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AN ASSESSMENT OF THE LIKELY IMPLICATIONS OF A SARB DUAL MANDATE ON CMA COUNTRIES

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The views and opinions expressed in this article are those of the authors and do not necessarily reflect the official policy or position of the Central Bank of Lesotho (CBL).

1. Introduction

The South African macroeconomic management has served as an anchor for the South African Development Community (SADC) through the implementation of its predictable and transparent monetary policy. This has been particularly true for the smaller economies of the Common Monetary Area (CMA). South Africa together with Eswatini, Lesotho and Namibia are under the CMA agreement which allows for a one-to-one peg of these countries' respective currencies to the South African Rand.

The South African Reserve Bank (SARB) is currently mandated to achieve and maintain price stability in the interest of balanced and sustainable growth, using inflation targeting as an anchor for its monetary policy since February 2000. However, the debate amongst the public on whether the SARB should amend its mandate to include full employment (and therefore growth, more explicitly) without compromising the current mandate of achieving and maintaining price stability, has recently gained ground. Others recognize that the SARB has performed well with its inflation targeting regime, while some argue that the current monetary policy regime has been less than efficient and call for the inclusion of real output to the current monetary policy.

It is therefore useful to study the feasibility of the public rhetoric of a SARB dual mandate becoming practical, as such a move would impact other CMA members. The paper therefore seeks to study the implications of such a move (if practical) on other CMA members given monetary policy ties between South Africa and other CMA countries. This is done by firstly examining whether the SARB has been successful in achieving its current mandate of price stability through inflation targeting. The outcomes of the brief examination will therefore provide an indication of whether it could be viable for the SARB to adopt a dual mandate. Thereafter,

an analysis of the implications of a SARB dual mandate on other CMA countries will be outlined.

2. The Role Of Central Banks In Macroeconomic Stability

The mandates of Central Banks mostly derive from national constitutions, which require stable macroeconomic environments to enable economic growth and development. The extent to which Central Banks can achieve this is through the implementation of monetary policy that is conducive with the country specific economic environment. Factors that could be considered when formulating the monetary policy include the simultaneous pursuit of other monetary policy objectives, the size and nature of cyclical fluctuations, the current economic policy stance as well as the public's expectations (Papademos, 2003 and CBN, 2006). Over and above these, Central Banks adhere to the Taylor rule as a tool to depict the variables they base themselves on when setting their policy rates. In its simplest form, the Taylor rule is denoted as:

$$i_t = r^* + \pi_t + \alpha(\pi_t - \pi^*) + \beta y_t$$

The Taylor rule (sometimes referred to as the policy reaction function) is equivalent to the equilibrium real interest rate (r^*) plus inflation at period t , π_t , plus the deviation of inflation at period t from the Central Bank's inflation target for period $t+k$, made at period t , that is, $(\pi_t - \pi^*)$ and the output gap (y_t). The coefficients (weights) on inflation and output gap reflect the response of the Central Bank to deviations of inflation from the target and deviations of actual output from potential output (Mansour, 2009).

Making reference to the Federal Reserve's monetary policy, Svensson (2019) indicates that the Federal Reserve employs a balanced approach to the weights on the targets variables – inflation (price stability) and output gap (maximum employment). This is to say that the two policy

target variables are treated equally as objectives of monetary policy, with each assigned a weight of 0.5. However, Svensson (2019) contends that the Taylor rule is too rigid and does not respond to all unforeseen country circumstances and structural changes overtime and should be utilized as a “mere” guideline to monetary policy.

As a remedial measure, Svensson (2019) advocates for the use of “Forecast Targeting”, a forward looking monetary policy whereby the Central Bank sets the policy rate and the policy-rate path so that the resulting forecasts for its target variables best fulfil the Central Bank’s mandate. Svensson (2019) argues that an effective monetary decision cannot only rely on the current policy rate but should also take into account future paths of the policy rate. He further notes that this method can be applied to three strategies of monetary policy; flexible price level targeting, flexible temporary price level targeting and flexible average inflation targeting. Average inflation targeting was found to be the most superior due to its stabilization properties. This entails adjusting monetary policy to overshoot the inflation target subsequent to periods when the inflation target was undershot, so as to stabilize inflation around the target over a 5-year period.

Raputsoane (2018) analyses the SARB’s monetary policy reaction function pre and post the global financial crisis and modifies the policy reaction function to include the financial stress index. His results indicate “negligible” evidence of monetary policy response to the increase in inflation in the pre and post financial crisis period. However, with respect to output, the results indicate a strong monetary policy response to deviations of actual output to the long term output target. Furthermore, it appears that the SARB adheres to a loose monetary policy stance during financially stressful times.

Bold and Harris (2018) explore the SARB’s monetary policy from 1994 to 2015 and the sub-

period 2002-2015 when inflation targeting was adopted, with the aim of examining whether the SARB aligns its policy rate decisions to the Taylor rule, which they modify to include inflation expectations and labour market conditions. Their findings suggest that under the inflation targeting regime, the SARB’s policy rate setting was closely aligned to the Taylor rule and that the SARB considers labour market developments when setting their rates. However, more weight is placed on inflation expectations than the output gap, consistent with the SARB’s price stability objective. Additionally, their findings reveal that the SARB’s policy reaction function considers business and trade union expectations as they are price setters. This provides evidence that the SARB’s policy reaction function addresses concerns being raised by the national debate.

Although evidence suggests that the Taylor rule has guided the SARB’s monetary policy response over the past years, studying the history of monetary policy in South Africa and how it has evolved over the years could benefit this study. Understanding previous policy regimes and the reasons behind each transition will allow for an effective assessment of whether or not the SARB should amend its current monetary policy.

3. The Evolution Of Monetary Policy In South Africa.

This section elucidates the evolution of the SARB's monetary policy from 1960. This is summarised in table 1 below, depicting how the monetary policy regime in South Africa has progressed to date. The observed evolution from one regime to another was influenced by evolving structural changes in the South African financial system (e.g the financial liberalisation in the 1980s and increased capital flows from 1994) which forced South Africa to switch from money supply targets to inflation targets. Moreover, evidence on money growth in South Africa suggests that the SARB was unable to control money supply from 1994. Money supply rose more than money growth guidelines (targets) , while inflation declined, contrary to previous outcomes. Money supply targets therefore lost credibility as a gauge for inflation expectations and therefore as a guiding tool for monetary policy stance (Casteleijn, 2001).

With the failure of money supply targets, inflation targeting was adopted in 2000. The switch to inflation targeting was aimed at magnifying monetary policy transparency, accountability and predictability and indeed these three have improved to a fair extent with the adoption of the inflation targeting regime.

The CMA countries' response (with respect to monetary policy dependence, inflation and interest rates) to each regime is also outlined in table 1 above. It is also evident that CMA countries remained dependant on the SARB's monetary policy from 1974 to date, and maintained similar advantages with each monetary policy regime.

Figure 2 presents the trend for inflation in South Africa following the introduction of the inflation targeting regime in 2000. It can be observed that since the adoption of inflation targeting, inflation was fairly anchored around the SARB's target band, with an average inflation rate of 5.7 per cent from 2000 to 2018. This was despite spikes

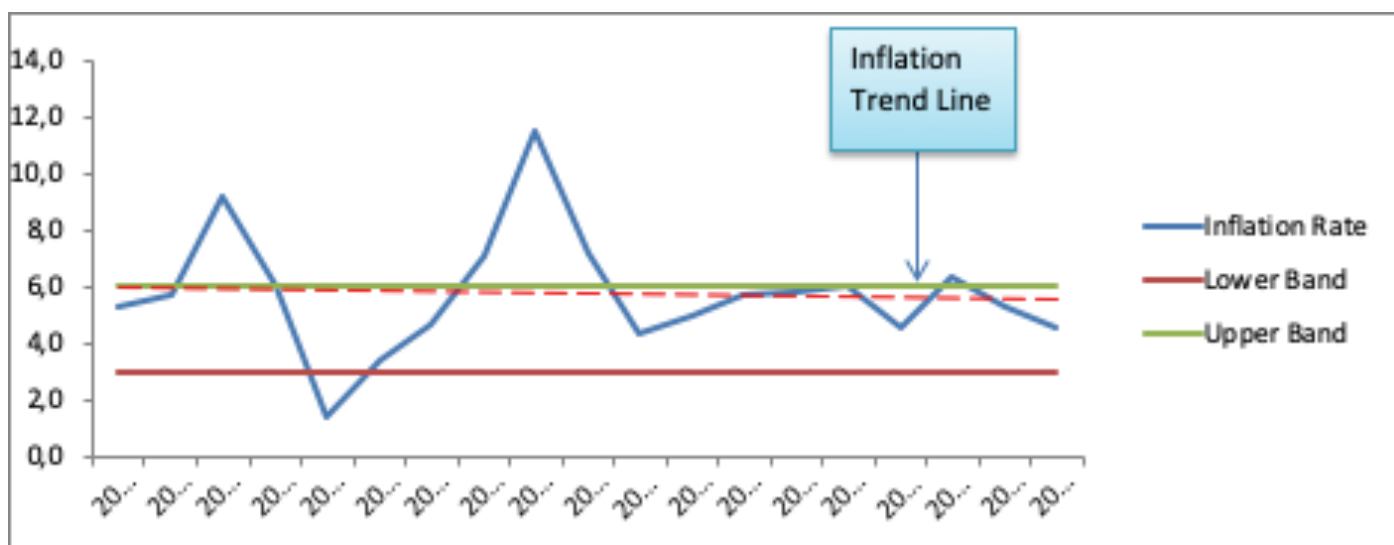
Table 1: Monetary Policy regimes in South Africa from 1960.

Year	SARB Monetary Policy	CMA countries' response
1960-1981	Liquid asset ratio-based system with qualitative controls on interest rates and liquidity.	Dependent monetary policy. Large pass-through from RSA inflation to CMA countries. Prime lending rates in CMA countries strongly determined by the RSA lending rate.
1981-1985	Mixed system during transition	Dependent monetary policy. Large pass-through from RSA inflation to CMA countries. Prime lending rates in CMA countries strongly determined by the RSA lending rate.
1986-1998	Cost of cash reserves-based system with pre-announced monetary targets (M3)	Dependent monetary policy. Large pass-through from RSA inflation to CMA countries. Prime lending rates in CMA countries strongly determined by the RSA lending rate.
1998-1999	Daily, later weekly, tenders of liquidity through repurchase (repo) transactions and pre-announced M3 targets and informal targets for core inflation	Dependent monetary policy. Large pass-through from RSA inflation to CMA countries. Prime lending rates in CMA countries strongly determined by the RSA lending rate.
2000-date	Price Stability with an inflation target of 3%-6%	Dependent monetary policy. CMA members indirectly follow an inflation-targeting policy with the concomitant advantages of such a policy.

Source: Aron and Muellbauer (2006) and Wang et al (2007)

observed in 2002 following the US terrorist attack in September 2001 and 2007 - 2009 due to the global financial crisis.

Figure 2: South Africa Inflation rate since 2000



Source: Author's own computation

As has been indicated, post 2000 CMA members' indirectly followed an inflation-targeting policy with the concomitant advantages of such a policy. This was also the case in previous regimes, whereby proceeds of the monetary policy in South Africa were transmitted into CMA countries. Given that the achievement of the primary objective of price stability in CMA countries is premised on price stability in South Africa, the pursuit of a dual mandate by the SARB could possibly threaten the price stability objective in other CMA countries. This therefore provides the basis for studying the likely implications of a SARB dual mandate on CMA countries.

4. The Likely Implications Of A Sarb Dual Mandate On CMA Countries

Section two highlighted on "forecast targeting" recommended by Svensson (2019). Forecast targeting may also be viable for South Africa to best achieve the SARB's mandate. The SARB has taken a step closer to forecast targeting, as evidenced by interest rate paths (forecasts) published in the SARB's Quarterly Projection Models. The forecasts may need to be extended from three years to ideally five years to meet the average inflation targeting postulated by Svensson (2019). In the same manner, CMA countries may

need to prepare themselves to also publish 5-year policy rate paths (most probably guided by the SARB's policy paths) in their outlook reports and report these amendments during CMA meetings. Wang et al (2007) note some of the issues and policy options that CMA countries tend to be

confronted with while seeking to achieve sustainable growth. First, CMA countries have consultations on monetary and exchange rate policies under the existing arrangements. Wang et al (2007) observe further that strengthening consultations would not benefit CMA countries in dealing with asymmetric shocks, given the size of the SARB under a weighted voting structure, which enables the SARB to dominate in the setting of monetary and exchange rate policies. This observation implies that there would be little or no role for CMA countries on their own policy setting or adjustment, should SARB amend its monetary policy to include real output more explicitly.

A second point noted by Wang (2007) is that CMA countries should be cautious of regional mechanisms to facilitate fiscal adjustment and structural reforms. Maintaining a sustainable fiscal position is important for the success of a monetary union (although the CMA is not a monetary union). Monetary unions such as the European Union (EU) have provided evidence of how rule-based fiscal frameworks could be a useful discipline tool in small member countries vulnerable to macroeconomic shocks. With the framework, member countries are compelled to avoid excessive debts and deficits, failing which members could be forced to undertake corrective measures within a specified period of time.

Disobeying the convergence criteria may lead to loss of reserves and compromise the currency peg and therefore price stability in member countries (Wang et al, 2007).

The CMA recently formulated and adopted (although not formally) a convergence criteria of fiscal deficit less than 3 per cent of GDP and total debt less than 60 per cent of GDP for all member states. Given the observations by Wang et al (2007), in the event of an explicit dual SARB mandate, the current convergence criteria would likely remain the same. However, CMA countries may need to strengthen their regional surveillance of fiscal policy further, by applying stricter corrective measures on countries who disobey the convergence criteria.

Above all else, it is important to observe lessons from previous changes of the SARB's monetary policy and their implications on the CMA. Existing evidence, for example Alweendo (1999) indicates that earlier changes on the SARB's monetary policy e.g, the switch from monetary targets to inflation targeting did not change the way in which CMA countries operated. Also, the adoption of inflation targeting in South Africa did not render other CMA countries monetary policy independence (BON, 2000). It has also been noted in table 1 above that CMA countries' maintained the same response with each monetary policy regime by the SARB. In a similar vein, with the adoption of a dual mandate, CMA countries will remain dependent on the SARB's monetary policy.

Subsequent to the announcement of the switch to inflation targeting, CMA central banks cushioned themselves to be wary of the future conduct of monetary policy. For example, in 2000, the Bank of Namibia held a Bankers' conference, which discussed the SARB's adoption of inflation targeting, challenges as well as implications of inflation targeting on CMA members. Likewise, in the event of a dual mandate by the SARB, CMA members may need to prepare themselves, in the form of conferences, to be wary of challenges and implications thereof.

5. Conclusion

The study revealed that the SARB has done fairly well with its current mandate of achieving price stability. Furthermore, although not stated explicitly, it appears that the SARB's policy reaction function responds to changes in deviations of inflation and output from their targets, indicating that the SARB is indeed responding to the concerns raised by the national debate.

It is also apparent that any policy amendment by the SARB will have some implications on the CMA, although it will not change the CMA's monetary policy dependence and how these central banks operate. CMA countries will have no role with formulating and executing their individual monetary policies that affect their own countries, in the event that the SARB was to amend their monetary policy.

However, if the SARB was to adopt a dual mandate, there could be room for further strengthening of fiscal reforms and surveillances by applying stricter corrective measures on countries who disobey the convergence criteria. Forecast targeting (average inflation targeting) may be viable for South Africa to best achieve the SARB's mandate. CMA members may then need to prepare themselves to adopt forecast targeting by publishing 5-year policy rate paths (in line with the SARB's policy paths) in their outlook reports and report these changes during CMA meetings.

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