South African Reserve Bank

RELEVANCE OF THE SA RESERVE BANK TO THE DEVELOPMENT AGENDA

Address by Dr Monde Mnyande, Advisor to the Governor and Chief Economist, South African Reserve Bank (SARB), at the Inkululeko Media & Marketing Power Breakfast, Avianto Hotel, Muldersdrift,

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Briefing note

Stable prices, that is, low inflation, stable currency value and stable financial systems are bedrock ingredients for the economic wellbeing of any society. These ingredients form the core of what the South African Reserve Bank (SARB or Bank) or any other central bank for that matter does. Explained differently, the realisation of these ingredients is the most important way in which the Bank can contribute to the developmental agenda of South Africa.

Relevance of the SA Reserve Bank to the Development Agenda

As the global economy emerges from the dusk of the financial crisis, it is widely recognised that the world finds itself in unchartered territory. Ironically, as luck will have it, it is a momentous opportunity to relook at how things can be done in a better way. Although South Africa, similar to other emerging economies, was not as adversely affected by the global recession as the advanced economies, it continues to be faced with challenges of high unyielding unemployment, poverty and inequality, and an inappropriate skills structure. Notwithstanding the laudable progress that has been made in reversing these trends over the recent past, much more needs to be done differently and at a faster pace so as to gain higher, sustainable levels of national output and economic participation.

May I thank you for this opportunity for the South African Reserve Bank to participate in this forum that can be viewed as a microcosm of the current national debate to find an appropriate micro and macroeconomic policy mix to forge the ‘new developmental growth path’. To my understanding, the vision of South Africa’s development agenda is to have a more inclusive economy that will unleash labour-absorbing industries, raise targeted public and private investments and savings, and enhance local and global competitiveness.

It is envisaged that this new growth trajectory will be supported by a refocused education and training regime; a low inflation environment; a competitive, stable exchange rate; and improved regulatory oversight. Through these elements of the development agenda, monetary policy creates an enabling environment and plays a supportive role to underpin the long-term growth path.

Back in 1989 Professor A P Thirlwall argued that: “The development of a national banking system, comprising a central bank, a commercial banking system and special development banks, is one of the first priorities of development planning”. The Bank has always recognised that it is a national asset, which should execute its mandate with integrity, accountability and utmost transparency. Governor Gill Marcus has embarked on an enhanced and systematic outreach programme that further crystallises the Bank's operational ethos. This initiative is line with the long-term vision of the Governor regarding the need for an ongoing engagement with analysts, the labour movement, political parties, community organisations, and business and international investors to build social consensus and understanding on why and how the Bank carries out its monetary policy mandate. In turn, the Bank also gains in that it better understands and internalises the challenges, concerns and aspirations of its stakeholders. As part of this outreach programme, the Bank seeks to engage and position itself to play its pivotal role in South Africa's new development agenda.

The Bank's mandate is explicitly set out in the Constitution of our Republic as "protecting the value of the currency in the interest of balanced economic growth". The main contribution therefore that the Bank can make to the development agenda of South Africa is primarily through the fulfilment of this mandate. The Bank fulfils this mandate by ensuring 1) price stability and 2) financial stability. To ensure price and financial stability, the Bank uses monetary policy and provides a variety of other essential financial services to the economy.

The other crucial functions of the Bank that are seen as enabling factors for the development agenda include the prudent supervision of banks, as well as management and maintenance of the national payments system. These, among others, are important in ensuring the effective flow and settlement of cross-border capital between South Africa and the rest of the world. Another function that was explicitly emphasised by the Minister of Finance, Mr Pravin Gordhan, in a letter to the Governor clarifying the expanded mandate of the Bank, is that of financial stability, which entails detecting and reducing threats to the financial system as a whole. South Africa, as a small open economy, has grown by successfully integrating into the global economy and gaining access to international capital markets over time. In cognisance of the strategic contribution of these critical central banking functions, the Bank will continue to manage prudently, effectively and efficiently its component of macroeconomic plane.

Inflation targeting and price stability

Inflation targeting should be understood as a broad framework for policy, which allows the central bank "constrained discretion", rather than as an ironclad policy rule in which inflation is the only variable to be considered when deciding the setting of monetary policy decision. Inflation targeting in South Africa has been very *flexible* and has resulted in increased coherence and transparency of the monetary policy strategy. It increased accountability and improved the ability of the Bank to anchor inflation expectations, as published in the Bureau of Economic Research (BER) surveys.

Although the framework did come across some serious challenges during the global financial crisis, overall, empirical research suggests that inflation targeting has worked well for emerging economies that implemented it, including South Africa.

South Africa has done better under the inflation-targeting framework than during other previous monetary policy frameworks. The success of the policy is largely attributable to the flexible way in which it was implemented. Inflation targeting has enabled the Bank to maintain reasonable price stability in a way that did not generate undue negative impact on economic growth. There has been gratuitous criticism to the effect that monetary policy in South Africa was responsible for the latest recessionary phase of the business cycle. That is untrue – a sharp drop in global demand was the key driver to the severe economic contraction of the recent past. Evidence will show that through macroeconomic discipline, of which monetary policy is a part, South Africa, by and large, was able to weather the storm of the international financial crisis.

Price stability means low inflation, as defined by the Government's inflation target of 3-6 per cent. Monetary policy is mainly directed at achieving this objective and providing a framework for non-inflationary economic growth – balanced and sustainable economic growth. Empirical evidence exists to the effect that very high inflation is associated with poor growth performance. High inflation:

a) Impacts negatively on poor households, who cannot effectively index wages and who have to endure reduced purchasing power in the face of rising prices for food, energy and basic services.
b) Discriminates against fixed-salaried workers, pensioners and low-income earners who cannot protect themselves from the impact of inflation.
c) Distorts income distribution.
d) Distorts the allocation of resources.
e) Discourages saving, an important source of investment funds.
f) Leads to high interest rates and this discourages investment.

It is important to note that although low inflation is a necessary condition, it is by no means a sufficient condition for economic and social transformation in South Africa. South Africa requires unfathomable structural changes in the opportunities for ordinary people through such things as improved education, healthcare, housing and general improvement of both services and the efficiency with which they are supplied.

Monetary policy and economic growth

It needs to be pointed out clearly, that economic growth is a function of many factors. Monetary policy is just one element in a set of economic policies, such as fiscal policy, industrial development policy, agricultural policy, mining policy, education policy and an array of many other microeconomic policies. These policies should complement each other, and not be viewed as substitutes.

The role of monetary policy in economic growth is still a contested terrain. In my honest opinion, I subscribe to the view that it will remain in this state as long as the contest on "What explains income and its distribution in society," between Marxian and Neoclassical theory remains. There is some consensus, however, that monetary policy does and can affect growth, but mostly in the short run. Nonetheless, the maintenance of price stability is one of the most important contributions that monetary policy can make to achieving the balanced and sustainable economic growth needed for high levels of employment.

During his speech in February 2010 in Parliament, the Minister for Economic Development, Mr Ibrahim Patel, highlighted a shift towards a growth strategy that will enhance labour-absorbing capacity in the economy. This view was also expressed in the “Industrial Policy Action Plan (IPAP)” document prepared by the Department of Trade and Industry (DTI). While various policies are being set and aligned to reach this goal, the Bank will continue to endeavour to maintain a stable and low inflation environment that will ensure that the increased labour force’s disposable income will not be eroded by the effects of high inflation.

A low inflation rate bodes well for the long-term investment plans of the sectors identified in the IPAP document. The IPAP document further notes the key structural challenges that have masked the relatively high growth rates achieved by the South African economy during 2004-2007. These include, firstly, the structural imbalances in the country’s current-account balance with the rest of the world.

May I point out at this stage that it is normal for a country in the strong upward or recovery phase of the business cycle to experience a large current-account deficit that is related to capital investment that will support future domestic production. The Bank takes it upon itself to create a non-inflationary economic environment that will attract investment into our country, needed to finance current-account deficits.

The second issue raised by the industrial policy action plan revolves around the performance of the manufacturing sector. The function of the monetary authorities is to control the monetary variable (nominal exchange rate), but it is the real variable (real exchange rate) that ultimately matters for the allocation of resources. This real variable is largely influenced by government policies, spending patterns (savings and investment), taxes, tariffs and exchange control developments, but also changes in sentiment. .

Thirdly, the high cost of capital relative to our trading-partner countries is regarded as a deterrent to investment in the country. Going forward, the challenge for our economy would be to attain a balanced policy mix that would encourage domestic savings, thereby promoting internal funding for future investment. Anchoring inflation at a low level could also assist in bringing the nominal cost of capital down to levels that will favour investment in productive projects.

Stability of the exchange rate

The volatility and competitiveness of the exchange rate of the rand, as well as the general view that the domestic exchange rate is over-valued deserve special response. It is worth noting that, recently, developments in the exchange rates depend on various factors, such as the inflow and outflow of capital into the country, relative interest rates, relative growth and commodity prices. The recent adjustments to the repo rate by the Bank’s Monetary Policy Committee have shown that the fluctuations in the nominal exchange rate of the rand are beyond the policy decision on the repo rate by the Bank’s monetary authorities.

Adjusting the repo rate can result (and has at times resulted) in some unexpected outcomes. The late 2008 depreciation of the domestic currency was more in response to the global financial crisis, while the subsequent recovery, from around April of 2008 was driven more by investors responding to rising commodity prices, the improved external trade position of the country, the improved inflation outlook and later on, acceleration in real economic growth.

Regarding the appreciated level of the exchange value of the rand, I have already mentioned that frequently countries with large current-account deficits experience an appreciation in their domestic currencies. The appreciation of the domestic currency may reflect strong capital flows into the domestic economy, encouraged by high yields, gains in share prices and strong macroeconomic fundamentals that support real economic growth.

Taking into consideration the challenge posed by the strong currency to the domestic sectors, the Bank will continue to support the measured steps proposed by the National Treasury, in an effort to mitigate the high volatility in the exchange rate.

The Bank has in the past monitored , and will continue to monitor developments in the exchange rate of the rand, and will intervene in the foreign exchange market when necessary. The extent of intervention, however, must be limited given the cost implications of this exercise. In addition, the level of reserves the Bank has accumulated thus far (some $40 billion) is not at all high relative to daily trade volumes in the rand foreign exchange market, which often exceeds $10 billion on a given day.

Most importantly though is that the exchange rate must be flexible enough to prevent persistent misalignments that would harm the competitiveness of domestic producers and their trade performance. At the same time, excessive volatility of exchange rate has to be avoided, as this heightens the risk of long-term investment, increases domestic inflation and encourages financial speculation.

Conclusion

The central thesis of this presentation, was to show the relevance of the Bank in the development agenda. And more broadly, microeconomic and macroeconomic policies should complement each other; that one should not override the other if the development agenda has to be realised. My view on the subject was also influenced by the profound words of Hugh O'Neil,[1] who observed that; "The advocates of Industrial Policy argue that industrial policy is," in the words of Robert B Reich, "the third leg on the policy stool, as critical as monetary and fiscal policies for economic growth and stabilisation." I will end along the lines of Robert B Reich, by arguing that for us, finding the right combination of the three legs of the policy stool is key to our developmental state, and not the issue of which stool is relevant to the developmental agenda.

Selected references

[1] With whom I had a great priviledge to work with at the Port Authority of New York and New Jersey, at one World Trade Center in New York between 1989 and 1991.

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