Mr. Stals discusses the current monetary situation in South Africa and the implications for 1998 Address by the Governor of the South African Reserve Bank, Dr. C. Stals, at an investment conference arranged by Huysamer Stals in Johannesburg on 18/11/97.

1. The task and function of monetary policy

Monetary policy is about money. Governments give central banks the special right to issue money, and also a mandate to manage the money system in the interest of economic development. In the final situation, monetary policy is about the quantity of money, the price of money and the value of money.

In the broad context of macroeconomic policy, the central bank is normally tasked with the function of protecting the value of money. This is but an immediate objective, making an important contribution to the achievement of the ultimate goal of economic policy, which is to sustain optimum economic development that will create more jobs and lead to an improvement in the standard of living of all the people of the country.

Monetary policy cannot be used to solve all the macroeconomic problems of a country. However, a stable financial environment with a low rate of inflation is regarded as an important precondition for the solution of many of the existing macroeconomic problems in any country. By focusing on the maintenance of low inflation, central banks do not distance themselves from the broader macroeconomic problems such as excessive budget shortages, untenable balance-of-payments deficits, short-term business cycle developments or uncompetitive international trade positions. It is indeed only in conditions of a stable financial environment, that is low inflation, that the real nature of the more fundamental macroeconomic deficiencies will be exposed, diagnosed, understood and rectified. In most cases, remedial action for structural economic ails will also not produce the required corrections in an inflationary environment.

Pressure is often put on central banks to harness the power of money creation for purposes other than pure monetary policy objectives, for example to facilitate the financing of public sector budget deficits, or to stimulate real demand for goods and services, or to help small businesses. Pursuing all kinds of non-monetary objectives with monetary policy will, however, normally lead the country inevitably on the dead-end road of higher inflation.

2. Recent monetary developments in South Africa

The main objective of monetary policy therefore is and should be to keep inflation low. In the absence of a national commitment to a predetermined and quantified target for inflation, the Reserve Bank's approach is that the rate of inflation in South Africa should be maintained more or less in line with the average rate of inflation in the economies of our major trading partners and competitors.

Measured against this benchmark, South Africa did not do well in recent years. It is true that the average rate of inflation stayed around a level of about 14 per cent for more than twenty years from 1972 to 1992 and has now been kept below 10 per cent per annum for almost 5 years. At the level of 8 per cent established over the twelve months up to September 1997, the most recent available statistic, the South African rate of inflation is, however, still about three times as high as the current rates of inflation in our major international trading partners.

After the depreciation of the rand last year, consumer price inflation increased from 5.5 per cent in April 1996 to 9.9 per cent in April 1997. Since then, it declined again to 8 per cent in September. Calculated at a seasonally adjusted annualised rate, consumer prices increased by only 6.6 per cent in the third quarter of 1997. Increases in the production price index followed a similar trend and declined from a peak of 9.6 per cent in March 1997 to 6.1 per cent in September. In the third quarter of 1997, the seasonally adjusted annualised rate of production price inflation indeed declined to a very low level of 2.1 per cent.

The rate of increase in the total amount of domestic bank credit extension to the public and private sectors together similarly showed an encouraging slowdown in recent months. The rate of growth in total bank credit extension reached a peak of 21.6 per cent in February 1997, before declining to 15.3 per cent over the twelve months up to September 1997. The growth from quarter to quarter in the average total domestic credit extension fell from 23.6 per cent in the first quarter of 1997 to 6.2 per cent in the third quarter. The growth in total bank credit extended to the private sector also declined to a level of less than 10 per cent in the third quarter.

Developments in the M3-money supply were less satisfactory. The growth rate in M3 measured over twelve months declined from 16.5 per cent in March 1997 to 12.7 per cent in June, but then accelerated again to 16.3 per cent in September 1997. On a quarterly basis, however, the rate of increase in M3 also slowed down from 18.1 per cent in the first quarter of 1997 to 12.2 per cent in the third quarter.

Another monetary aggregate which is of great importance for the Reserve Bank is the amount of liquidity available in the banking sector as reflected in the amount of loans banking institutions seek from the Reserve Bank's discount window every day. This amount declined from a daily average level of R10.6 billion in March 1997 to R5.3 billion in October, indicating that the lower rate of increase in the demand for credit was no longer absorbing the increases in liquidity arising from the large net capital inflows from abroad. The banks no longer needed large amounts of Reserve Bank assistance for most of the time.

These trends in monetary conditions were also reflected in interest rates which first rose quite substantially last year but then declined since the beginning of 1997. The rate on bankers' acceptances with a maturity of three months declined from 16.2 per cent at the end of January 1997 to 14.2 per cent on 25 October.

Satisfactory developments also occurred in the international financial aggregates over the past twelve months. The net inflow of foreign capital gained momentum again towards the end of 1996. During the first three quarters of this year, the total net capital inflow amounted to almost R20 billion. Net purchases of bonds and equities by non-residents amounted to about R34 billion, which enabled South African residents, mainly institutional investors, to switch a further R17 billion of their South African portfolios into foreign currency denominated assets.

The relatively large net capital inflows during the first three quarters of 1997 exceeded a smaller deficit on the current account of the balance of payments and enabled the Reserve Bank and the private banking sector to increase their holdings of short-term foreign assets. At the end of September 1997, the total gross gold and other foreign exchange reserves held by the combined banking sector amounted to an estimated R33.6 billion, or the equivalent of about 10 weeks' imports.

These favourable overall balance of payments developments contributed to a more stable exchange rate for the rand. After depreciating by almost 22 per cent in 1996, the nominal effective exchange rate of the rand, measured against a basket of the currencies of South Africa's major trading partners, depreciated by less than one per cent from 31 December 1996 to 31 October 1997. Larger depreciations against the US dollar and the British pound were neutralised by appreciations against most of the European currencies and the Japanese yen. The average value of the rand against foreign currencies for the first ten months of the year is about 6 per cent lower compared with the average value for the first ten months of 1996.

3. Implications for monetary policy

Monetary policy decisions in South Africa are guided mainly by developments in financial aggregates such as the money supply, bank credit extension, money market liquidity, market interest rates, the official foreign reserves and the exchange rate. There is, over time, obviously a relationship between developments in the financial aggregates and in real economic activity.

The growth rates of most of the financial aggregates over the past few months showed a marked slowdown, particularly the rates of growth in the components of gross domestic expenditure, which already started to decline in the second half of 1996. Critics of the Reserve Bank are often of the opinion that monetary policy should be linked more directly to changes in real economic activity, and not to changes in the financial aggregates. The experience of the 1960s and 1970s, when monetary policy was still guided by Keynesian demand management principles, proved that premature relaxations of monetary policy could easily lead to "stop-go" or "boom-bust" economies, and to a persistent rise of inflation to a higher level after the completion of each successive business cycle. In the modern approach of supply side economies, monetary authorities in most countries now link policy changes with great success rather to changes in the financial aggregates. There is therefore a different and more effective timing of changes in monetary policy.

Taking account of developments in real economic activity in South Africa over the past year, in the overall balance of payments and in the financial markets, the Reserve Bank adopted an easier monetary policy stance already in the middle of 1997. The Bank acquiesced in gradual increases in money market liquidity, and also in the declines of market interest rates such as the yield on long-term government bonds and Treasury bills, and on bankers' acceptances and negotiable certificates of deposit.

The Reserve Bank endorsed the easier monetary conditions by reducing the Bank rate from 17 to 16 per cent on 20 October 1997.

4. Recent developments in the monetary situation

Since the last week of October, turmoil in the currency and capital markets overflowed the cauldron of certain overheated East Asian economies and disrupted also the South African financial tranquillity. These developments led to some substantial selling of South African bonds and equities by non-residents, sharp declines in equity prices, volatile conditions in the foreign exchange markets, an increase in the money market shortage and upward pressure on interest rates. Understandably, the new situation created great uncertainty in the financial markets and initiated an ongoing debate on what the consequences of these developments would be for South Africa.

There is no doubt that major adjustments will be necessary to restore equilibrium in the economies of the affected East Asian countries. Some of the countries, for example Thailand, are already biting the bullet and are now implementing IMF austerity programmes for painful macroeconomic adjustments that cannot be avoided. It will take time to restore confidence and to put a new tiger in the tanks of those countries that are perhaps now suffering from growth fatigue.

It remains to be seen to what extent the unavoidable slow-down in real economic activity of the East Asian region will affect global economic developments over the next year. The South African economic conditions will obviously also be influenced by these developments, although our direct trade with the affected economies is relatively small. We have perhaps a greater interest in the early recovery of the ailing Japanese economy, which can now also be delayed because of adverse influences of conditions in the economies of the tired tigers of the region.

South Africa has also recently been affected by the decline in the gold price, a development which is of course not completely unrelated to the developments in the foreign exchange and capital markets. There may be some disappointment that on this occasion international investors looking for value in a flight from securities opted for the US dollar, and not for gold. Once again, the possible adverse effects of the decline in the gold price on the South African balance of payments or the exchange rate of the rand should not be exaggerated. It holds a much greater social problem if one or two gold mines should be forced to close and many mine workers should be retrenched because of the low gold price.

Monetary policy must obviously even in the short term be adapted to major changes in underlying conditions, and must take account of the recent dramatic movements in the foreign exchange and financial markets. The basic fundamentals in South Africa, however, remain sound and well-balanced. Should these external disruptions settle down soon, and should the events of the past few months in East Asia not have too much of a ripple effect on the overall global economic growth prospects for 1998, South Africa can look forward to a period of steady and sound economic recovery next year.

5. Implications for 1998

The macroeconomic consolidation process in the South African business cycle has been completed to an important extent:

There is better equilibrium now between real total domestic production and real total demand;

- The overall balance of payments is in surplus and the capital inflows up to the third quarter exceeded a relatively small current account deficit;
- In the financial sector, both money supply and bank credit extension still increased at relatively high rates over the past year, but slowed down significantly over the past few months;
- The total gold and foreign exchange reserves is now at a more comfortable level than at any stage last year;

- The rate of inflation has declined since the first quarter of this year and the rates of increase in both consumer and producer prices will hopefully continue on a downward path;
- the average nominal effective exchange rate of the rand stabilised over the past year.

Not everyting is, however, favourable for an expected economic recovery in South Africa next year. In our forward planning we must take account of:

the possible adverse effects on the global economy of the present problems of certain East Asian countries and Japan;
- the adverse effects of the lower gold price, particularly for the official objective of increasing total formal sector employment in South Africa; and
- the threatening danger of adverse climatic conditions because of the El Nino effect.

On balance, South Africa can with justification look forward to a better economic performance in 1998 after the successful consolidation period of 1997.