The monetary policy stance

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Statement issued by Mr T T Mboweni, Governor of the South African Reserve Bank, at a meeting of the Portfolio Committee on Finance, Cape Town

Introduction

The primary objective of the Reserve Bank is to achieve and maintain financial stability in South Africa, i.e. price stability as well as stability in the financial sector. Price stability is achieved when changes in the general price level do not materially affect the economic decision-making process. Stability in the financial sector is achieved when there is a high degree of confidence in the ability of the financial infrastructure to meet the requirements of market participants.

In this statement the current monetary policy stance to achieve financial stability is described in some detail, with reference to

- stability in the financial sector;
- recent developments in domestic prices;
- the inflation outlook;
- the monetary policy measures applied;
- the monetary policy decision-making process; and
- the transparency of monetary policy.

Stability in the financial sector

In contrast to many other emerging-market economies, the South African banking sector proved to be remarkably resilient during the global financial turmoil of 1997 and 1998. The banking sector's thorough preparations to avoid the possible effects of the transition to the year 2000, were also very effective. With the exception of a few minor disruptions which generally were not Y2K related, normal operations were reported by the banks during the change to the new millennium. The positive spin-offs of large-scale technology renewal, the rationalisation of systems and processes, the improvement of human resources and closer co-operation in the sector, should enhance efficiency.

Although the non-performing loans of banks have increased during the financial crisis and in 1999, increased provisions were made for bad and doubtful debts. As a ratio of total loans and advances, gross overdues in the banking sector increased from 4,6 per cent in the second quarter of 1999 to 4,9 per cent in the fourth quarter. However, provisions for doubtful debts were also increased and amounted to 57,5 per cent of total overdues in the fourth quarter of 1999. This is much more conservative than the international norm of 40 per cent.

The banks in South Africa are well capitalised and other sound banking principles are being applied. In particular, the anticipated short-term liquidity mismatch of banks, i.e. the difference between liabilities maturing within the next 31 days and assets maturing during the same period, decreased from 14,0 per cent of total liabilities in December 1999 to 12,6 per cent in February 2000.

All the other statistical information available to the Reserve Bank shows that conditions in the banking sector are stable and that profitability improved during 1999.

Although some of the smaller banks experienced a temporary liquidity squeeze towards the end of 1999 and the beginning of 2000 due to the reduction of wholesale deposits, these problems were dealt with quickly and efficiently.

Recent developments in domestic prices

The annual average rate of increase in the consumer price index for metropolitan and other urban areas, excluding interest on mortgage bonds, declined marginally from 7,1 per cent in 1998 to 6,9 per cent in 1999. However, the year-on-year increase in this index picked up somewhat from a low of 6,5 per cent in October 1999 to 7,1 per cent in February 2000. This rising trend in consumer prices could mainly be attributed to increases in the prices of petrol and diesel, transport equipment and food.

The decline in interest rates on mortgage bonds brought overall consumer price inflation down from a year-on-year rate of 9,4 per cent in November 1998 to 1,7 per cent in October 1999. The rate of increase in this index then accelerated to 2,4 per cent in February 2000. The annual average increase in the overall consumer price index amounted to 5,2 per cent in 1999, compared with 6,9 per cent in 1998 and 13,9 per cent in 1992.

By contrast, production prices have risen sharply in recent months, mainly on account of the rise in international crude oil prices. Increases in international oil prices are reflected with a short lag in imported prices when contract prices are adjusted to reflect auction prices on international markets. The year-on-year change in the prices of imported goods rose from 5,9 per cent in December 1998 to 14,4 per cent in February 2000. The year-on-year inflation in the prices of domestically produced goods rose from 3,7 per cent to 6,5 per cent over the same period. As a result of these developments, the annual average increase in the total production price index accelerated from 3,5 per cent in 1998 to 5,8 per cent in 1999.

Inflation outlook

The recent acceleration in the increase in the all-goods production price index indicates that consumer prices will rise more rapidly over the coming months. The second-wave effects of the increase in international oil prices and domestic food prices will probably contribute to sharper increases in consumer prices over the short term. However, oil prices have started to decline since late March from levels in excess of US$30 per barrel to current levels of around US$22 per barrel because of a decision by OPEC to increase oil production by 1,7 million barrels per day. The favourable agricultural conditions experienced over the past six months should also have a positive spin-off on food prices. It is, therefore, expected that the acceleration in price inflation will peter out.

Various other developments reinforce this positive inflation outlook over the medium to longer term. The rate of increase in nominal unit labour costs in the non-agricultural formal sectors of the economy, for instance, has declined from nearly 11 per cent in 1994 to 3,5 per cent in 1999. A slowdown in the growth of earnings of workers was partly responsible for this development. The growth in nominal salaries and wages per worker declined from levels around 14 per cent in 1994 to about 7 per cent in 1999. In addition, labour productivity continued to rise sharply in the past five years. The average annual increase in productivity came to nearly 4½ per cent from 1995 to 1999. In view of the underutilisation of labour resources it seems likely that the growth in nominal unit labour costs will be contained in the next few years,

although a shortage of skilled workers could arise with a prolonged pick-up in economic activity.

There are no signs of excessive increases of domestic demand in the next three years. More rapid growth in economic activity is projected, but this growth is not expected to lead to unduly large deficits on the current account of the balance of payments. Favourable international conditions could lead to continued high growth in the exports of South Africa, which should partly offset increases in imports emanating from higher capital investment and a rise in domestic demand during the expected economic upswing.

South Africa should not experience any difficulty in financing the deficits on the current account of the balance of payments, provided that large disruptive international capital outflows do not occur. From 1994 to 1999, a net inflow of capital of about R78 billion has been recorded, of which R38 billion consisted of direct investment by non-residents in South African companies. The planned further restructuring of government assets should promote an even larger inflow of direct investment capital in the next three years. The total foreign debt of the country at a ratio below 30 per cent of gross domestic product is comparatively low. This allows some scope for foreign borrowing if the need should arise.

Conditions therefore seem favourable for the exchange rate of the rand. Inflation differentials between South Africa and its main international trading partners and competitors, however, could at times lead to a systematic and contained depreciation of the rand, which could affect the prices of imported goods. The planned further reduction in import duties and South Africa's trade agreement with the European Union will probably restrain the growth in imported prices and, through increased competition, the increase in domestic prices.

In addition, there are indications that inflation is rising in many of the advanced economies, which could narrow inflation differentials between South Africa and these economies. Price increases in advanced economies, however, are expected to be relatively moderate and should not have any significant impact on the prices of imported goods. These pressures on imported prices could also be alleviated by an expected sharp reduction in the inflation rates of developing countries and of the so-called countries in transition.

A prudent monetary policy will be pursued by the Reserve Bank to control the growth in money supply and bank credit extension. Inflation is a monetary phenomenon and cannot occur without more rapid increases in the quantity of money than in output, provided that changes in the velocity of circulation of money do not offset the growth in money supply. The Reserve Bank will continue to influence the growth in money supply and bank credit extension carefully by managing overall liquidity in the banking sector and the total demand for money. Considerable success has recently been achieved in this regard, and the growth rates in both money supply and bank credit extension have subsided to relatively low levels.

A further factor pointing to a decline in the inflation rate over the medium to long term is the fiscal discipline applied by the government. The public-sector borrowing requirement has been brought down from a level of nearly 6 per cent in the fiscal year 1994/95 to only 1,7 per cent in the first nine months of the fiscal year 1999/2000. In the Medium Term Expenditure Framework the government has indicated that it intends to keep a tight rein on expenditure over the next three years.

Considerable success has also been achieved in improving the collection of government revenue.

Monetary policy measures

Taking account of the favourable inflationary outlook and the generally more stable international economic conditions, the repurchase rate of the Reserve Bank was reduced considerably during 1999. At the height of the international financial crisis, when the Russian government declared a moratorium on the repayment of debt, the repurchase rate of the Reserve Bank rose to 21,86 per cent on 28 August 1998. The repo rate was held steady at this level until there was clear evidence that the crisis was over. From 13 October 1998 the repo rate was gradually reduced to 11,75 per cent on 14 January 2000, or by just more than 10 percentage points.

The marginal lending rate was also reduced during 1999. The marginal lending rate was initially introduced at one percentage point above the repo rate. This rate was then increased to a level of 20 percentage points above the repo rate during the global financial crisis. As a result of the more stable conditions internationally, the marginal lending rate was then reduced in steps to 5 percentage points above the repo rate from 25 November 1999.

In view of the pressures on domestic prices which arose during the last few months of 1999 and the projected developments in the inflation rate, the Reserve Bank managed the daily liquidity requirement of the banks in such a way that the repo rate has remained at a level of 11,75 per cent from the middle of January 2000. In making this decision the Bank not only took note of domestic economic developments, but also of the fact that official interest rates in many of the advanced economies have been raised from the second half of 1999 and that it is generally expected that they could increase further in the near future. Long-term interest rates and yields have also increased in these economies and the spread between yields on South African securities and those of the advanced economies narrowed considerably.

Obviously capital flows to and from South Africa can be affected by changes in interest rate differentials. In determining the level of official interest rates it is important to avoid any unnecessary fluctuations in interest rate levels. This is not always possible because of unforeseen developments. Likely domestic and international developments, however, have to be carefully taken into account when determining the monetary policy stance.

Greater stability in domestic interest rates also seemed warranted on account of the heightened volatility in many financial markets. These gyrations were to a large extent sparked off by volatility in the share prices of companies in the information technology sector in the United States. This was the first time in the past two years that developments in emerging markets were not responsible for global volatility. The uncertain conditions nevertheless led to increased risk aversion and affected portfolio flows to South Africa. In March 2000, non-residents were net sellers of bonds and shares to the tune of R5,9 billion. In April these net sales seem to have come to an end. The stability in domestic short-term interest rates contributed to an orderly adjustment in the external value of the rand.

The present level of interest rates in South Africa does not seem to be out of line with international interest rates. The real repo rate in South Africa at the end of February 2000 amounted to 4,3 per cent, compared with 2,5 per cent in the United States, 3,6 per cent in the United Kingdom and Australia, 6,3 per cent in Mexico and

more than 10 per cent in Brazil and Argentina. The real yield to maturity on domestic long-term government bonds at 6 per cent at the end of February 2000 was also not much higher than the 3,6 per cent in the United States and 4,7 per cent in Australia. In evaluating the level of long-term interest rates and yields in South Africa, some allowance must be made for currency and country risk.

The Reserve Bank's liquidity management during 1999 was aimed at increasing the private banks' dependence on central bank funding in order to create a more effective and efficient functioning of the daily auction of repurchase agreements. The operations of the Bank to withdraw liquidity from the market included increases in the issue of Reserve Bank debentures, reverse-repurchase transactions and foreign currency swaps with private banks.

Towards the end of 1999 the Reserve Bank actively engineered a sharp decline in the private banks' liquidity requirement to alleviate possible Y2K problems. The liquidity requirement of banks accordingly declined from R11,3 billion at the end of September 1999 to R2,4 billion at the end of December 1999. Subsequently, the Bank has again increased the liquidity requirement to approximately R8 billion at the beginning of April 2000.

The monetary policy decision-making process

The decision-making process in the conduct of monetary policy was changed considerably with the establishment of a Monetary Policy Committee. The Monetary Policy Committee consists of the Governor and deputy governors as voting members and senior officials of the Bank as non-voting members. It held its first meeting on 13 October 1999. Since its establishment the Monetary Policy Committee has now convened five times. This committee has proven to be of great value in the formulation of monetary policy. International and domestic economic developments are analysed in depth and the committee has made consensus decisions at each meeting about the policy stance to be pursued.

Monetary policy is always forward-looking because of the long lags from 18 to 24 months between monetary policy steps and their impact on inflation. Considerable use is therefore made of econometric models to forecast the likely path of inflation and other related variables. This does not imply that the results of models can be followed blindly. The Reserve Bank realises that econometric models have serious limitations, but they are nevertheless useful instruments to aid decision making.

The Reserve Bank currently uses a large, multi-purpose econometric model to assist the Monetary Policy Committee in reaching decisions. This model has 169 equations, of which 88 are stochastic behavioural equations. Although this model has been carefully constructed and maintained, it is not primarily focused on inflation targeting and therefore of limited use in this regard. Internationally, inflation-targeting countries prefer more simplified and smaller models, because the maintenance of larger models is cumbersome.

With the assistance of a number of central banks, the Reserve Bank is busy with the development of a suite of models which should be invaluable in the decision-making process. In particular, a core model is being developed which will be supplemented by a number of other models when forecasts of inflation are prepared.

The aim is to keep the core model concise so as to focus on key economic variables influencing inflation. The framework of the core model will consist of about 40 equa-

tions, of which about half will be stochastic behavioural equations. These stochastic structural equations are being estimated with co-integration and calibration techniques. In addition to the core model, a small-scale macroeconomic model of five equations, Philips-curve models and vector auto-regression models will be developed.

Transparency

For the effective application of monetary policy and greater credibility of the central bank, transparency is regarded as an important precondition. In the past year the Reserve Bank has made a major effort to enhance the transparency of its policy stance and operations without becoming counter-productive. The adoption of the inflation-targeting monetary policy framework has further assisted in making monetary policy transparent. The announcement of a numerical inflation target makes the intentions of monetary policy clear and precise. If targets are not met, the central bank will have to explain what went wrong.

The monetary policy stance is now communicated regularly to the public. This is done by means of a monetary policy statement after every meeting of the Monetary Policy Committee. A Monetary Policy Forum has also been established to open an avenue for ongoing discussions on monetary policy and general economic developments and to ensure that the views of interested parties are taken into account in the determination of monetary policy. The Monetary Policy Forum will meet twice a year in the major centres of South Africa to allow as many stakeholders as possible to participate in these discussions.

The Reserve Bank also plans to publish twice a year a Monetary Policy Review to increase transparency in the application of monetary policy. This Monetary Policy Review will attempt to describe in more detail the decisions taken by the central bank and will analyse developments in South Africa and the rest of the world that could affect inflation. In addition, the Bank already publishes a *Quarterly Bulletin*, *Annual Economic Report*, the *Annual Report* of the Bank Supervision Department and the *Governor's Address* at the Ordinary General Meeting of Shareholders. These publications and addresses of the governors are also made available on the website of the Bank.

Conclusion

By striving for financial stability and carefully analysing underlying economic conditions before adopting a specific monetary policy stance, the Reserve Bank believes that it is making its contribution to economic development in South Africa. Although financial stability will not automatically lead to higher employment-creating economic growth, it will contribute significantly to that end and is an important precondition for the improvement of the living conditions of all the people of South Africa.