T T Mboweni: The objectives of monetary policy with reference to the independence of the South African Reserve Bank

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Free State Branch of the Economic Society of South Africa and Chamber of Trade and Commerce, Bloemfontein, on 12 April 2000.

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1. Introduction

The task of macroeconomic policy is the promotion of economic growth and development, the creation of more jobs and the employment of more people, the improvement of the living conditions of all the people of the country, and the elimination of unjustifiable discrepancies between average incomes of various groups of participants in economic activity.

Monetary policy, being a part of macroeconomic policy, has but an intermediate role to play in the implementation of overall macroeconomic policy. It is expected of monetary policy to create and maintain a stable financial environment within which overall economic activity can be expanded. None of the above ultimate objectives of macroeconomic policy will be attainable in an environment of unstable financial conditions. Although overall financial stability by itself cannot guarantee the achievement of the ultimate macroeconomic objectives, it is an important precondition for reaching those goals.

In order to comply with its obligation and to meet its commitment, the central bank should pursue its objectives with a medium and longer term view in mind. Financial stability should, for example, be maintained throughout the business cycle in both the expansion and contraction phases of the economy, and should in the democratic political system of periodic elections, stretch beyond the duration of successive governments. It is inter alia for this reason that central banks need some autonomy for the execution of their duties.

2. Primary objective of the Bank

The primary or strategic objective of the Reserve Bank is therefore to achieve and maintain stable financial conditions in the country. This objective is spelled out in both the Constitution of the Republic and in the South African Reserve Bank Act. In these acts it is recognised that only by protecting the currency can balanced and sustainable economic growth be achieved.

The question may be asked what is meant by the term financial stability? In a broad sense financial stability can be defined to include price stability as well as stable conditions in the financial sector as a whole. Price stability is achieved when changes in the general price level do not materially affect the economic decision-making process. Although relative price movements will still have an impact on production, consumption and investment, the rate of inflation or deflation is not an important factor in the decisions taken by producers, consumers and the authorities under stable price conditions.

The stability of key institutions and markets in the financial system is achieved when there is a high degree of confidence that the financial infrastructure of the economy is able to meet the requirements of market participants. However, it is important to realise that financial stability does not exclude the failure of individual banks or financial institutions. A financial institution can go bankrupt in stable financial conditions. It is only where systemic risks arise, i.e. where the financial sector as a whole may be influenced by an incident, that the situation can be described as financially unstable.

The two elements of financial stability, i.e. price stability and stability of the financial sector, are closely related. Failure to maintain one of these elements provides a very uncertain operating environment for the other, with causality running in both directions. For example, high inflation can lead to tighter monetary policy, higher interest rates, and increase in the non-performing loans of banks and a fall in asset and collateral values, which can cause bank and other failures in the financial sector. Conversely, disruptions in the financial system will make the transmission mechanism of monetary policy less effective and can materially affect changes in the general price level.

3. Why is it important to maintain financial stability?

There are many convincing reasons why financial stability is regarded as a prerequisite for the promotion and support of economic development. All modern market-oriented economies are based on the extensive use of money as a unit of account, as a means of exchange and as a store of value. Money that changes in value all the time cannot fulfil these functions. Money must be trusted by the public to be a constant yardstick of value, otherwise it will not be acceptable as a means of exchange, and cannot continue to serve as a store of value.

The many disadvantages of inflation are well-known. High inflation distorts the allocation of resources and favours investment in non-productive hedge assets. High inflation discourages saving and leads to more consumption. High inflation erodes the competitiveness of local manufacturers and other producers vis-à-vis foreign producers. High inflation leads to an unfair redistribution in wealth by penalising the poor more than the rich. High inflation leads to lower growth, fewer jobs and more unemployment.

There can be no rational reason for the support of inflation in any country except by those few financial wizards that have learned how to take advantage of inflation at the cost of their fellow human beings. This may even include the managers of the national budget who have learned through experience that taxation through inflation often meets with less resistance from ill-informed tax payers. For the economy as a whole, however, inflation is always bad.

An argument is often made for a trade-off between inflation and growth based on the Philips-curve analysis in terms of which, at a low level of inflation, real growth can be stimulated through an expansionary monetary policy, even if it should create some higher rate of inflation. There may be some truth in this for the short-term but it is easy to prove that a continuing expansionary monetary policy will eventually lead to an acceleration in the rate of inflation. A little bit of inflation once started can easily gain momentum, get out of control and develop into hyper-inflation. It is also true that with modern electronic forecasting techniques and increasing sophistication in the role of rational expectations, the effective period for the trade-off has become very short.

4. How does the Reserve Bank achieve financial stability?

Inflation is a monetary phenomenon, i.e. inflation cannot take place without a more rapid increase in the quantity of money than in output, provided that the velocity of circulation of money remains unchanged. Although the causes of inflation are too wide for any individual institution to prevent it from occurring, the Reserve Bank can at all times use the powers at its disposal to reduce inflationary pressures by influencing the growth in money supply and bank credit extension.

The Reserve Bank can influence money supply and bank credit extension either by influencing overall liquidity in the banking sector, that is, by influencing the supply of money or by influencing the demand for credit emanating from the private sector. Liquidity in the banking sector can be influenced through various operational instruments, such as changes in minimum cash reserves for banking institutions, open market-operations and short-term money market interventions through swaps and repurchase transactions.

The demand for bank credit is to an important extent interest rate driven. By influencing the general level of interest rates, the Reserve Bank can exert some influence on the total demand for credit, and therefore on the money supply. The main operational instrument in this case will normally be the repo rate, that is the interest rate at which the Reserve Bank provides in the liquidity needs of banking institutions.

In its objective to establish and maintain financial stability another important responsibility of the Reserve Bank is to encourage and support the development of sound and well-managed banking institutions. The objective of banking supervision is to ensure that banks manage their risks in such a way that systemic risk in the banking sector is minimised, thereby ensuring the safety of depositor's money. Banking supervision is based to a large extent on the prudential regulation of banks, which is aimed mainly, but not exclusively, at promoting the financial soundness of banks and of the banking system as a whole.

In order to fulfil the responsibility for systemic protection of the banking system, bank supervision must ensure the prudential soundness of participants in the banking system. As soon as a bank failure could cause a systemic problem, the prudential and systemic measures pertaining to the supervision of banks converge. If a large bank is in financial difficulty, the expectation of losses may become so widespread that the public loses confidence in the banking system as a whole, causing withdrawals of deposits and general liquidity problems in the banking system.

Financial stability also requires well-developed and efficient functioning financial markets. The basic foundation for the functioning of markets is the provision of money. It is therefore an important function of the Reserve Bank to issue banknotes and coin in South Africa.

In any payment system there arises the need for clearance and settlement of claims of banks on one another because cheques drawn on any particular bank will in many cases be deposited by their holders with other banks. This function of clearance and settlement has therefore been performed by the Reserve Bank since 1921.

In its endeavours to maintain financial stability the Reserve Bank also has a vested interest in the development and functioning of the money, capital and foreign exchange markets. Although the Bank is not directly responsible for the development of the money and capital markets, considerable effort has been made in the past to establish efficient markets in South Africa. For the efficient functioning of the money market, daily cash shortages in the banking system are accommodated by the Bank through the extension of overnight loans against suitable collateral to banks. As custodian of the country's gold and other foreign reserves the Bank is also involved in the functioning of the foreign exchange market. In recent years, the Bank in close cooperation with the Minister of Finance has made considerable effort to gradually phase out exchange controls and to integrate South African financial markets further with international markets.

5. The autonomy of the central bank

In fulfilling its primary objective of creating and maintaining financial stability, it is generally argued that the central bank should be able to do this relatively independently of any government interference or in an autonomous way. The traditional argument in favour of a strong autonomous central bank is that the power to spend money should in some way be separated from the power to create money. According to this argument politicians generally have short-term horizons in determining economic objectives. Many governments have accordingly given way to the temptation to reduce interest rates ahead of elections. This may boost spending and employment in the short term, but ultimately it normally also causes higher inflation over the long term unless the capacity of the economy can meet this higher level of demand. This higher inflation, however, only becomes apparent a couple of years later. An incumbent government concerned about its immediate popularity is likely to be tempted to go for the short-term gains from lower interest rates, even at the risk of promoting somewhat higher inflation further down the road because some other political party may then have to pick up the pieces.

Central bankers normally operate on a longer term time scale than politicians and therefore do not face the same temptation to relax policy to achieve short-term objectives. By delegating decisions on interest rates and other monetary matters to such an independent institution, with a clearly defined mandate, society can then hope to achieve a better inflation outcome over the longer term.

The main criticism against making central banks autonomous entities is not so much based on economic but rather on political arguments: it is that turning over decisions regarding interest rates, exchange rates, the efficiency of the financial system and other monetary matters to a body of unelected officials is simply “undemocratic”. In a democratic government all decisions should be subject to scrutiny by the elected legislative and the concept of an autonomous central bank is therefore not acceptable.

Aside from the fact that there are plenty of other areas of national life in which decision making is delegated to independent unelected officials - the judiciary being the prime example - there is a fundamental confusion here between being autonomous and lacking accountability. No central bank can be totally independent, in the sense that it is not answerable to any one. Even the most autonomous central bank has to report in one form or the other to the legislative, which in any case also has the ultimate power to change the laws relating to the central bank. All the same, there is a difference between a situation in which the policy decisions are under continuous scrutiny, and an arrangement where the central bank reports to the legislative periodically.

An important precondition for central bank autonomy is therefore credibility. Central bankers that seek autonomy must commit themselves and their institutions to a programme of action that will support their demands. It is generally believed in this regard that they should fulfil three basic conditions, namely:

(i) Central banks should have a clearly defined monetary policy framework and monetary policy operational procedures. Monetary policy should clearly indicate what it is attempting to achieve, how it will achieve it and in what manner it will operate to reach its primary objective.

(ii) Both the government and the public should on a continuous basis be informed regarding the monetary policy stance pursued by the central bank.

(iii) An efficient institutional framework should exist within which decisions on monetary policy can be made without undue interference by political functionaries. This involves decisions regarding the ownership of a central bank, the management of the bank and the responsibility for monetary policy.

The final question then arises: does the South African Reserve Bank fulfil these conditions and what degree of independence does the Reserve Bank have?

The Reserve Bank in the past has always clearly indicated what monetary policy framework and monetary operational procedures it follows in the application of monetary policy. Only last week on 6 April we again issued a statement explaining the new monetary policy framework of inflation targeting to the public. In this statement we confirmed that inflation targeting would have no material affect on our operational procedures which we have been applying since March 1998.

The South African Reserve Bank also fulfils the second condition for autonomy, namely transparency. The numerical inflation target was announced explicitly to the public to indicate clearly what the Reserve Bank should be held accountable for and to make the application of this framework as transparent as possible. The announcement of the target makes the intentions of monetary policy explicit. If targets are not met, the central bank has to explain what went wrong. Regular reporting on the stance of monetary policy, as is the case internationally, are made to Parliament.

The monetary policy stance is communicated regularly to the public. This is done by means of a monetary policy statement after the completion of every meeting of the Monetary Policy Committee. A Monetary Policy Forum has also been established to open an avenue for ongoing discussions on monetary policy and general economic developments and to ensure that the views of interested parties are taken into account in the determination of monetary policy. The Monetary Policy Forum will meet twice a year in the major centres of South Africa to allow as many stakeholders as possible to participate in these discussions.

The Reserve Bank will also publish twice a year a Monetary Policy Review to increase transparency in the application of monetary policy. This Monetary Policy Review will attempt to describe in more detail the decisions taken by the central bank and will analyse developments in South Africa and the rest of the world that could affect inflation.

Finally, the present institutional framework in South Africa in the form of the South African Reserve Bank Act, Act No. 90 of 1989, provides the Reserve Bank with a great degree of autonomy in its operations. The Reserve Bank's functional independence on monetary and related policies is clearly stated in Sections 10 and 35 of the South African Reserve Bank Act. Section 35 empowers the Board of the Bank to make rules "for the good government of the Bank and the conduct of its business". In Section 10 the powers and duties of the central bank are spelled out in great detail. Most of the functions described in this section are the normal functions that one would expect a central bank to perform. In Section 10(2) it is also clearly stated that "the rates at which the Bank will discount or rediscount the various classes of bills, promissory notes and other securities, shall be determined and announced by the Bank from time to time", clearly giving the Bank the right to determine Bank rate in an autonomous manner.

The personal dependence of the Reserve Bank is determined by Section 4 of the Act indicating the conditions of appointment of the Governor, three deputy governors and other board members of the Reserve Bank. This section clearly precludes any person actively involved in politics of becoming a board member of the Bank. Seven of the directors, including the Governor and three deputy governors, are appointed by the State President, while the other seven are elected by the shareholders. By means of these appointments the government, of course, have an effective say in the policies of the Bank. The governors are, however, after their appointment normally allowed to operate in an independent manner.

The instrumental independence of the Reserve Bank is clearly spelled out in the Act and the Reserve Bank is precluded in Section 13(f) of making excessive direct purchases of government stock. In this last-mentioned section it is stated that the Bank may not "hold in stocks of the Government of the Republic which have been acquired directly from the Treasury by subscription to new issues, the conversion of existing issues or otherwise, a sum exceeding its paid-up capital and reserve fund plus one-third of its liabilities to the public in the Republic". This section therefore restricts the direct financing of government deficits.

The South African Reserve Bank is also financially independent from the government because of adequate financial resources and complete control over its own budget.

6. Conclusion

The South African Reserve Bank is therefore at present, according to all distinguished principles, a fairly autonomous central bank and fulfils all the main conditions necessary for independence. The Constitution of the Republic of South Africa also formally recognises the independence of the Reserve Bank. The Constitution namely states in Section 196 that: "The South African Reserve Bank shall, in the pursuit of its primary objective .... exercise its powers and perform its functions independently, subject only to an Act of Parliament .... provided that there shall be regular consultation between the South African Reserve Bank and the Minister responsible for national financial matters".