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Assessing inflation targeting and its communication

It is less onerous to achieve policy objectives when they are clear, credibly implemented and appropriately communicated, all of which reduces uncertainty

What does the paper say?

A recent paper[1] finds that:

- The South African Reserve Bank's (SARB's) **monetary policy stance shifted to support increased economic activity**[2] in the wake of the 2008 global financial crisis. At the same time, the implicit inflation target – the implied point target within the SARB's 3-6% inflation range – rose.
- **From 2015, these trends reversed**. The SARB tightened its monetary policy and the implicit inflation target declined. The mid-point of the 3-6% range is now the preferred anchor for inflation expectations, and policy rate changes have become smaller and less frequent.
- **Communication on monetary policy has become more forward-looking and balanced**.
- **Monetary policy is gradually getting better at anchoring inflation expectations**. This means that policy rate changes are less significantly affecting inflation expectations of the general public, businesses, trade unions and economic analysts, implying that these groups find monetary policy credible and realistic.

In summary, the SARB has strengthened the credibility of monetary policy since 2008, with an inflation targeting framework that reduces uncertainty and interest rate volatility.

About the research

The study assesses:

- The **SARB's monetary policy stance** since 2000, when it adopted flexible inflation targeting. The Bank aims to maintain consumer price index inflation between 3% and 6% yearly.[3]
- Whether changes in the policy stance are reflected in **changes to the SARB's communication.**
- The **credibility** of the SARB's monetary policy.

[1] A. Coco and N. Viegi (2019). The monetary policy of the South African Reserve Bank: Stance, communication and credibility. ERSA Working Paper 788. Available at https://econrsa.org/publications/working-papers/monetary-policy-south-african-reserve-bank-stance-communication-and.

[2] In the technical term used in the study, the stance became more "accommodative". An accommodative stance refers to looser monetary policy that places greater emphasis on supporting output relative to containing inflation, implying lower interest rates. Tighter monetary policy implies the reverse.

[3] In 2015, the SARB's mandate was extended to include overseeing and maintaining financial stability.

What is the research context?

Countries that adopt an inflation targeting framework tend to experience lower inflation. However, these frameworks may result in excessive exchange rate volatility and sluggish economic performance. Previous studies suggest that South Africa's inflation targeting framework has been relatively successful at anchoring inflation expectations close to the target and containing the volatility of inflation.

How does it get to these findings?

Assessing the SARB's monetary policy stance

The study assessed the SARB's monetary policy stance using a rule ("the Taylor rule")[4] to **measure the responsiveness of the policy rate to changes in inflation, output and the real exchange rate over different time periods**. Between 2000 and 2018, the interest rate increased in response to an increase in inflation expectations or the output gap, and decreased when the real exchange rate appreciated. However, there were **differences at various times within this eight-year period.**

As South Africa targets inflation flexibly, the SARB can use its discretion to emphasise these variables based on economic conditions at the time. The SARB's monetary policy stance became **more accommodative in 2009,** after the global financial crisis, as it placed a relatively higher emphasis on economic output, leading to an increase in the inflation target. **After 2014**, when Governor Kganyago replaced Governor Marcus, **the stance tightened** as the emphasis on inflation increased and a series of supply-side shocks reduced the gap between the country's actual and potential economic output. As a result, the inflation target started declining.

After the crisis, the policy rate changes became less frequent and smaller in size. The authors suggested that this could be to contain the volatility of interest rates, in line with the SARB extending its mandate to include financial stability.

Communicating this stance

Effective communication is essential for the SARB to anchor inflation expectations and achieve its mandate. The study applied communication techniques[5] to assess how the SARB's monetary policy statements have changed over time.

Broadly, the SARB's communication changes consistently with the shift in stances described above. Between 2000 and 2009, the SARB's communication focuses on price and inflation developments, likely in an effort to establish the credibility of the new inflation targeting framework.

In 2009, the focus clearly changes, with more emphasis placed on talking about global and local growth. The communication becomes more negative in response to uncertainty about the impact of the crisis.

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[4] The Taylor rule is based on the principle that central banks should raise interest rates when inflation or employment is high, and decrease interest rates when inflation and employment levels are low.

[5] The techniques are taken from Natural Language Processing, a field of linguistics that uses technology to study human language.

From 2015, the communication changes again, becoming more neutral: growth concerns are replaced by a greater emphasis on inflation expectations and forecasts. This more forward-looking approach to communication is in line with other central banks around the world. The shift coincides with the change of leadership at the SARB, as Governor Kganyago took over from Governor Marcus in 2015.

Considering different measures of inflation expectations to assess credibility

The study used the following measures to assess the SARB's credibility in terms of anchoring inflation expectations:

- The reaction of **market interest rates** to monetary policy decisions.
- The response of **one-year, two-year and five-year inflation expectations** to the changes in actual inflation over the same periods.
- The **dispersion** of inflation **forecasts**.

All three measures confirm that the SARB has increasingly succeeded in anchoring inflation expectations over the last decade.

So what?

The study illustrates the interaction between the SARB's policy, communication and credibility. The authors found that the SARB has achieved a good level of credibility and reputation since implementing the inflation targeting framework. **Stronger credibility and communication means less frequent use of interest rates to manage inflation**.

Their findings are **consistent** with the **global move** towards more forward-looking, active communication (in place of frequent policy changes) from central banks, and with the **SARB's recent articulation** of 4.5% as the preferred anchor for inflation expectations. The authors also found some evidence indicating that expanding the SARB's mandate to include financial stability has affected monetary policy decisions by lowering the volatility of interest rates.