T T Mboweni: Challenges of central banking in Africa

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at a conference to commemorate the Bank of Zambia's 40th Anniversary, Lusaka, Zambia, 5 August 2004.

* * *

1. Introduction

Your Excellency, the President of the Republic of Zambia, Dear Colleague, the Governor of the Bank of Zambia, Excellencies, Management and staff of the Bank of Zambia, Retired former Governors of the Bank of Zambia, ladies and gentlemen.

It is indeed an honour and privilege to make this presentation on the occasion of the celebrations marking the 40th anniversary of the Bank of Zambia. Indeed, the Government, the management and staff of the Bank of Zambia and the people of Zambia as a whole have every justification to be proud on reaching this historic milestone.

I am truly overwhelmed by your invitation, not only to say a word or two today on the challenges of central banking in Africa, but also for providing me the opportunity to return to Lusaka which was my home in the late 1980s and early 1990s. Zambia's contribution to the freedom struggle in Southern Africa is firmly embedded in our memories. So I have returned, this time in a central banker's suit and tie, to my home here in Lusaka. Mr President, may I express our gratitude on behalf of my contemporaries who found a home here.

As will be evident from my address, the challenges facing central banks are generally the same all over the world, but in some instances they are more pronounced in emerging markets than is the case in developed countries.

2. Price stability

In a paper delivered at the Jackson Hole[1] conference in 2003, Professor Kenneth Rogoff, who was at the time the Economic Counsellor and Director of the Research Department of the International Monetary Fund (IMF), describes how over the last ten years global inflation has dropped from about 30% per annum to below 4 per cent per annum. This is indeed a remarkable achievement.

In the economically advanced countries, inflation averaged 9 per cent in the first half of the 1980s and 2 per cent since the beginning of this decade. Following on this success, the developing world has performed even better. While inflation averaged around 30 per cent in the developing countries in the first half of the 1980s, it was on average below 6 per cent in the first few years of this decade.

Recent estimates and forecasts by the IMF indicate that for the year 2003, inflation in Africa averaged 10,3 per cent and for 2004 it is expected to decline to 8,6 per cent. Bearing in mind that average inflation in Africa was around 40% in the early 1990s, this is quite an achievement. The African success in containing inflation is in reality even better. The higher inflation rate is occasioned by the impact of a few countries that still have very high inflation. Examples in this regard are Angola, Zimbabwe and the Democratic Republic of Congo.

Nonetheless, if the average inflation rate of 10,3 per cent for Africa in 2003 is compared to 2,7 per cent for developing countries in Asia, it is clear that there is still room for improvement. Consequently, the pursuit of price stability is a major challenge for governments and central banks in Africa.

The worldwide success in bringing inflation down to more acceptable levels cannot be ascribed to monetary policy alone. It is certainly also a consequence of other important factors such as more prudent fiscal policy, the easing of trade barriers, greater competition, productivity improvements and changing public expectations of inflation. While the causality regarding inflationary expectations is not totally clear, it does appear plausible that success in the quest for price stability is rewarded with

[1] Jackson Hole, Wyoming, is the venue for the Annual Meetings of Central Bank Governors, academics, and financial editors, organised by the Federal Reserve Bank of Kansas City.

further success as inflationary expectations adjust downwards, influencing the overall price setting mechanism or chain.

These expectations also depend on the credibility of the central bank. Whatever other factors influence the inflation rate, one can hardly deny that the execution of monetary policy in pursuit of price stability is a core function of central banks in all modern economies. The credibility of central banks depends to a large extent on whether they are perceived as either consistently applying monetary policy in a fair, dynamic, flexible and socially responsible manner or whether they are perceived as institutions staffed by arrogant, narrow-minded unelected bureaucrats.

Almost in passing, one would like to refer to the phenomenon of "dollarisation". In some countries foreign currency, usually the US dollar, is preferred to domestic currency. One is not convinced that this would happen if the central bank has earned its stripes as a consistent inflation fighter.

There are of course other reasons beyond "dollarisation" why central banks should pursue price stability. There has been a growing consensus that high and variable inflation distorts decision making in the economy, leading to a misallocation of resources and ultimately to bad economic performance. Inflation also tends to lead to an unequal redistribution of wealth to the benefit of the wealthy who can hedge themselves against inflation and to the detriment of the poor who have neither the resources nor the skills to protect themselves. In a real sense, central banks are there to protect those who cannot protect themselves against the vagaries of inflation.

An emphasis on the pursuit of low inflation as an important challenge facing central banks in Africa would be incomplete without at least a reference to inflation targeting. Following the successful example set by New Zealand, a growing number of countries have in recent years adopted inflation targeting as a framework or anchor for monetary policy. While it should be acknowledged that not all countries in Africa might be ready to adopt inflation targeting, it follows quite logically from the pursuit of price stability. Many African countries could probably benefit from working towards adopting an inflation targeting monetary policy framework. It is important to emphasise that governments and <u>not</u> central banks should ideally decide on the target and the central bank should implement such a framework.

After using different monetary policy frameworks over time, an official inflation target was specified for the South African Reserve Bank for the first time in February 2000 by the government. Notwithstanding the impact of considerable exchange rate volatility, this monetary policy framework is serving South Africa well. In deciding on monetary policy, the SA Reserve Bank emphasises the inflation rate. Despite acting with due regard to the short-term impact of monetary policy on production and employment, the SA Reserve Bank keeps its focus firmly on inflation. This steadfast approach has been rewarded with success and since September 2003, the twelve-month percentage change in CPIX, the official measure for inflation targeting purposes, has been inside the 3 per cent to 6 per cent official target range.

3. Autonomy

While low inflation cannot be the responsibility of the central bank and monetary policy alone, there can be no doubt that the central bank has a special role to play in combating inflation. In order to do that, the central bank needs to be properly empowered. This implies that the central bank has to be autonomous or independent enough to take the monetary policy decisions that are required to pursue price stability. The central bank must have total instrument independence which it must pursue without fear or favour.

Pursuing the requisite autonomy is the next challenge facing central banks in Africa. This autonomy must be explained as one could ask why an institution of unelected officials making such critically important policy decisions in a country that has a democratically elected government should be independent. In the words of Mr B Gaolathe, Minister of Finance and Development Planning in Botswana: "However, there is need to reflect deeply on the issue of independence of the Central Banks. While we all agree that there should be autonomy of Central Banks, those institutions are created by the State [or legislators] to serve an important public purpose, and cannot completely be de-linked from the policies and laws of the nation, especially those pertaining to promotion of economic development".

It should be borne in mind that being independent does not imply not being accountable. No central bank can be totally independent in the sense that it not answerable to anyone. Even the most autonomous central bank has to report in some form or another to the legislature, which in any case has the ultimate power to change the laws governing the central bank. Independence also does not mean that there is a lack of dialogue between the government and the legislature as the political authorities on the one hand and the central bank on the other.

It has become customary to distinguish between goal independence and instrument independence for central banks. Once again, I would like to explain the difference by referring to South Africa. Our inflation target is set by Government after consultations between the Bank and the National Treasury have taken place. Thus the Bank does not have autonomy in choosing the inflation target and as such does not have goal independence. The Bank, however, has complete independence in making monetary policy decisions aimed at achieving the target. This is instrument independence par excellence.

The autonomy entrusted to the Bank in the use of monetary policy instruments implies that the Bank has to be accountable for these decisions, and it should therefore ensure transparency. To this end, the Bank publishes Monetary Policy Reviews on a bi-annual basis, while regular regional Monetary Policy Forums are arranged to provide a platform for discussions of monetary policy with a broader range of stakeholders in the country. More importantly, the Bank's annual report, which is submitted to Parliament by the Minister of Finance, combined with the Governor's regular testimonies before Parliament's Portfolio Committee on Finance, ensure that there is a democratic structure to enforce accountability and transparency.

The explanation above should hopefully clarify the concept of central bank autonomy. It is a difficult paradigm shift for the political leadership. One of the major reasons for this autonomy was explained as follows by President Mbeki in 2001 at a meeting of the Association of African Central Bank Governors: "In our case this commitment is borne of the understanding that monetary policy should not be subjected to the vicissitudes that necessarily confront ruling political parties." Monetary policy decisions, which impact on the economy with a lag and over extended periods of time, should be insulated from the short-term pressures that accompany party politics and elections.

There is one other aspect of central bank autonomy which deserves mention, namely the potential impact of fiscal policy on monetary policy. Without fiscal discipline, the ability of even the most independent central bank to combat inflation successfully is severely curtailed. This is particularly true when the government has significant recourse to the central bank to finance its budget deficit. A central bank can hardly be autonomous if it is obliged to finance unsustainable government deficits. In the central banking literature, this is referred to as "fiscal dominance".

4. Uncertainty

It might sound strange to observers who are not central bankers or economists, to indicate that uncertainty is one of the difficult challenges facing central banks. How, after all, can central banks ask for operational autonomy if they are uncertain about major issues such as, for instance, the monetary policy transmission mechanism? One might hasten to add that the theory and practice of central banking and monetary policy have developed a great deal in recent decades. Nonetheless, monetary policy decisions are still taken against a background of considerable uncertainty. As will be indicated, this is even more true in the developing world.

A few examples could illustrate the uncertainties confronting central banks. The first would be the impact of unexpected exogenous shocks or disturbances on the economy and inflation. In this regard, one can refer to developments in the oil price. Earlier this year, the SA Reserve Bank's Monetary Policy Committee was still convinced that the higher oil prices would be transitory and as such would only be a short term risk to inflation.

Unfortunately, the oil price has remained higher for longer, implying a greater risk for inflation. In general, monetary policy in South Africa does not react to exogenous shocks like the oil price, exchange rate or drought. If, however, these exogenous shocks result in a more generalised impact on inflation, some monetary policy reaction might be called for. Any response to these exogenous factors would depend on how the Monetary Policy Committee viewed their second round effects. This often calls for judgement beyond any econometric forecast as the second round effects can be very uncertain. It is also virtually impossible to judge with any accuracy whether an exogenous shock like the oil price increase is transitory or whether it will continue for a prolonged period of time.

A further example of uncertainty facing central banks would be structural changes in the economy. This is a challenge facing not only emerging market economies, but also developed economies. While the emphasis might differ somewhat among countries, the causes of structural changes could be productivity increases, flexible labour markets, technological innovation, the spread of information technology, globalisation and increasing competition. These structural changes all affect micro and macroeconomic relationships, making it very challenging to forecast the future.

Zambia is currently contemplating a Financial Sector Development Plan. While this plan could potentially deliver considerable benefits, it will certainly alter the structure of the Zambian financial system and economy. Beneficial as this will be, successful implementation of the plan will change established relationships between interest rates, output, employment and inflation, making the task of monetary policy even more uncertain than in the past.

In essence, structural changes impact on the monetary policy transmission mechanism. At the best of times, it is difficult to judge whether monetary policy, through interest changes, affects the economy mostly via domestic demand, asset prices, the exchange rate, credit extension or inflation expectations. When economies change rapidly, as many African countries are trying to do, a further layer of uncertainty is added.

The additional uncertainty facing African central banks extends further. Monetary policy decisions inevitably depend on a host of economic developments. Determining the appropriate stance of monetary policy requires that the current state of the economy should be correctly reflected in the available economic statistics. The relevant statistics should also be available timeously and be reliable and credible. Therefore adequate resource allocation to the statistics offices is of paramount significance for central banks and monetary policy.

In the absence of correct and timeous economic statistics, it is impossible to determine the current state of the economy, let alone forecast future developments. In this regard, it seems appropriate to once again refer to South Africa, although this time as an example of how things should preferably not be done. In 2003, a relatively small distortion in the compilation of the CPI caused, when it was discovered, a downward revision of some 2 percentage points in the inflation rate. The consumer price index in South Africa covers approximately 1500 goods and services. A mistake in one component, housing rental, soon compounded to a sizeable deviation. For March 2003, the CPIX inflation measure targeted by the South African Reserve Bank was revised to 9,3 per cent, compared to the 11,2 per cent published originally.

This example amply illustrates the potential consequences of incorrect information on monetary policy decisions. The appropriate stance of monetary policy is often judged by considering developments in indicators such as the real interest rate, the slope of the yield curve, the output gap, the natural rate of interest and the natural rate of unemployment. To determine some of these measures is difficult enough at the best of times. In the absence of correct information it is impossible.

5. The development of the financial system

As was indicated earlier, there is no denying that price stability has become a core objective of central banks all over the world. It is also becoming increasingly apparent that well-functioning financial systems require financial stability as well. This could be described as the presence of soundly managed financial institutions and robust financial markets.

Central banks in emerging markets typically face a more fundamental challenge in the sense that their financial systems are under-developed. Today some developing countries experience low rates of economic growth, partly because of under-developed financial systems and a concomitant lack of financial intermediation. Financial markets, including the institutions involved such as banks, through the process of financial intermediation, serve as a conduit for the efficient and optimal allocation of financial resources and can accelerate the rate of economic growth. In essence, financial intermediation tends to raise the level of saving and investment as it reduces the costs associated with bringing lenders and borrowers together.

As in the case with price stability, the central bank cannot accept sole responsibility for the development of banks and financial markets, but is well placed to shoulder a major portion of the burden. The scope of the central bank's role in developing the financial system is far too broad for an exhaustive discussion in one address and a few related comments will have to suffice.

The first comment is an example of what a central bank can do in practice to help markets develop. Some years ago, as part of the development of the market in government bonds in South Africa and prior to the appointment of primary dealers, the SA Reserve Bank acted as a market maker in the market for government bonds. This was an interim phase in the development of the market. The Bank contributed to the market's development by managing liquidity. While the Bank is still involved in the primary market as the issuer of government bonds, we have no role left as a market maker. The government bond market has matured with a group of primary dealers having to act as market makers.

The Bank also played an active role in the early stages of the development of the spot and forward foreign exchange market involving the Rand. As we know only too well this participation by a central bank in the market can be fraught with risk. As such, it should be planned carefully and managed diligently. It can, however, expedite the development of a market if the central bank acts as market maker while other participants develop the capacity to fully participate. The central bank's participation should be purely to provide and manage liquidity for a defined period and should not degenerate into intervention to influence market trends.

A second comment relates to financial stability. Central banks and Finance Ministers in Africa have an important role to play to ensure that a proper regulatory infrastructure for supervising banks and other financial institutions and financial markets is established. An effective regulatory infrastructure, efficient financial markets and sound financial institutions are essential for financial stability.

At a micro-prudential level, central banks have a real interest in banking supervision while at a macro-prudential level, central banks should focus on promoting overall financial system soundness. The debate about the most appropriate location of banking supervision is, in the final analysis, dependent on country specific factors. There is no ready-made case study or example.

A third comment relating to the development of the financial system is to point out that central banks have a pivotal role to play in the development of clearing and payment systems. An efficient and reliable clearing and payment system is an important component of overall financial stability. The central bank has to be involved in various aspects of the payment system, such as the establishment of the appropriate legal framework and the oversight of the payment system.

6. The role of markets

Having reviewed the pursuit of price stability, autonomy, uncertainty and the development of financial systems as important challenges facing central banks in Africa, the next challenge, namely the role of markets, seems to fit in quite logically.

In an address in 2001, reviewing changes that have transformed the economic and financial landscape as well as the way that monetary policy is conducted over the last two to three decades, Mr Jozef Van't dack, Adviser to the General Manager, Bank for International Settlements, stated that: "No doubt the first and most fundamental change has been the almost universal reliance on market forces and the competitive price mechanism in organising real and financial activity".

A decrease in government's role in the economy, fiscal discipline, financial liberalisation and reliance on market forces have also spread to Africa. In many African countries, however, further progress is still possible. Concomitant with this process, central banks have to develop market oriented instruments of monetary policy such as repurchase agreements and other open market operations. In a financial environment characterised by liberalisation and markets, the so-called direct instruments of monetary policy such as credit ceilings and directed lending are less effective.

7. Monetary cooperation

In recent years, important initiatives have been taken with a view to the sustainable development of Africa. Key amongst these would be the Constitutive Act of the African Union and the New Partnership for Africa's Development (NEPAD). Central banks in Africa will have to face the implicit challenges in these initiatives. The political will to pursue monetary union, a single currency and an African central bank should not be under-estimated.

Article 44 of the Abuja Treaty calls for the harmonisation of economic policies across the African continent. The Treaty emphasises two important pillars of economic integration: the promotion of intra-Africa trade and the enhancement of monetary cooperation. The African Monetary Co-operation Programme (AMCP) seeks to operationalise the monetary cooperation mandate of the Abuja Treaty and the Constitutive Act of the African Union. In the main, this involves a single monetary area, encompassing a common currency and a common central bank by the year 2021.

In terms of the AMCP monetary union in Africa is to be achieved in six stages starting in 2002/2003 and culminating in stage VI in 2021 with the introduction and circulation of the common African currency. During these six stages, African governments and central banks will have to work towards harmonisation and coordination of macroeconomic and monetary policies, the harmonising of interconnected payment and clearing systems, the strengthening and harmonisation of banking and financial supervision and the observance of increasingly strict macroeconomic convergence criteria.

At the continental level, the Association of African Central Bank Governors subscribes to the AMCP. At the level of the Southern African region, the Committee of Central Bank Governors in SADC (CCBG) has become more involved in the various initiatives taken at the continental level. The CCBG has pledged support for the AMCP and the various projects that fall under NEPAD.

The CCBG was established in 1995 with the specific purpose of achieving closer cooperation and integration in the area of monetary policy among SADC central banks. The work of the CCBG has contributed to major developments towards regional monetary cooperation such as significant progress in the harmonisation of the payment and clearing systems, the approval of Memoranda of Understanding on Cooperation, Coordination of Exchange Control Policies in SADC, and Cooperation in the area of Information and Communication Technology. The CCBG has also contributed to the coordination of training for central bank officials in SADC and the creation of a Training and Development Forum.

The economies of our Southern African region are closely intertwined. Whilst it is evident that our countries experience differences in levels of GDP, inflation, employment or unemployment, exchange rate regimes, etc. we are nonetheless, one of the promising regions in our continent.

Most SADC countries experienced higher growth rates in real GDP in 2002. Indications are that this continued in 2003. Notwithstanding this improvement, the aggregate growth in the SADC region still falls below the 7 per cent as recommended by international financial institutions to impact positively on poverty. In 2002 Angola, Mozambique and Tanzania reached commendable growth rates in excess of 6.0 per cent.

The average rate of inflation for the region slowed down from 2001 to 2002. Figures for 2003 indicate that most SADC countries are making progress to achieving single digit inflation rates as proposed in the stage of implementation of the African Monetary Co-operation Programme (AMCP) for the period 2004 - 2008.

A budget deficit/GDP ratio target of less than 5 per cent for the medium term (2004 - 2008) and a ratio of not exceeding 3 per cent by 2012 is proposed in the AMCP. Seven SADC countries recorded deficit/GDP ratios of 5 per cent or less in 2002.

Most SADC countries have made progress in implementing economic reform policies, resulting in moderate inflation rates and reduced levels of Government deficit as percentage of GDP. However, the region still faces the challenge of generating higher rates of sustainable growth that will satisfy regional and global policy objectives of significant poverty and unemployment reduction and other aspects of social development.

According to the IMF World Economic Outlook, April 2004, economic activity in sub-Saharan Africa is expected to increase to 4.25 per cent in 2004 and 5.75 per cent in 2005. It is expected that various large-scale development projects in manufacturing and infrastructure in the region by South Africa will provide economic stimulus to several countries. One of the projects is the expansion of the Mozal aluminium plant in Mozambique, construction of a gas export pipeline from Mozambique to South Africa and the Inga Dam project in the Democratic Republic of Congo.

Achieving macro-economic stability and convergence in key macro-economic aggregates are important pre-requisites for the eventual achievement of monetary union. This does not all fall in the ambit of central bank responsibility. Nonetheless, central banks play a key role in pursuing macroeconomic stability. If central banks successfully pursue price stability, that is low inflation, they will be making a fundamental contribution to macroeconomic stability, which is a prerequisite for monetary union.

8. Conclusion

In reflecting on the challenges facing central banks in Africa, one cannot but notice the overarching need for capacity building. To face all these challenges and others that have not been touched upon in this address will place significant demands on the staff of central banks. The training and development of staff is in reality a further important challenge facing our central banks.

It is my pleasure to wish the Bank of Zambia well for the future. You have an important role to play in Zambia, SADC and Africa. You can count on us as your ally, friend and colleague.

Happy birthday!

Thank you very much

References

1. Gaolathe, B (2004): "Official Opening Speech for the SADC Committee of Central Bank Governors' Meeting", Gaborone, 30 April

2. Mbeki, T (2001): "Address at the 25th meeting of the Association of African Central Bank Governors", Johannesburg

3. Rogoff, K (2003): "Globalisation and Global Disinflation", Paper prepared for the Federal Reserve Bank of Kansas City conference on "Monetary Policy and Uncertainty: Adapting to a Changing Economy", Jackson Hole, WY, 28-30 August

4. Van't dack, J (2001): "The Framework of Monetary Policy: An Overview of Issues", Presentation to the Conference on Monetary Policy Frameworks in Africa, Pretoria, 17-18 September.

5. Mboweni, TT(2000): Address at the Reuters Forum Lecture, 11 October, Johannesburg. South Africa.