Monetary Policy in South Africa: From 1994 to now

Policy Paper 39
March 2025

Nicola Viegi

About the ERSA 1994 to Now Policy Paper Series

ERSA Policy Papers typically address current issues pertinent to the national economic policy discourse. These papers aim to succinctly summarise a policy challenge and discuss its relevance, significance, and potential pathways forward for South African policymakers and researchers. They are primarily narrative-driven, drawing on existing research and descriptive analysis. We hope that, through this, ERSA can contribute to constructive and informed economic policy debate.

This paper is one of nine papers prepared for the 1994 to Now Policy Paper Series, prepared for the SALDRU, South Africa at 30 Years of Democracy Conference scheduled for 2-4 April 2025. The papers will be (were) presented at the conference with the aim of contributing to discussions and debates and fostering informed and constructive economic dialogue.

Fouché Venter

Executive Director

The views expressed in this economic note are those of the author(s) and do not necessarily represent those of Economic Research Southern Africa. While every precaution is taken to ensure the accuracy of information, Economic Research Southern Africa shall not be liable to any person for inaccurate information, omissions or opinions contained herein.

Monetary Policy: From 1994 to now

Handle with Care: A Brief History of Monetary Policy in South Africa

Nicola Viegi[1]

Abstract

The evolution of South Africa's monetary policy over the past three decades has demonstrated its ability to manage both external shocks and domestic economic volatility. The adoption of inflation targeting and the South African Reserve Bank's (SARB) role as a "credibility provider of last resort" have shaped monetary policy in response to the country's structural uncertainties. This paper reviews the trajectory of South African monetary policy from 1994 to the present, outlining key policy shifts, challenges, and outcomes. Monetary policy has a risk management function that is as important as its traditional monetary policy role. The evolution of the country monetary-fiscal policy framework should favour a reduction of long term inflation, and a reduction in the country risk to support an increase in productivity and a reduction in the economy cost-base.

Keywords: Monetary policy, inflation targeting, South African Reserve Bank, credibility, structural reforms.

JEL classification: E52, E58, O23.

1 Professor at the Economic Department of the University of Pretoria and Research Fellow at Economic Research Southern Africa

EXECUTIVE SUMMARY

The evolution of South Africa's monetary policy over the past three decades has demonstrated its ability to manage both external shocks and domestic economic volatility. The adoption of inflation targeting and the South African Reserve Bank's (SARB) role as a "credibility provider of last resort" have shaped monetary policy in response to the country's structural uncertainties. This paper reviews the trajectory of South African monetary policy from 1994 to the present, outlining key policy shifts, challenges, and outcomes.

The Evolution of Monetary Policy

Phase 1: 1994–1999 – Establishing an Institutional Framework

In the initial years of democracy, SARB operated under an eclectic monetary policy approach, balancing inflation control with exchange rate management. However, financial turbulence, such as the Asian financial crisis of 1997, exposed vulnerabilities in the existing framework, leading to high short-term real interest rate volatility. SARB struggled to stabilise inflation while managing capital flows, and monetary policy was often reactive rather than proactive. The need for a clearer and more structured policy framework became evident.

Phase 2: 2000–2008 – The Adoption of Inflation Targeting

Inflation targeting was introduced in 2000 to provide a more stable framework for monetary policy, reinforcing SARB's credibility and enhancing transparency. The approach allowed the central bank to smooth responses to external shocks while maintaining long-term price stability. Although the policy was tested by external shocks such as the post-9/11 currency depreciation, SARB successfully avoided drastic interventions, focusing instead on controlling second-round inflationary effects. The credibility gained during this period helped attract foreign investment, supporting economic growth. However, much of this growth was fuelled by favourable global conditions, including a commodity boom and strong capital inflows, rather than fundamental productivity improvements.

Phase 3: 2009–2014 – The Global Financial Crisis and Its Aftermath

The global financial crisis (GFC) posed a major test for South Africa's monetary policy framework. SARB responded with an accommodative stance, cutting interest rates to support economic activity. However, the crisis revealed deep structural weaknesses in the economy, particularly in labour markets, and highlighted the limits of monetary policy in stimulating long-term growth. Inflation expectations remained anchored but tended toward the upper bound of the target range (6%), signalling underlying economic fragility. Despite monetary easing, the economy failed to recover its pre-crisis momentum, leading to debates about the effectiveness of inflation targeting in the face of prolonged stagnation.

Phase 4: 2015–Present – Domestic Challenges and Economic Stagnation

Rising political and economic uncertainty post-2015 saw SARB actively reasserting its independence to maintain credibility. The fallout from the Marikana massacre, state capture, and weak growth intensified the country's economic risks, leading to an increase in the risk premium on South African assets. Government fiscal instability and concerns over debt sustainability created additional pressures. SARB's response, including targeted rate hikes and clearer communication on inflation targeting, helped stabilise expectations but could not offset broader economic weaknesses. The COVID-19 pandemic further strained the system, necessitating emergency monetary interventions, but these measures highlighted the limitations of monetary policy in addressing long-term structural problems.

Key Debates in Monetary Policy

The Role of Monetary Policy in Economic Stagnation

Critics argue that SARB's inflation targeting has been procyclical, exacerbating economic downturns by maintaining a high real interest rate environment. Some contend that a more flexible approach, incorporating growth objectives, could have mitigated economic stagnation. However, empirical analysis suggests that monetary policy has been largely countercyclical, with economic stagnation more attributable to structural weaknesses, such as declining productivity and labour market rigidities. The debate continues as policymakers weigh the risks of loosening inflation targets against the need for greater economic stimulus.

Policy Response to External and Internal Shocks

Monetary policy has increasingly had to account for global financial cycles and domestic credibility risks. The GFC demonstrated the interconnectedness of South Africa's financial system with global markets, necessitating a flexible yet credible response from SARB. Similarly, political and fiscal instability since 2015 has required SARB to act decisively to maintain investor confidence. The bank's decision in 2017 to emphasise the midpoint of the inflation target range (4.5%) rather than the upper bound (6%) was a significant step in reinforcing credibility. The success of this approach has been evident in the gradual anchoring of inflation expectations, although long-term economic growth remains constrained by structural inefficiencies rather than monetary policy decisions alone.

The Impact of the Post-COVID Inflation Surge

The post-COVID period has been another test for emerging market central banks. While developed economies debated the transitory versus persistent nature of inflation, SARB, like many emerging market central banks, acted decisively to normalise interest rates. This swift response helped prevent inflation from spiralling out of control and reinforced SARB's credibility. The experience underscored the importance of maintaining an independent and proactive monetary policy framework in times of global uncertainty.

The Future of Monetary Policy in South Africa

Looking ahead, South Africa's monetary policy will continue to navigate the balance between flexibility and credibility. The structural weaknesses of the economy, including weak productivity growth, high unemployment, and fiscal vulnerabilities, suggest that monetary policy alone cannot drive economic recovery. Instead, SARB's role will remain centred on maintaining price stability while allowing fiscal and structural policies to address deeper economic challenges. Key areas of focus include:

- **Reduce Country Risk premium:** a credible reduction of the inflation target to induce a sustainable reduction in the long term country risk, with long term significant expansionary effect.

- **Managing External Risks:** As the global political and economic environment becomes more volatile , SARB must refine its approach and its communication of its risk management, ensuring credibility and resilience against external shocks.

- **Coordinating with the fiscal authority towards a macroeconomic program for structural growth:** While SARB maintains independence, coordination with fiscal authorities will be essential to create an environment of lower long term risk, increase productivity and lower cost-base.

Conclusion

South Africa's monetary policy has evolved significantly over the past 30 years, demonstrating resilience in the face of external shocks and domestic economic uncertainties. SARB's role as a provider of macroeconomic credibility has been crucial in stabilising inflation expectations and maintaining financial stability. While monetary policy alone cannot drive economic growth, its ability to anchor long-term stability remains essential for a sustainable economic future. Moving forward, addressing structural constraints alongside prudent monetary policy will be critical in ensuring long-term economic development and resilience in an increasingly uncertain global environment.

1. Introduction

The effectiveness of emerging markets monetary policy in controlling the inflation surge post-pandemic has been one of the policy surprises of the last few years. Emerging markets have largely outperformed industrial countries, responding more rapidly and more forcefully to the inflation shock (Evdokimova et al., 2023).

This episode has been a coming of age for monetary policy in emerging markets. In the last thirty years, most emerging markets have developed a robust monetary policy framework that has absorbed some historically large global shocks, from the global financial crisis in 2007 to the COVID-19 pandemic and the following global inflation surge.

South Africa's monetary policy is a prime example of the evolution of this emerging market policy framework. While apparently mimicking the institutional framework established in industrialised economies in the 90s, with inflation targeting at its core, it has developed characteristics that adapt the framework to its economic, political and institutional environment. A review of the history of monetary policy of democratic South Africa shows that monetary policy is characterised by a strong “risk management” function. In countries characterised by high levels of structural uncertainty, real volatility, and weak institutions, the Central Bank becomes the provider of “credibility of last resort” for the whole macroeconomy.

This paper analyses the evolution of monetary policy in democratic South Africa, describing some salient characteristics that are worth highlighting when thinking about the future of its policy framework in an increasingly uncertain and dangerous international environment.

This paper adds to a large body of literature that analyses all different aspects of South African monetary policy. Aron and Muellbauer (2007) review South African monetary policy from the 90’s to the early 2000s, focusing on the gains in transparency and credibility brought by the adoption of inflation targeting; Coco and Viegi (2020) review the whole inflation targeting period, showing the changes in policy directions, transparency and credibility; Honohan and Orphanides (2022) instead review the overall coherence of the framework and propose changes to tight its credibility and performances.

The literature also focused on three further aspects of South African monetary policy, namely its policy rule, its communication and its credibility. Aron and Muellbauer (2002) were the first to analyse South African monetary policy using a Taylor rule setting, although they showed that the latter was not very suitable for periods dominated by exchange rate management policies and financial repression. Ortiz and Sturzenegger (2007) use a DSGE model to estimate the SARB policy rule, showing that the SARB anti-inflation stance was somewhat moderated by a greater weight on output than what is typically found in inflation-targeting central banks. Klein (2012) confirms this result. He finds that the implicit inflation target tended to drift towards the upper level of the target band (6%), implying that the SARB had a high tolerance for inflation, especially after the outbreak of the Global financial crisis.

Regarding bank communication, Reid and Du Plessis (2010) were the first to study the content of each SARB monetary policy statement. They found that the statement provided information consistent with the present policy decision and forward-looking policy stance. Coco and Viegi (2020) add to this literature by analysing the SARB monetary policy statements using natural language processing techniques, which have been used to a greater extent in the following years.

Finally, the evolution of SARB's credibility and its ability to anchor expectations have been extensively analysed. Several papers have estimated the response of market or inflation expectations to monetary policy decisions. Kabundi et al. (2015), Kabundi and Mlachila (2018) and Miyajima and Yetman (2018) have documented an increase in SARB credibility by showing a lower exchange rate passthrough or a lower

dispersion among inflation forecasters. Coco and Viegi (2020) follow this literature by looking at different measures of anchorage of inflation expectations, confirming the increasing credibility of monetary policy.

This vast literature tends to map the South African monetary policy on frameworks typically conceptualised for industrialised countries. In fact, the Taylor Rule is unlikely to be a good description of monetary policy in an environment with uncertain structural trends, hysteresis in the labour market (Dadam and Viegi, 2015) and strong exposure to external and internal shocks. While we have a clear definition of the credibility of monetary policy when inflation is the main policy concern, we have little guidance in determining the meaning of credibility and independence when inflation is not the main threat to economic stability.

In Pirozhkova et al. (2024), we take a more agnostic approach. We use high-frequency identification of monetary policy shocks (G¨urkaynak et al., 2020), and we identify four different channels of monetary policy transmissions. A core result of that paper is the importance of the "country risk" channel of monetary policy, which is as important as the traditional interest rate channel in determining macroeconomic outcomes. Using narrative analysis, we show that these shocks are associated with the perceived credibility of the SARB's response to either external shocks that increase economic risk or internal events that threaten its independence and price stability mandate.

In this paper, we tell the story behind those numbers, showing South Africa's monetary policy as an evolutionary response to internal and external pressures coming from an economic environment volatile and uncertain.

Monetary institutions and policies have been developed to answer two questions: can monetary policy provide an umbrella of long-term economic and financial stability under which economic development can flourish, and can monetary policy be flexible enough to protect the country from internal and external turbulence? Monetary policy operates in this contradictory space between commitment to a long-term objective and discretionary response to an uncertain economic environment. This is expected to remain the case going forward, as the structural weaknesses of the South African economy and an increasingly uncertain global environment are not expected to ease any time soon.

We identify four periods of monetary policy in democratic South Africa:

- In the first period, in the second half of the nineties, the institutional framework is established. The objective of monetary policy and the independence of the Central Bank are enshrined in the constitution. The policy follows an eclectic approach, dominated by the targeting of monetary aggregates, controlling exchange rate fluctuations, and controlling the losses from the open assets position of the Central Bank. The Asian crisis of 1997 and a series of turmoil in emerging markets makes monetary policy too reactive, increasing the short-term real cost of economic fluctuations.

- The second period saw the establishment of the inflation-targeting regime as a response to the monetary instability of the previous years. Inflation targeting provides a flexible framework that allows smoothed responses to external shocks while maintaining long-term anchoring for the economy. It takes time for the policy to build the technical and institutional framework to gain acceptance and credibility. The external environment turns positive, with a commodity boom, capital inflows and fiscal stability.

- The Global financial crisis represents the first strong test of the inflation-targeting regime. The crisis has enormous real costs in the labour market and shows the structural weakness of the South African economy. Monetary and fiscal policy have been supportive of the economy for over a decade, but

the economy failed to recover and entered a structural slump that has not been overcome yet. Inflation expectations converge to the upper bound of the inflation targeting band of 6%. The regime is tested because of the peculiarity of the shock and the sudden dominance of global financial flows and the bond market in particular.

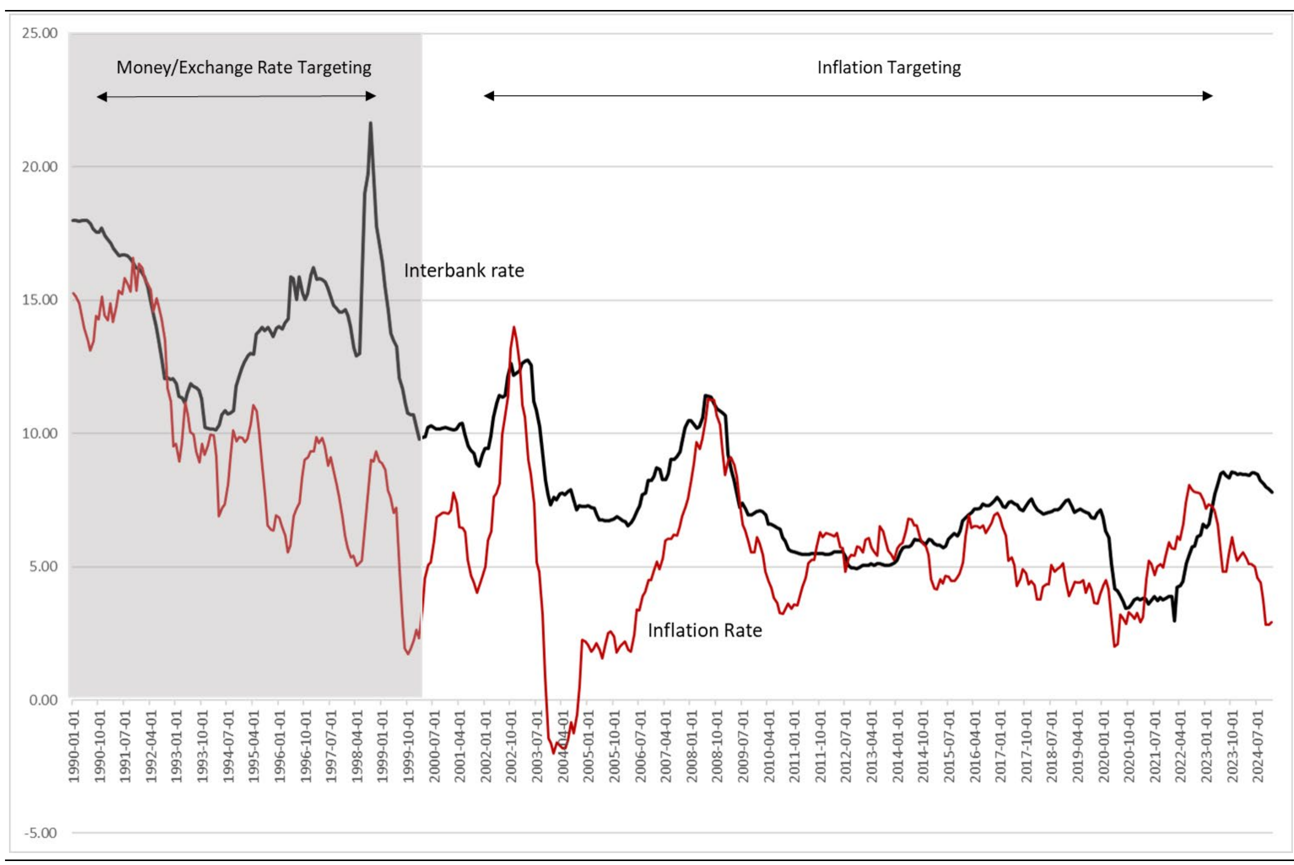
- After 2014, the regime is tested internally. Economic stagnation and political uncertainty threaten the stability of the system. The central bank fought to reassert its independence and its role as the provider of ”credibility of last resort”. Fiscal instability threatens the appearance of a fiscal-dominant regime, with a widening gap between the policy rate and long-term government bond rates. The country's risk is driven by internal turmoil, pushing the policy rate higher. The Covid crisis shows the weakness of the system and the need to risk managing the economy.

In what follows, we review these four ages of monetary policy in South Africa and discuss some of the debates surrounding the policy framework and implementation.

2. Out with the Old, Waiting for the New

Looking back at South African monetary policy, the volatility of South Africa’s policy instrument is remarkable at the beginning of democratic South Africa (Figure 1). While the new democratic dispensation had reinforced the independence of the Central Bank and defined its objective in the constitution, the SARB’s operational rules were still a hybrid between strict monetary targeting, intervention in the exchange rate markets to limit excessive fluctuations and a not well-defined commitment to low inflation.

Figure 1: Interest Rate and Inflation: 1990-2024 (Source: OECD)



This framework was put under stress by the opening of the economy and its increasing integration into the world capital market. As Governor Stall argued in 1997, “*There is no doubt that the money supply has lost*

some of its usefulness as an anchor for monetary policy. With South Africa not yet being ready for direct inflation targeting and with our inability to fix the exchange rate of the Rand because of a lack of foreign reserves, the Reserve Bank is gradually moving to a more ecclesiastic approach where a wider range of monetary indicators are being used as a basis for monetary policy decisions".

The constitutional commitment to price stability was supported by a policy that was often unpredictable, targeting an array of intermediate targets. One year later, the Asian financial crisis showed the vulnerability of this policy framework, with the policy rate having to reach levels of 20% to withstand negative capital flows and the increase in world uncertainty. Moreover, the attempt to control the fluctuation of the exchange rate by effectively borrowing international reserves on the market was imposing a real risk to the stability of the overall public sector balance sheet and limited the possibility of long-term stable planning of the public finances.

The opening of the economy and its reintegration into the world market needed a new policy framework that could provide enough flexibility in the short run to withstand external shocks while strengthening the policy commitment to the long-term stability of prices and the financial system. Enter the inflation targeting.

3. The South African "Great Moderation"

South Africa's adoption of the inflation-targeting regime was not an obvious choice. At the time, only a few emerging countries had adopted the framework. The consensus was also that for inflation targeting to work, a country needed to satisfy a series of structural criteria. Mishkin (2000), in particular, pointed towards the need for strong fiscal and financial institutions, a credible, independent and transparent Central Bank and an economy that is resistant to external volatility, as inflation targeting required a flexible exchange rate and free capital mobility.

In fact, inflation targeting has been the instrument by which Central Banks in emerging markets could gain credibility by building a clear framework for assessing monetary policy and its commitment to low and stable inflation. As argued by Demertzis and Viegi (2009), in an uncertain economic environment where information is imperfect, inflation targeting provides a partially clear signal that can anchor long-term private sector expectations and help the Central Bank withstand unfavourable shocks.

In this context, inflation targeting is, first and foremost, a pragmatic response to a dilemma. Emerging countries characterised by large external shocks and weak institutional credibility need to find a policy framework that builds credibility while allowing for the necessary flexibility to withstand shocks. Regimes that emphasised the need to acquire credibility, like managed exchange rate regimes and formal dollarisation, proved to be too rigid and, therefore, not robust enough to withstand unexpected shocks. On the other hand, discretionary regimes tended to provide weak nominal anchors and would often be subjected to accelerating inflationary shocks.

In 2007, Du Plessis et al. (2007) argued that "the South African economy has experienced a remarkable period of economic stability coupled, since 1999, with the longest business cycle expansion in the country's history. Indeed, a 'great moderation'- [..] has come about in South Africa. The important dimensions of the South African moderation include lower and stable inflation, lower and stable real interest rates, positive and steady GDP growth, and stable fiscal deficits, and debt".

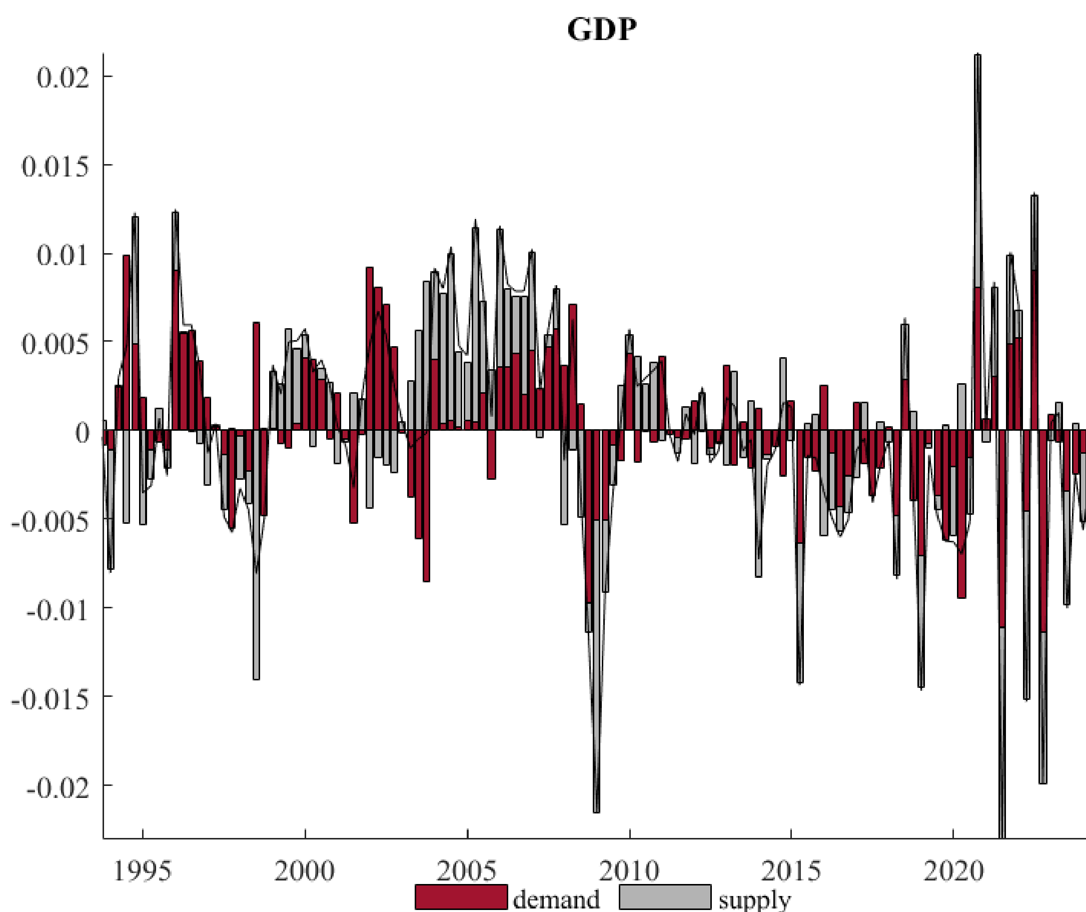
The inflation-targeting regime was certainly part of the success. Policy became more transparent and predictable (Aron and Muellbauer, 2007). The framework was tested from the start, with a sharp depreciation of the currency after 9/11, but the policy response was much less dramatic than in previous

periods, focusing more on the second-round effect of exchange rate volatility rather than trying to control the exchange rate directly.

In fact, in the following years, the main policy dilemma confronting the SARB was the perceived excessive re-valuation of the exchange rate, which was pushed upward by increasing foreign investment in South African assets. Monetary policy would often surprise the markets with unexpected cuts in interest rate driven by the preoccupation that a continuous appreciation of the currency would weaken the real economy. For example, in April 2005, the MPC statements read, *"Although the overall performance of the South African economy seems to be reasonably well sustained, the MPC noted with concern evidence of some slackening in activity in some sectors of the economy as a result of the move by the Rand to a higher trading range over the past six months. It remains the view of the MPC that a competitive and stable exchange rate would contribute to continuing sustainable growth in output and employment"*. The following day, Business Day commented: *"Is it a coincidence that the last time the Reserve Bank surprised the market with an interest rate cut, it also followed a hue and cry by labour unions about the strong Rand's toll on the economy?"*.

Was it good policy or good luck? Certainly, shocks were of the right kind. Between 2000 and 2007, the country was subjected to a series of positive supply and demand shocks, as shown in Figure 2, where we show the historical decomposition of supply and demand shocks for the South African economy in the last thirty years.

Figure 2: Historical Decomposition of Supply and Demand Shocks in South Africa



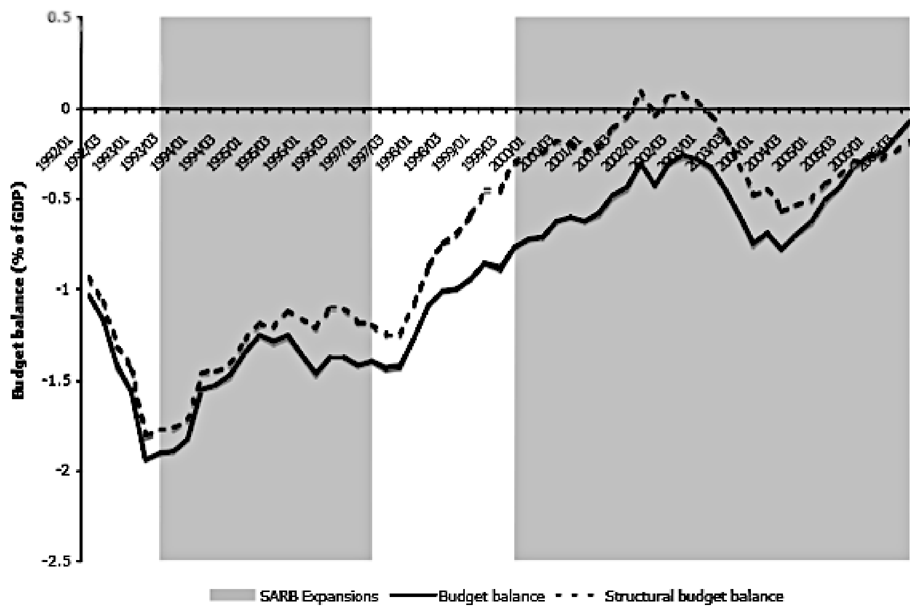
Nevertheless, the South African great moderation was never fully "NICE": Non-Inflationary, Consistently Expansionary, the term used by Mervin King in 2003 to describe the UK 90's economic environment. The favourable term of trade shock at the beginning of the century helped establish a credible fiscal-monetary

policy framework and propel the economy forward in a benign international environment. However, the policy framework was never supported by an underlying productivity revolution. We can now see (Dadam et al., 2019) that South African productivity started to decline from 2005 onward once the reform momentum started to slow down and the country started to rely on expanding fiscal resources to support aggregate expenditure. The fundamental economic weaknesses will be exposed soon enough when the global environment becomes dramatically adverse.

Macroeconomic Policy and Long-Term Trends

The most remarkable achievement of the period is the stabilisation of fiscal policy in the context of increasing fiscal expenditure to support the social transformation of the country. Figure 3, taken from Du Plessis and Boshoff (2007), shows the level of fiscal adjustment achieved by the country between 1994 and 2006. The corresponding level of public debt reached less than 25% of GDP in 2006 when the government registered an overall budget surplus.

Figure 3: Observed and structural budget balances for South Africa (source: Du Plessis and Boshoff(2007), fig. 8)



The figure also shows the estimated structural budget balances at the time, which is the government fiscal position once business cycle components are netted out. It shows that, at the time, the consensus was that the economy was well below its potential output level and that there was more policy room to be used for structural fiscal expenditure. For monetary policy, the overestimation of the negative output gap induced a real policy rate that became negative for some of the periods and resulted in an overheated credit market and private consumption. This shows a core issue of policy in emerging markets: Aguiar and Gopinath's (2007)' "cycle is the trend" problem. Our models of short-run macroeconomic policy rely on evaluating permanent versus transitory components of the observed macroeconomic variables (Orphanides (2002)). Potential output, equilibrium exchange rate and the natural rate of interest are core concepts in the current policy framework, but their estimation is fraught with difficulties and uncertainty. For the whole period we are analysing, there is a tendency in South African policymaking to overestimate the potential output of the country and, thus, the fiscal and monetary policy space available.

For example, Kuhn et al. (2017) estimate the neutral real interest rate in South Africa using a small open economy variant of the Laubach-Williams methodology. They find that the Natural rate of interest has fallen significantly after the GFC, but less than in advanced economies, due to falling domestic savings and rising

risk premium. This suggests that monetary policy had to follow the global reduction in interest rates while struggling between the contractionary effect of exchange rate appreciation and the destabilising effect of depreciation on international capital flows. Fedderke and Mengisteab (2017), using a series of filtering techniques, find a similar negative trend in potential output, which implies inflationary pressure appearing at a relatively low level of GDP growth. While ex-post the potential policy mistake is clear, the real-time decision relies on imperfect models and information.

4. Pushing Against the "Dilemma"

The global financial crisis represented a dramatic shift in the international economy, with long-lasting economic and political consequences that are still felt around the world. It also represents a sea change in monetary policy thinking with new instruments added to Central Banks armoury. "Forward guidance" and "quantitative easing" enter the policy toolbox of central banks.

This period highlights the importance of global factors in driving economic policies in small, open economies. A country's integration into the global financial system raises the question of what the exchange rate regime is, the monetary policy framework and the financial stability regulation that guarantee the benefit of financial integration while allowing a significant degree of independence in local policymaking.

The choice in South Africa, and in many emerging countries, has been to rely on a combination of flexible exchange rate, inflation targeting and free capital mobility. This is in accordance with the Mundellian trilemma hypothesis (Obstfeld et al., 2005), by which an independent monetary policy is compatible with free international capital mobility only at the cost of letting the exchange rate be determined by market forces. This has been the consensus in international economics for decades, and it justifies the policy framework that has been chosen in many emerging countries.

The promise of globalisation was that connectivity and institutional homogenisation (through national reforms and super-national delegation of sovereignty) would provide emerging markets a path to growth and stability by borrowing the stability provided by the developed countries.

After the international financial crisis, the reality proved to be very different. Not only the financial crisis itself, but the economic and political instability in Europe first and in the United States after, has subjected emerging countries to a series of waves of market instability and uncertainty generated in the industrialised countries and exported across the world by an integrated global financial market.

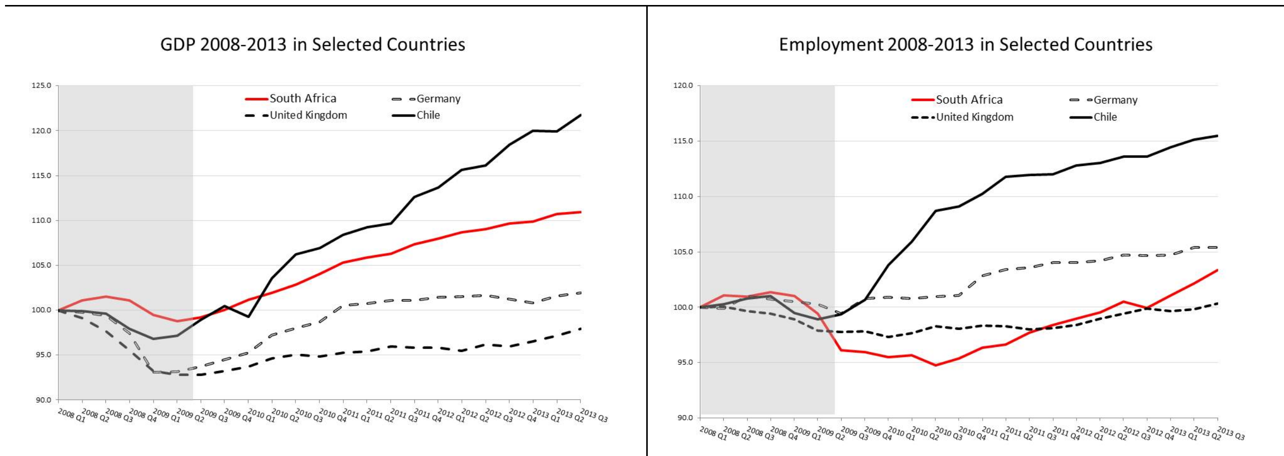
Rey (2015), at the Jackson Hole meeting of 2013, famously raised the possibility that global financial flows are transmitting the United States monetary policy to the rest of the world. She argued that because the US dollar plays a central role in international transactions, US monetary policy is transmitted to other countries through an international credit and/or risk-taking channel. This transmission generates a strong co-movement in risky assets across the globe, thus generating a global financial cycle. The transmission of the global financial cycle to local economies compels monetary policy in each country to react to prevent local financial instability instead of focusing on its main macroeconomic objective. Any country faces a dilemma: either allow the free movement of capital and lose monetary independence or introduce capital controls or macro-prudential tools to gain renewed control on the instruments and goals of monetary policy.

For South Africa, the first effect of the shock can be summarised by the two graphs in Figure 4. A relatively low slump in real GDP is matched by a dramatic and persistent loss of more than 1 million jobs that has been replicated for all the following negative shocks that the country has experienced in the following years.

The GFC put in focus the fundamental weakness of the South African economy, partly wiping out some of the previous period's optimism.

On the other hand, what the previous decade has bequeathed the country was a large policy space. Both fiscal and monetary policy would remain broadly expansionary for almost a decade.

Figure 4: GDP and Employment dynamics after the GFC



Notwithstanding the large policy effort, the economy never recovered the dynamism of the previous period, and the imported crisis soon became an internally driven one.

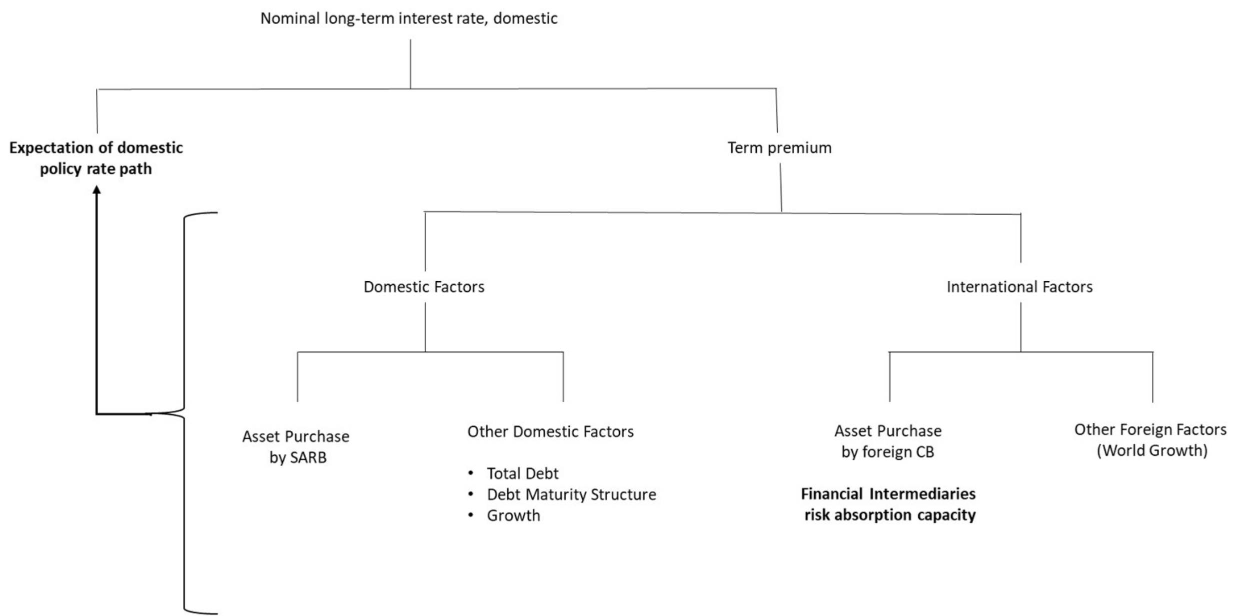
How Many Instruments Does Monetary Policy Have?

The Global Financial crisis was followed by significant changes in the monetary policy toolkit, with quantitative easing and forward guidance entering the policy discourse. Both instruments aim to control long-term interest rates once the policy instrument has reached the zero lower bound. In Loate et al. (2021), we discuss the applicability of Quantitative Easing to the South African policy framework.

Figure 5 describes the way in which the SARB can affect the long-term nominal interest rate and how its actions interact with other factors influencing the long-term rates. The first way the SARB influences the long-term interest rate is via the private market's expectations of the future path of the policy rate. The SARB tries to control this direct influence by maintaining a predictable policy path and by controlling inflation expectations.

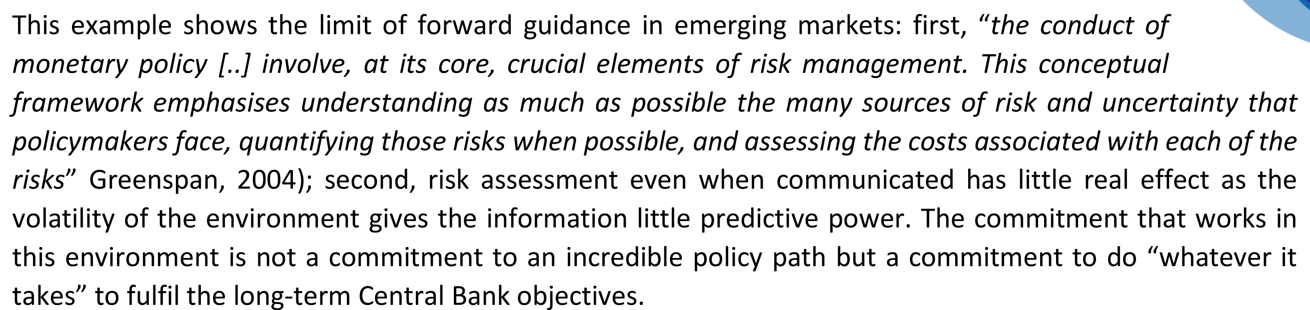
Beyond the SARB policy rate, the term premium is influenced by domestic and international factors illustrated on the right side in Figure 5. Domestically, the main determinants are expected growth, the stock of government debt and its maturity structure. Internationally, the main determinants are world growth, foreign central bank policies, and the risk absorption capacity of financial intermediaries.

Figure 5: Determinants of Nominal Long-Term Rates in Small Open Economy



The SARB can certainly use its own balance sheet to control the long-term interest rate. Many South African commentators have called for " yield curve management" to reduce the cost of government debt and reduce the cost of long-term investment. The problem with trying to use Quantitative Easing to deal with the trend growth in long-term nominal rates is that this policy will affect the expectations of the domestic policy path, the left side of Figure 5, pushing the nominal interest rate in the opposite direction than desired by inducing higher inflation expectations. While this is the objective of QE in countries in a liquidity trap, it would not solve the South African problem by steering the country towards higher inflation expectations and higher inflation. It is critical for the success of any new monetary policy intervention that it does not affect the long-term objective of monetary stability.

Forward guidance instead affects long-term interest rates via the information that the Central Bank give about the future path of the policy rate. Campbell et al. (2012) make the distinction between Delphic Forward Guidance when the Central Bank releases forecast or economic projections, which signals how it believes policy rates may change and Odyssean Forward Guidance, when the Central Bank commits to a state of monetary policy in the future. In Pirozhkova et al. (2024), we identify an implicit forward guidance channel for monetary policy in South Africa. The Central Bank gives information in its policy statements that the market uses to infer potential future policy paths. However, this information is not about commitment but mainly about changes in the evaluation of risks to the outer run of the forecasts. For example, in September 2011, during the European debt crisis, the credit rating of several European banks was downgraded on the week before the Monetary Policy Committee, inducing a confidence crisis and a sharp devaluation of the Rand. The SARB didn't change the policy rate, as expected, but, in the world of the Business Day commentary the day after, " said there had been a 'significant' debate on whether a cut was warranted. [...] The Bank did not change the inflation outlook it had at its last meeting in July but said the Rand's sharp depreciation was a 'potential upside risk'. [...] The Bank revised its growth forecasts sharply down and warned that they were still at risk from the global downturn. It was concerned about the potential impact of global turmoil and was ready to act appropriately should the need arise" [Interest rates kept steady on inflation fears - Business Day (Johannesburg, South Africa) - September 23, 2011 - page 1]. The market reacted to this information, and the long-term rate eased significantly.

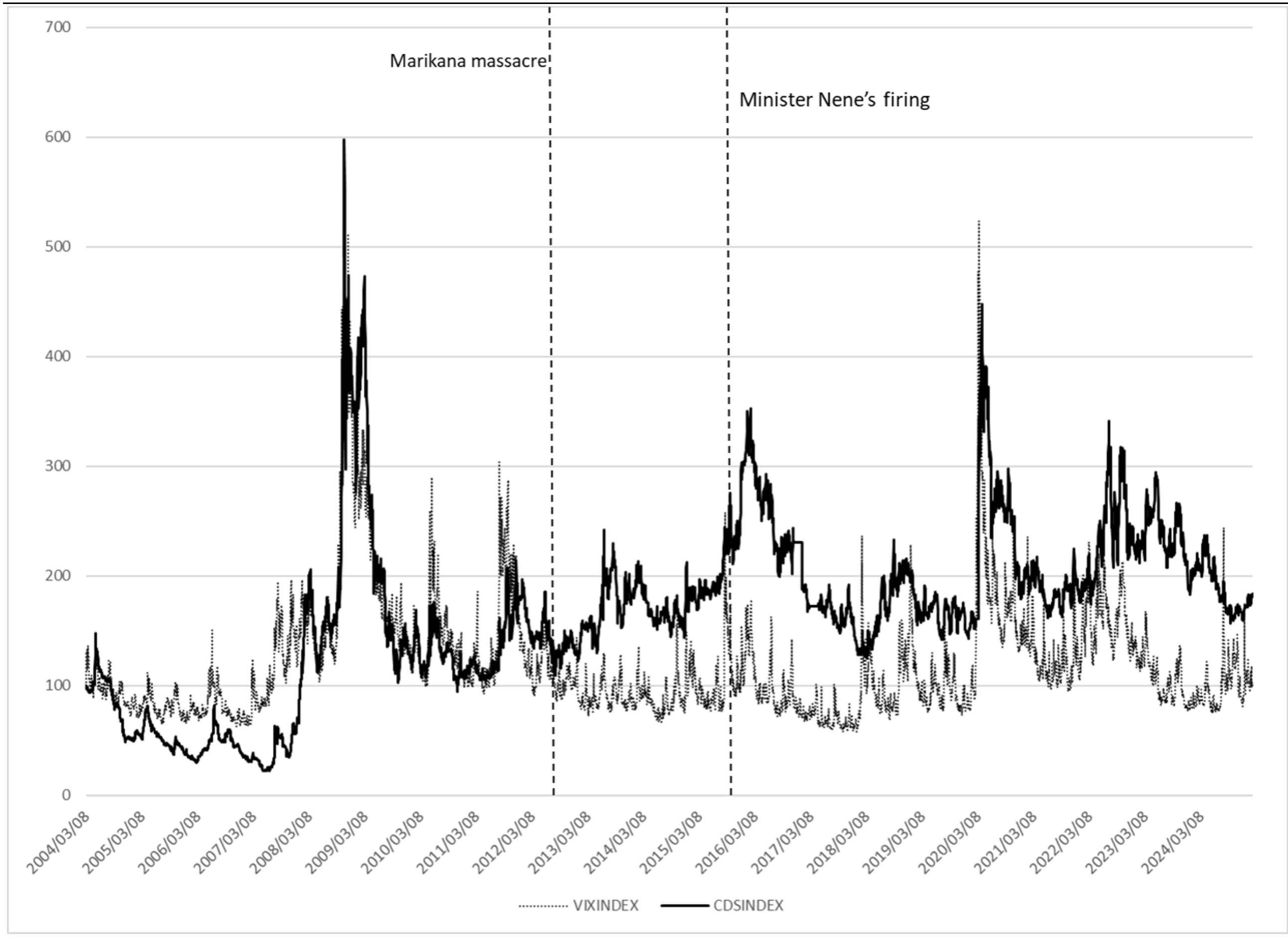

This example shows the limit of forward guidance in emerging markets: first, "*the conduct of monetary policy [..] involve, at its core, crucial elements of risk management. This conceptual framework emphasises understanding as much as possible the many sources of risk and uncertainty that policymakers face, quantifying those risks when possible, and assessing the costs associated with each of the risks*" Greenspan, 2004); second, risk assessment even when communicated has little real effect as the volatility of the environment gives the information little predictive power. The commitment that works in this environment is not a commitment to an incredible policy path but a commitment to do "whatever it takes" to fulfil the long-term Central Bank objectives.

5. The Dimming of the Rainbow

It started in Marikana. The Marikana massacre showed the fragility of the South African economic and social condition. Economic growth didn't return after the global financial crisis. The extensive fiscal year of the previous years had ballooned government debt, and a consistent expansionary monetary policy wasn't able to revitalise the economy. For the first time, the country's risk has become part of South Africa's description. As the MPC noticed a month later, *"the Rand appears to have decoupled from the euro and reacted to domestic issues, including the wider-than-expected current account deficit and developments in parts of the mining sector following the tragic events at Marikana."*

The increasing importance of internal sources of vulnerability is clearly seen by comparing the dynamics of the Vix, a measure of global risk, versus the CDS for South African debt, a measure of the country's risk. Until 2012, the country's risk is directly linked to global risk, showing risk-off, risk-on behaviour of financial investors driven by global factors, a reflection of Rey's (2015) dilemma.

Figure 6: VIX and South Africa CDS (source:Bloomberg)



From 2012, the country risk accelerates and remains high for the rest of the period. The increasing economic weakness was certainly behind this, together with the successive downgrading of South African credit rating by international rating agencies and the evident deterioration of public infrastructure. In 2016, though, the country risk suddenly spiked when the surprising firing of Finance Minister Nene and the following revelation about state capture raised serious questions about the credibility and stability of the country's economic policy direction.

The role of monetary policy in supporting the credibility of the system overall is evident if we analyse the market reaction to the policy stance the SARB took after Minister Nene's firing. In January and March 2016, the SARB reacted with an unexpected increase in the policy rate, highlighting the upward risk in its projections. In the following day, the commentator in Business Day argues, *"It is hard not to wonder whether the events of the past few days were the factor that tipped the monetary policy committee into opting for a 25-basis point hike rather than a hold. And rightly so. This is not the time to take any chances with either policy credibility or the exchange rate.[...] The dramatic disclosures of the Gupta family's influence on ministerial appointments have undermined SA's credibility with investors further and put new downward pressures on the Rand. If the committee's response was on the hawkish side (in the monetary policy sense), it cannot be faulted for acting to manage the risks as best as it can.*"

These decisions induced an immediate reduction of the country risk premium. The SARB provided a strong signal of commitment to long-term economic stability. This was not enough to avoid a decade of economic stagnation. The question of how much fiscal and monetary policy contributed to this outcome has been a core South African debate ever since.

Is Monetary Policy Responsible?

Is monetary policy responsible for the stagnation? Stiglitz (2008) notoriously argued that inflation targeting is not the right policy framework to deal with large external shocks and that it has imposed more restrictive conditions than would have been necessary if the policy had been inactive. Many South African commentators have followed this line of reasoning. For example, Kantor (2017) has argued that " the insistence on inflation targeting regardless of the causes of inflation has made South African monetary policy highly procyclical" (p.34), inducing a credit bubble during the expansion phase and worsening the recession after the GFC. Match this procyclicality with a strong hysteresis effect, and short-run over-reaction becomes long-run stagnation in capital accumulation and growth (Jord`a et al., 2020).

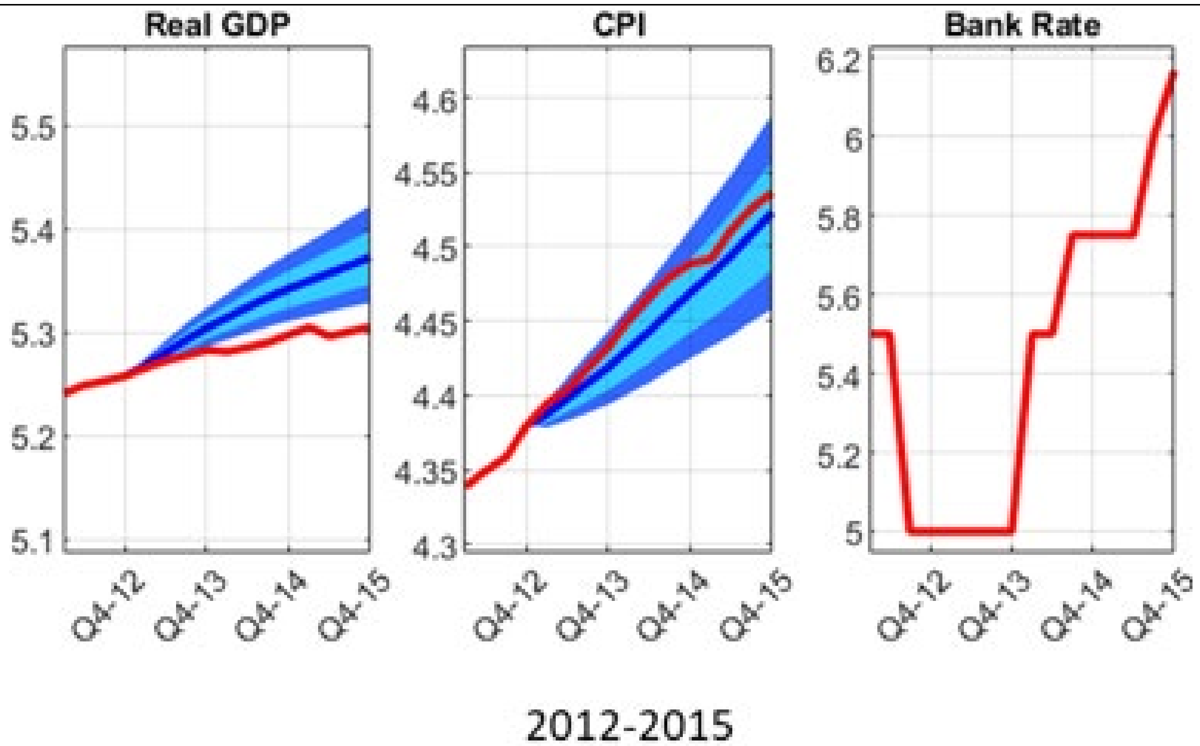
The evidence seems not to support the idea that monetary policy in South Africa is procyclical or that the average real interest rate after the adoption of inflation targeting has been, on average, higher than in other regimes. Du Plessis et al. (2007) show the stabilising effect that monetary policy played before the GFC. Alton (2018) finds that monetary policy is strongly countercyclical only when real-time estimates of the output gap are considered. Considering the ex-post realisation instead, monetary policy was strongly procyclical, especially during the expansion phase between 2000 and 2007. The reason for this difference is not the source of shocks but rather the uncertainty around the trend growth rate of the economy (Orphanides (2002). In the period leading up to the financial crisis, the acceleration in growth was interpreted as a structural improvement, not a cyclical boom. When inflation accelerated faster than expected, the real interest rate became negative, reinforcing the cycle. After the GFC, interest rates were cut rapidly to support growth and then kept low as growth continued to disappoint, assuming that the slowdown was largely cyclical. Instead, most of the growth slowdown has been attributed to a slowdown in potential output, thus making monetary policy inflationary.

Loewald et al. (2020) present a strong defence of the SARB policy after the GFC, focusing on the structural nature of the South African crisis. They point out that monetary and fiscal policy in South Africa has been expansionary for 10 years after the crisis but that this could not stop the negative trend in potential output and the country's natural rate.

In Loate and Viegi (2024), we try to answer this question directly, investigating the interaction between macroeconomic variables and fiscal and monetary policy mix over the 2012 to 2019 period, a period characterised by increasing public debt, risk premium and low economic growth. The strategy is to compare the expected path of macroeconomic variables conditional on the actual monetary and fiscal policy followed with the actual path. An example of the results is shown in Figure 7.

The red lines are the actual GDP and CPI numbers for the two periods, 2012-2015 and 2015 - 2019. The blue areas are the forecast of GDP and CPI consistent with the monetary policy actually followed (the third panel in each row). The simple explanation of the results is that monetary policy was consistent with a higher path of growth and lower inflation than the one experienced. Even simulating a more expansionary monetary policy does not change the result: the underperformance of the economy can be attributed to factors that are outside the macroeconomic policy sphere.

Figure 7: Actual and Expected GDP and CPI Conditional on Actual Monetary Policy (source: Loate and Viegi (2024))



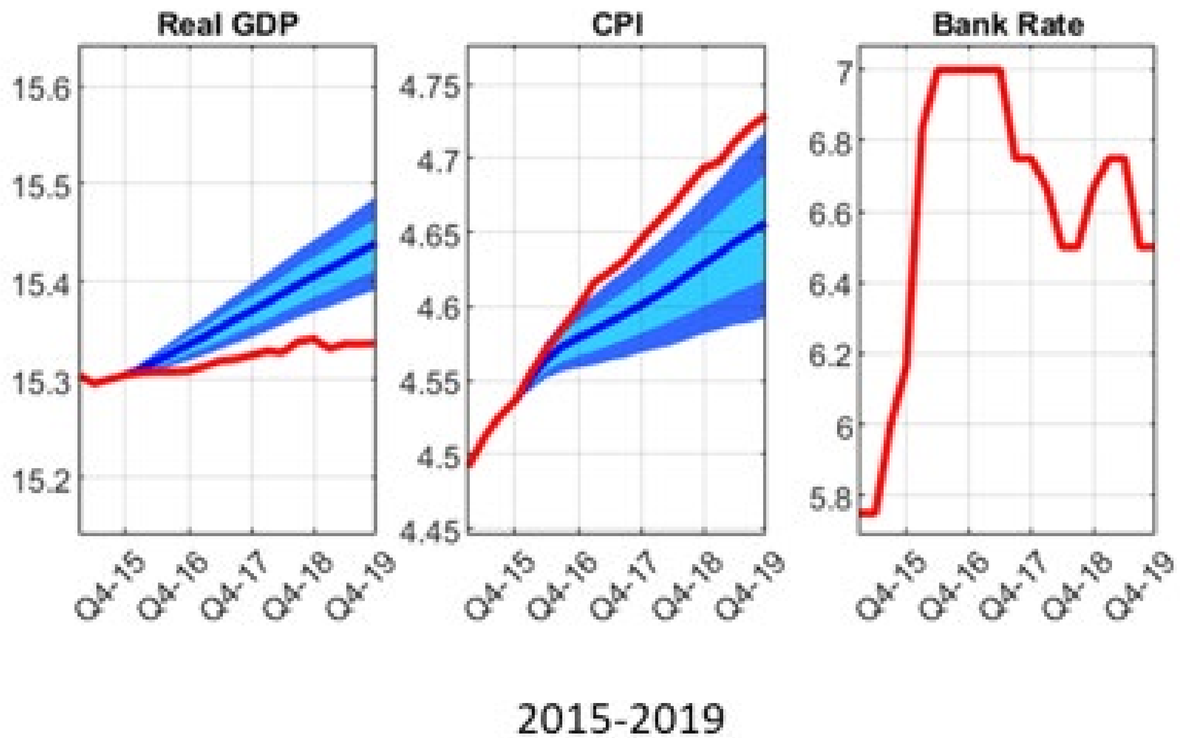
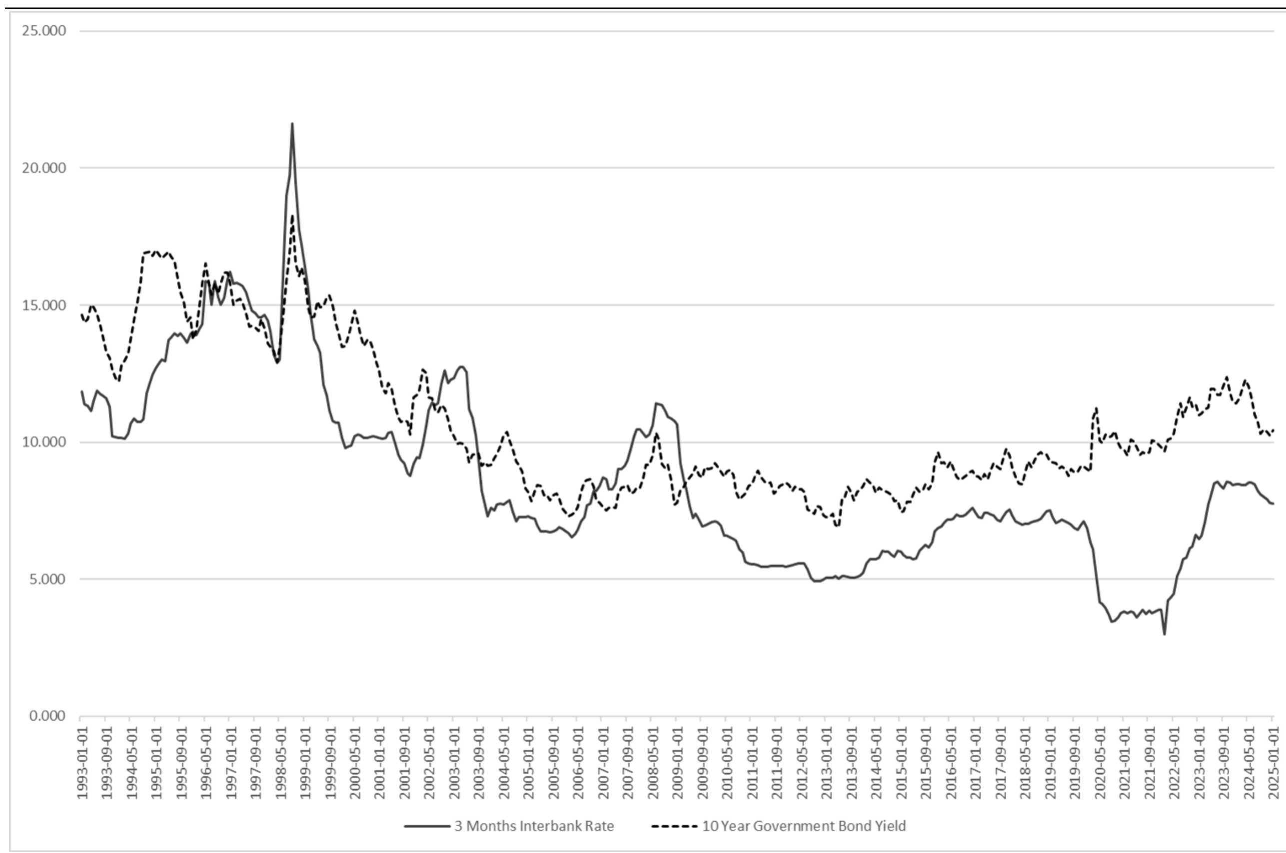


Figure 8: Short and long term interest rates in South Africa (source: SARB)



6. Searching for a Robust Anchor

The history of these 30 years shows the importance of maintaining the credibility of monetary policymaking. Monetary policy always operates on the edge between the flexibility necessary to support the economy and the commitment to long-term stability essential for the efficacy of the policy. In Emerging markets, the commitment to long-term stability needs to be reaffirmed frequently. When uncertainty increases, either because of external shocks or because of internal policy conflicts, the Central Bank has to reinforce the policy with a commitment to do "whatever it takes" to maintain long-term stability.

The reaction of emerging market central banks to the post-COVID global inflation surge shows this commitment at work. While the FED and other central banks in industrialised countries were arguing about transitory vs long-lasting inflationary shocks, emerging countries started normalising their policy rate as soon as the first inflationary pressures materialised. The inflation targeting framework proved once again its resilience. Honohan and Orphanides (2022) review the South African inflation targeting framework and introduce a debate about the correct level of the inflation target for South Africa. South Africa has operated an inflation target with a high target and a wide band around it, compared to what is applied by other similar emerging markets and the country's trade partners.

The discussion about the level of the Inflation Target in South Africa is really a discussion about the policy framework that would solidify the long-term commitment to macroeconomic stability. The level of target and the target range define the socially acceptable policy outcome and the confidence in the ability of the policy maker to reach that outcome. A large target range of 3 to 6% did not provide enough policy certainty, and inflation tended to drift towards the top end of the inflation target band of 6% (Klein, 2012)

For this reason, in 2017 the SARB decided to clarify the policy framework by emphasising the middle of the target band (4.5%) as the preferred focal point of the policy. The change in policy communication induced inflation and inflation expectations to converge toward the new target. In Pirozhkova and Viegi (2023) we evaluate the effect of this policy by comparing the macroeconomic outcome of this policy with what we would have expected if the policy had not been changed. The change in policy did not have any real effect. Any potential contractionary effect of the implementation of the policy was balanced by a reduction at the long end of the yield curve driven by a reduction in inflation expectations and the country risk premium.

7. Conclusion

At a time of increasing global policy uncertainty, monetary policy might once again be called to provide the last defence to protect the county economy against populism and nationalism threatening the global economy and population well-being.

However, monetary policy is just a little part of the story and not the most important. South Africa has to find a way out of the current stagnation and generate a productivity revolution that can dramatically change the lives and prospects of all its citizens. Monetary policy, in the long run, can only influence nominal variables such as inflation and exchange rate. In the longer term, monetary policy cannot increase the average level or the growth rate of real variables such as GDP and employment.

While it is theoretically possible to build a model where monetary policy plays a central role in the country's growth strategy, Gürkaynak et al. (2023) show the fallacy of building policy on magical thinking.

It is appropriate for monetary policy to define a long-term desired inflation level as an expression of what monetary policy can and should achieve. Inflation Targeting is just the technical expression of the recognition of the limits of monetary policy. It is also the long-term anchor that can provide credibility to a real growth strategy.

8. References

Aguiar, M. and G. Gopinath (2007). Emerging market business cycles: The cycle is the trend. *Journal of Political Economy* 115 (1), 69–102.

Alton, T. (2018). Policy cyclicality in the post-crisis period. Occasional Bulletin of Economic Notes 8877, South African Reserve Bank.

Aron, J. and J. Muellbauer (2002). Estimating monetary policy rules for South Africa. *Series on Central Banking, Analysis, and Economic Policies* 4, 427–475.

Aron, J. and J. Muellbauer (2007, 09). Review of monetary policy in South Africa since 1994. *Journal of African Economies* 16 (5), 705–744.

Campbell, J. R., C. L. Evans, J. D. Fisher, A. Justiniano, C. W. Calomiris, and M. Woodford (2012). Macroeconomic effects of Federal Reserve forward guidance [with comments and discussion]. *Brookings papers on economic activity*, 1–80.

Coco, A. and N. Viegi (2020, June). The monetary policy of the South African Reserve Bank- stance, communication and credibility. Working Papers 10024, South African Reserve Bank.

Dadam, V., M. Hanusch, and N. Viegi (2019, July). Why South Africa Is Cheap for the Rich and Expensive for the Poor: Reconsidering the Balassa-Samuelson Effect. Policy Research Working Paper Series 8942, The World Bank.

Dadam, V. and N. Viegi (2015). Labour market and monetary policy in South Africa, pp. 113–138. South African Reserve Bank Conference Series.

Demertzis, M. and N. Viegi (2009). Inflation targeting: a framework for communication. *The BE Journal of Macroeconomics* 9 (1).

Du Plessis, S. and W. Boshoff (2007). A fiscal rule to produce countercyclical fiscal policy in South Africa. *Stellenbosch Economic Working Papers* 13/07, 17.

Du Plessis, S., B. Smit, and F. Sturzenegger (2007). The cyclicality of monetary and fiscal policy in South Africa since 1994. *South African Journal of Economics* 75 (3), 391–411.

Evdokimova, T., P. Nagy-Mohacsi, O. Ponomarenko, and E. Ribakova (2023). Central banks and policy communication: How emerging markets have outperformed the Fed and ECB Peterson Institute for International Economics Working Paper (23-10).

Fedderke, J. W. and D. K. Mengisteab (2017). Estimating South Africa’s output gap and potential growth rate. *South African Journal of Economics* 1, 1–23.

Greenspan, A. (2004). Risk and uncertainty in monetary policy. *American Economic Review* 94 (2), 33–40.

Gürkaynak, R. S., B. Kısacıko˘glu, and S. S. Lee (2023). Exchange rate and inflation under weak monetary policy: Turkey verifies theory. *Economic Policy* 38 (115), 519–560.

Gürkaynak, R. S., B. Sack, and E. Swanson (2020). Do actions speak louder than words? The response of asset prices to monetary policy actions and statements: Updated dataset. *International Journal of Central Banking*.

Honohan, P. and A. Orphanides (2022). Monetary policy in South Africa, 2007-21. Number 2022/29. *WIDER Working Paper*.

Jorda, S. R. Singh, and A. M. Taylor (2020, January). The long-run effects of monetary policy. Working Paper 26666, *National Bureau of Economic Research*.

Kabundi, A., E. Schaling, and M. Some (2015). Monetary policy and heterogeneous inflation expectations in South Africa. *Economic Modelling* 45, 109–117.

Kabundi, A. N. and M. M. Mlachila (2018). Monetary policy credibility and exchange rate passthrough in South Africa. *International Monetary Fund*.

Kantor, B. (2017). Get South Africa Growing. Jonathan Ball Publishers.

Klein, N. (2012). Estimating the implicit inflation target of the South African Reserve Bank. Technical Report 12/177, *International Monetary Fund Working Paper*.

Kuhn, L., F. Ruch, and R. Steinbach (2017). Reaching for the (r)-stars: estimating South Africa's neutral real interest rate. Technical Report WP/19/01, SARB Working Papers.

Loate, T., E. Pirozhkova, and N. Viegi (2021). Sailing into the Wind: evaluating the (near) future of Monetary Policy in South Africa. Economic Research and Statistics Department, South African Reserve Bank.

Loate, T. and N. Viegi (2024). Can monetary and fiscal policy account for South Africa's economic stagnation? Technical report, SARB Working Papers.

Loewald, C., D. Faulkner, and K. Makrelov (2020). Time consistency and economic growth: A case study of South African macroeconomic policy. Technical report, South African Reserve Bank.

Mishkin, F. S. (2000). inflation targeting for emerging-market countries. *American Economic Review* 90 (2), 105–109.

Miyajima, M. K. and J. Yetman (2018). Inflation expectations anchoring across different types of agents: The case of South Africa. International Monetary Fund.

Obstfeld, M., J. C. Shambaugh, and A. M. Taylor (2005). The trilemma in history: trade-SARB speaks? *South African Journal of Economics* 78 (3), 269–286.

Rey, H. (2015). Dilemma, not trilemma: the global financial cycle and monetary policy independence. Technical report, *National Bureau of Economic Research*.

Stiglitz, J. E. (2008). The failure of inflation targeting. https://www.projectsyndicate.org/commentary/the-failure-of-inflation-targeting.

Taylor, J. (1993). Discretion versus policy rules in practice. Carnegie-Rochester Conference Series on Public Policy 39, 195–214.