Monetary Policy Challenges

in South Africa

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1. Challenge number one - to find consensus on what the objective of monetary policy should be in South Africa

In the international community of central bankers, there is widespread consensus that the primary goal of monetary policy must be domestic price stability. Price stability, however, is only a means to an end, and not a final goal of overall macroeconomic policy. The ultimate goal is determined by governments and is normally linked to the objective of maximum economic growth, development and the creation of more employment opportunities.

Contemporary economic theory supports the view, however, that financial stability, as measured by a low rate of inflation, is a precondition for the attainment of optimum economic development. Furthermore, monetary policy, being only one of the sub-elements of overall macroeconomic policy, is tasked with the responsibility to create and maintain such a stable financial environment that will be conducive for sustainable economic growth at an optimum rate in the medium and longer term.

In South Africa, however, confusion remains on what the task and the functions of the central bank should be. The most important delusion, supported by certain business people, politicians and even some academics, is linked to the now defunct Phillips curve approach in terms of which the assumption is made that a higher inflation rate can produce a sustained lift in growth and employment. World-wide experience, as long back as in the 1970's, provided sufficient evidence that the assumed trade-off of higher inflation for lower unemployment could only be exploited over the limited period in which inflation expectations did not fully adjust to the new higher rate of inflation. With a more effective implementation of the theory of rational expectations within modern communities, this limited period has indeed become very short.

Another reason why the conventional theory of demand management through the application of monetary policy is no longer appropriate, is the major shift that took place in recent years in macroeconomic management, away from conventional Keynesian demand management to contemporary supply side economics. The Phillips-curve approach is based on the theory of demand-driven inflationary or deflationary conditions. The world-wide situation in the 1970's, when there was a simultaneous rise in inflation and in unemployment in many of the industrial countries, refuted the theory of the trade-off and forced new thinking on particularly the implementation of monetary policy.

The present universal approach on monetary policy therefore takes account of the new electronic environment of instant communication leading to a more swift dissection of policy actions and immediate reaction by markets, and of the more general need in most countries to raise production capacity, and not to stimulate demand. In this environment, the appropriate role for monetary policy has been redefined as a responsibility for the creation and maintenance of stable financial conditions that will be reflected in low inflation. This is what central banks can do best to support governmental programmes for overall economic growth and development.

In South Africa, considering the many attacks made on Reserve Bank policy during this past year, there is still a major lack of consensus on what the prime objective of monetary policy should be. Unless we can get consensus and support for the almost global approach of contemporary central bank policy, and unless we can agree to pursue these policies also in South Africa, the road to the internationalisation of the South African economy will be rough and difficult.

2. Challenge number two - deciding on an appropriate framework for monetary policy

Given the objective of price stability, each central bank must design a framework or a consistent model within which monetary policy can be implemented, taking account of the structure of the financial system and of the economy of the country. Various models are available to choose from, but whatever model is preferred, the final objective of monetary policy should always be the protection of the value of the currency.

In the Bretton Woods system of fixed par values, the main intermediate objective of monetary policy was the protection of exchange rates, or the external value of the currency. By linking global exchange rates through fixed gold parities, there was a convergence of inflation, at a relatively low level, at least for the many countries that succeeded in maintaining fixed exchange rates over relatively long periods of time. Needless to say, the system broke down in the late sixties and early seventies when more expansionary monetary policies were followed by some of the major industrial countries, and inflation escalated. Today, some smaller countries still attach their exchange rates to a selected major international currency, and then accept the unavoidable consequence that the rate of inflation in the smaller country must converge with the rate of inflation in the economy of the anchor currency. A good example of this approach is provided by Argentina with its convertibility law of 1 Peso = 1 US dollar.

A second widely-used model is the one of monetary targeting where an important monetary aggregate such as the money supply or the amount of bank credit extension is used as an anchor for monetary policy. Within the context of the prime monetary policy objective of maintaining low inflation, a monetary target (or exchange rate target) represents but an intermediate objective of the policy.

South Africa is one of the many countries that introduced money supply targeting as an anchor for monetary policy during the course of the 1980's. Initially, the policy served the country well. It made an important contribution to a better understanding of policy decisions, and also made a major contribution towards the successful reduction in the level of the rate of inflation from an average of about 15 per cent over the twenty years from 1973 to 1992, to about 8½ per cent over the past four years.

The South African experience with money supply targeting is not very different from those of other comparable countries such as Canada and Australia -- with the difference that the process in South Africa is a slower and lagged one, mainly because of the economic isolation of this country from the rest of the world up to 1993. Australia introduced money supply targets in 1976, and then abandoned them "with reluctance" in February 1985. At the time, Australia tendered two reasons for ending the M3-targeting stage:

"The first was the problem of controllability. The fact that targets were often missed was an indication that close control was either not possible, or would have required undesirable movements in the policy instruments. The second was the instability of the relationship between money supply and the ultimate objective of policy such as inflation ..." (Address by Governor Macfarlane at a Conference of Economists in Hobart, 1997-09-29.)

It was Governor Gerald Bouey of Canada at the time who made the famous statement: "In Canada, we did not abandon money supply targets, they abandoned us".

In view of the liberalisation of the South African financial markets in recent years, the integration of the South African economy in the world financial markets and the increasing importance of large and volatile international capital flows, South Africa may have reached the same stage now where the usefulness of the M3-money supply as a target for monetary policy has been diluted to a point where some alternative anchor should be considered.

Following the demise of money supply targeting during the mid 1980's, both Canada and Australia went through a transitional period which lasted until the early 1990's. During this transitional period a policy of "monetary pragmatism" was followed. There was indeed no formal or strictly defined framework to guide monetary policy. A "check-list" of an *ad hoc* mixture of intermediate objectives was introduced and the central bank was allowed a wide degree of discretion in the implementation of monetary policy. After the "rule" of monetary targeting broke down, the policy was "to look at everything".

Although such a pragmatic approach may have some advantages, particularly in an environment of major structural changes and volatile international shocks, it has the major disadvantage of not being transparent. As Charles Goodhart put it:

"Supporters would describe it as sensible pragmatism, detractors as a reversion to a muddled discretion which, once again, allows the authorities more rope than is good for them, or us". (The Conduct of Monetary Policy, Economic Journal 1989).

Both Australia and Canada, and a growing number of other countries, have recently moved to direct targeting of inflation. In all these countries, however, not only central banks but also governments commit themselves jointly with the central banks to a predetermined target for inflation. In the United Kingdom, the Chancellor of the Exchequer indeed sets the target for inflation in his Annual Budget, and then instructs the Bank of England to pursue the goal with its monetary policy instruments. Nowhere does the central bank on its own decide on an inflation target.

For an inflation target to be credible, there must be a commitment at least of the central bank and the government, and, if possible, also of the business community and labour, to the achievement of the goal. Furthermore, it will do more harm than good for a country to introduce a formal inflation target that is much out of line with the rest of the world. Of the seven countries reported in the BIS Annual Report for 1996 with formal inflation targets, no one has set a goal for inflation of *more than 3 per cent per annum*. The central bank must be given sufficient operational autonomy to pursue the inflation target with vigour and without the fear of intimidation by politicians or other pressure groups. And, finally, markets must be free, flexible and responsive to underlying changes. Inflation is often a symptom of malfunctioning markets and the cure lies not with monetary policy, but with a restructuring of the markets.

It is a big challenge for South Africa to prepare itself for this new age of direct inflation targeting as an anchor for monetary policy. The proposals made by the Reserve Bank last week for the introduction in March next year of a more flexible system of providing accommodation to banking institutions, represents an important further step on this road towards a more effective monetary policy system that will be compatible with global policies.

3. Challenge number three - establishing an effective institutional framework for monetary policy

There is a lot of misunderstanding in South Africa about what is meant with the independence of the Reserve Bank. The Bank can never be made responsible for determining the overall macroeconomic policy objectives of the country. This is a prerogative of government. The central bank must, however, be given a clear mandate from government on what its policy objective should be, but should then be given the necessary autonomy to pursue and achieve this objective.

Taking account of the powers and influences of central banks, the obvious directive by government to the monetary authority should be to protect the value of the currency in the interest of sustainable optimum economic growth and development in the longer term. To achieve this objective, a central bank must at times apply financial disciplines that are unpopular, will be opposed by pressure groups and are perceived to be against the interests of private sector profiteers, and political popularity. It is *inter alia* for this reason, and only in respect of the implementation of measures that may at times prove to be unpopular, that central banks should be given "independence" from governments. To quote once more from what a former Governor of the Reserve Bank of Australia once said:

"The Reserve Bank must be given all the freedom of the prison exercise yard". (R.A. Johnston - "Comments on Professor Schedvin - Economic Papers - 1992).

Although this autonomy has been given to the South African Reserve Bank in terms of the Constitution of the Republic of South Africa, the disciplinary actions applied by the Bank in the pursuance of its mandate are often challenged by economists, business people and politicians whenever they believe their vested interests are impeded by the actions. Many South Africans must still learn to be more tolerable towards the need of painful financial disciplines, when justified by adverse macroeconomic situations. These may often be forced on us by international developments over which we have no control.

Apart from an effective institutional framework for the Reserve Bank, South Africa also needs well-managed private sector banking institutions, well-functioning financial markets and an effective clearing, settlement and payment arrangement for inter-bank transactions. The challenge is therefore not only to liberalise the South African financial sector further, but also to ensure good and prudent financial regulation, and to provide the country with a modern electronically-based national payment system. The new system to be introduced by the Reserve Bank in March 1998 for an improved clearing and settlement system will provide a further step on the road of preparing for an effective integration of the South African financial system in the global economy.

The challenge for South Africa is not to isolate itself from the adverse effects of the globalisation process, but to continue to participate in the programme of gradual international integration.

4. The overriding challenge for monetary policy is to keep inflation low

Financial stability in South Africa is threatened from time to time by new and more intensive inflationary pressures. We have not yet succeeded in suppressing the prevailing inflation psychosis in this country. Expectations at this juncture may have settled around the 8 per cent per annum level, which is about half of what it used to be at the beginning of this decade. But this is still about three times the amount of actual inflation in the economies of our major trading partners.

The process of globalisation unavoidably leads to a convergence of the major financial aggregates such as inflation, real rates of interest and budget deficits. South Africa will either continue to be part of the globalisation process, together with its inevitable convergence effects, or will be marginalised and excluded from the advantages of being part of the world-wide process.

In this period of transition from monetary policy targeting to the introduction of a national inflation objective, monetary policy must continue to maintain overall financial stability. This is essential in order to buy time while other policies (as proposed in GEAR) are put in place to handle the more deep-seated structural deficiencies that must be corrected before South Africa will be able to experience optimum economic growth with financial stability.

5. <u>Conclusion and summary</u>

The challenges facing monetary policy in South Africa at this stage can be summarised as follows:

- We must convince more South Africans that the one and only task for monetary policy must be to protect the value of the currency.
- We must adapt monetary policy to the changing environment in which we now have to operate. This may require of us to move away from money supply targeting and to adopt a more direct focus on inflation developments.
- We must guard against growing pressures in our country for the curtailment of the autonomy of the central bank.
- The Reserve Bank must continue to guide the South African financial markets into the world financial system. This will require further progress in the gradual elimination of exchange control, the modernisation of the payments system, the encouragement of the development of more efficient markets and, in the context of Africa, support for co-operation and integration of financial markets within the Southern Africa Development Community.
- The overriding challenge remains to bring inflation in South Africa to a lower level that will be more in line with the average rate of inflation of our major trading partners. This

will require a sound monetary policy approach, based on realistic (but not necessarily low) interest rates; a stable (but not necessarily fixed) exchange rate; a sound (but not necessarily protected) banking sector, and effective and well-functioning financial markets.