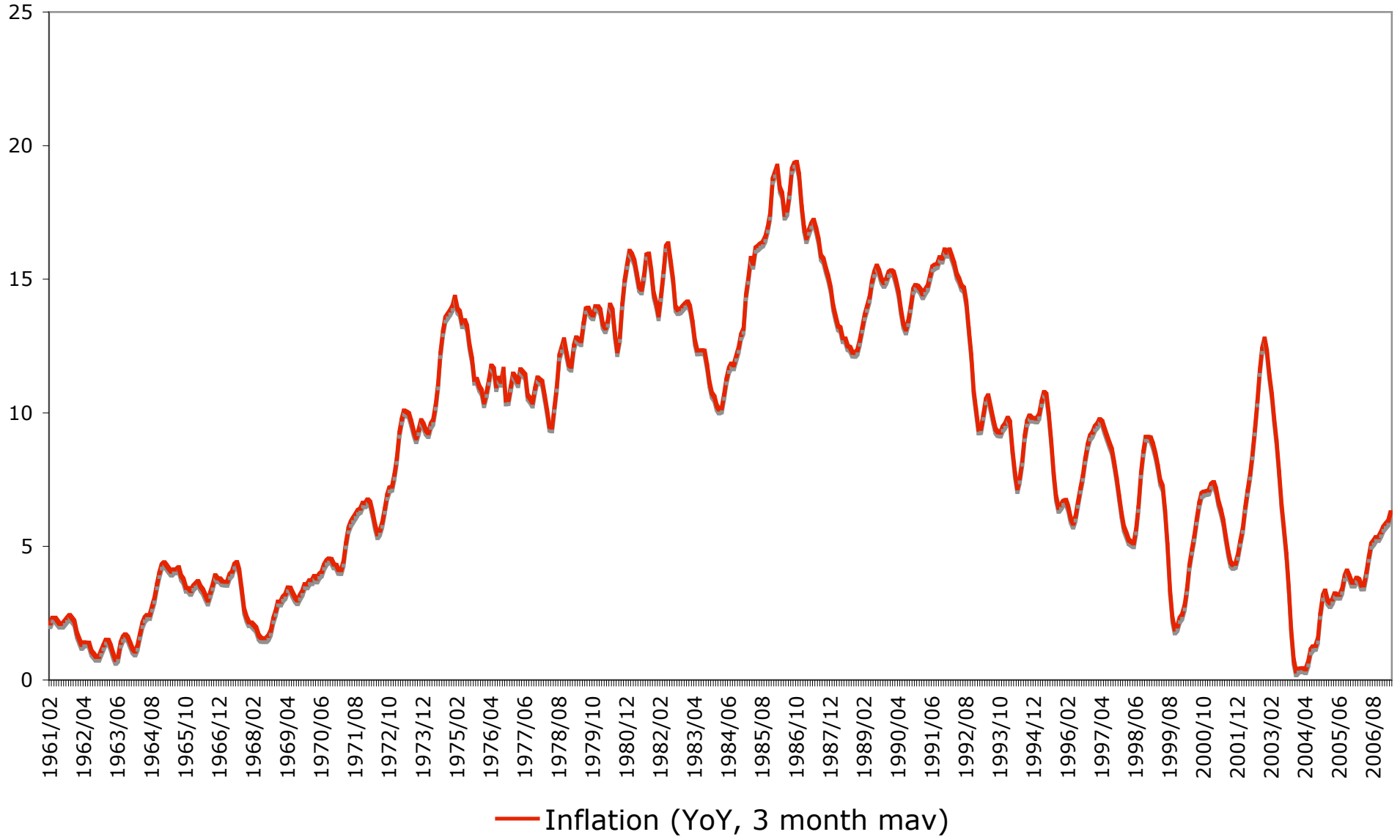
Favourable trends

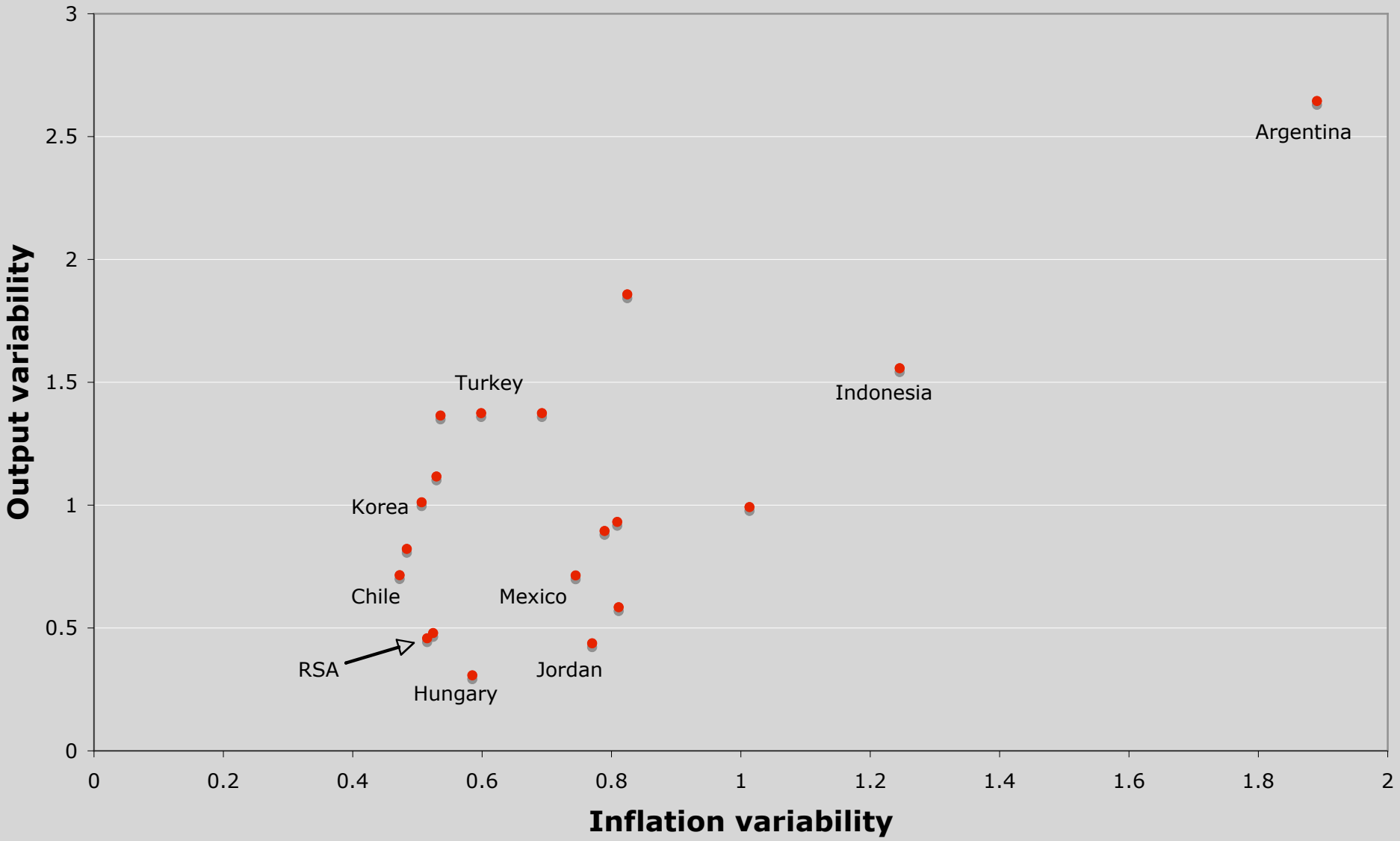
- Robust economic expansion
  - with high rates of real output growth
  - without disruptive imbalances
  - and low and stable inflation

Real GDP is growing faster, but not disruptively



Inflation remains low





International perspective

Output and inflation variability relative to the EME class, for the last decade

SA economy favourable trends

- Robust economic expansion
    - with high rates of real output growth
    - without disruptive imbalances
    - and low and stable inflation
- Policy has played an important role, but the degree is difficult to quantify

Recent academic research

Recent papers that evaluate monetary policy in SA

- Aron, J. and J. Muellbauer (2007). "Review of Monetary Policy in South Africa Since 1994." Journal of African Economies, forthcoming.

- Rigobon, R. (2007). Through the Pass-Through: Measuring Central Bank Credibility. Boston, MA, CID Working Paper No. 143, March 2007.

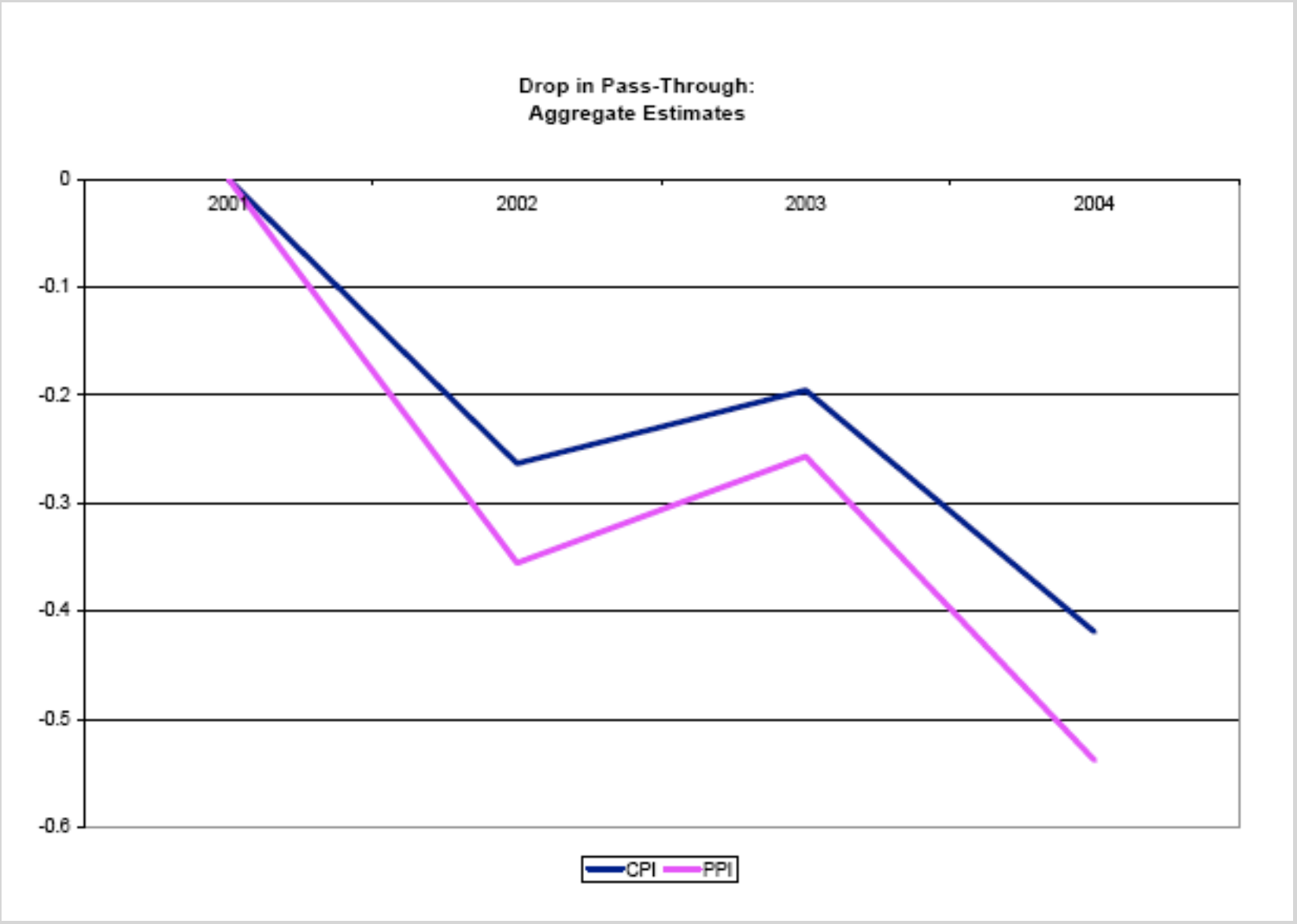
- Du Plessis, S. A., B. W. Smit and F. Sturzenegger (2007). The Cyclicality of Monetary and Fiscal Policy in South Africa since 1994. Stellenbosch, University of Stellenbosch, Stellenbosch working paper 12/2007.

Aron and Muellbauer (2007) on inflation expectations

- Used interest rate and inflation data to calculate
  - The improved predictability of inflation in SA
  - The anchoring of inflation expectations
  - Whether the real interest rate was indeed discouraging investment expenditure

Rigobon (2007) on “pass-through”

- Rigobon tests the credibility of monetary policy by considering the pass-through of exchange rate shocks to local prices
- He presents evidence at the economy-wide level and at the level of individual items
- The evidence shows a marked drop in the pass-through of exchange rate shocks
- Which is consistent with a large gain in credibility by the SARB since 2000
    - but the economy has also become more open,
    - and the world economy more benign



Rigobon's measure of rising credibility

The aggregate level drop in exchange rate pass-through

Du Plessis, Smit and Sturzenegger (2007) the "pro-cyclicality" of monetary policy

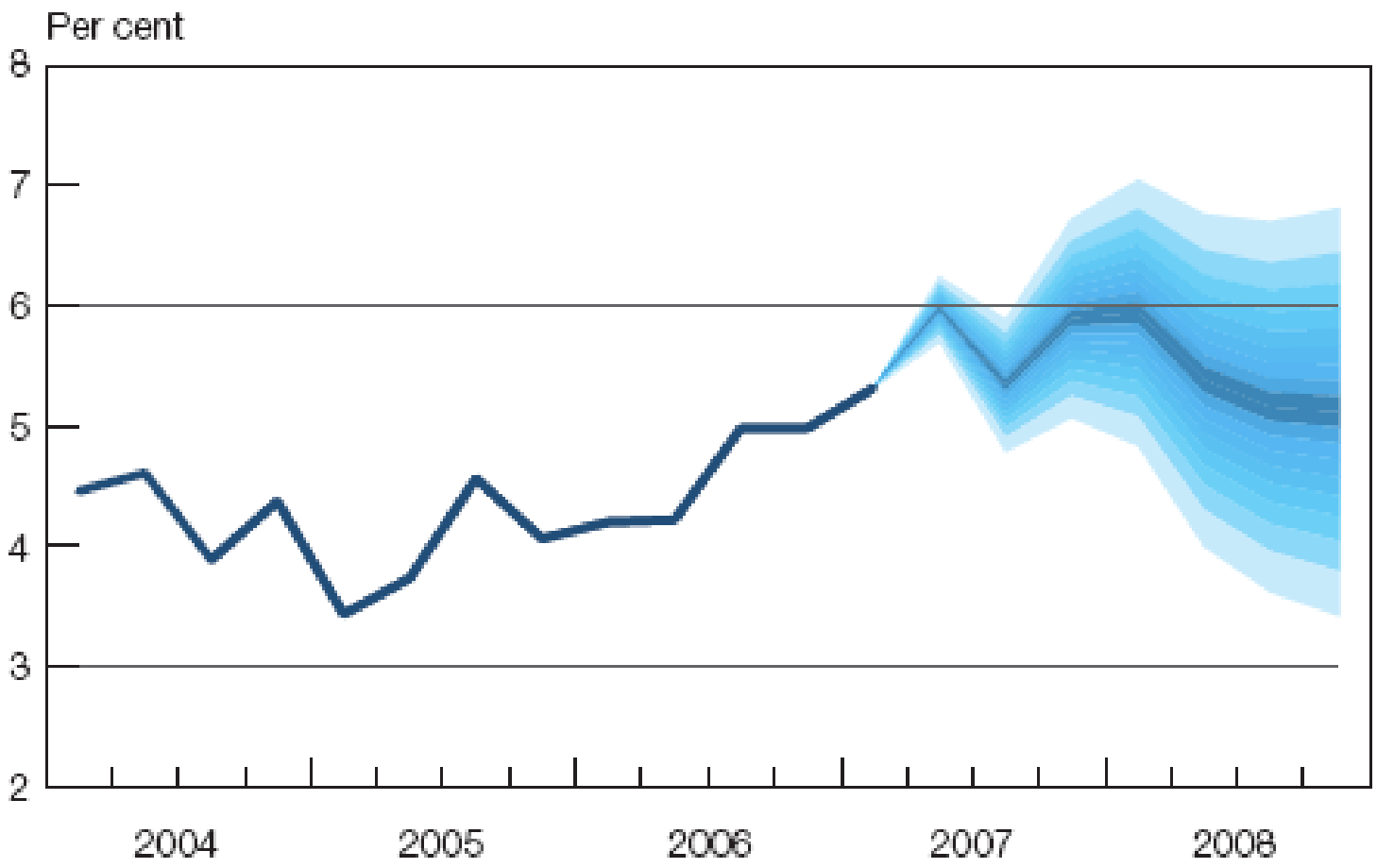
- We investigated the potential pro-cyclicality of monetary policy under inflation targeting
  - This is a theoretical possibility and a major criticism of IT
  - But flexible inflation targeting need not suffer this downside
- We used a small macro model to identify supply-side, fiscal and monetary policy shocks since the 1960s
  - We found that monetary policy has responded counter-cyclically to aggregate supply shocks
  - And in a policy simulation we calculated that monetary had contributed to overall economic stability since 1994

Recent challenges

A more difficult environment

- Internationally
  - international imbalances, food prices, energy costs
- Locally
  - rapid consumer spending (with large credit component), economic growth perhaps outpacing capacity, wage settlements and wage demands, administered prices

Figure 18 CPIX forecast



SARB's assessment of the risks

May 2007 "fan chart"

Survey conducted during	2007Q1				2007Q2			
	Analysts	Business people	Trade union officials	Average	Analysts	Business people	Trade union officials	Average
Overall CPI inflation during the year								
2007	5.6	5.1	5.2	**5.3**	5.7	5.3	5.4	**5.5**
2008	4.6	5.2	5.0	**4.9**	4.9	5.4	5.5	**5.3**
2009	4.7	5.3	5.2	**5.1**	4.5	5.5	5.4	**5.1**
CPIX inflation during the year								
2007	5.3	5.1	5.1	**5.2**	5.5	5.3	5.5	**5.4**
2008	5.0	5.2	5.1	**5.1**	5.0	5.4	5.5	**5.3**
2009	4.9	5.3	5.1	**5.1**	4.7	5.4	5.4	**5.2**

The benefits of credibility

BER's inflation expectations survey, Q2 2007

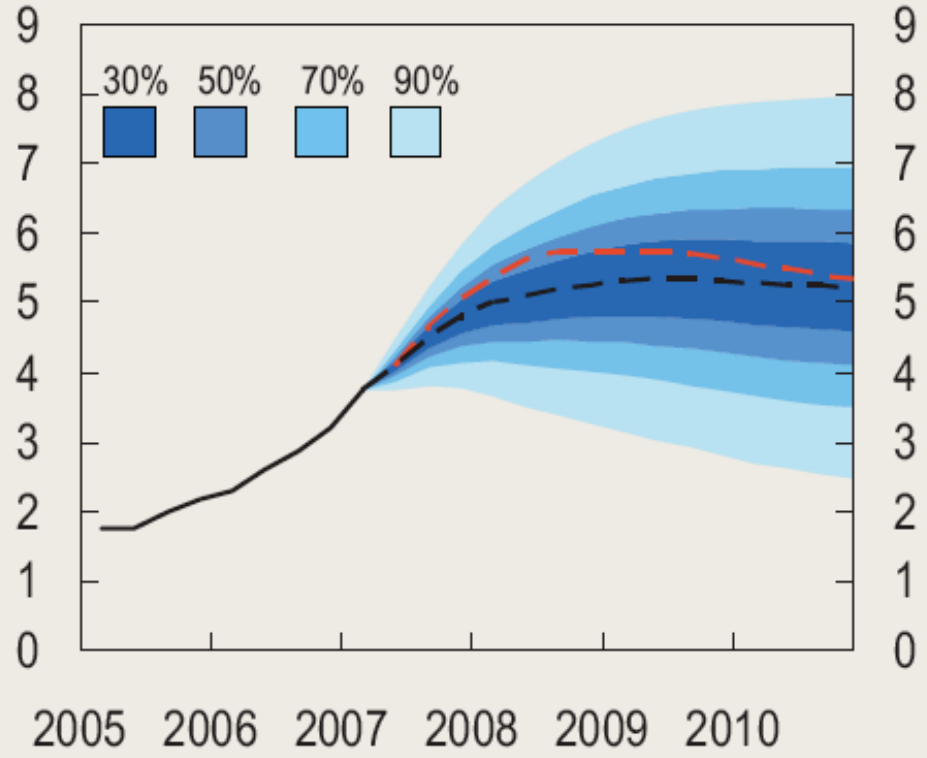
Monetary policy credibility

- A credible market-based monetary policy achieves decentralised co-ordination between wages and prices, and anchors both
    - It is a decentralised version of what failed attempts at wage-price controls attempted to achieve centrally
- A major benefit of such credibility is the flexibility gained by the monetary authorities to respond to shocks in a measured way
- It is now (in more difficult times) that we see the benefits of “flexible” inflation targeting

The SARB's challenge

- Observed inflation has moved outside the target range for the first time since September 2003
- Governor Mboweni and the MPC is right not to "fight the last battle"
- And can use their credibility and the open nature of IT to map a sensible path for forecasted inflation given the more difficult environment
- To this end I would like the MPC to consider publishing a forecasted path for the repo rate, by analogy with the fan chart for inflation
    - and move away from the constant interest rate basis for the "fan chart"
- This will be a projection (or forecast), not a commitment, but will help private sector decision makers appreciate the forward-looking character of credible monetary policy

Chart 3 Key policy rate in the baseline scenario in MPR 1/07 with fan chart and key policy rate in the baseline scenario in MPR 2/07 (red line). Per cent. Quarterly figures. 05 Q1 – 10 Q4



Source: Norges Bank

Example of an interest rate forecast

Monetary policy Report, Norges Bank, Q2 2007

end