Mr Stals discusses the challenges to monetary policy in increasingly volatile international markets

Address by the Governor of the South African Reserve Bank, Dr Chris Stals, at a conference on 'The South African Economy in a World of Volatile Financial Markets', arranged by the Bureau for Economic Research of the University of Stellenbosch in Johannesburg on 25 May 1999.

The contagion effect

The globalisation or international integration of the world's financial markets brought with it new challenges for monetary and other macroeconomic policies. The volatile conditions in world financial markets over the past two years created new problems for macroeconomic management in a number of countries. It was particularly smaller economies with partly developed financial markets – the emerging markets – that were more seriously affected by these adverse developments.

Ex post analyses of the financial crisis of 1997/98 focused attention on purported deficiencies of macroeconomic policies, and of economic structures in many of the afflicted countries. From these lessons, programmes for a major reform of existing structures, particularly financial structures, and of essential adjustment in macroeconomic policies, are now emerging. At the same time, attention is given to the need for some restructuring of the global financial architecture with the objective to avoid a repetition of the 1997/98 crisis. Crisis prevention, after all, is better than crisis resolution.

Without going into the details of the many proposals now being discussed at the global and national level for reforming macroeconomic structures and policies, pragmatism leads to the conclusion that the present globalised financial market structure is by its nature unstable, unpredictable and, with all its virtues and advantages, at times very disrupting for domestic national economic policy objectives.

Easy communication through a worldwide network, the instant transfer of information on a real-time basis to all destinations, economic liberalisation and the transfer of resources such as surplus saving from more developed to developing countries have changed the environment in which macroeconomic policies must now be framed.

Recent developments exposed an important aspect of this new global environment and that is the so-called contagion effect, or the ease with which economic problems that may develop in one country, region or functional group of countries can be transmitted to others. The conduit for the transfer of the problem is not in all cases the same. Referring to the East Asian crisis of 1997/98, at least three distinct transmission mechanisms can be distinguished in the contagion process:

- First, there was the group of countries in East Asia, with many similarities and fairly intimate economic relationships, where individual countries were affected almost immediately after the Thai baht collapsed in mid-1997, partly because of perceptions and the herd-like reactions of international investors. In the case of this group of countries, contagion worked mainly through the withdrawal of short-term foreign financing to banking institutions, trade financing, and all forms of foreign loan facilities.

- Second, there was a further group of countries that were affected only gradually through a decline in the flows of portfolio investments from industrial to developing countries. Emerging market economies with fledgling capital markets were mainly affected with some time lags by the change in the attitude of the managers of major institutional investment funds who at some stage decided to convert high-yielding, high-risk assets into low-yielding, high-quality assets. South Africa is a good example of such a country that suffered in the wake of the East Asian crisis, mainly as a result of a large-scale withdrawal by nonresidents of portfolio investments previously made in the country.
- Third, another group of countries representing mainly exporters of primary products, metals and minerals were affected with an even longer time lag by depressed world economic conditions created by the East Asian cum global financial market crisis of 1997/98.

Not all countries have therefore been affected in the same way by the global financial crisis of the past two years, and not all countries can therefore rely on the same protective measures to prevent the same disastrous effects in future.

There are, nevertheless, many commonalties in the challenge for monetary policy, despite the differences in conduits followed in the transmission of contagion to the various countries. Whether a balance of payments deterioration takes place through an outflow of short-term finance and the withdrawal of loan funds, or through the repatriation of previously invested portfolio funds, or through a decline in exports, the proximate monetary effects are more or less the same:

- First, the overall supply and demand conditions in the market for foreign exchange will change and a short supply in foreign currency may develop. Some pressure for depreciation will therefore be exerted on the exchange rate.
- Second, liquidity conditions in the domestic money and capital markets will tighten, and upward pressure will be exerted on interest rates and yields on financial assets.
- Third, banking institutions will lose liquidity and their capacity to provide loans to their domestic clients will be reduced.
- Fourth, inflationary pressures will emerge within the economy, particularly in a relatively open economy where import inputs play an important part in the overall economic process.
- Fifth, if not reversed fairly quickly, these adverse developments in the financial markets will disperse throughout the economy and will eventually also depress real economic activity.

It should be noted once again that, as happened last year in the case of South Africa, the adverse developments were transmitted into the South African economy as part of an international contagion process, without any special reason or obvious explanation for it in the domestic environment. It is true that, like a real virus, the international transmission process seeks weaknesses in the world environment and exploits structural deficiencies in the economies of globalised markets. Weaker economies are therefore affected more severely in the process, and unacceptable macroeconomic policies are punished with greater venom.

The contagion effect and the South African economy

It is history now that South Africa was also struck by the global financial crisis of 1997/98 when nonresident investors in May 1998 suddenly started to withdraw large sums of portfolio investments previously made in South African bonds, mainly government bonds of longer maturity. In the first four months of 1998, nonresidents increased their holdings of South African bonds by R16 billion; in the subsequent eight months, from May to December 1998, they reduced their holdings of South African bonds by R26 billion. This sudden switch from a large net inflow to an even larger net outflow of portfolio foreign investment in South Africa exposed the country to the East Asian financial crisis and triggered all the predictable adverse developments in the financial markets referred to above.

The predicament for the South African macroeconomic policymakers in the situation was that the adverse developments took place at a very inconvenient time if account is taken of prevailing conditions in the domestic economy in the first half of 1998. These adverse financial developments indeed forced an early abortion of an economic recovery that was in its infancy during the first quarter of 1998. During the rest of last year, the economy lost its momentum and is only now beginning to show tentative signs of a resumed recovery.

South Africa and other emerging market countries learned a lot from the experience of the past two years. For those countries, such as South Africa, that are committed to continued and enhanced participation in the process of financial globalisation, there is no escape from volatile international capital flows. These countries, including South Africa, are now working together in the multinational forums of the International Monetary Fund (IMF), the World Bank, the Bank for International Settlements and many groupings such as the Willard Group and the Basel Committee for Banking Supervision to create a more stable global financial environment. For the time being, however, they have to accept greater volatility in the financial markets as a fait accompli.

Challenges for monetary policy

The market economy provides its own disciplines and its own mechanism for adjustment when disequilibrium develops in the system. The foregoing analysis of financial developments in countries afflicted by the turbulence in world financial markets last year provides a brief description of the market mechanism of self-adjustment. The outflows of capital forced a depreciation of the currency, higher interest rates and inflationary pressures in those countries from where foreign investments were repatriated.

The challenge for monetary policy is to accommodate these adjustments, however unpopular they might be at the time, and even if they come in direct conflict with the contemporary needs of the domestic economy at that stage. Despite the depressed conditions in the South African economy at the beginning of 1998, we had to accept a depreciation of the rand of almost 20% last year; we had to adjust to a sharp rise of about 7 full percentage points in the level of the cost of money; banking institutions were forced to reduce the rate of lending to their clients, and the rate of inflation increased from 5% in April 1998 to 9.3% in October 1998. Painful adjustments in real economic activity were unavoidable.

Monetary policy had to flow with the flood. Reserve Bank intervention in the financial markets became necessary to smooth adjustments, prevent a crisis situation from developing in the foreign exchange market (still subject to many exchange controls) and facilitate the

adjustment process by partly redistributing the cost of adjustment between private and public sector participants. Monetary policy, however, could not avoid, and should not have tried to prevent, the painful but essential market adjustment process.

With hindsight, South Africa came out of the global financial crisis of 1997/98 relatively well, but not without some scars. In three areas, the South African economy showed its strength and resilience:

- Unlike in many other countries, South Africa's financial system managed to survive the turbulences of 1997/98 without any major failure.
- South Africa became an exception to the emerging market world by not approaching the IMF for any special financial assistance. At this stage, South Africa has zero loans outstanding by the IMF.
- Financial stability returned to South Africa relatively quickly after the major disruptions in the second and third quarters of 1998. The negative flow of portfolio investments turned positive again towards the end of last year; liquidity conditions in the banking sector eased; interest rates declined and are almost back to levels that applied at the beginning of last year; inflation peaked at 9.3% and is now gradually declining again; and the country's foreign exchange reserves are on a rising path.

In the heat of the situation, monetary policy, which in the case of South Africa had to carry a heavy burden in the adjustment process, was criticised a lot and was even blamed by armchair economists for causing the problems. With hindsight, the policy of letting the markets work with only smoothing-out intervention operations may not have worked as badly as the critics of the policy predicted.

Exchange rate policy

One of the elements of the restabilisation programme used by the South African monetary authorities over the past 30 years again elicited a lot of criticism recently, and that is the Reserve Bank's so-called forward book. There is a lot of misunderstanding about this facility, perhaps because 'forward books' were used by many other central banks for completely different purposes. In many cases, misuse of the forward book contributed to the eventual downfall of financial markets.

In the case of the Reserve Bank, a hedge facility is made available, mainly to South African residents, to protect them against exchange rate changes over which they have no control. These hedge transactions may only be entered into in respect of 'firm, ascertained and documented' commitments to make allowable balance of payments transfers within a 12-month period. The Reserve Bank's forward book is perhaps a misnomer, and should rather be referred to as an 'insurance policy' available to South African residents with foreign exchange exposures, either because they have to make payments in foreign currency or because they will receive payments in foreign currency within the next 12 months.

The Reserve Bank's forward book the therefore at any time represents a duplication of part of the stream of balance of payments transactions that will take place over the next 12 months. Analysts often make the mistake of adding a net oversold position in the Reserve Bank's forward book to their estimates of future balance of payments streams as an additional

commitment of the country to make foreign payments. This is obviously wrong and must lead to a distorted assessment of the country's overall foreign exchange position.

By making use of this hedge facility, South African residents can transfer their exchange rate risk exposures to the Reserve Bank for account of the government (that is, the taxpayers). The concerns we have in the Reserve Bank and in the Treasury on the forward book are not linked to the availability of foreign exchange for the country – that will be determined by the overall balance of payments position. Our concerns are more about the transfer of the exchange rate risk from certain sectors of the private sector (importers, exporters, borrowers of foreign funds) to taxpayers in general (the Budget). What we must ask ourselves is whether this transfer of risk brings on a net basis a macroeconomic social advantage to the overall community, or whether the final net cost in the form of losses on the forward book will exceed the overall social advantages of the insurance scheme.

The decision to provide the hedge facility through the Reserve Bank dates back to the early 1960s, when South Africa introduced exchange controls. These controls prevented private sector users of foreign exchange from protecting themselves through the market mechanism for possible exchange rate changes. As long as South Africa still has exchange controls, albeit substantially relaxed in the meantime, there is some justification for the continued provision of a government-backed insurance policy for the protection of exchange rate risks.

There are many disadvantages to the scheme, most important of which must be the distorted perception in world financial markets of the use of the Reserve Bank's forward book. In a crisis situation, such as was experienced last year, there are also indisputable advantages in the provision of a government-sponsored hedge facility for exchange rate changes. The availability of this facility last year, for example:

- enabled South African importers and exporters and other borrowers of short-term foreign exchange funds, to continue to make use of these facilities (note: South Africa did not experience large outflows of short-term funds as many other countries did);
- prevented the exchange rate of the rand from depreciating more, and interest rates from rising to even much higher levels;
- protected the private sector, including financial institutions, from huge losses on outstanding foreign commitments (part of the explanation, perhaps, why our banking institutions survived the crisis so much easier than their counterparts in many other countries).

There is, however, a price to be paid for this protection, and that is huge losses on the forward book that are now being carried by the Reserve Bank for account of the Treasury. Future premiums on the insurance policy will, hopefully, go some way towards the recovery of part of these losses. The cost of financial stabilisation in the case of South Africa has been concentrated in the Reserve Bank's forward book. In the case of many of the other afflicted countries, it remained vested in the private sector but eventually also came to book in national budgets, that is after private sector institutions collapsed under the burden of huge exchange rate losses. Is the forward book of the Reserve Bank/Treasury really such a bad thing after all? How can it be phased out from future stabilisation programmes, that is after exchange controls have disappeared? We South Africans should approach this challenge in a more positive and constructive way, and should not only concentrate on the obvious disadvantages of a scheme that also provides very valuable protection to private sector users of foreign currencies.