Mr. Stals looks at the role of central banks in today's economies and discusses the experience of South Africa Address by the Governor of the South African Reserve Bank, Dr. Chris Stals, given at a Conference on Current Economic Policy Issues arranged by the Economics Department of the University of Durban-Westville and The Mercury in Durban on 25/4/97.

1. The objective of monetary policy

There is fairly general consensus in the world of central banking today that the objective of monetary policy should be to protect the value of the currency. There was a time up to the late 'seventies when economists and central bankers advocated a much wider role for monetary policy in the management of the macroeconomy. Under the influence of the Keynesian demand management approach, monetary policy was seen as a useful instrument to be used by the authorities to depress demand in times of an excessive rise in total real expenditure on goods and services, or to stimulate real demand in times of recessionary conditions.

Monetary policy may have been an effective instrument for the purpose of demand management in the global system of fixed par values, or in the times of Keynes' General Theory of Employment, Interest and Money, (1936), when a lack of overall demand caused production resources to remain under-utilised. During the 1970's, however, the Bretton Woods System of fixed par values was replaced with the global system of floating exchange rates and over-stimulation with expansionary monetary and fiscal policies created inflationary pressures and persistent balance of payments crisis situations.

The emphasis in macroeconomic policy gradually shifted from demand-side management to supply-side expansion in which monetary policy was assigned a different role. Monetary policy was no longer accepted as a useful short-term anti-cyclical policy instrument, but was tasked with the responsibility of creating on a continuous basis a financial environment that will be conducive to sustainable optimum economic growth in the longer term. This environment can be characterised by stable overall financial conditions in which the rate of inflation will at all times be low.

In this new approach, central banks focused their attention on major financial developments such as changes in the money supply and in bank credit extension, the level and the structure of interest rates, changes in the official foreign reserves of the country, and movements in the exchange rate. The ultimate objective of monetary policy became the value of the currency, and whatever strategies were followed with the implementation of monetary policy, the success or failure of the policy was measured by the level of inflation.

The major industrial countries were extremely successful with this new approach, and during the eighties most major economies succeeded in reducing inflation to relatively low levels, that is, in general to about 1 to 2 per cent per annum. This left but little choice for the smaller economies of the world to follow suit, particularly as the drive towards global financial integration gained more momentum during the ninety- nineties.

The odd old-time economist who believes that contemporary monetary policy is on a wrong track, particularly in the developing economies, still surfaces from time to time. The counter-argument is often based on the so-called Phillips Curve or an assumed trade-off that is perceived to exist between inflation and economic growth. There is sufficient evidence to confirm, however, that in the longer term, maximum economic growth is invariably attained at the lowest possible rate of inflation. The development of the theory of rational expectations questions the validity of the existence of a Phillips Curve trade-off, even in the short term.

Be that as it may, a country such as South Africa with its open economy can hardly maintain overall financial stability unless its rate of inflation stays more or less in line with the average rate of inflation in the economies of its major international trading partners and competitors.

2. The South African experience

On recommendation of the De Kock Commission of Inquiry into the Monetary System and Monetary Policy in South Africa, the South African Reserve Bank adopted money supply targets as the anchor for its monetary policy model in 1986. After the money supply increased by 27 per cent in 1988, and the rate of inflation at one stage rose over 20 per cent, the new monetary policy model of the Reserve Bank was implemented with more vigour, and the rate of increase in the money supply was gradually reduced to below 10 per cent in 1992. For two years in succession, the M3 money supply rose by about 8 per cent.

Almost as if by magic, the rate of inflation also declined to below 10 per cent in 1993, and stayed in single- digits for the next four years. In 1996, the average rate of inflation was only 7.4 per cent, the lowest level for any calendar year since 1972.

The Reserve Bank seems to have lost some of its tight grip over the money supply over the past three years, when the rate of increase in M3 accelerated to a level of about 15 per cent during each of the years 1994, 1995 and 1996. These were, however, extremely difficult years with major political and social reforms and the gradual reintegration of South Africa in the global economy. The liberalisation of the foreign exchange market in South Africa, the access of more than fifty foreign banks to the South African financial market, and the easier access of South African banks to foreign sources of liquidity, brought major changes to the pattern of financial flows and banking activities. The consequences of these changes for monetary policy must still be digested and analysed in more detail, and some adjustments to the monetary policy model applied by the Reserve Bank may be necessary.

Initially, the acceleration in the rate of increase in the money supply had little effect on inflation. The rate of inflation indeed continued to decline to reach a lower turning point of 5.5 per cent over the twelve months up to April 1996.

A sharp depreciation in the exchange rate of the rand after February 1996 provided a new shock stimulus for inflation in South Africa and, assisted by a continuous excessive rate of increase in the money supply, the rate of increase in overall consumer prices accelerated to 9.8 per cent over the twelve months up to February 1997.

The Reserve Bank is greatly concerned about these latest trends in the rate of increase in the money supply, the rate of increase in bank credit extension, and in the rate of inflation. It is accepted that the depreciation of the rand last year must inevitably lead to some price rises, but there is a real danger that these price adjustments (of internationally tradable versus non-tradable goods and services) will become embedded in a permanently higher rate of inflation.

3. The monetary policy model

The South African experience with the “monetarist” approach applied since 1986 was relatively successful. The present threat of a new surge in inflation should not be seen as a failure of the policy approach, but rather as a result of an external shock -- the currency depreciation -- and a severe testing of the monetary policy model in light of the changing macroeconomic environment.

Central bankers may concur in general on the main objective of monetary policy, namely to protect the value of the currency, but they do not all follow the same strategy in pursuing this objective. The South African model, which is also used by many other countries, is primarily linked to the growth in the M3 money supply, and predetermined guidelines for an acceptable rate of growth in M3 should be seen as an intermediate objective of monetary policy. It is based on the assumption that, over time, there is a link between the rate of expansion in the money supply and inflation. If the real economy, for example, expands by 3 per cent per annum, and the current rate of inflation is 7 per cent, a continuous increase in the nominal money supply at rates of more than 10 per cent per annum will eventually exert upward pressure on inflation. Increases in the money supply of less than 10 per cent will drag inflation downwards.

Over the past few years, the Reserve Bank had indicated that an appropriate rate of increase for the South African money supply would be between 6 and 10 per cent. The realised rates of increase were, however, around the level of 15 per cent during each of the years 1994, 1995 and 1996. Initially, the Bank was less concerned about this excessive rate of increase in the money supply, particularly also in light of the relatively low rates of increase of well below 10 per cent established in 1992 and 1993. Inflation also remained on a downward path up to April 1996. It is only over the past twelve months therefore that inflation started moving up again, triggered by the depreciation of the rand last year.

The persistently high rates of increase in M3 were partly caused by structural changes in the South African economy. More people were absorbed in the market economy, earned regular incomes, and opened bank accounts for the first time. More banks were established in South Africa, particularly foreign banks, and offered more banking services to the South African public. South African banks found easier access to foreign sources of credit, and made the conventional Reserve Bank instruments to control overall liquidity in the banking sector less effective.

The main reason for the larger than desirable increases in the money supply was concentrated in relatively large increases of almost 20 per cent per annum in the total amount of bank credit extended to the private sector. The monetary policy model based on the control of increases in the money supply, requires some effective control over the amount of bank credit extension, because this is the main source of money creation in the South African market-oriented economy.

Control over bank credit extension requires not only a restriction on the amount of liquidity available in the banking sector, but also the acceptance of realistic interest rates. Despite the maintenance of relatively high interest rates in South Africa, and a series of increases in interest rates since November 1995, the demand for bank credit remained relatively strong. This may indicate a less interest-rate sensitive demand for credit in South Africa that may be associated with the socio-political changes over the past few years already referred to above.

The Reserve Bank remains concerned about the excessive rates of growth in the money supply, and remains committed to reducing this monetary stimulation of inflation during the course of 1997. Recent trends in the money supply and bank credit extension beg the question, however, whether monetary policy at this juncture is restrictive enough and whether even more stringent measures may not be required to reduce overall liquidity further, which could, of course, lead to even higher interest rates and hopefully also a decline in the demand for credit.

4. Other functions of the central bank

Restricting the functions of the central bank to the monetary objective of creating a stable overall financial environment, vests a further important responsibility with the monetary authorities, and that is to encourage and support the development of sound and well-managed banking institutions. Banking institutions replace the central bank as the major supplier of money to the public, and therefore have become important conduits for the implementation of monetary policy.

The South African Reserve Bank has therefore been vested also with the task of bank regulation and supervision. This task is becoming increasingly more difficult as banking institutions become more multi-national, and as cross-border financial operations increase. The Reserve Bank's Bank Supervision Department works very closely with their counterparts in many other countries to ensure that uniform, compatible and effective prudential directives are complied with by all banks operating in South Africa, and also by the foreign branches and subsidiaries of South African resident banking institutions.

The defined objective for monetary policy also requires of the central bank to accept some leading role in the development and administration of an efficient functioning national payments, settlement and clearing system. The Reserve Bank is now working with the other banking institutions to upgrade the South African payments, settlement and clearing system. Provision will soon be made for real-time on-line settlement of large transactions, and for the daily netting and settlement of smaller payment transactions done through the banking system.

Efficient monetary policy in a market-oriented economy finally also requires well-functioning financial markets. The Reserve Bank therefore has a vested interest in the development of the money, capital and foreign exchange markets. In the case of the South African foreign exchange market, the Reserve Bank is working closely with the Minister of Finance gradually to phase out exchange controls, and to integrate the South African financial markets with international markets.

5. Conclusion

The South African experience ratifies the international experience that monetary policy should primarily be aimed at financial objectives and should at all times be used to promote overall financial stability. This is the best contribution monetary policy can make to the promotion of economic growth and development in the interest of all the people of the country.

In pursuing its strictly defined financial objectives, the central bank should have some autonomy from Government and should be enabled to take quick and objective decisions on the implementation of monetary policy. There must, however, always be close co- operation with the Minister of Finance, and monetary and fiscal policy should be closely co-ordinated. In the final situation, the Minister of Finance and the Governor of the Reserve Bank are jointly responsible for maintaining overall financial stability in the country.