**Mr. Stals discusses the current economic situation and factors influencing monetary policy in South Africa in 1999** Address by the Governor of the South African Reserve Bank, Dr. C. Stals, at an International Conference arranged by ABN AMRO Bank and Kagiso Financial Services, held in Johannesburg, on 3/11/98.

## 1. Domestic economy dominated by international developments

During the past six months the South African economic scene was dominated by developments in the international financial markets. The East Asian financial market crisis, which already started with pressures in Thailand's foreign exchange market in June 1997, took some time before it spread to other emerging markets outside of the East Asian region, and also to the smaller industrial countries of the world. More recently, financial markets in major industrial countries also became contaminated.

In the case of South Africa, the contamination took place through the disinvestment of foreign funds from the South African Bond Exchange. During the first four months of 1998, non-residents increased their holdings of South African bonds by R16.3 billion. During the next five months, from May to September 1998, they reduced their holdings of South African bonds by R22.4 billion. This major switch was directly linked to a reassessment made by foreign investors during April/May 1998 of their investment positions, and the decision to reduce their exposure in fixed-interest bonds of the emerging market economies.

It is interesting to note that non-residents continued to increase their investment in South African equities. After increasing their investment in South African shares acquired through the Johannesburg Stock Exchange by R19.4 billion in the first four months of 1998, they added a further R17.3 billion during the following five months. The reversal in the investment trend on the Bond Exchange was, however, sufficient to change drastically the outlook for the South African economy, and some promising economic developments in the first quarter of this year were promptly aborted.

## 2. Adverse financial developments lead the downward trend in the economy

The sudden switch of foreign investors' sentiments had far-reaching effects in the South African financial markets:

- The immediate effect of the withdrawal of investment funds from the Bond Exchange was a sudden and sharp increase in the yield on long-term bonds. The average monthly yield on long-term government bonds rose from 12.9 per cent in April 1998 to 18.3 per cent in September.
- The withdrawal of foreign investments created pressure in the foreign exchange market and the average effective exchange rate of the rand against a basket of currencies depreciated by 21.4 per cent from 22 May 1998 to 31 August 1998, to bring the cumulative decline in the external value of the rand from the end of last year to 24.6 per cent.
- The depreciation of the exchange rate encouraged further capital outflows in the form of negative "leads and lags", and also led to speculative positions taken against a further depreciation of the rand. In the end, a net outflow of more than R13 billion in the form of private sector short-term capital exerted additional pressure in the foreign exchange market.

- The outflow of capital reduced liquidity in the banking sector and forced the banks to borrow more from the Reserve Bank on a day-to-day basis. The estimated daily liquidity needs of the banks increased from about R2 billion at the beginning of May to more than R13 billion in early June 1998.
- Other interest rates followed the yield on long-term government bonds on its strong upward surge. The rate for repurchase transactions from the Reserve Bank increased from 14.78 per cent on 12 May 1998 to 24 per cent on 22 June 1998, before it settled early in July at a level just above 21 per cent. Banking institutions raised their prime overdraft rate from 18.25 per cent at the end of April 1998 to 25.5 per cent on 28 August 1998.
- In order to provide liquidity to the drained foreign exchange market, the Reserve Bank drew about R8 billion on foreign loan facilities and increased its outstanding hedge facilities in respect of future international balance of payments commitments from US$ 17.5 billion at the end of April 1998 to US$ 25.3 billion at the end of June 1998.
- Having risen by 32.3 per cent from December 1997 to an all-time high in May 1998, the average monthly level of share prices listed on the Johannesburg Stock Exchange declined by 38.7 per cent between May to September 1998.

Although the financial conditions started to stabilise again in early July 1998, the situation remained extremely sensitive throughout the next three months, up to September 1998. Exchange rates, yields and interest rates and share prices reacted to rumours, speculative transactions and adverse international developments, and most of the financial aggregates showed great volatility.

3. Adverse financial conditions brought negative developments in real economic activity

The adverse developments in the financial markets had a negative effect on an already fragile real domestic economy. The GDP growth rate remained subdued at a level of ½ per cent in the first two quarters of this year. All indications are that it became more subdued in the third quarter, and there may even have been some decline in the level of total production.

A much smaller decline in inventories during the second quarter of this year caused some improvement in the level of gross domestic expenditure from the first quarter. Total domestic final demand, however, declined marginally to a rate of expansion of 3 per cent in the second quarter. Indications are that the expansion in demand may have been maintained at this level throughout the third quarter.

The current account of the balance of payments recently also showed the strains of the adverse international conditions. The main reason for a substantial weakening in the current account balance from the first two quarters of 1998 into the third quarter lay with an unexpectedly sharp rise in total imports whereas total exports, at least in volume terms, declined from the second to the third quarter.

As could have been expected after the depreciation of the rand, inflation moved upwards. The rate of increase in consumer prices measured over a twelve-month period increased from 5.0 per cent in April 1998 to 9.1 per cent in September, and the rate of increase in the overall producer price index rose from 2.3 per cent in March 1998 to 4.3 per cent in September.

In this environment, the rates of increase in bank credit extension and in the money supply remained on a high level. Together with the external strains, the situation forced a very restrictive monetary policy approach on the Reserve Bank in order to restore overall financial stability to the South African financial markets.

The overall South African economy is now going through a cycle that is led very strongly by developments in the financial markets. The recent decline in real economic activity was directly caused by the adverse developments in global financial conditions. The East Asian crisis had started already in the middle of 1997, but had a delayed effect on the South African financial markets, which deteriorated badly, particularly during the second quarter of this year. Trends in the real economy followed the downward trend in the financial markets with but a short time lag.

## 4. More stable conditions return to financial markets

Although the underlying conditions in the South African financial markets had already become more stable in early July, conditions started to improve noticeably only in late September and early October. Just as the initial negative impact on South Africa was closely linked to adverse developments in the international financial markets, the recent recovery also followed an improvement in international financial conditions that gained momentum during and after the 1998 Annual Meetings of the International Monetary Fund and the World Bank.

The improvement in the South African financial market conditions was reflected in:

- A decline in the net sales of South African bonds by non-residents. The net outflow in October declined to less than R1 billion and was the smallest for the past six months.
- An easing in the overall liquidity position of banking institutions. The total liquidity requirement at month-ends declined from R12.2 billion in June to R7.2 billion in September and R5.9 billion in October.
- A decline in long and short-term interest rates. The yield on long-term government bonds declined from 20.09 per cent on 28 August 1998 to below 16 per cent at this stage. The rate on repurchase transactions from the Reserve Bank declined from 21.85 per cent on 13 October to 20.45 per cent today. Banking institutions reduced their prime overdraft and mortgage lending rates by 1 full percentage point during the past few weeks.
- An appreciation of the rand from the very low level reached in July. During the month of October the average effective exchange rate of the rand appreciated by 3.9 per cent to reduce the cumulative depreciation since the beginning of the year to about 17½ per cent.
- A significant slowdown during September 1998 in the rates of growth of both the M3 money supply and bank credit extended to the private sector.

Conditions in the financial market will hopefully continue to improve further and to lead real economic activity into recovery in the course of the current business cycle. The recent improvements in the South African financial market conditions should therefore hopefully lead to an improvement in real economic activity, and particularly in gross domestic production, during the course of next year.

## 5. What monetary policy must take into account for 1999

The tight monetary conditions, high interest rates and restrictive monetary policy in 1998 were forced on South Africa by adverse developments in the international financial markets. In the situation, monetary policy had to carry a heavy burden in restoring financial stability to the South African financial markets. Unpopular measures, such as a reduction in bank liquidity and high interest rates, had to be embraced in order to avoid more serious problems, such as a foreign reserves crisis, or a breakdown in the banking system.

Provided the encouraging recent trends towards greater stability in the international financial markets continues, monetary conditions in South Africa should also gradually become easier. From the point of view of real economic activity this is, of course, a most desirable development at this stage.

There are a number of reasons why any deliberate actions taken by the monetary authorities to relax monetary policy should be implemented with caution.

Firstly, not all problems in the international markets have been resolved. The world is still holding its breath on the vulnerable situation of the Japanese banking and financial systems; Brazil is still lingering on the edge of a dangerous cliff with its international financial relations; weaknesses recently surfaced in the financial markets of a few industrial centres; and the secondary effects of the financial market crisis are only gradually filtering through in the form of a decline in global real economic growth.

Secondly, the recent financial turmoil left the South African scene with a few additional scars that need time to heal. The depreciation of the rand forced inflation to a higher level and even more out of line with the rest of the world; the weakening of the current account of the balance of payments in the third quarter provides a further warning for caution; a monetary stimulation may easily increase demand without increasing production; and the continuing low level of the country’s official foreign reserves do not provide much scope for manoeuvring unless large foreign capital inflows will again supplement the supply of foreign exchange.

Structural deficiencies in the South African economy that restrict the country’s economic growth potential to a relatively low level place an almost permanent obligation on monetary policy to remain relatively restrictive. A relaxation of monetary policy would normally stimulate demand and, unless production responds flexibly and quickly to increases in expenditure, monetary stimulation is inclined to lead either to an unsustainable overall balance of payments deficit and/or an unacceptably high rate of inflation. The monetary policy targets in the Government’s Strategy for Growth, Employment and Redistribution (GEAR) cannot be achieved unless all the other goals for structural adjustment are also achieved at the same time.

In view of the depressed real economic situation in the country at this stage, there is, however, some room for a responsible relaxation of monetary policy, provided the international and domestic financial conditions continue to improve further. The Reserve Bank will move cautiously with and not against any improvement in the underlying conditions, and will allow market forces to exert normal pressures on important prices such as the exchange rate and domestic interest rates.