The challenges for monetary policy

Address by Dr C. L. Stals, Governor of the South African Reserve Bank, at the 19th Annual Investment Conference arranged by Frankel Pollak (Pty) Limited Johannesburg, 20 February 1996

1. The task of monetary policy

Macroeconomic policy measures are normally directed towards the promotion of economic growth and development, the creation of more jobs and the employment of more people, the improvement of the living conditions of all the people of the country, and the elimination of unjustifiable discrepancies between average incomes of various groups of participants in economic activity.

Monetary policy, being a subsidiary part of macroeconomic policy, has but an intermediate part to play in the implementation of overall macroeconomic policy. It is expected of monetary policy to create and maintain a stable financial environment within which overall economic activity can operate. None of the above ultimate objectives of macroeconomic policy will be attainable in an environment of financial instability. Although overall financial stability by itself cannot guarantee the achievement of the aforementioned ultimate macroeconomic objectives, it is an important precondition for reaching those goals.

In order to comply with its obligation and to meet its commitment, the central bank should pursue its objectives with a medium- and longer-term view in mind. Financial stability should, for example, be maintained throughout the business cycle in both the expansion and contraction phases of the economy, and should in the democratic political system of periodic elections, stretch beyond the duration of successive governments. It is *inter alia* for this reason that central banks need some autonomy for the execution of their duties.

What are the challenges now facing the South African Reserve Bank to meet the objective of maintaining overall financial stability in the context of the new South Africa?

2. Major economic developments during the past year

From the point of view of the central bank, the South African economy performed extremely well during 1995.

Firstly, the real rate of growth in gross domestic product of almost 3½ per cent last year may not be good enough for the actual needs of the country at this stage, but nevertheless represented the best performance since 1988. This relatively good growth was attained despite declines of 15 per cent in agricultural and 10½ per cent in gold production. Total value added by manufacturing actually increased by 7½ per cent after it had already risen by 2½ per cent in 1994.

The growth in domestic production was supported by even stronger growth in real gross domestic expenditure, which rose by 5½ per cent last year, following upon an even larger relative increase of 6½ per cent in 1994. As in the previous year, gross domestic fixed investment made the most important contribution to total growth in 1995, with a rise of 10½ per cent. Inventories increased further, whereas private consumption expenditure gained strong momentum and rose by seasonally adjusted annualised rates of 6½ and 5 per cent in the last two quarters of last year.

Secondly, the improvement in real domestic economic activity did not in 1995 lead to any undue pressure on the balance of payments. The rise in domestic expenditure, particularly in fixed investment in manufacturing, led to a predictable sharp increase of almost 30 per cent in the value of imports, mainly attributable to a rise of about 20 per cent in the volume of imports. Excluding gold, merchandise exports also performed well, with a rise of almost 25 per cent on the level of 1994. The volume of exports rose by about 16 per cent. Declines in the value of net gold exports and in the negative figure for net services, however, contributed to a substantial increase in the deficit on the current account of the balance of payments, which rose to R12½ billion in 1995.

The financing of the current account deficit, equal to about 2½ per cent of gross domestic product, presented no difficulties as the net capital inflow into the country rose to almost R22 billion in 1995. Short-term capital (mainly in the form of foreign borrowing by South African banking institutions) accounted for about R9 billion of this total. The net inflow through the acquisition of South African securities by non-residents accounted for R6 billion of the so-called medium- and long-term capital inflows.

The excess of the supply of foreign exchange enabled the Reserve Bank to increase its net foreign reserves (gross reserves minus foreign liabilities) by R9 billion. This was mainly done through intervention in the foreign exchange market. At the end of 1995, the gross foreign reserves of the country had risen to R18,2 billion, which represented about 7 weeks' imports at current levels.

The foreign exchange rate of the rand remained remarkably stable in 1995, despite the fact that all remaining foreign exchange controls on non-residents were removed, and some progress was also made with the gradual reduction in exchange controls applicable to resident corporates and institutional investors. Against the background of the large net foreign capital inflows into the country, the average weighted nominal value of the rand against a basket of currencies of South Africa's major trading partners declined by only 3,6 per cent over the year as a whole, but rose by 4,4 per cent over the last five months of 1995, and by a further 1,4 per cent in January 1996. Adjusted for inflation rate differentials, the effective average real value of the rand appreciated by 1,5 per cent from December 1994 to December 1995, and by 5,3 per cent from May until December 1995.

Thirdly, the combination of improved real domestic economic activity and a surplus on the overall balance of payments was accompanied by relatively stable conditions in the domestic financial markets. The Reserve Bank had some concern about a substantial increase in the M3 money supply which rose by 15,1 per cent over the twelve months up to December last year. From the fourth quarter of 1994 to the fourth quarter of 1995, the average level of the money supply rose by 14,3 per cent, which was sizeably higher than the upper limit of an acceptable guideline range of 6 to 10 per cent indicated by the Reserve Bank at the beginning of last year. It should, however, be noted that the rate of increase in M3 abated towards the end of last year. The quarter-to-quarter growth in M3, at seasonally adjusted and annualised rates, peaked at 27,3 per cent in the second quarter of 1995 and then declined to 15,5 per cent in the third, and only 6,9 per cent in the fourth quarter.

Although the increase in the Reserve Bank's net gold and foreign exchange reserves also added to the money supply, this was partly offset by a significant increase in the foreign borrowing of the banking sector. A large increase in bank credit extended to the private sector, which rose by 17,5 per cent over the calendar year, was therefore mainly responsible for the increase in the money supply. In the longer run, economic growth based on a continuous rise in the money supply cannot be sustainable and will eventually lead to unstable financial conditions and an unavoidable painful downward adjustment. It is therefore encouraging to note that the annualised rate of increase in the net amount of bank credit extended to the private sector slowed down to 14,1 per cent in the fourth quarter, compared with 21,3 per cent in the second quarter of 1995.

Most short-term interest rates were driven upwards by a strong demand for credit in 1995, particularly during the first six months of the year. The rate on bankers' acceptances with a maturity of three months, for instance, increased from 12,5 per cent at the end of December 1994, to 14,2 per cent at the end of June 1995. During the second half of the year, short-term rates remained firm, with only slight marginal declines in some cases.

Long-term rates, however, showed a different trend. The monthly average yield on long-term government stock initially receded hesitantly from a high of 17,02 per cent in January 1995, and then declined rapidly to 13,77 per cent in January 1996. At this stage, the yield curve was not only markedly lower than a year before, but also relatively flat.

Fourthly, and very encouraging from the monetary policy point of view, inflation showed clear signs of further abatement last year. Trends in the consumer price index were distorted by, first, a rise and then an equally sharp decline in food prices in the second half of the year. The rate of increase over periods of twelve months in the overall consumer price index declined from a peak of 11,0 per cent in April 1995 to a low point of 6,3 per cent in October, before rising again to 6,9 per cent in December 1995. The average rate of inflation for the year 1995 was 8,7 per cent – the lowest rate of increase in consumer prices over a year since the 6,1 per cent registered in 1972.

Producer price inflation also remained below 10 per cent last year, although the average of the increase for the year in the all-goods production price index rose from 8,0 per cent in 1994 to 9,6 per cent in 1995.

The combination of higher economic growth, an overall balance of payments surplus, relatively stable conditions in the domestic financial situation, and relatively low inflation, was facilitated by the political and social changes over the last few years, and vindicated the course of recent macroeconomic policies. In the longer term, the economic growth potential of the country will have to be raised to a higher level.

3. Challenges for 1996

Can monetary policy again succeed in maintaining overall financial stability in 1996? It should be noted that monetary policy can only be successful to the extent that underlying developments in the market will support stable financial conditions. In case of major shocks in the markets, monetary policy operating in the environment of a market economy can normally only lean against the wind, smooth out some volatile over-reactions, and alleviate painful adjustments in the short term. In the longer run, fundamentals should be allowed to determine financial aggregates such as interest rates, exchange rates and financial asset prices.

Firstly, as far as the domestic financial situation is concerned, monetary policy in South Africa is still firmly guided by changes in the money supply. The model for monetary policy, introduced by the De Kock Commission of Enquiry into Monetary Policy in the mid-eighties, was never intended to be a rigid money rule for monetary policy, but fitted the situation well in serving as the most important indicator or reflection of current developments of underlying potentially inflationary pressures in the economy. Indeed, the decline in inflation in South Africa from over 20 per cent at one stage in 1987 to its present level, coincided with the introduction and consistent implementation of the model based on a pre-announced acceptable range for the rate of increase in the M3 money supply.

The Reserve Bank has in recent years occasionally stated that the value of the M3 money supply, as an anchor for monetary policy may be eroded by South Africa's reintegration into the international financial markets, particularly at a time when the globalisation of financial markets is reducing the usefulness of domestic financial indicators, such as the money supply, also for other countries. The Bank is therefore gradually applying a more pragmatic approach and is taking a broader view of movements in a whole array of financial developments to guide it in its decisions on monetary policy. In the new emerging model, however, changes in the money supply still carry by far the highest weight.

It is becoming increasingly difficult for the Reserve Bank to control the money supply. South African banks now have easier access to an outside source of liquidity, and that is foreign borrowing. This was evidenced by the increase of approximately R6 billion in the outstanding short-term foreign liabilities of the South African banking sector (excluding the Reserve Bank) in 1995. It is therefore of growing importance that the South African financial markets be liberalised further and become more effective as a self-regulatory discipline on the participants in the markets.

The challenge for the Reserve Bank is to maintain some influence over the overall liquidity situation in the country, despite inflows and outflows of large amounts of funds through the balance of payments. This gives new importance to the open market operations of the Bank – monetary policy has become more complex and more dimensional. The Bank, therefore, over the past year used this instrument of monetary policy more actively to absorb surplus liquidity created by the relatively large net inflows of capital from abroad. In the process the Reserve Bank's own portfolio of government stock declined from R8,8 billion at the end of December 1994 to R4,8 billion at the end of 1995.

The interest rate policy of the Reserve Bank is also being challenged by the new situation. Interest rates are, of course, determined by market forces of demand and supply, but can always be influenced to some extent by monetary policy intervention working through the market mechanism. On the one hand, in the present situation, an excessive expansion of bank credit is putting undue pressure on the money supply and dictates the need for maintaining high interest rates. On the other hand, high interest rates attract more short-term and volatile capital from the rest of the world, which again adds to the liquidity of the system, and to the ability of the banks to extend more credit and, in the process, adds to the money supply. It is a challenge for monetary policy to strike a right balance between these opposing financial forces in the implementation of its interest rate policy.

Secondly, as far as the international financial relations with direct implications for monetary policy are concerned, similar interesting challenges now face the Reserve Bank. During the past year, the Bank intervened quite heavily in the foreign exchange market, mainly as a net buyer of foreign exchange in order to prevent the exchange rate of the rand from appreciating under the pressure of a continuous large net inflow of capital. These intervention operations at times clashed with the monetary policy model of the Bank which is in principle anchored to the control of the money supply, but they were nevertheless justified on the basis of the following three arguments:

- The Reserve Bank found itself in April 1994 in the unenviable situation that, on a net basis, it had zero foreign reserves to assist it in its efforts to maintain orderly conditions in the foreign exchange market.

- Based on the fundamentals of the South African economy, any strong appreciation of the exchange rate of the rand at this stage will not be in line with the developments in the relative competitiveness of the South African production machinery, be it in the primary, secondary or tertiary sectors of the economy.

- It must be remembered that the floating exchange rate system in terms of which forces of demand and supply operating through the foreign exchange market determine the exchange rate of the rand, remains subject to the distortions of the exchange controls still applicable to outward capital investments by South African residents. The determined rate is, therefore, not necessarily a reliable reflection of an equilibrium exchange value of the rand.

With these considerations in mind, the Reserve Bank, contrary to the dictates of the accepted monetary policy model anchored to changes in the money supply, bought a substantial amount of foreign exchange in the market last year. At the same time, the Bank used internal measures such as open market operations to neutralise the counter-effects of the foreign exchange market intervention on the domestic money and capital markets.

Should the surplus on the overall balance of payments continue in 1996, the management of the sometimes conflicting objectives of preventing an appreciation of the rand and controlling the money supply at the same time, will certainly provide an interesting challenge for monetary policy.

The intervention by the Reserve Bank over the past year in the foreign exchange market in a situation of continuous upward pressure on the external value of the rand, apparently created the false impression in certain circles that the Reserve Bank is now targeting the exchange rate and is fixing it within a narrow band around the US dollar. This is a completely false perception.

Taking account of the aforementioned reasons for the Bank's intervention in the foreign exchange market over the past year in order to prevent an appreciation of the rand, the deduction may be made that the Bank's exchange rate policy is asymmetrical. The Bank, however, has no intention of fixing the exchange rate of the rand at any predetermined level. Once exchange controls have been removed and the amount of foreign reserves held by the Reserve Bank has been restored to a more comfortable level, there should at most times be only little official intervention in the foreign exchange market.

This policy approach was illustrated by the developments of the last few days when an unfortunate combination of a few events led to a large-scale speculation against the exchange rate of the rand. The Reserve Bank intervened in an effort to bring some order to the market, to ensure that enough liquidity would prevail and to discourage over-reaction based on unfounded and obviously mistaken rumours. The Bank, however, did not fix the exchange rate at any predetermined level.

In the present global environment, where foreign exchange transactions arising from capital movements are seventy times as big as gross turnovers for current balance of payments transactions, it is extremely difficult to decide what the appropriate exchange rate for any currency should be, particularly in the short term. We, in the Reserve Bank, believe that references to an overvalued or undervalued exchange rate of the rand should in these circumstances be used sparingly. It is not possible for the authorities to decide what an equilibrium exchange rate would be, and it will be dangerous policy to try to fix the exchange rate at any artificial level. In the environment of financial globalisation, we shall have to learn to accept the dictums of the international market place. Even the wise economists of the Bahnhoffstrasse can easily be proved wrong in their assessment of over- or undervalued exchange rates.

Thirdly, what should the exchange control policy be in this situation? The Reserve Bank has always supported a gradual approach to the elimination of exchange controls. Government has the final say on the exchange control policy, but the Minister of Finance has on various occasions also expressed his views, which are similar to those of the Bank. It is therefore preposterous to speculate from time to time that there will be a sudden "big bang" removal of all the remaining exchange controls.

Furthermore, the Bank has many times stated that gradualism in practice means exchange control relaxations with the retention of financial stability. The Bank would not advise the Government to relax on exchange controls if it should believe that such relaxations will lead to the destabilisation of internal or external financial conditions.

As long as exchange controls are in force, there will always be rumours and speculation on their removal – one of the many disadvantages of direct controls applied in a basically market-oriented economy. Investors should, however, not be disturbed by such rumours. The Reserve Bank will continue to act with responsibility and within the framework of the aforementioned stated objectives of the programme of gradually removing the exchange controls applicable to outward investment by South African residents. The challenge to abolish exchange controls in this way and to maintain financial stability at the same time, is not an easy one. So far it has worked well – we have good reason to believe it will continue to work well in future.

Fourthly, the Reserve Bank also faces the challenge of maintaining a sound and well-functioning banking system in South Africa, a system that will not only retain the confidence of the international financial community, but will also be trusted by the South African public in general. The banking system is the trustee of the public's money and of an important part of people's savings. The Reserve Bank cannot support the development, under the aegis of the banking system, of high-risk financial ventures that must eventually lead to losses for some investors. This will not only cause unreasonable claims for compensation to be made against the Bank and the Government, but will also undermine confidence in the South African financial system.

The Reserve Bank therefore faces the demanding challenge, on the one hand, to promote and develop a sophisticated national payments, clearing and settlement system, based on modern electronic technology that will link our financial system with the global economy and, on the other hand, also to foster a banking system that will provide in the diverse needs of all the people of South Africa.

In summary, the challenges the Reserve Bank faces to maintain overall financial stability, to integrate the South African financial system in a volatile and complex global market economy, to continue with the process of a gradual relaxation of exchange controls, and to foster and protect the development of a sound banking system, will be very demanding. I have full confidence in the integrity, devotion and competence of the staff of the Reserve Bank to meet these challenges.