Dr. Stals looks at current developments in monetary policy in South Africa

Address by the Governor of the South African Reserve Bank, Dr. C. Stals, at a Luncheon of the Rotary Club of Durban on 17/3/97.

1. Monetary policy and total economic activity

At this stage, there is general expectation amongst economists in the private sector that monetary policy will be eased during the course of 1997. Differences of opinion may exist on how soon the easing will begin, or by how much interest rates will decline as a result of the easier conditions.

This assumption is based, firstly, on a projection of some further slow-down in the rate of expansion of the total domestic economic activity. Last year, the rate of growth in gross domestic production declined to 3.1 per cent, down slightly from the 3.4 per cent of 1995. It must also be noted that the decline in the rate of growth in the non-agricultural sectors was even more pronounced, where the rate of increase in total real value added declined from 4½ per cent in 1995 to only 2 per cent in 1996. In the very important manufacturing sector, the decline was from 7½ per cent growth in 1995 to only ½ per cent in 1996. It was a strong recovery in the agricultural sector that maintained overall growth at the level of 3 per cent plus for last year.

Agriculture will not make the same contribution to growth in 1997 and for economic analysis purposes it makes sense to assess the future prospects for non-agricultural production before deciding on a possible course for monetary policy during the rest of this year. There were some tentative signs that total manufacturing production may have started with a new expansionary phase in the fourth quarter of last year when a seasonally adjusted annualised decline of 1 per cent in the third quarter switched to a 2 per cent expansion in the fourth quarter. This expansion in production was boosted partly by a rising demand from the rest of the world for South African products, following the depreciation of the rand last year. This important development can make a further contribution to the maintenance of reasonable growth in 1997.

Developments on the demand side of the economy also indicated a marked slow-down in total economic activity last year. The rate of increase in total domestic expenditure declined from 6.5 per cent in 1994 and 5.2 per cent in 1995, to 3.0 per cent in 1996. In this case, the decline was more broadly based and the rates of increase in gross domestic fixed investment, private sector consumption expenditure and accumulation of inventories all receded last year. There was only one exception, and that was consumption expenditure by general government which rose by 5 per cent in real terms, compared with an increase of only ½ per cent in 1995.

This slower rate of increase in total domestic expenditure established better balance between production (supply) and expenditure (demand). With both sides of the economy now growing at about 3 per cent per annum, there is better equilibrium and less friction in the economy, which contributes also to more stable conditions in the financial markets.

It is important that this balance between aggregate demand and aggregate supply be retained -- both should gradually be raised to a higher level, but the upward movement should be in tandem. Monetary policy has an important part to play in maintaining this equilibrium over time. Any artificial stimulation of the economy through a premature easing of monetary policy will lead to further tensions in the balance of payments and in the financial markets, and will lead to further upward pressure on inflation.

At this stage, economists predict some further slow-down in the rate of increase in private sector consumption expenditure with continued growth at the current levels in gross domestic fixed investment. An important factor in this projection therefore will be the behaviour of government consumption expenditure. It is in this regard that the provision made by the Minister of Finance in his Budget Speech of last week for an increase in total government expenditure of only 6.1 per cent in 1997/98 is of vital importance. In real terms, that is after provision for depreciation, total government expenditure will indeed decline and therefore make an important contribution to the retention of macroeconomic equilibrium this year.

2. Monetary policy and the balance of payments

Monetary policy decisions are obviously also affected by the overall balance of payments situation, and not only by developments in the domestic economy. Last year, international economic relations dominated the South African economic scene. Towards the end of the year, however, better equilibrium was also restored in the external accounts and this contributed to the expectation of an easier monetary policy in 1997.

The current account of the South African balance of payments showed a substantial and growing deficit in the first half of 1996. In the second quarter, the seasonally adjusted annualised rate of the deficit reached R12.9 billion and there was justifiable concern that it could increase even further. Against the background of a slow-down in total domestic expenditure in the second half of the year, the growth in imports levelled off and, with some good increases in exports, the current account of the balance of payments improved to an annualised deficit of R4.7 billion in the fourth quarter of last year. Prospects are good that only a small deficit will be recorded in the current account of the balance of payments in 1997.

The main reason for the balance of payments problems of last year was to be found in the capital account. The net capital inflow declined from R19.2 billion in 1995 to only R3.9 billion in 1996. The capital inflow was no longer sufficient to cover the deficit in the current account, and the official gross foreign reserves, which were at a very low level to begin with, declined by R5.4 billion.

These developments exerted extreme pressures on the exchange rate of the rand and, as is well-known, the average weighted value of the rand against the basket of currencies of South Africa’s major trading partners depreciated by 21.9 per cent from 31 December 1995 to 31 December 1996.

The balance of payments situation obviously demanded a restrictive monetary policy throughout the past twelve months. Here also, however, important changes took place after October 1996. The improvement in the domestic economic situation and in the current account of the balance of payments restored some confidence in the market for foreign exchange, particularly as the foreign reserves started rising again in the fourth quarter. The exchange rate of the rand reached a lower turning point in October 1996, stabilised in November and December and showed an impressive appreciation of about 9 per cent since the beginning of the new year.

Optimism for the balance of payments for 1997 rests very strongly on the expectation that there will be a good net inflow of capital into the country during this year. So far, the results have been encouraging with a relatively strong demand for South African equities and bonds from non-residents. In January and February, non-residents were indeed net buyers of more than R5 billion of South African listed securities, but this total amount did not necessarily represent a net inflow of foreign exchange into the reserves.

The announcements made by the Minister of Finance in his Budget Speech last week for the further relaxation of exchange controls can also have an important effect on the capital account of the balance of payments. It is difficult to forecast how much capital of residents may leave the country because of these relaxations, but it is generally assumed that this will be balanced by the inflow of more non-resident funds into the country. Indeed, it is not unreasonable to assume that a total net inflow of capital in excess of the projected current account deficit will add some amount to the official foreign exchange reserves during the course of this year.

If these assumptions prove to be correct, the exchange rate of the rand, measured against the basket, should be more stable this year than the experience of last year. Such a balance of payments situation will also reduce pressure on monetary policy and will contribute to easier domestic financial conditions.

3. Monetary policy and the domestic financial situation

In a more stable macroeconomic situation with better equilibrium in the balance of payments, monetary policy can be aimed more directly at influencing developments in the more important domestic financial aggregates. In a statement issued last Friday, the Reserve Bank indicated that the rate of increase in the M3 money supply should not exceed 10 per cent in 1997. This will provide for real growth in the economy at a rate of between 2 and 3 per cent, and inflation at a level well below 10 per cent.

The Reserve Bank is concerned about the rising trend in inflation that gained substantial momentum during the course of 1996. The average rate of inflation for last year was 7.4 per cent, being the lowest rate of inflation South Africa had since 1972. The annual figure disguises the fact however, that inflation reached a lower turning point of 5.5 per cent in April 1996, and has since then risen to a level of 9.4 per cent in December 1996 and also in January 1997. In the fourth quarter of last year, the quarter-to-quarter seasonally adjusted annualised rate of inflation was as high as 12.7 per cent.

The escalation in inflation was caused mainly by the depreciation of the rand, by sharp rises in food prices, by rising interest rates and also by a rise in the unit labour costs per unit of production. In this situation, however, it is imperative that the rate of increase in the money supply will be constrained, which requires a meaningful slow-down in the rate of increase in bank credit extension. Last year, the M3 money supply rose by 13.6 per cent, and total bank credit extended to the private sector by 16.1 per cent. If we want to make sure that the current trends in inflation will not be perpetuated, we must make sure that increases in the money supply will not automatically accommodate rising prices, or even further stimulate the inflationary pressures that are emerging from other sources.

The most recent developments in the financial situation therefore do not emit the same optimistic signals emanating from the real economy and from the balance of payments for an early easing of monetary policy. On the contrary, the Reserve Bank would still want to see clear signs of a slow-down in the rates of increase in bank credit extension and in the money supply before lending official support to a decline in interest rates, or an easing in monetary policy in general.

4. Monetary policy and the Budget

For monetary policy purposes, the most important aspect of the Fiscal Budget is the deficit that must be financed through borrowing by Government. A large deficit absorbs a greater share of the available savings of the private sector and therefore leaves less scope for expenditure in the private sector. A large deficit will force an increased demand from the private sector for more bank credit to replace what Government is withdrawing from the savings pool. More bank credit, however, creates more money and increases the risk of higher inflation in future.

The Reserve Bank is therefore particularly pleased with the determined effort made by the Minister of Finance to reduce the deficit in the Budget from 5.4 per cent of gross domestic product in 1996/97 to 4.0 per cent in 1997/98. In absolute terms, the net borrowing requirement (i.e. the deficit after taking the opening cash balance into consideration) increased by only R1.3 billion, from R23.5 billion to R24.8 billion. Taking account of a much lower amount of maturing debt in the new fiscal year, the total gross borrowing requirement has in fact been reduced from R41.0 billion in the current fiscal year to R36.8 billion in the next.

There are more reasons than just relieving pressure on monetary policy for reducing the deficit on the annual budget. One is, of course, the growing burden in the budget of the cost of servicing government debt. In the Budget Review Document, it was indicated that total Government debt as at the end of February 1997 amounted to R309.5 billion, equal to 55.3 per cent of gross domestic product. This is a relatively large deficit for a country with a relatively low overall savings ratio, and with massive needs for the development of infrastructure. For the 1997/98 fiscal year, total interest payments in the government debt will absorb R39 billion, or more than 20 per cent of the total expenditure.

It is also laudable to note that the smaller deficit on the Budget is being achieved through constraints on government expenditure, and not through an increase in taxes. Both government expenditure at a level of 30 per cent and government revenue at 26 per cent of gross domestic product, are regarded as on the high side and there is a desire to reduce these levels over the next few years. This will further ease the burden on monetary policy.

5. Summary

The 1997/98 Budget will, in summary, bring about a better balance in the monetary and fiscal policy mix that is required to maintain overall financial stability in the South African economy. In the longer term, as the implications of the Budget work through to the financial markets, it should reduce some pressure in monetary policy.

In the short term, however, the main objective of monetary policy must be to force a similar mood of financial discipline also in the private sector. Not only government, but also private sector individuals and corporates must reduce their reliance on credit for the financing of their economic activity. Some decline in the rate of increase in the total amount of bank credit extension to the private sector, together with some slower growth in the total money supply, have become first priorities of monetary policy. This will be the only way to avoid the current inflationary pressures in the economy from being perpetuated into a new extended period of double digit inflation.