T T Mboweni: Monetary policy and sustainable economic growth

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the BER conference on Growing the South African Economy, in Somerset West, Pretoria, 9 November 2005.

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Thank you for your invitation to speak at this conference on Growing the South African Economy. Over many years the Bureau for Economic Research (BER) has in numerous ways helped to inform economic analysis and policy in South Africa. It has for instance in recent years been commissioned by the South African Reserve Bank to survey inflation expectations in South Africa. This has been very helpful in the deliberations of the Bank's Monetary Policy Committee. But apart from this narrower interest which the Bank has developed in the activities of the BER, the Bureau and its respondents provide a wide range of economic indicators which warrant the attention of analysts and policymakers alike. The BER also stirs debate on highly relevant topics, as again demonstrated by today's conference.

The economic situation in and outlook for South Africa have already been covered earlier today, alongside the possible direction of political developments. Industrial policy and fiscal policy have also already been discussed. My remarks on monetary policy and sustainable growth will consist of some thoughts on enhancing the tempo of growth and development in general, before narrowing in on what monetary policy can do and cannot do in this regard and reflecting on some developments which are important in informing current monetary policy decision-making.

Sustainable economic growth

Vibrant growth, sustained over lengthy periods of time, opens up exciting possibilities. Some of the most dynamic examples in this respect are Korea, where real gross domestic product per capita is now four times its level in 1980, and Botswana, where the same comparison yields an increase to 3.3 times what it was 25 years ago. In South Africa real gross domestic product per capita has been rising steadily since 1993, but this followed a gradual decline during the preceding 13 years, resulting in real per capita production at present being quite close to its level a quarter of a century ago. Stepping up the tempo of per capita gains of the past 11 years is an important focal point, and is currently receiving the attention of government, business, labour and community.

A G-20 conference on economic growth, co-organised by the South African Reserve Bank together with the People's Bank of China and the Banco de Mexico, was hosted in the Bank's conference centre in August this year. It might be worthwhile recalling some of the points made at that meeting of minds.

While it was generally agreed that economic growth is one of the most important challenges facing all countries, it was emphasised that no universal recipe for growth exists since each country faces a different set of constraints. There is more to growth than good macroeconomic policy. To obtain higher growth does not seem to require a large set of very fundamental or deep reforms, but rather a more effective focus on a small set of binding constraints. It is extremely important that appropriate strategies be developed to properly identify such binding constraints. Such action requires an institutional setting that allows for a dynamic process where problems are identified, on the one hand, but also effectively addressed, on the other. In doing so not only government failures have to be dealt with, but also market failures, such as large externalities, that require government action.

The list of possible binding constraints is virtually endless. Some studies have suggested that high levels of taxation discourage growth through their effect on incentives to work, save and innovate. Others have pointed to the importance of protecting private property rights if growth is to be dynamic. Still others note the importance of human capital, and highlight the role of education as a determinant of economic growth. Excessive rules and regulations can stifle economic progress, slowing fixed capital formation, undermining flexibility and discouraging productive enterprise. Establishing which of these, and many more candidate constraints, is most relevant and then getting policies right is crucial if trend growth is to be increased. As these examples illustrate, many of the things that impact on the quantity and efficiency of the factors of production are quite broader than monetary policy and the ambit of central bank influence.

As we all know, economic growth might be a necessary but not a sufficient factor in employment creation.

What monetary policy can do

Sound monetary policy can provide a stable platform for sustainable economic and employment growth. This is recognised in national economic policy and in the South African Reserve Bank Act, both of which assign to the Bank the objective of achieving and maintaining price stability in the interest of balanced and sustainable economic growth in the Republic.

High inflation causes numerous well-documented distortions and frictions in the economy. The higher inflation is, the more variable it also tends to be, adding further uncertainty to economic decision-making. Low inflation enhances predictability and planning, reduces the uncertainty premia built into nominal and real interest rates, and thereby supports sustained and balanced economic growth. The view that a monetary policy aimed at keeping inflation low is anti-growth is simply wrong. There is no permanent trade-off between inflation and unemployment, and even the short-run trade-off tends to be elusive in an environment where expectations formation is increasingly sophisticated and forward-looking.

That said, getting from high inflation to low inflation requires a sustained tight monetary policy. It cannot be denied that a tightening of policy will tend to hurt short-term growth, just as getting fit invariably requires some sacrifice by the athlete. But South Africa's experience under formal inflation targeting has been relatively favourable. When in late 2001 and during 2002 the inflation targeting framework was severely tested on account of an extraordinary depreciation of the exchange rate of the rand which fuelled inflation, the Bank had to raise short-term interest rates by a total of 4 percentage points. Alongside a conservative fiscal policy and a recovery in the exchange value of the rand, this was enough to first brake and later on reverse the acceleration in inflation.

This was done with quite limited loss of real output, partly because of the stimulation to the tradables sector imparted during 2002 by the over depreciated exchange value of the rand, and partly because policymakers deliberately refrained from raising interest rates excessively, mindful of the lags characteristic of the transmission of monetary policy to the economy. Thorough investigation of the business cycle reveals that the economy remained in an upward phase of the business cycle throughout the period of tighter policy in 2002 and 2003. In fact, the upswing has now been sustained for some six years.

Being directed at combating inflation with a medium-term orientation, the other side to the coin of the inflation targeting framework which has been adopted in South Africa is that real interest rates are likely to remain positive under virtually all circumstances. This supports balanced and sound growth, inter alia by ensuring that the relative prices of the factors of production are reasonably aligned with their true scarcities. Previous experimentation with negative real interest rates in the 1970s and 1980s contributed to suboptimal allocation of scarce capital, excessive capital intensity in production and weak growth outcomes. Avoiding this obvious pitfall is a very important contribution which monetary policy can make, at the same time helping to ensure fair returns to savers and combating the deterioration in the national saving rate.

What monetary policy cannot do

Unrealistic expectations regarding what monetary policy can do abound. While monetary policy can contain inflation, reduce inflation risk and uncertainty premia in the economy, ease the cash flow of borrowers once interest rates have adjusted to the low-inflation environment, and contribute towards sound factor allocation, it cannot do any of these things overnight. Allowance should be made for long and variable lags in the operation of monetary policy.

A stable environment of low inflation is no guarantee that the private sector will be willing to take risk and establish enterprises, in the process employing resources and producing more output. Neither can it guarantee that government will produce the public goods and services necessary to support sound growth and development. Efficiency in such production, whether by the private sector or by government, can also not be guaranteed. Nevertheless, the absence of distortions arising from inflation significantly improves prospects that these very deserving things will happen and will be reflected in improved growth and employment outcomes.

Monetary policy in our case does not simultaneously target inflation and the exchange rate. Once the inflation targeting framework was introduced, the exchange rate has essentially been left to be determined by supply and demand forces in the market. Not that there is no relationship between inflation and the exchange rate: If inflation is kept low as it is in our significantly large trading partner countries, the exchange rate is mostly likely to move sideways over the long run. But this does not constitute exchange rate targeting.

To develop this point further, one of the calls frequently made is for deliberate depreciation of the exchange value of the rand in order to retain and expand employment in the tradables sector and to enhance overall growth. To realise such a goal in practice would conceivably require some combination of significant exchange rate interventions by the Bank, a radical lowering of interest rates, abolishing of exchange controls and pronouncements by the Bank that it views the external value of the rand as too strong. Each of these, however, has its own challenges. Foreign exchange interventions of the kind demanded of the Bank involve payment of rand by the Bank to the private-sector banks for such foreign currency. In order not to flood the money market with excessive rand liquidity, the rand created has to be sterilised. This involves an interest cost on the instruments used to sterilise the excess liquidity, such as the Bank's debentures or government bonds. Having raised the Bank's gross reserves from US$8 billion two years ago to almost US$20 billion at present, the interest cost of sterilisation – ultimately for the account of the taxpayer – has been considerable.

Lower interest rates could lead to exchange rate appreciation if expectations of increased short-term profitability and higher share prices overshadow the conventional mechanism which is based on comparative interest rates on bonds and loans, and these expectations are reflected in substantial share purchases by non-residents. Similarly, further relaxation of exchange control could boost confidence in the rand and prompt inflows rather than outflows of foreign currency, thereby leading to appreciation of the rand. Finally, pronouncements on an appropriate level for the rand's external value might need to be backed up by currency interventions if they are to be taken seriously by the market. But in any case the desired outcome may not arise.

Despite these complications, the Bank has a preference for a relatively stable and competitive level of the external value of the rand. Large movements in the exchange rate disrupt resource allocation and economic growth, while an overvalued exchange rate would disqualify deserving exporters from entering international markets on a sustainable basis. Nevertheless, experience with large-scale intervention in the foreign exchange market has been unfavourable. With 1½ days' turnover in the South African foreign exchange market equal to the entire US$20 billion gross reserves currently held by the Bank, and with numerous forces outside of the South African authorities' control having an important bearing on supply and demand in the market for foreign exchange, caution is warranted before entering the market with an exchange rate objective in mind. Accordingly, the Bank prefers to leave the determination of the exchange rate essentially to market forces.

The Bank of course helps with price discovery in the market by disseminating data on its foreign exchange reserves and international liquidity position, and on the balance of payments and foreign debt situation. The Bank participates in the market on a moderate scale to cream-off any excess foreign exchange. Since other countries with similar characteristics tend to have more reserve assets relative to imports than South Africa, the Bank has over the past two years, on balance, accumulated an additional US$12 billion in foreign exchange – not without at least some impact on the level of the exchange rate. This is common knowledge in the market.

Further constraints and risks

Fiscal policy has been prudent over the past decade and has contributed to the stable macroeconomic environment. There is currently no fiscal dominance over monetary policy decision making. Government lowered its debt ratio and debt service ratio, thereby freeing resources for productive service delivery, and the public sector borrowing requirement has been maintained at low levels.

However, there is widespread agreement that higher economic and employment growth on a sustained basis would require stronger capital formation. Currently the ratio of fixed capital formation to gross domestic product is around 17 per cent, and the real fixed capital stock is growing by 2 per cent per annum. It is calculated that this ratio should ideally rise to 22 per cent in order to boost the rate of growth in the capital stock to 4½ to 5 per cent per year – as seems necessary in order to sustain a real growth rate of around 6 per cent. Stepping up the investment ratio is set to entail much higher levels of fixed capital formation by government, public corporations and the private sector.

There are encouraging signs that this is starting to happen, although not without delays and some frustration. In many instances financing seems not to be the binding constraint, but skills - in particular project management and other real-sector implementation capacity issues. Fortunately the public sector's debt ratio is favourably low. Insofar as capital formation will be import intensive, the country's level of international indebtedness is also quite low, at around 71 per cent of one year's export proceeds. This provides latitude on the balance of payments front, alongside the fact that South Africa has a flexible exchange rate which can adjust to changing circumstances.

Training, education and productive employment of all the people wishing to work is probably the most crucial factor on which sustained long-term growth depends. The challenges in this area are enormous. Sparkling growth requires utilisation of all those skills that are in short supply, entrepreneurship, adequate and relevant training, and a dedicated workforce using those acquired skills productively and ploughing back whatever has been learnt. Six years of economic expansion have been drawing idle resources into the growth process in South Africa, thereby allowing "learning by doing" to take place and building up considerable momentum. But numerous concerns related to human capital formation remain.

With the sustained upswing in the economy and more favourable financial conditions there is of course the risk that South African consumers will get carried away as real household disposable income rises briskly and real estate and share investments yield high returns. The level of household debt relative to annual disposable income has already risen to almost 62 per cent, marginally higher than its previous peak value. While currently debt service ratios are undemanding on account of the reduction in interest rates since mid-2003, households would be well-advised to remember the ever-present risk of a deterioration in inflation prospects, which could result in a tightening of monetary policy and the stresses and strains of servicing that debt at a higher interest rate.

And talking of deterioration in inflation prospects, the latest BER inflation expectations survey of course showed higher expected inflation than before. In the wake of oil price trends during the past year, this did not really come as a surprise. However, 25 months of CPIX inflation within the 3-to-6-per-cent target range has demonstrated that low and stable inflation can be achieved and remains a priority of economic policy. The Monetary Policy Committee will not allow price shocks to develop into sustained inflation spirals, but will be vigilant, safeguarding the gains made in combating inflation.

Conclusion

Central banks combat inflation precisely in order to nurture economic and employment growth – balanced growth of the sustainable types. The South African Reserve Bank will certainly not neglect its duty in this regard.

But let the debate continue. Maybe in the process all of us will learn new lessons on how to do things in a nuanced manner.

Once again, thank you very much for affording us this opportunity to interact with such an august gathering of people interested in high economic growth and employment creation.

Thank you very much.