Mr. Stals discusses the independence of the central bank and monetary policy in South Africa Address by the Governor of the South African Reserve Bank, Mr. C. Stals, at the 21st Annual Investment Conference of Société Générale Frankel Pollak (Pty) Ltd. in Johannesburg, on 24/2/98.

1. Introduction

The debate on the independence of central banks is, fortunately for both governors of central banks and Ministers of Finance, gradually losing its momentum. The discussions were often misguided and created the misleading impression that central bankers had a desire to be completely isolated from their political masters, and that monetary policy objectives could and should be pursued in complete isolation from fiscal and other macroeconomic policies.

This is, of course, not realistic. Monetary policy is but part of the overall macroeconomic strategy pursued by governments. Monetary policy must, after all, support the overall macroeconomic goals of governments, and must be applied in a consistent framework of overall macroeconomic strategy. The independence of the central bank therefore applies not to the setting of the final destination, but to the choice of the route it prefers to take to reach that predetermined destination.

In the context of the South African macroeconomic policy framework, Government has decided, by means of the Constitution of the Republic of South Africa, that the task of the South African Reserve Bank shall be to protect the value of the currency. Without giving an explicit definition of what "protection of the currency" precisely means, it is clearly the intention that the Reserve Bank shall pursue a policy that will keep inflation under control.

The pursuance of this objective, however, often requires unpopular measures that politicians may find difficult to force on their voters, particularly in times of pending elections. For this reason, and to ensure consistent and persistent implementation of the required financial disciplines, central banks are given independent discretionary powers on the operational procedures they regard as necessary to discharge of their responsibilities. The South African Government therefore wisely wrote into the Constitution that the South African Reserve Bank will be allowed to pursue the objective of financial stability independently and without fear of interference by pressure groups, be they from government or the private sector. In the final instance, success will be measured not by the degree of independence of the central bank, but by the results it will achieve.

After the turmoil in the South African financial markets in 1996, the South African Reserve Bank had no alternative last year but to follow a restrictive monetary policy, intended to restore overall financial stability and confidence. The Bank was often criticised for not resisting the market pressures for higher interest rates, and for not providing more liquidity by using its unlimited powers to create more money. Private business people, many home-owners and heavily indebted individuals, economists with vested interests in speculative financial operations, labour unions and some politicians, criticised the Bank for its stance, and blamed monetary policy for all the ills of the economy.

Seasoned central bankers, however, know that the opposition to unpopular monetary policy measures gets more intense in situations when constraints are needed most, and when the catalyst of painful monetary adjustment is indeed producing the desired results. In this game, there is no gain without pain. Wise governments know that this is the time for them to stand aloof of independent and often stubborn central bankers. South Africans can be grateful for the country's political leadership last year when the Reserve Bank was allowed to pursue unpopular policies in an unfriendly environment. The beneficial effects of the policies are now being reflected in recent encouraging developments in a number of the more important financial aggregates.

2. 1997: Year of financial consolidation

At the beginning of 1997, the Reserve Bank predicted that the year ahead would be one of consolidation. Time was needed to recover from the shocks of 1996 when foreign capital inflows suddenly subsided and left the overall balance of payments with a R5 billion deficit. In the process, the country's official foreign reserves declined to the extremely low level of less than R14 billion (in September 1996), and the average effective exchange rate of the rand depreciated by 23.2 per cent from February to October 1996.

Monetary policy, which was tightened considerably during the course of 1996, had to remain restrictive throughout the major part of 1997. The Reserve Bank's lending rate to banking institutions, which was raised to 17 per cent in November 1996, was retained at this level until late in October 1997. Those market interest rates, such as the prime overdraft and mortgage lending rates of banking institutions that are closely linked to the Bank rate, therefore also remained relatively high.

The high level of interest rates reflected a continuing high demand for credit, against the background of a further marginal decline in overall domestic saving. Total bank credit extended to the public and private sectors together increased by 16 per cent over the year. There was, however, some slowdown in the rate of increase in bank credit extension to the private sector from 17 per cent in 1996 to 14 per cent in 1997. This figure, however, still includes credit extended to local authorities. A refined version of the definition of bank credit extension to the private sector, excluding local authorities, indicates a growth of only 12.4 per cent over the twelve months up to December 1997.

Be that as it may, the Reserve Bank remains concerned about the high level of bank credit extension in South Africa over the past three years. Bank credit extension is the main source of money creation, and the increase of 17 per cent in the M3 money supply last year raised the level of the total money supply to gross domestic product to 60.2 per cent in the fourth quarter of 1997, compared to 56 per cent a year earlier. With a low income velocity of circulation at this stage, there is always the danger that idle money can easily be activated in spending on real goods and services.

It is accepted, however, that a number of structural changes affected the developments in the major financial aggregates over the past few years which require discreet interpretation of the meaning of the observed changes. The almost explosive increases in the volume of transactions in the financial markets, for example, may have contributed significant amounts to both bank credit extension and the money supply. Total turnover in the secondary bond market increased by 41 per cent in 1997 to an aggregate amount of R4,269 billion. The number of shares traded on the Johannesburg Stock Exchange almost doubled from 1996 to 1997, whereas the total value of transactions increased by 77 per cent to R207 billion. Less spectacular, but also significant, increases were registered in the markets for derivatives and for foreign exchange. Financial market operators obviously needed more cash (money) against the inflated turnovers.

However, no central banker should ever become complacent about excessive increases in bank credit extension and in the money supply. Even if such increases do not have any visible or proximate effect on real spending or inflation, the excessive amount of money, once it has been created, can easily be redirected, at some inopportune future time, into spending on goods and services. What is of even more importance, is that excessive growth in the banking sector, relative to real economic growth, can lead to a systematic decay in the health and soundness of the financial system. Ample evidence of the dangers of persistent excessive expansion in the financial aggregates can be found in the recent frustrating experiences of many countries in South-East Asia.

It is, however, true that the excessive increases in bank credit extension and in the money supply last year, did not prevent the restrictive monetary policy pursued from supporting meaningful restoration of overall financial stability. Firstly, equilibrium was restored in real economic activity because of a significant slowdown in the rate of growth in gross domestic expenditure. After increases of about 6 per cent in 1994 and 1995, total demand increased by 2½ per cent in 1996 and 1½ per cent in 1997.

Secondly, with growth in total domestic demand more or less in line with but modest increases in total production, the current account of the balance of payments returned to a more sustainable deficit during the last six months of 1996 and the first nine months of 1997. Preliminary indications are that the deficit widened again in the fourth quarter of 1997, although the deficit for the year as a whole remained well below the R10 billion level.

A third very encouraging development last year was the return of foreign investor confidence and a substantial increase in the net inflow of capital from the rest of the world. After slumping from R19.2 billion in 1995 to only R3.9 billion in 1996, the total net inflow of capital through the balance of payments recovered again to R20.2 billion in 1997. The net inflow of long-term capital indeed amounted to about R30 billion, which was partly neutralised by a net outflow of R10 billion in short-term funds.

The surplus on the overall balance of payments enabled the country to increase its net gold and other foreign reserves by R11½ billion from the end of December 1996 to the end of December 1997. The total gross foreign reserves held by the Reserve Bank and the rest of the banking sector amounted to R36.6 billion at the end of 1997, the equivalent of about 10 weeks' imports of goods and services.

3. Results of macroeconomic financial consolidation

Two important beneficial macroeconomic results flowed from the frustrating consolidation process of last year. Firstly, because of the improvement in the overall balance of payments situation, the exchange rate of the rand became much more stable. As a matter of fact, were it not for the substantial net purchases of foreign exchange by the Reserve Bank, the rand could have appreciated quite strongly last year. The average weighted value of the rand against a basket of the currencies of South Africa's major trading partners declined by 0.3 per cent from 31 December 1996 to 31 December 1997. The average level of the effective exchange rate of the rand throughout the year 1997, compared with the average level in 1996, showed a depreciation more or less equal to the inflation differential between South Africa and its major trading partners. The more stable exchange rate also reduced the demand for forward cover in respect of outstanding foreign exchange commitments of South African residents. The net oversold forward book of the Reserve Bank, about which there is much misunderstanding in financial markets, declined from US $22 billion at the end of 1996 to less than $15 billion at this stage.

The second gratifying development was that South Africa succeeded in 1997 to arrest the inflationary pressures created by the 1996 depreciation of the rand. The rate of increase in consumer prices, measured over a twelve months' period, accelerated from 5.5 per cent in April 1996 to 9.9 per cent in April 1997. During the rest of last year, however, the rate of increase in consumer prices gradually drifted down to 6.1 per cent in December 1997. On a seasonally adjusted annualised basis, the rate of inflation declined to 4.1 per cent in the fourth quarter of 1997.

Against the background of the relatively successful financial consolidation process of 1997 and the progress made during the course of the year towards reaching overall financial stability, it is understandable why the turmoil in the international currency markets after the East Asian crisis only had a limited effect on the South African situation. It hit the South African markets just at a time when the country had more or less completed painful adjustments to restore equilibrium after its own crisis of 1996. Apart from the downward adjustment of prices in the equity market, the contagion on South Africa from the currency problems in East Asia appeared to have been limited.

4. Prospects for 1998

At the beginning of 1998, South Africa therefore finds itself in a much more comfortable situation than a year ago, at least as far as the overall financial situation is concerned. The improved conditions were already recognised by a gradual easing of monetary policy in recent months. Bank rate was reduced from 17 to 16 per cent on 20 October 1997, and the money market shortage allowed to decline from R11.1 billion at the end of November 1997 to R7.6 billion at the end of January 1998 (and R7.2 billion last Friday).

The more flexible interest rates in the money and capital markets drifted downwards. The monthly average yield on long-term government bonds declined from 14.5 per cent in November 1997 to 13.6 per cent in January 1998, and to 13.3 per cent at the end of last week. The rate on bankers' acceptances with a maturity of three months gradually drifted lower from 15.0 per cent at the end of November 1997 to 14.45 per cent at the end of January 1998, and 14.05 per cent at this stage.

There is a general expectation in the markets that the level of interest rates in South Africa will decline further during the course of 1998. This expectation can be justified in terms of recent developments in most of the underlying domestic financial conditions, except that the Reserve Bank must remain on its guard for any further acceleration in the growth rates of total bank credit extension and the money supply. Prudence requires lower rates of growth in these aggregates in 1998. The continuing East Asian crisis, which placed many of the emerging market economies under pressure, also calls for caution. It should be pointed out that, even at the current high levels, real interest rates in South Africa fall more or less in the middle of comparable rates in the economies of the thirty or so countries that have become known as the emerging economies of the world.

The prospects for inflation in 1998 are also very encouraging. With production price inflation at 4.0 per cent and consumer price inflation at 6.1 per cent in December 1998, and both still on a downward trend, South Africa finds itself now more in line with inflation in the rest of the world. In the longer term, as the South African financial markets get more integrated into the world financial markets, the level of inflation in this country will be determined more by international inflation levels, and not so much by domestic policies. In a fully liberalised economy, the initial impact of excess nominal demand or other inflationary pressures will fall on the balance of payments, and not in the first instance on domestic prices.

The current more stable overall financial situation in the country provides a good opportunity for the introduction of further structural adjustments aimed at improving the efficiency of the South African financial markets. Next month, the Reserve Bank will introduce two important new initiatives in this regard:

Firstly, on 9 March 1998, the South African Multiple Option Settlement System (SAMOS) will be activated to pave the way for the introduction later this year of an on-line real-time inter-bank settlement system. This will reduce risk exposures in respect of open inter-bank positions and lead to a more efficient financial system in general.

Secondly, also on 9 March 1998, the Reserve Bank will change its present operational procedures of supplying accommodation to banking institutions through overnight loans at the discount window. A new system for repurchase transactions (Repo's) between the Reserve Bank and banking institutions will be introduced, and the banks will tender on a daily basis for an amount of central bank liquidity that will be determined by the Reserve Bank. The new system will bring more flexibility into money market interest rates and will place South Africa on a basis of central bank/private bank relationships that is being followed by many other countries in the world.

The Department of Finance will also switch to a new system for the primary issues and secondary dealings in government bonds as from 1 April 1998. Eleven banks have already been appointed by the Department of Finance as authorised Securities Dealers for this purpose.

With the continuing further removal of the remaining exchange controls, the South African financial markets will provide some exciting new challenges over the rest of this year. We hope that foreign investors, so well represented at this Conference today, will continue to participate in these challenges.

The better overall financial environment provides a more supportive background for improved real economic conditions. Monetary policy should never be used to stimulate total nominal demand artificially when the stimulation will only be reflected in higher inflation. Monetary policy should also not unduly restrict aggregate nominal demand once the objective of stable overall financial conditions has been accomplished. The present financial situation in South Africa must be seen as conducive for an improvement in real economic activity over the next year. If last year was a year of consolidation, 1998 can easily turn out to be the year of recovery.