The role of monetary policy in support of economic development

**Address by Dr C.L. Stals, Governor of the South African Reserve Bank, at a World Economic Development Congress Meeting, New York,
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1. Introduction

The new South Africa has now been firmly established on the foundation of what turned out to be, after a long and frustrating run-up, a very successful democratic election. The new executive, legislative and administrative functionaries have been appointed, and the mechanism for running this exciting new country is now in the process of activation.

In the few short weeks since the inauguration of President Mandela, the major attention of the public debate switched away from the party-political feuds of the election campaign, to the real economic needs of the people of the new country, to the economic constraints that must now be faced as economic realities, and to macro-economic plans and programmes needed in order to address these problems. In the election campaign, the wrong-doings of the past and the economic distortions created by history received a lot of attention. Governing the country now and solving the problems of poverty and expectation, however, are about the future.

What role is there for monetary policy in this future? In order to answer this question, we first need to glance at the main economic priorities of the Government of National Unity, and also at the current economic situation in South Africa.

2. Main economic objectives

The new Government has been very decisive in its statements on economic priorities and objectives. It has left little doubt for the domestic and the international business community that its main objective will be to address the socio-economic problems of poverty, and to relieve the suffering of millions of people in the South African community because of distress.

Some guidance on the relief programme has been published early in 1994 in an ANC document with the title "The Reconstruction and Development Programme – A Policy Framework". Although the contents of this document may have been drafted with party-political objectives of the pre-election campaign in mind, it nevertheless provide a comprehensive identification of the more urgent needs of the people, and also make suggestions on a programme for addressing these needs. As the title indicates, it is not only a programme of economic reconstruction, but also one of economic development.

The Reconstruction and Development Programme (RDP) is based on six basic principles which can be summarised as follows:

* Economic reconstruction and development must take place in an integrated and sustainable programme.
* The process is intended to serve the people and must therefore be driven by the people.
* It must promote peace and security for all.
* The Programme must contribute to constructive nation building.
* In the macro-economic context, the processes of reconstruction and economic development must be linked.
* The RDP must promote the democratisation of South Africa.

On the basis of this declared philosophy of the RDP, it proposes a number of "strategies and policy programmes" for implementation. Five key programmes are identified, namely:

* meeting the basic needs;
* developing human resources;
* building the economy;
* democratising the state and society; and
* implementing the RDP.

The extent of the more detailed programmes can be illustrated by, for example, quoting the list of proposals for "Meeting the basic needs" of the people. These are:

* the creation of jobs through public works programmes;
* land reforms;
* provision of housing and services;
* providing improved services in respect of:
  - water and sanitation;
  - energy and electrification;
  - telecommunications; and
  - transport;
* improve the management of the environment;
* provide better nutrition services;
* improve nation-wide health care; and
* expand social security and social welfare.

The proposals for "Building the economy" provide some useful guidance for the business community on the broader policy approach to economic development. Based on the basic principle of linking reconstruction and development, proposals are made for:

* a strategy covering industry, trade and commerce;
* resource-based industries;
* the upgrading of the infrastructure;
* a reform of the financial sector;
* the protection of labour and worker rights; and
* a Southern Africa regional policy.

The major debate on the RDP at this stage is not so much about the objectives of the programme, but about the affordability. As in all other countries, the needs of the

people of South Africa, and the very legitimate and urgent basic needs, are far more than what can be produced in the short-term with the resources at the country's disposal. It is often overlooked that what is at question here is not only the provision of cash flows or financial resources, but the physical capabilities, including management capacity, to implement the programme.

The macro-economic constraints on the South African economy were analysed in a similarly authoritative document published by the previous Government in March 1993 under the title "The Restructuring of the South African Economy: A Normative Model Approach" (NEM). The RDP and the NEM should be seen as two very useful complementary analyses of the South African macro-economic problem. The RDP's approach is what economists will call a "bottom-up" analysis in which the starting point is the numerous and legitimate needs of the South African population. The NEM, on the other hand, has a "top-down" approach in which the emphasis falls upon the limited capacity of resources available to the country to produce the goods and services demanded (and needed) by the community. The RDP in its total context does not ignore the economic reality of limited resources and the NEM in its turn does not deny the legitimacy of the massive needs of the many disadvantaged or underprivileged people of South Africa.

In the practical world where South Africans must now face the harsh realities of infinite needs and limited resources, the "bottom-up" and the "top-down" approaches of the economic analyses must sooner or later meet. The time has come now to marry the RDP and the NEM. Various political leaders recently referred to a new government paper that is now in preparation and that will re-confirm the Government of National Unity's commitment to the RDP, and also its understanding of the limitations of the NEM.

3. The current economic situation

Monetary policy at this stage must also be framed within the context of the current economic situation. The evaluation of the current economic situation is, however, not easy, as developments recently were severely distorted by the political events leading up to the election.

After more than four years of recession, the South African economy started to recover during the course of 1993. The economic growth rate, measured by the seasonally adjusted changes in gross domestic product on a quarterly basis, rose from 1,6 per cent in the first quarter of 1993 to 5,7 in the second, 8,2 in the third and 6,2 per cent in the fourth quarter of last year. In the first quarter of 1994, however, gross domestic product was 3,7 per cent down on the level of the fourth quarter of 1993.

These growth rates were partly dominated by changes in total production of the agricultural sector, due to volatile climatic conditions, but also by the changing perceptions of the political situation. At this juncture and despite the adverse developments in the first quarter, there is still enough optimism to predict economic growth of between 2 and 3 per cent for calendar 1994.

One of the encouraging developments in recent times has been a modest but promising revival in the gross domestic fixed investment which has been declining ever since 1990. New investment, particularly in manufacturing, contributed to the economic recovery of last year and will hopefully provide further stimulus to the economic expansion phase in 1994.

Another encouraging development has been a significant moderation in the rate of increase in average wages and salaries. Indications are that the average real wage per worker in the non-agricultural sectors of the economy showed almost no increase in 1993, compared to a rise of more than 2,6 per cent in 1992. Coupled with a "technical" improvement in productivity, brought about by a reduction in employment, the nominal unit labour costs of production increased at a much lower rate. The real unit labour costs actually declined by more than 2 per cent last year.

Should this encouraging trend continue, it will make South Africa more competitive again in the international markets. Indeed, an increase in multi-factor productivity is an imperative to support a successful re-absorption of South Africa into the world economy at this stage.

In the overall economic analysis, the balance of payments still remains one of the major constraints for economic development. For nine years in succession, from 1985 to 1993, the current account of the South African balance of payments showed continuous surpluses. Over the period as a whole, the cumulative current account surplus amounted to R46,5 billion, equal to an annual average of R5,2 billion.

Over this same period, however, the total cumulative net outflow of capital amounted to R58,5 billion for an average annual amount of R6,5 billion. The net capital outflows therefore exceeded the surpluses on the current account and depleted the country's net foreign reserves to an extremely low level.

On the average, South Africa's imports account for about 25 per cent of all the goods and services used in the country. Not only does the country have a relatively high "import penetration ratio", it also has a very "high marginal propensity to import". This was clearly illustrated again in the first quarter of 1994 when imports rose by 2 per cent, after having already increased by more than 13 per cent in 1993, mainly because of the revival of demand in the domestic economy.

With increases in imports now outpacing a more modest rise in exports, the surplus on the current account of the balance of payments is dwindling. In the first quarter of 1994, it amounted to a seasonally adjusted annual rate of only about R2,3 billion, down from R5,9 billion for calendar 1993.

The big surpluses on the current account of the balance of payments since 1985 could only be maintained in an environment of a depressed domestic

economy. The average annual rate of growth in the gross domestic product over the period 1985 to 1993 was only 0,6 per cent per annum, that is, well below the average growth rate of 2,3 per cent in the total population over the same period.

With official foreign reserves now at a level of only about R10 billion, that is the equivalent of less than six weeks' imports, it is clear that South Africa will not be able to support higher economic growth on a sustainable basis unless there will be a dramatic change in the capital account of the balance of payments in the near future. The total net capital outflow for last year was estimated to have been about R16 billion. In the first four months of 1994, there occurred a further net capital outflow roughly estimated at between R3 and R4 billion.

Despite these balance of payments disturbances, the domestic financial situation has remained relatively stable. Although there has been some temporary acceleration in the rate of increase in the money supply recently, M3 last year rose by only 7 per cent, and total domestic credit extension by less than 10 per cent. Most interest rates declined last year, although they still stayed at a relatively high level if measured in real terms. The current prime overdraft rate of banking institutions at 15,25 per cent is now at a level of more than 8 per cent above the latest rise of 7,1 per cent over the past twelve months in the consumer price index.

One last remark about the current economic situation is to express some concern about the state of government finances. Over the past two years, the deficit before borrowing on the Budget of the central government increased quite substantially. Compared with an average of only 3,2 per cent of gross domestic product in the preceding 8 years, this deficit then rose to 8,2 per cent in 1992/93, and an estimated 6,8 per cent in 1993/94. The funding of a deficit of this magnitude will lead to undue stresses in the capital market once private sector demands also increase in the light of an expected further rise in the economic growth rate. The increase in the fiscal deficit is, however, regarded as a temporary aberration caused by the depressed domestic economic conditions of the past two years.

4. Monetary policy in support of economic development

The basic philosophy behind the monetary policy followed in South Africa since about 1988 is that monetary policy has one prime and overriding responsibility, and that is to protect the value of the currency. The Reserve Bank believes that by combating inflation it can make the greatest contribution to economic development. We regard financial stability as a very important precondition for sustainable economic growth. Indeed, it will hardly be possible to make meaningful progress with the Government's programmes for reconstruction and for development in an environment of financial instability.

The framework within which monetary policy is applied by the Reserve Bank is based on predetermined guidelines for an acceptable rate of increase in the money supply. A broad definition of money, M3, including short and longer-term deposits of the private sector with the banking sector, is used for this purpose. For the current calendar year, the guidelines were set at a range of 6 to 9 per cent, which may seem to be rather generous in the context of similar targets set in those industrial countries that still make use of monetary targeting. These limits, however, were determined against the background of an average rate of inflation of 9,7 per cent in 1993, and an expected overall economic growth rate of 3 per cent for 1994. If anything, the guidelines were intended to signal a clear message from the monetary authorities of their determination to reduce the rate of inflation further.

The Reserve Bank does not regard its money supply guidelines as a rigid overriding money rule which precludes any discretion by the authorities. In making policy decisions, developments in other financial variables, such as interest rates, changes in domestic credit extension by banks, the level of and the current trend in the foreign reserves, and exchange rate movements, are also carefully monitored. If rational decisions are taken all the time:

* the expansion of the money supply should remain within the target range;
* the general level of interest rates in the country should remain realistic and should stay at least at some margin above the rate of inflation;
* domestic bank credit extension should not rise excessively;
* the total foreign reserves will remain at an adequate level;
* the exchange rate of the rand as determined by market forces will remain relatively stable; and
* inflation will be contained.

The Reserve Bank does not, however, quantify or predetermine set targets for all the different variables and uses divergences of the money supply from the target range as the most important indicator for its monetary policy decisions.

The Reserve Bank's key operational variable in achieving its goals is its Bank rate – that is, the lowest rate at which it lends to banks experiencing a shortage of liquid funds. The money supply in South Africa is to an important extent demand driven, and money is created mainly by the extension of credit by banking institutions. There is therefore a close relationship between the growth in money supply and the level of interest rates. A more restrictive policy on the growth in the money supply would obviously require a higher level of interest rates than a more expansionist monetary policy. This link between changes in the money supply and the level of interest rates is often disregarded by the critics of the Reserve Bank who believe that the Bank takes a sadistic

pleasure in keeping interest rates at an unnecessary high level.

The Reserve Bank also does not have a predetermined target for the exchange rate of the rand, except that it should be as stable as possible. The Bank intervenes from time to time in the foreign exchange market to smooth out short-term fluctuations, and sometimes even to counteract somewhat longer-term movements, as long as they are considered to be of a transitory nature. In 1993 and in the first four months of 1994, for instance, the Reserve Bank sold considerable amounts of foreign currency in the exchange market to lean against the wind of a depreciating currency when we were of the opinion that the overall balance of payments deficit was not founded on long-term economic fundamentals, but rather on perceptions of a more non-economic nature. On the other hand, the Bank would be the first to recognise that trying to stop an exchange rate movement that has its origin in changed economic fundamentals would be counter-productive.

Finally, the philosophy, the framework and the operational procedures of the monetary authorities in South Africa are all based on the presence of sound financial institutions, particularly banking institutions, in the country, and on the existence of well-functioning financial markets. The Reserve Bank is therefore also actively involved in developing the money and capital markets, and, at this stage, particularly in promoting a more effective foreign exchange market in South Africa. It also has the responsibility of managing the bank regulatory function which is now firmly based on the principles and directives of the Basle Committee.

5. Concluding remarks

There are some reasons for satisfaction in the results achieved with monetary policy over the past six years. In an extremely unfriendly financial environment, we succeeded in:

* bringing the rate of increase in the M3 money supply down from 27 per cent in 1988 to 7 per cent in 1993;
* reducing the rate of increase in the total amount of bank credit extended to the private sector from almost 30 per cent in 1988 to less than 10 per cent in 1993;
* reducing the Bank rate from 18 per cent in 1991 to 12 per cent now (and establishing the firm conviction that interest rates should remain positive in real terms at all times);
* bringing the rate of inflation down from 20,7 per cent in 1986 to below 10 per cent last year. Over the twelve months up to April 1994, the rate of increase in consumer prices declined to 7,1 per cent, the lowest rate of increase in any twelve months period since 1972;
* establishing a sound and internationally compatible system of bank supervision and regulation; and
* introducing greater sophistication and efficiency in our money and capital markets.

There are, however, some remaining obstacles to the longer-term goal of persistent overall financial stability:

* The relatively low level of the country's gold and foreign exchange reserves at this stage makes it extremely difficult to switch to a more relaxed monetary policy.
* The exchange rate of the rand has remained under pressure. The average weighted value of the rand against the value of a basket of the currencies of our major trading partners last year depreciated by 9,2 per cent, and in the first four months of 1994, by a further 7,0 per cent.
* The foreign exchange market is still subject to extensive regulation. The dual exchange rate system and the extensive exchange controls applicable to residents lead to distortions in exchange rates, interest rates and financial asset prices that make rational economic decisions difficult.
* The recent growing deficits on the Budget of the Government, the large demand for funds emanating from Government and the rising level of the public sector debt are, in the longer run, not reconcilable with the goals of overall financial stability.

The view of the Reserve Bank is that the underlying forces that cause these problems must be addressed and corrected first before the symptoms can be eliminated. The persistent capital outflows from the country in recent years provided the major obstacle in our efforts to restore and maintain overall financial stability. A resumption of capital inflows into the country has become an important prerequisite for the successful conclusion of our efforts to establish and maintain financial stability. This is the role we see for monetary policy in support of economic development in South Africa.