T T Mboweni: Monetary policy and inflation - the next decade

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Conference of the Bureau for Economic Research, Stellenbosch, 18 November 2004.

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1. Introduction

Chairperson, ladies and gentleman, I have been asked to share my views with you today on what will happen with monetary policy in the next ten years. Looking into the future is always a hazardous undertaking. It requires a careful analysis of what has changed already and what likely changes will occur in the coming years. Such an analysis cannot only concentrate on what has happened in South Africa, but must also take into account the structural changes in the rest of the world and how these developments could perhaps affect South Africa. This is indeed a formidable task. In the next thirty minutes I will do my best to give you my view on these matters.

2. Structural changes in the world's financial sector

World War I and the great depression of the 1930's left the world with highly regulated capital markets and a disintegrated international financial system. The highest priority was therefore attached to restoring multilateral payments and current account convertibility towards the end of World War II, which led to the Bretton Woods Agreement and the General Agreement on Tariffs and Trade. In the period after the war, the emphasis shifted to the liberalisation of trade and payments. Progress with these reforms was relatively slow and at first concentrated on the currency convertibility of current account transactions. In the 1980's the authorities of the industrialised countries began liberalising financial systems, which were later followed by a number of emerging-market economies. The convertibility of the capital account of the balance of payments gained further momentum with the negotiations in the World Trade Organisation to liberalise transactions in financial services.

This financial liberalisation was accompanied by a process of globalisation, i.e. a growing economic interdependence of countries became discernible through the increasing volume and variety of cross-border transactions and through the rapid and widespread diffusion off technology. New technological advances reduced transportation, telecommunication and computation costs, thus greatly increasing the ease with which national markets may be integrated at the global level.

The liberalisation and globalisation resulted in a growing interdependence of national financial markets. Although these markets still do not form a single global market, the degree of interdependence is already strong enough to have altered the environment in which monetary policy is conducted. In particular, it has affected the volume of international financial transactions. International transactions in goods and services have become considerably less important than financial transactions. The closely linked financial markets have changed the monetary transmission mechanism, and shocks that occur in one country can easily have an impact on other countries.

As a transition phase of or perhaps as an alternative to globalisation, considerable emphasis has been placed on closer international co-operation, convergence and integration since the end of World War II. Many regional economic co-operation arrangements have been formed or are under consideration. The aim of these regional arrangements is to free international trade and financial transactions between a group of countries. But many of them also want to encourage the movement of labour across domestic frontiers and the eventual attainment of political unions. The establishment of the European Union is, of course, the best example in this regard. This regional arrangement has created the largest government bond market in the world and led to the development of the euro into a major international currency.

Another important structural change in the world's financial market has been the achievement of greater price stability. Over the past twenty years the rate of inflation has declined dramatically in most countries of the world. The disinflation process was at first mainly concentrated in the industrialised countries. According to the International Monetary Fund the average annual inflation rate in the major advanced countries already started to decline from the early 1980s from 12,3 per cent in 1980 to 1,7 per cent in 2003. By contrast, the average inflation in emerging-market and developing countries continued to increase from 25,0 per cent in 1980 to 107,7 per cent in 1992, before declining sharply to

6,1 per cent in 2003. These developments brought the average rate of inflation in the world as a whole down to only 3,7 per cent in 2003.

This disinflation process has been so strong that some countries even experienced declines in their average price indices. Consumer prices have actually been declining in Japan and Hong Kong for quite a while, while some other countries such as China recorded decreases for a short period. As could be expected, disinflation to low positive values has been accompanied by a corresponding decrease in short-term interest rates to low levels.

Finally the financial sector, just like all other activities in the world, has been severely influenced by the revolution experienced in information technology and telecommunication. In central banking the advances made in information technology and telecommunication have particularly led to a more efficient payment system catering for real-time gross interbank settlement. New developments in commercial banking include automated teller machines, credit and debit cards, telephone and inter-net banking, intelligent cards and card reading devices. In the 1990s a further advance in technology made it possible to store monetary value on a silicon chip embedded in a plastic card or in a personal computer. This was the first step in the development of electronic money or e-money. Initially it was believed that this development would lead to a quick and dramatic change in the way that payments are made. Such a change would have required large investments in infrastructure and the general acceptance of this new payments method by the public. It is thus not surprising that it did not take off in the way predicted by some analysts. However, initial setbacks to new innovations are a common experience and it is quite possible that the public could eventually be more willing to accept this new innovation.

3. Effects on South Africa’s financial structure

These changes in the rest of the world did not affect South Africa’s financial sector to any great extent during the 1980s, i.e. in a period in which the country became increasingly isolated from the rest of the world as a result of trade boycotts, embargoes and financial sanctions. The subsequent transition to a new political dispensation and the normalisation of the country’s international relations completely changed this situation. These circumstances forced the South African financial sector to move from a relatively isolated position to a world that had changed in many ways from the time when our financial institutions were still actively involved internationally.

To cope with the challenges faced in this new environment it was important to improve the functioning of the domestic financial markets and to reintegrate them in the world economy in an orderly way. Great efforts were accordingly made to bring the rules and regulations applying to financial institutions in line with international norms and standards. The re-entry of South Africa in an integrated financial community also made it important to reconsider the strict exchange control rules applicable at that time. The country’s limited foreign exchange reserves prevented the immediate removal of all exchange control measures, which caused the authorities to opt for a policy of a gradual relaxation of capital account transactions.

From 1994 South African financial institutions started operating on an increasing scale in major international financial centres and opened branches or subsidiaries in other African countries. At the same time foreign financial institutions were encouraged to conduct business in South Africa by the creation of a level playing field between local and foreign service providers. In addition, the regulatory authorities actively encouraged the development of appropriate clearing, settlement, ownership-transfer and market information systems, and proper intra-market and cross-market risk management systems.

This restructuring led to a sharp increase in the involvement of foreign banks and other non-residents in domestic financial markets. In particular their transactions on the Bond Exchange and the Johannesburg Stock Exchange increased considerably. This participation of non-residents contributed to the increase in the turnover of these two markets. It also caused more volatility in long-term interest rates because investors quickly altered their positions with changes in domestic and international conditions, while prices on the Johannesburg Stock Exchange became even more susceptible to changes in the prices on the stock exchanges of major financial centres.

Moreover, the normalisation of relations with the rest of the world led to a turnaround in the international financial flows of South Africa from a net outflow of about R45 billion in the period from 1985 to 1993 to a net inflow of nearly R204 billion since 1994. At the same time the volatility in these financial flows increased. Although the country generally experienced an inflow of capital from the rest of the world, the magnitude of these inflows varied considerably from year to year. For example, a net financial inflow of about R29 billion in 1998 was followed by inflows of just more than R7 billion in each of the next two years, before these inflows increased again to about R30 billion in 2002 and R63 billion in 2003.

Most emerging-market economies now seem to experience large and volatile capital movements. Despite considerable efforts to make South Africa a more investor-friendly country, it can safely be assumed that fluctuations in capital movements will continue to be a feature of our economy in the future. This volatility will not only be influenced by domestic developments, but also by events in the rest of the world.

The volatile capital movements brought about large swings in the exchange rate of the rand not only against individual currencies but also on a trade weighted basis. For instance, in 2000 and 2001 the nominal effective exchange rate of the rand declined by 13 percent and 39 per cent, respectively, before it increased again by 24 per cent in 2002 and by 44 per cent in 2003. These fluctuations have complicated the implementation of monetary policy. In particular, monetary policy was dominated in 2002 by inflationary pressures arising from the substantial depreciation in the external value of the rand in late 2001, combined with a sharp rise in international oil prices as well as in domestic food prices. These external shocks were responsible for a surge in the twelve-month rate of increase in the CPIX from a low of 5,8 per cent in September 2001 to a peak of 11,3 per cent in October 2002. Subsequently, the appreciation of the rand from the beginning of 2002 again had to be carefully taken into consideration in the formulation of monetary policy.

The fluctuations in the exchange rate of the rand clearly illustrated the need for structural adjustments in the foreign exchange market in South Africa. The Reserve Bank accordingly concentrated on eliminating its negative net open foreign reserve position and its oversold forward book. With the success achieved with these objectives, the focus of the Bank has now shifted to a gradual strengthening of the official foreign exchange reserves. Since the end of 2002 the official foreign exchange reserves of the country have increased from US$7,6 billion to US$13,0 billion at the end of October 2004. The higher foreign exchange holdings should help to stabilise the external value of the rand.

4. Implications for monetary policy

Taking these changes in the world and more specifically in South Africa into consideration, we now come to the crucial question on how will monetary policy be affected or what will happen to monetary policy in the next ten years. More in particular I want to concentrate on three questions in this regard, namely:

(1) Will monetary policy still be effective?

(2) What should the primary objective of monetary policy be?

(3) What monetary policy framework should be applied?

4.1 The effectiveness of monetary policy

As in the rest of the world, e-money has not really taken off in South Africa. Although several potential products have been evaluated by the Reserve Bank, no roll-out on a significant basis has yet occurred. The failure of e-money to meet expectations can possibly be ascribed to the fact that cash remains a trusted and very convenient payment mechanism, debit and credit cards are widely used and e-money products generally do not allow for person-to-person payments. However, it is conceivable that this could change in the future and that e-money could to an increasing extent become a substitute for banknotes and coin. As Benjamin M. Friedman (1999) has pointed out it is possible, albeit at present highly unlikely, that e-money could be used as a means of payment as well as settlement and therefore erode the role of currency and reduce banknotes and coin in circulation.

Friedman also stated that the size of base money (currency in circulation plus the balances of banks at the central bank) could decline in future because of the declining role of banks in advancing credit to the non-bank private sector. If bank credit extension to the private sector decreases, less deposits are created. The reserves that banks are required to hold at the central bank are then smaller, which reduces base money.

Securitisation and the liberalisation and globalisation of South Africa's financial markets have led to a declining role of banks in the advancement of credit to the non-bank private sector. As already indicated, South African organisations are now more easily able to obtain financing from abroad than they were before 1994. Many private sector companies have also started to make increasing use of the bond market to raise funds for development purposes. Although this disintermediation has not led to a decline in reserve requirements of banks, it has affected the growth of base money.

Friedman further indicated that private bank clearing mechanisms could be developed that would further reduce base money. Mervyn King (1999) also pointed out that there is a possibility that the demand for settlement balances could eventually be eliminated by the development of electronic networks allowing payments to be settled without the involvement of the central bank.

These arguments led Friedman to the conclusion that the central bank in the future will become "an army with only a signal corps". Central banks will only be able to indicate to the private sector how they believe monetary conditions should develop, but will be unable to do anything about this if the private sector has a different view.

It nevertheless seems highly unlikely that the effectiveness of monetary policy will decline in South Africa in the next ten years because of the increased use of e-money, the liberalisation and globalisation of our financial markets or the development of private banking clearing mechanisms. At most these factors should only have a limited impact on the effectiveness of monetary policy. As Woodford (2000) stated, the effectiveness of monetary policy is not dependent "upon a mechanical connection between the monetary base and the volume of nominal spending, which is then presumably dependent upon a need to use base money as a means of payment". In fact, in South Africa the supply of money is endogenously determined. The repo rate is the operational variable of the Reserve Bank and this rate is not affected by the size of base money.

4.2 The primary objective of monetary policy

Having determined that monetary policy should remain effective in the coming ten years, what should the primary objective of monetary policy be in South Africa?

It is now generally accepted all over the world that the central bank's responsibility is to ensure price stability. As already indicated, considerable success has been achieved with the attainment of this objective and in the advanced countries of the world price stability has been maintained for a relatively long period. As a consequence, many of the central banks of these countries seem to have become less engrossed with combating inflation and have again moved somewhat in the direction of fine tuning economic growth. Many economists are of the opinion that this is the right approach. For example, in a recent article of Carl Walsh (2003) he states that modern central banks must "recognise that achieving and maintaining low inflation cannot be their only objective. Monetary policy has important short-run effects on real economic activity and there is, therefore, a role for monetary policy to play in conducting stabilisation policy". The danger of such an approach is, of course, that central banks could concentrate too much on expansionary policies at the cost of maintaining price stability.

Despite the fact that South Africa has only been able to maintain low inflation over a relatively short period, it can be argued that the Reserve Bank should now give more attention to the promotion of economic growth. It is true that short-term interest rates do have some affect on long-term interest rates which, in turn, is an important determinant of the growth in investment and production. However, it must be realised that reductions in short-term interest rates do not always lead to a reduction in the cost of capital. If it is generally expected that lower levels of short-term interest rates will lead to higher inflation, long-term interest rates are bound to rise. Monetary policy may therefore be less effective in having the desired impact on real economic activity over the short term than generally believed. At the same time it must be admitted that the actions of central banks do have some affect on the growth of domestic product over the short term.

Although monetary policy measures affect real economic activity over the short term, long-term economic growth can only be achieved if production capacity and productivity increases. Besides increases in employment, the expansion in production capacity requires additions to capital stock in the form of net fixed investment. Productivity refers to the efficiency with which labour, capital and other inputs are combined and used to produce goods and services of a specific quality in order to satisfy the needs of the market. Technological progress, improving the quality of the labour force and the more productive utilisation of resources are among the factors needed to increase productivity.

Monetary policy measures cannot directly influence the factors on which long-term economic growth depend. Monetary policy has the most control over changes in the overall price level and therefore on the long-run impact of inflation on economic growth. But it should at least not discourage and preferably rather encourage domestic saving, investment and the inflow of foreign capital to promote economic growth. Monetary policy should also not stand in the way of the optimal allocation of resources and the most efficient utilisation of these resources in business enterprises, because this could lower the potential growth in output. All in all, monetary policy should therefore not add to the risks that normally confront private business or dampen technological innovations.

The South African Reserve Bank believes that the best way that monetary policy can contribute to the important objective of sustained economic growth is to achieve and maintain price stability. The maintenance of price stability should continue to be a major objective of monetary policy particularly now that we have achieved some success in bringing the inflation rate down within our inflation targets. If we are unable to do this, the credibility of monetary policy will be questioned, which could have a severe affect on the effectiveness of monetary policy measures in the future. As Carl Walsh (2003) has indicated "the three most important ingredients to a successful monetary policy are credibility, credibility and credibility".

There are many convincing arguments why price stability should be regarded as a prerequisite for sustainable economic growth. All modern market-orientated economies are based on the extensive use of money as a unit of account, as a means of exchange and as a store of value. Money that deteriorates in value all the time cannot fulfil these functions effectively. High inflation discourages savings and foreign investment, on which economic growth is highly dependent.

Not only is the supply of funds for investment reduced by high inflation, but the flow of existing saving to risk capital is distorted. The finance that do become available is invested in such a manner where they can provide the best protection against inflation, and not necessary where they could be the most productive and lead to employment creation. In the past when we experienced high inflation, large amounts of investment in South Africa were made in the construction of office blocks, shopping centres and expensive housing, which cannot be regarded as the most productive forms of investment and which probably lowered the growth potential of the economy. Inflation accordingly undermines the efficiency of the pricing system and does not lead to the optimum allocation of production resources.

4.3 The monetary policy framework

In the pursuit of price stability the South African Reserve Bank and the central banks in many other parts of the world have found that the inflation targeting monetary policy framework has proved to be highly effective. In particular, inflation targeting has led to a better co-ordination between monetary policy and other economic policies than with other monetary measures applied in the past. This is largely owing to the fact that the Government is responsible for the determination of the inflation target in South Africa in co-operation with the Reserve Bank. This target is therefore determined in a structured manner, and taking into consideration the other economic objectives of government. After the determination of the target it is the Reserve Bank's responsibility to see that it is achieved, i.e. the Reserve Bank has instrumental independence but not goal independence. It is therefore surprising that the Bank is sometimes criticised of being over obsessed with the attainment of the target at the detriment of economic growth. Since the target is established in a co-ordinated way, it should in theory form part of the government's objectives for economic growth and employment creation. Even more importantly, after the target has been established, it is the Reserve Bank's task to see that it is achieved.

Inflation targeting has the further advantage that it provides a nominal anchor to inflation expectations if monetary policy is perceived to be credible. This facilitates a reduction in inflation and should form the basis for future price and wage setting. It is a transparent policy framework, because the target is publicly announced. This announced target provides the basis of accountability of the central bank. This disciplines the actions of the central bank and leads to a better understanding among the public why monetary policy decisions are made.

In view of these advantages of inflation targeting in comparison with other monetary policy frameworks, there seem to be little reason to start applying a new framework. The authorities will accordingly continue to apply inflation targeting as the monetary policy framework of South Africa in the next ten years and at most probably only refine the system further to ensure that it continues to function efficiently.

5. Conclusion

My general conclusion is therefore that the recent major structural changes in the world and in South Africa will have little effect on the determination and implementation off monetary policy in the coming years. It is true that vast developments have taken place in information technology and telecommunication and that we could probably expect further significant changes in the next ten years which will have a major impact on our lives. The process of liberalisation, globalisation and integration is also bound to change our lives even further. It seems unlikely however, that these changes will affect the efficiency of monetary policy. In this expected changed world the South African Reserve Bank will continue in its quest for the achievement and maintenance of price stability by applying an inflation targeting monetary policy framework.

References

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