

# The Reserve Bank and its functions

Presentation to the National Economic Forum by Dr Chris Stals, Governor of the South African Reserve Bank

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## 1. The institutional framework

The Reserve Bank is a juristic person created in terms of a special Act of Parliament. The Bank was originally established in 1920 and commenced with its operations in June 1921. It now operates in terms of Act No 90 of 1989, known as The South African Reserve Bank Act of 1989.

In terms of the Act, the Reserve Bank is a public company with its own share capital of two million rand, divided into two million ordinary shares of one rand each. No individual shareholder is allowed to hold more than 10 000 shares in the Bank, and the shares are listed on the Johannesburg Stock Exchange. At present the Bank has about 720 shareholders, and the Government does not hold any shares in the Bank. Because of the special nature of its functions, the annual dividend that the Bank may pay on its share capital is restricted to 10 per cent, and provision is made for the transfer of the surplus profits of the Bank to the Treasury.

The Bank is managed by a Board of fourteen directors, consisting of a Governor, three Deputy Governors (of whom one is designated as Senior Deputy Governor) and three other directors appointed by the State President, and seven directors elected by the shareholders. Without holding any shares in the Bank, the Government nevertheless has the right to appoint one-half of the directors.

In terms of the Act, the Governor must annually submit to Parliament through the Minister of Finance copies of the Bank's annual financial statements, and also a report relating to the implementation by the Bank of monetary policy. The Bank is therefore accountable to Parliament. At least once a year, the Governor is summoned to appear before the Parliamentary Joint Committee on Finance, and to answer questions on the monetary policy of the Bank.

The Bank has a total staff of about 2 000 people, and for administrative purposes, the Head Office administration has been divided into a number of Departments, with a Departmental Head — General Manager — in charge of each Department. Each Departmental Head falls under one of the Deputy Governors, and reports directly to him. In addition, the Bank also has eight branches, situated in the main financial centres, with the main function of providing bank notes to the banking system throughout the country.

## 2. The functions of the Reserve Bank

In Article 10 of the Reserve Bank Act, all the duties and responsibilities of the Reserve Bank are spelled out in some detail. All these duties and responsibilities can be

summarised under four main headings, and that is:

- \* to determine and conduct monetary policy;
- \* to manage the money and the banking system;
- \* to provide financial and economic services to Government; and
- \* to provide economic and statistical services (to Government, the Bank's clients and the public in general).

For internal administrative purposes, a fifth function can be identified, and that is to provide internal corporate services for the smooth functioning of the organisation on a day-to-day basis.

These five basic functions have led to the design of the logo of the Bank, which represents in an artistic form the Head Office building of the Bank in Pretoria, with its four facades depicting the four functions, bound together symbolically by a look-out platform on the 32nd floor representing the corporate services. These functions in combination serve to protect the value of the currency, as illustrated symbolically by the coin lying at the back of the building.

Of particular importance is Article 3 of the South African Reserve Bank Act which reads as follows:

"In the exercise of its powers and the performance of its duties the Bank shall pursue as its primary objective monetary stability and balanced economic growth in the Republic, and in order to achieve these objectives the Bank shall influence the total monetary demand in the economy through the exercise of control over the money supply and over the availability of credit."

The Reserve Bank forms part of overall economic policy, and the ultimate objective of overall economic policy is to promote stable economic growth. Many other factors, however, contribute to this ultimate objective and the Reserve Bank is only one of the many cogs in the complex machine of the overall macro-economy. It is important therefore that the Bank should define its role clearly, and should be committed to making its contribution to the achievement of the overall objective. For this reason, the Reserve Bank regards as its Mission, conferred on it by Parliament:

"The protection of the domestic and the external value of the rand".

This is the contribution that the Reserve Bank must make towards the achievement of balanced economic growth in South Africa.

### 3. Why is it important to protect the value of the currency?

Critics of the Reserve Bank and its policy often say that the Bank is too possessed by the imaginary dangers of inflation, and that the Bank should concern itself more directly with the problem of economic growth. Some even believe that more inflation can be stimulatory for growth and that there is a "trade-off" between growth and inflation. In analysing all the consequences of inflation and taking account of the experience of other countries, and also the harm that has been done to the South African economic system over almost twenty years of double-digit inflation, we in the Reserve Bank cannot but reject all these criticisms against our policy approach. We are of the conviction that South Africa will not have sustainable economic growth at a reasonably high level in the years to come unless we, and others in the process, will resolutely stick to our efforts to reduce inflation in this country.

In coming to this conclusion, we are being influenced by the many other inflationary forces at work in the South African economy — if the Reserve Bank does not fight inflation, who else will? We are also being influenced by the many well-recorded disadvantages of inflation of which we can again list but a few:

(i) Inflation erodes the value of money and thereby makes it impossible for money to play its proper role as a means of exchange, as a store of value and as a common denominator.

(ii) Inflation undermines the proper working of the price mechanism and therefore distorts the signals that price changes are supposed to emit through the market system to decision makers in the market economy. Wrong signals lead to wrong decisions, and therefore to a distorted economic structure.

(iii) Inflation leads to an unequal, and unfair, redistribution of wealth and income. Rich people can protect themselves easier against inflation than poor people. Higher income people have more opportunities to benefit from inflation than low-income people (fringe benefits). The government through fiscal drag gains from inflation. Lenders (or savers) are expropriated to the advantage of borrowers. Fixed-income earners, e.g. those who earn fixed salaries and wages, are at a disadvantage to other income earners. And so we can go on.

(iv) Inflation discourages saving, and stimulates extravagant consumption habits.

(v) Inflation leads to a non-economic allocation of resources. Scarce capital is employed to protect its owners against erosion, rather than in productive activity.

(vi) Inflation distorts the accounting results of corporates and businesses. Illusory profits are declared and dividends and salary adjustments are made on the basis of unrealistic financial accounts.

(vii) Inflation impairs the competitive position of South African manufacturers vis-à-vis their international competitors. Both our exporters and our importers cannot maintain their positions against foreign competition indefinitely in an environment of inflation, particularly not as long as our rate of inflation exceeds that of our major trading partners and competitors in world markets.

(viii) Inflation encourages the introduction of direct controls by government in an effort to protect its nationals from the disadvantages of inflation.

(ix) Inflation leads to more inflation. Inflation is indeed a function of inflation. A little bit of inflation tends to escalate if not vividly opposed.

(x) Sooner or later, inflation depresses economic growth and increases unemployment.

(xi) Inflation often leads to social unrest and public revolt by those adversely affected by rising prices.

More disadvantages of inflation can be offered, but we in the Reserve Bank are satisfied that the argument against inflation is convincing enough to justify our affliction with this problem.

### 4. The South African record

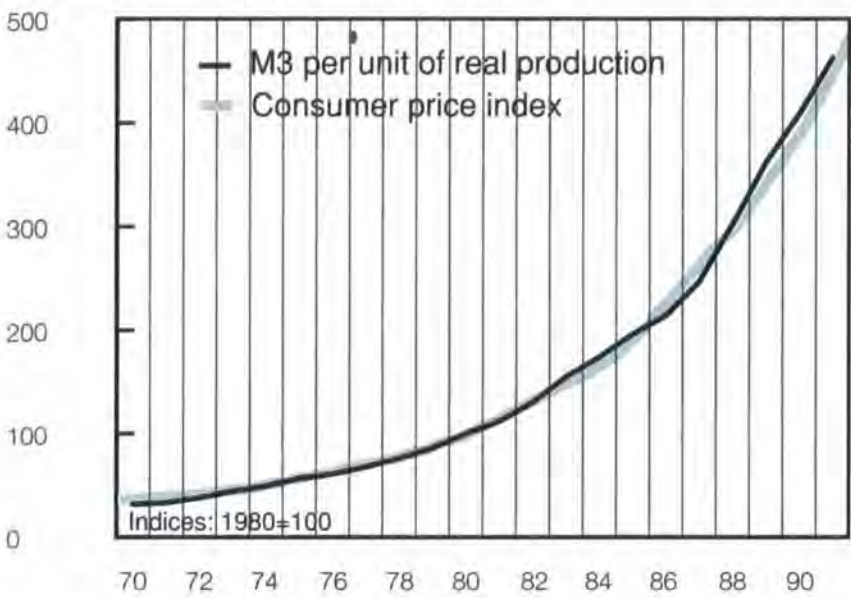
Inflation can be defined as a continuous and sustained increase in the general level of prices of goods and services, caused by a continuous and sustained decline in the value of money.

Inflation is a very complex matter, and there is no single cause for inflation. It will be an over-simplification to regard inflation only as a monetary phenomenon (although this is the view of certain monetarists such as the renowned American economist Milton Friedman). It is true, however, that money plays a very important role in any process of inflation. In the practical world it may, however, be extremely difficult to eliminate inflation completely through monetary policy alone. It is equally true, however, that all other efforts to stop inflation will be in vain if the monetary authorities cannot at the same time constrain the expansion in the money supply.

Although we have succeeded in avoiding hyperinflation in this country, our record is not a very good one. Since 1974, the annual rate of inflation, that is the average level of prices in any one year compared with the preceding year, has never been below 10 per cent. Many factors contributed to this sustained



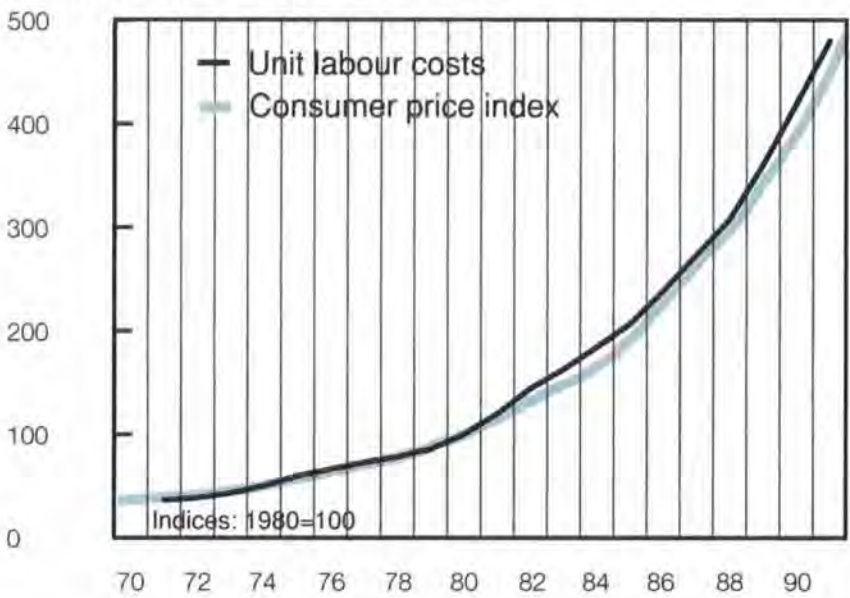
**Inflation and monetary growth**



high rate of inflation. Without trying to identify cause and effect, we must take notice of the fact that the persistent decline in the value of money in South Africa was accompanied by:

- (i) a continuous (and excessive?) rise in the money supply, as measured by the number of units of M3-money available for every one unit of real production in the economy;
- (ii) an exponential rise in the public debt per unit of real production, reflecting the effect of the cumulative

**Inflation and unit labour costs**

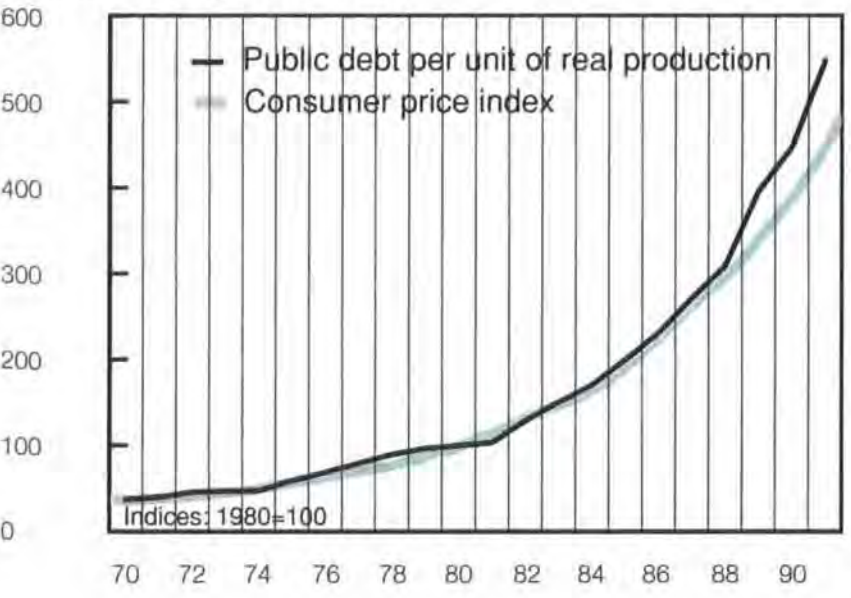


large deficits before borrowing on the budgets of general government;

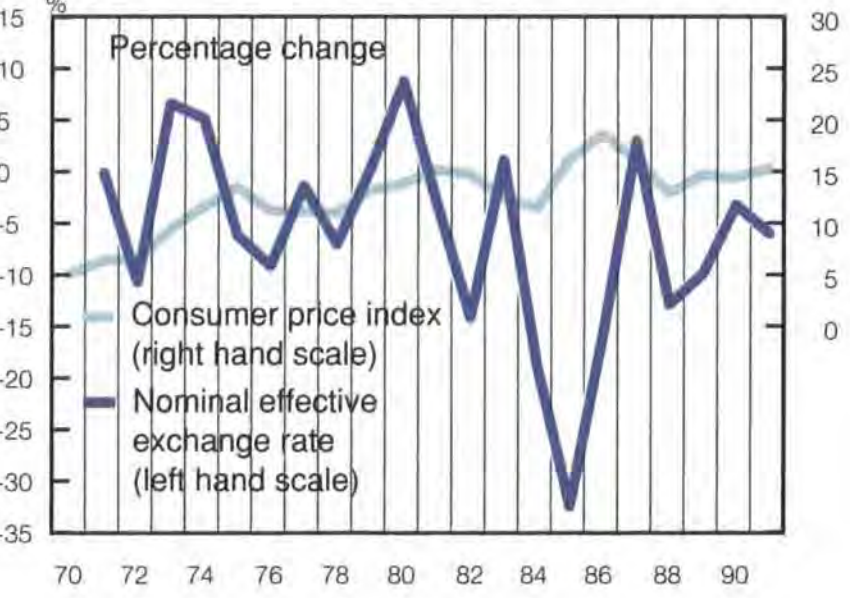
- (iii) the continuing rise of the nominal unit labour costs per unit of production, indicating the effect of rises in nominal wages and salaries and declining trends in labour productivity; and
- (iv) periodic but persistent depreciations in the exchange rate of the rand over the past twenty years.

If South Africa wants to have a low-inflation econ-

**Inflation and public debt**



**Inflation and the exchange rate**





omy, that is an economy with a high-growth potential, we shall have to tolerate a lower rate of increase in the money supply with whatever consequences this might have for interest rates and the supply of bank credit; we shall have to accept discipline in the management of the finances of government to avoid the large shortfalls of current public sector revenue compared with total public sector expenditure; we shall have to constrain average wage and salary increases to bring it more in line with productivity changes; and we shall have to build up our gold and foreign exchange reserves to enable the Reserve Bank to intervene in the foreign exchange market from time to time to stabilise the exchange rate of the rand.

The alternative is stagflation — that is, high inflation, a low rate of economic growth and increasing unemployment. South Africa has hopefully had enough of this bitter medicine over the past decade to convince everybody that the alternative is no longer an acceptable option. We must bring inflation down to prepare the way for sustainable economic growth at a reasonable level over the next decade.

## **5. Monetary policy objectives of the Reserve Bank**

In conformity with the mandate given to it in the Reserve Bank Act and in accordance with its Mission statement, the Reserve Bank persistently follows a monetary policy aimed at protecting the value of the rand. To assist the Bank in being consistent in its actions, the Bank follows a certain sequence with its decisions on monetary policy.

Firstly, the Bank sets and announces guidelines for an acceptable rate of growth in the money supply at the beginning of each year. In its fight against inflation, the Bank has over the past three years progressively reduced these guidelines from an acceptable rate of 14 to 18 per cent in 1989 to 7 to 10 per cent for 1992. The guideline range for 1993 has not yet been announced.

Secondly, and in recognition of the fact that money is mostly created through the extension of bank credit in South Africa, the Reserve Bank regularly keeps a close watch on the increase in the outstanding amount of bank credit. Excessive increases in bank credit lead to excessive increases in the money supply and therefore defeat the prime objective of monetary policy.

Thirdly, we accept the fact that increases in the amount of bank credit are driven by the supply of funds on the one hand, and the demand for funds on the other. The Reserve Bank therefore has to guard against excessive increases in overall liquidity, and must regularly use the instruments at its disposal, e.g. open market operations, foreign currency swap transactions and discount window activities to manage or influence the amount of liquidity in the banking system.

Fourthly, to the extent that the rate of increase in the money supply is driven by the demand for funds, it is imperative that realistic interest rates shall be maintained at all times. The Bank can influence interest rates in two ways, that is, through its management of overall liquidity and through its Bank rate, that is the rate at which the Reserve Bank is prepared to make funds available to banking institutions at the discount window.

Fifthly, in support of the monetary policy objectives, the Bank would like to see a relatively stable (but not necessarily fixed) exchange rate for the rand. The Bank itself can only contribute to this objective, particularly at times of a depreciating currency, provided the Bank has command over a reasonable amount of foreign reserves. It is therefore a legitimate desire of the Bank at this stage to build up the country's foreign exchange reserves to a more comfortable level.

Finally, the Bank believes that monetary policy can only be effective if the country has a sound financial system. The Bank therefore has a great interest in the development and existence of sound banking institutions, and well-functioning money, capital and foreign exchange markets.

## **6. Recent achievements of monetary policy**

Over the past three years, monetary policy set out to achieve a more stable financial environment. This required:

- \* A reduction in the rate of increase in bank credit extension from the level of almost 30 per cent reached in 1988. Over the twelve months up to November 1992, total bank credit extended to the private sector rose by 7 per cent.

- \* A reduction in the rate of increase in the money supply, which rose by 27 per cent over twelve months' periods in the second half of 1988. Over the calendar year 1992 the M3 money supply increased by 8,6 per cent.

- \* An improvement in the underlying soundness of the banking system. The introduction of the new Deposit-taking Institutions Act in 1991, and a new approach in bank supervision where the emphasis has now shifted towards risk management rather than prudential provisions have made major contributions towards this objective.

- \* An increase in the net gold and other foreign reserves of the country. In the middle of 1989, the net foreign reserves of the Reserve Bank amounted to only a few hundred million rand. The net foreign reserves of the Bank recently at times exceeded R10 billion. However, this still leaves the country very vulnerable to unpredictable external shocks.

\* A more stable exchange rate for the commercial rand (but not a rigid fixed exchange rate). Over the past two years, the average weighted value of the commercial rand against a basket of the currencies of South Africa's major trading partners depreciated more or less by the inflation differential between South Africa and those countries. The Bank has unfortunately not yet been in a position to support a more stable exchange rate for the financial rand, which continued to fluctuate violently over the past year.

\* A reduction in the rate of inflation, which peaked at over 20 per cent in 1986 and was at a level of almost 17 per cent in the middle of 1989. In December 1992, consumer prices were only 9,6 per cent above the level of December 1991, whilst producer prices on the average increased by 7,5 per cent from November 1991 to November 1992.

Against the background of these achievements, some economists believe that the monetary authorities can now afford to relax on their policies, and be less concerned about the objectives of establishing an overall stable financial environment. All the set goals have not been achieved, however, and the financial disciplines will have to be retained in 1993.