

ERSA Research Brief

Inflation targeting: how the SARB is succeeding in anchoring of inflation expectations

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Evidence suggests that the use of inflation targeting by the South African Reserve Bank (SARB) has supported the anchoring of inflation expectations in South Africa. This monetary policy success is gauged by measuring the sensitivity of inflation expectations to surprise movements in macro-economic variables.

In "The Sensitivity of South African Inflation Expectations to Surprises" (ERSA Working Paper no. 131), Monique Reid applies the methodology of Gürkaynak, Sack and Swanson to determine how responsive inflation expectations in South Africa are to unexpected shifts in key macro-economic variables. Her findings for South Africa compare favourably with those of countries in the original studies and support the view that inflation targeting is a useful framework for the management of private sector expectations. If correctly applied, inflation targeting improves the predictability of monetary policy, thereby facilitating the anchoring of inflation expectations.

Reid's conclusions are not pure praise for monetary policy, though: she points out that instances of market surprise in response of interest rate adjustments by the SARB suggest that there is scope for the policy maker to improve its communication.

She explains that credibility, transparency and accountability on the part of the central bank are the key to successful implementation of its policy. In particular, the commitment to rules-based policies – like inflation targeting – has become central to the implementation of monetary policy.

This policy transparency and credibility pave the way for less aggressive policy adjustments to maintain price stability, since "markets should believe that inflationary spikes are transitory". Since market players keep their expectations of long-term inflation at modest levels, "they would not adjust their market decisions in a way that adds upward inflationary pressure", Reid says.

Using daily data for South Africa, spanning five years to 2007, Reid measures the impact of surprise outcomes in key macro-economic data – CPIX inflation, PPI inflation, quarterly economic growth and the current account -- on inflationary expectations. The extent of the surprise was captured by calculating the difference between the actual outcome and the median forecast. Inflationary expectations were measured by isolating the difference between nominal and real forward interest rates.

The regressions yield results in line with those conducted for inflation targeters such as the UK, Sweden and Chile. Reid describes these findings as "encouraging", arguing that they confirm the usefulness of inflation targeting as a framework for monetary authorities to communicate with market players.

But Reid concludes with a warning that credibility building is not a once-off exercise: she urges the SARB to engage in transparent and predictable policy making on a continuous basis, as a means towards promoting coordination with financial markets.