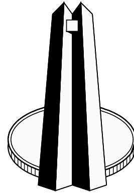

South African Reserve Bank

An address by Francois Groepe,
Deputy Governor of the South African Reserve Bank,
at the 60th anniversary celebration of the Bank of Ghana

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The changing role of the central bank in economic policy

Governor Addison, distinguished guests, ladies and gentlemen.

It is a great honour for me to address you on this auspicious occasion. Thank you for the invitation.

The Bank of Ghana has been operating for 60 years. Much has changed over this period in terms of its role and operations. This is not surprising, as the historical backdrop in which central banks have had to operate has kept changing over the decades.

Central banks in the developing world often play a vital role in economic policymaking, but that role tends to change as the economy and financial markets develop and new institutional capacity evolves. This is true of many African central banks. Similarly, in the advanced economies, the role and even mandates of central banks have come under intense scrutiny and challenge, and many have found themselves with broader mandates and a wider scope of responsibilities in the wake of the most recent global financial crisis.

Numerous roles have been assigned to central banks over the years, many of which do not have to be performed exclusively by these institutions and could also be

carried out by others. Apart from supporting state financing during times of crisis, two main functional roles have traditionally been at the heart of central banking: maintaining price stability (subject to the monetary regime) and maintaining financial stability. This includes crisis prevention and management and resolution as well as the promotion of financial development in the economy. How these roles have been interpreted and implemented and their relative emphasis, however, has continued to evolve over time in response to changing circumstances.

Today, central banks have many other functions, some of which have also evolved over time. In South Africa, apart from the price stability and financial stability objectives, the responsibilities of the central bank include the printing of physical notes and coin, the regulation and supervision of the banking system, ensuring the effective functioning of the national payment system, and managing the foreign exchange reserves of the country.

However, in the African context, central banks have had to take on other roles as well. This is partly due to a relative scarcity of skills and other resources in the context of pressing developmental needs. In some African countries, central banks have an explicit developmental role. In Nigeria, for example, the central bank plays a significant role in providing finance to the agricultural sector. How multiple developmental needs are dealt with differs from country to country. As is often the case when it comes to policy prescription, there is no ‘one size fits all’ solution.

In my remarks to you today, I give you a perspective of how South Africa has dealt with changing demands and circumstances, particularly since the global financial crisis.

The South African Reserve Bank (SARB) has been confined to a relatively narrow and traditional mandate. We do not play a central role in development issues, as there are specialised institutions for these purposes. The Land and Agricultural Development Bank of South Africa, as its name suggests, provides financing and technical assistance to the farming community. The Industrial Development Corporation provides loans to facilitate industrial development. The Development Bank of Southern Africa specialises in funding for infrastructure expenditure in

Southern Africa. There are also a number of institutions that specialise in the financing and promotion of small businesses.

Why does the SARB not engage in developmental activities beyond those traditionally in the ambit of central banking? The short answer is: because South Africa has institutions that are better equipped to do so than us. There is no reason for these activities to be conducted by central banks. By the same token, there is no reason why central banks should not undertake such activities if resources and capacity are limited in the rest of the economy. It should, however, be remembered that central banks are not elected and hence it is preferred that their mandates are specific and narrowly defined.

There should also be a clear delineation between the balance sheets of these different activities of central banks – to avoid any conflicts of policy objectives, but also to ensure that these activities are not financed through direct loans from the central bank, i.e. through money creation. Under these circumstances, the role of the central bank would generally be to disburse funds that are raised in the capital markets at competitive rates, or that are funded by grants from government and/or multilateral organisations. There is no inherent reason why the central bank would have the advantage of assessing the needs of these sectors relative to the specialised institutions that would have the necessary expertise to do so. Having separate institutions helps to avoid conflicts over resources within the central bank and reduces the possibility of the politicisation of monetary policy, which could ultimately undermine central bank independence.

The conduct of monetary policy changed markedly during the 1980s, in line with global developments. Price stability became an important focus, particularly following the emergence of inflation that followed the collapse of the Bretton Woods era and the 1973 oil crisis. During this period, there was a general move away from direct controls and quantitative restrictions and ceilings to the targeting of monetary aggregates in the context of more liberalised financial markets. Interest rates became the main instrument of monetary policy, and during the 1990s the trend moved away from a focus on intermediate targets to targeting inflation directly.

In 2000, South Africa adopted an inflation-targeting framework, with government and the SARB agreeing on a target range of 3-6%. Similar developments were evident in many other African countries, including in Ghana, which adopted inflation targeting in 2011. While the operational framework had changed, the underlying objective of price stability did not.

During the 1990s, the SARB's primary mandate was written into the country's new Constitution. This mandate was and remains the protection of the value of the currency in the interest of balanced and sustainable economic growth in the country. We are given constitutionally entrenched independence in carrying out this objective. This approach is not very different from that of the Bank of Ghana, whose 'monetary policy objective is to ensure price stability – low inflation – and, subject to that, to support the government's economic objectives, including those for growth and employment'.[1]

Having a price stability objective does not, however, necessarily resolve the debates about the broader role of monetary policy in the economy or reduce the pressure on central banks to play a more prominent role in stimulating growth. As a flexible inflation-targeting central bank, we do not ignore growth or employment. In carrying out our price stability mandate, we have always been highly sensitive to the growth needs of the economy and to the implications of our policies for growth. Ideally, we would try to conduct a contracyclical monetary policy: tightening policy when the economy is overheating with inflationary pressures evident, and providing some stimulus or accommodation when the economy is in a downturn – and when inflationary pressures are benign.

This approach is, of course, standard textbook prescription. Admittedly, we have faced a number of challenges, not least of which is the fact that the breaches of our target range have generally been the result of supply-side pressures, including international oil prices, food prices, and the exchange rate of the rand. These exogenous forces have at times pushed us in the direction of procyclical monetary policy. Although we do try to look through the first-round effects of these pressures and only react to the emergence of second-round effects, our objectives are at times

[1] Bank of Ghana website (https://www.bog.gov.gh/)

criticised for not being sufficiently pro-growth. Furthermore, in times of very slow growth, as is currently the case in South Africa, there are those who see monetary policy as a solution to the growth problem, despite the fact that monetary policy has a very limited ability to change the long term growth potential of an economy.

While we see some role for monetary policy in a cyclical context, we view our main contribution to growth as being in the provision of a stable and enabling environment for investment and employment creation – through maintaining price stability. Price stability also has other important social outcomes, not least of which is the protection of the poorest in society from the ravages of inflation. The poor are the least able to hedge against price increases. However, we are very clear that monetary policy has a limited role to play in addressing structural growth problems in an economy. In other words, monetary policy has a limited impact on potential output. This is the role of other policies.

The decade from the mid-1990s was a period of widespread adoption of inflation targeting in the advanced economies and in a number of emerging market economies. It was also the period of the 'great moderation', which some analysts interpreted as the end of the business cycle. Asset markets were booming and global inflation was low, as were interest rates. In fact, in the early part of the 2000s, only a handful of countries were experiencing double-digit inflation. The role of central banks was increasingly seen as simply maintaining this benign inflation environment.

At the same time, there were, however, increasing concerns that the excessive leverage created by the low interest rate environment could pose financial stability risks. The prevailing view at the time was that low inflation would be a sufficient condition for financial stability. It was also generally believed that it was not the duty of central banks to deal with financial stability risks. This view was epitomised in Alan Greenspan's address at the 2003 Jackson Hole Symposium where he argued that not only were central banks not well equipped to recognise asset price bubbles, but that they also did not have the tools to deal with such excesses – and that the best they could therefore hope to do was to clean up once the bubble had popped.

Dissenting voices, notably from Bill White and Claudio Borio[2] of the Bank for International Settlements (BIS), maintained that asset prices were in bubble territory, driven by excessive bank lending. This view argued that central banks should not have a narrow focus on inflation and that they should rather lean against this excessive leverage with higher interest rates and focus on the financial cycle, which is typically longer than the business cycle. This would have implied significantly higher interest rates than those prevailing before the global financial crisis, despite the low inflation environment.

At that stage, when it came to financial stability, the focus of central banks was on the microprudential regulation and supervision of individual banks and on the banking system as a whole. Not much attention from a policy perspective was given to asset markets. The trend was also increasingly more towards a 'light touch' regulation of banks, with moves in a number of countries to more self-regulation. The macroprudential view was not very widespread. At that time, many central banks had only implicit financial stability mandates or no mandate at all in this respect. In South Africa, for example, although the SARB had explicit microprudential responsibilities for regulating and supervising individual banks, we did not have an explicit mandate to ensure the stability of the broader financial system.

I should point out that while many central banks were responsible for bank regulation and supervision, this is not necessarily an exclusive central bank function. In South Africa, for example, this responsibility was transferred from the then Department of Finance to the SARB only in 1986. In a number of countries, for example in the United Kingdom (UK) and Australia, this function was transferred out of the respective central banks in the 1990s to independent regulators. The UK move was reversed in the post-crisis period with the establishment of the Prudential Regulation Authority within the Bank of England.

The global financial crisis brought the need for a broader financial stability focus starkly to the fore. The dangers that some were warning about were real, and the

[2] See, for example, the article titled 'Should monetary policy lean or clean: a reassessment' by W White, published in *Central Banking* 19(4) in 2010.

consequences of ignoring them were disastrous. It also became clear that inflation targeting on its own was not sufficient to guarantee financial stability. Central banks then found themselves with an increased number of responsibilities. Not only were they expected to play a leading role in responding to the global recession; they were now also given explicit financial stability mandates.

The role that central banks play in combatting inflation is clear-cut, but their role in financial stability is less so. This is because financial stability is multifaceted, and because not all aspects of financial stability are within the control of the central bank. In general, therefore, financial stability is a shared responsibility.

While it has now been generally accepted that financial stability should be an explicit focus of policy, there is no complete unanimity about where this responsibility should lie and which instruments should be used. The debate has partly centred around the relationship between monetary policy and macroprudential policy. If interest rates are used for macoprudential policy purposes, it could result in potential conflicts between monetary and financial stability policies.

An example is Sweden, where the Riksbank attempted to deal with a perceived financial stability risk of sharply rising house prices and burgeoning household debt by raising interest rates in 2010 – even though inflation was below target and the unemployment forecast was above the estimated long-run sustainable rate. This led to inflation falling well below the target and rising unemployment, forcing a reversal of the monetary policy tightening.

One view, put forward by the BIS and others, has argued in favour of using interest rates as a financial stability tool, but with policy focusing on the financial cycle. This would result in tighter monetary conditions in the event of excessive leverage, even if inflation risks were relatively low. The advantage of using interest rates is that it affects all parts of the financial sector, although this could be a disadvantage at the same time, as interest rates are seen to be a 'blunt tool', impacting on the cost of credit in areas where this is not desired. Using the interest rate tool could also result in higher inflation variability. Although there is evidence that raising interest rates

can reduce leverage and reliance on short-term funding, some analysts have argued that the required levels could be prohibitively high and impact negatively on growth.

Others, however, have argued that these two policy objectives should be separated, with different tools applied to different objectives. Lars Svensson, for example, argues that monetary policy and financial policy are different and distinct policies that should be conducted independently and with different instruments, although each policy should take account of the other.[3]

The well-known Tinbergen rule suggests that there should be the same number of instruments as there are targets. If the same instrument is used for multiple objectives, conflicts could occur and trade-offs could be required. According to this view, interest rate policy should remain a monetary policy tool and be the main instrument to control inflation. Other policies, which could be well targeted, would need to be introduced in order to deal with financial stability risks.

This suggests a need for a different committee, separate from the monetary policy committee. Although it does not necessarily follow that such a committee should be located within the central bank, it is generally the model that is followed. Sweden is a notable exception, where the responsibility for financial stability lies outside the central bank.

There are strong arguments for locating the financial stability function within the central bank. Charles Goodhart argues that the essence of central banking lies in its power to create liquidity by manipulating its own balance sheet, i.e. to lend either to an individual bank or to the market as a whole. To quote him:

> "It would cause massive complications if liquidity management remained the sole province of the central bank while a separate financial stability authority was to be established without any command over liquidity management. I infer from that that the financial stability authority has to be given command over liquidity management; but that also implies that the financial

[3] Svensson, L E O. (2014). 'Monetary policy and financial stability are different and normally best conducted independently'. Paper presented to European Central Bank Forum on Central Banking.

> stability authority would have command over the central bank balance sheet. Indeed the financial stability authority would then, de facto, become the true central bank."[4]

There are practical advantages to allocating monetary, microprudential and macroprudential policy responsibilities to a single institution. Such an arrangement makes the coordination of different policies much easier, be it through crisis prevention or crisis management. This is particularly relevant during times of a financial crisis when the situation tends to deteriorate very rapidly and quick responses are required.

In South Africa, we have adopted the latter approach. The responsibility for financial stability has been given explicitly to the SARB, and is overseen by an internal Financial Stability Committee (FSC). The FSC monitors the broader financial system but does not regulate or supervise individual banks. This remains the responsibility of the Bank Supervision Department at the SARB. This department will be transformed into a Prudential Authority (PA) in terms of the Financial Sector Regulation Bill (FSR Bill) that has recently been through the parliamentary process and currently awaits the signature of the President. Once established, the PA will regulate individual banks, insurance companies, and financial market infrastructures, while the Financial Sector Conduct Authority, previously the Financial Services Board, which oversaw the insurance sector, will take responsibility for market conduct.

The FSR Bill also provides for the establishment of a Financial Stability Oversight Committee, chaired by the SARB Governor and including representatives from the Bank, National Treasury, and other financial regulators. The objective of this advisory committee is to support the SARB in protecting and enhancing financial stability and to facilitate cooperation and coordination of action among the financial sector regulators and the SARB in financial stability matters. Within the SARB, the formulation of macroprudential policy is the responsibility of the FSC. While monetary, macroprudential and microprudential policy are all separate functions within the SARB, their coordination is facilitated by being within the same institution and through some degree of overlapping membership of committee structures.

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[4] Goodhart, C. (2010). 'The changing role of central banks'. Bank for International Settlements Working Papers No. 326.

This raises the question as to the nature of macroprudential tools. Many countries are still grappling with this concept. Part of the challenge is that financial instability could emanate from multiple and sometimes unexpected sources. A number of different tools are required to deal with different eventualities. We are also unsure as to how effective such tools would be and because institutional structures and banking systems vary widely, we cannot assume that policies which work in one country would necessarily work in others.

The SARB's approach is set out in a paper[5] released for comment in November 2016. The macroprudential instruments that are being considered are classified into three categories, namely capital-based instruments (including countercyclical capital buffers, sectoral capital requirements, and dynamic provisions), asset-side instruments (including loan-to-value and debt-to-income ratio caps), and liquidity-based instruments (including countercyclical liquidity requirements). These tools are intended to target the sources of systemic risk, such as liquidity and maturity mismatches, leverage, and interconnectedness. The advantage of using a more targeted, or function, approach is that it can cover the shadow-banking sector, asset markets, and the non-financial sector as well. Financial vulnerabilities do not only emerge from the banking sector.

At this stage, the main policy decision that is made in the FSC relates to the Basel III countercyclical capital buffer. This is a potential capital add-on to bank capital should the committee decide to increase the capital requirement of the banking sector as a whole during an upswing, and should the ratio of credit growth to GDP[6] be above its long-term trend. This would then be reversed during a downswing. Up to now, this requirement has been set at zero, as the credit gaps are very low.

At present, the focus of the FSC is on identifying any vulnerabilities that could cause systemic risk. This is done by monitoring potential risks to the system through assessing various macroprudential systemic risk indicators. These indicators include macroeconomic, financial sector, market-based as well as other qualitative indicators. Should any mitigating actions be required, the FSR Bill provides the

[5] South African Reserve Bank. (2016). 'A new macroprudential policy framework for South Africa'.
[6] gross domestic product

SARB with the powers to advise and/or direct financial regulators to take certain actions; this is done through the FSC.

Having these additional responsibilities comes with its own set of challenges. The expanded mandate of financial stability in itself may have implications for central bank independence. Compared to financial stability, monetary policy decisions, while not easy, are nevertheless more straightforward and better understood by the public. These decisions generally involve the use of one tool (the interest rate), and there is a clear objective.

It is important to appreciate that financial stability is not an end in itself but rather a means to an end, generally regarded as an important precondition for sustainable economic growth, serving the constitutional mandate of the SARB. A financial stability mandate is however more complicated, as it is a shared responsibility. The political economy aspect of this comes out strongly when we distinguish between crisis prevention and crisis management or resolution. The policy tools are more directed at particular sectors, and may therefore be more politically sensitive as the distributional impacts are more apparent than in the case of monetary policy. There could be perceptions of particular institutions or sectors being favoured over others.

In particular, crisis management generally involves lender-of-last-resort facilities and/or providing some sort of assistance to banks that need it. These are inevitably quasi-fiscal decisions or actions, as they either directly involve government money or could lead to losses on the central bank balance sheet, which are potentially losses for government. As we saw during the global financial crisis, there were often political tensions between the need to save individual institutions in order to prevent the whole system from collapsing and the moral hazard concerns of bailing out large institutions. However, even crisis-prevention tools may be politically unpopular, especially in good times.

Furthermore, as has been argued in an International Monetary Fund staff discussion note[7], financial stability is difficult to measure but crises are evident, so policy

[7] Bayoumi, T *et al.* (2014). 'Monetary policy in the new normal'. International Monetary Fund staff discussion note.

failures are observable, unlike successes. As noted in the paper, ‘central banks would find it difficult (even ex post) to defend potentially unpopular measures, precisely because they succeeded in maintaining financial stability’. Any perceived failures on the financial stability front have the potential to undermine monetary policy independence through a general loss of credibility of the central bank.

In conclusion, the role of central banks has changed since the global financial crisis. There is a sharper focus on financial stability issues, and there is also a different way of looking at these issues. This, however, does not mean that other areas of policy have been downplayed. In the wake of the crisis, central banks were relied upon, possibly excessively so, to help the recovery from the global recession and to avoid deflation. The recovery has taken some time. Fortunately, there appears to be a sustained recovery in the global economy, and there are now tentative moves by central banks in the advanced economies to normalise monetary policy settings.

It would also appear that the concerns that extraordinary monetary accommodation would generate widespread inflation have not transpired. Although central banks have been given expanded mandates, the role of ensuring price stability has not been undermined or minimised. It is as important and as relevant as ever, and remains a crucial pillar of central banking.

Thank you again, Bank of Ghana, for the honour of addressing you at this celebration of 60 years of central banking in your country.