T T Mboweni: Economic growth, inflation and monetary policy in South Africa

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the business conference of the Bureau for Economic Research, held in Stellenbosch on 17 November 2000.

*   *   *

1. Introduction

It should by now be well-known that the mission of the South African Reserve Bank is to achieve and maintain stable financial conditions in our 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 value of the currency can balanced and sustainable economic growth be achieved. It is believed in the Bank, and indeed in most countries of the world, that the potential for economic growth and creating job opportunities can only be fulfilled under stable financial conditions. By achieving this primary objective the Reserve Bank will make its contribution to sustainable higher economic growth in South Africa.

Some economists and other commentators on monetary policy in South Africa seem to think that the Reserve Bank is applying an over-zealous monetary policy stance to achieve its primary objective of price stability. They argue that the Bank is obsessed with inflation at the expense of economic growth and job creation. At the current level of the inflation rate, this implies that an inflation rate of 8% is too low to be treated as a serious concern. The Bank should therefore provide more liquidity to the money market, allow the interest rate on repurchase transactions to fall and in this way encourage the economy to grow more rapidly. In the Bank we believe that it would be a big mistake to shift the goal of monetary policy away from controlling inflation to promoting economic growth.

2. The determinants of economic growth

Economic growth is basically determined by three factors, namely:

(i) the quantity of capital and labour available in a country;

(ii) the quality of capital and labour; and

(iii) the ingenuity of people in combining the available production resources in the creation of goods and services.

Output will rise if more production resources are put to work, or where a given supply of labour and capital is utilised more productively. Nowhere does the aggregate stock of money or the aggregate price level form part of the determinants of any production model for sustained long-term economic growth.

Government policies, including monetary policy, affect the growth of domestic output to the extent that they affect the quantity and productivity of capital and labour. For example, government policies that restrict commercial activities for fear that these activities may cause undue environmental or ecological damage, raise the cost of doing business and make firms less productive. Obviously there may be good reasons to have such policies, but they can harm productive activity and economic growth.

Monetary policy is only one element of overall macroeconomic policy, and can only affect the production process through its impact on interest rates. There are two main channels of monetary policy. One is through the effect that interest rate changes have on the exchange rate of a currency, and the other is through the effect that interest rate changes have on demand. Therefore monetary policy has an impact on economic activity and growth through the workings of foreign and domestic markets for goods and services.

Economic growth involves the allocation of production factors to productive use and this allocation of resources takes place in markets. In a modern economic system, markets for goods and services, and for production factors, function more efficiently because of the existence of money as a medium of exchange. Without such a medium of exchange, barter trade would take place and most modern market arrangements would simply cease to exist. Money allows markets to allocate economic resources to sectors of economic activity in a highly efficient and cost-effective way.

In a market economy, exchange values are expressed in terms of money prices which are determined by the forces of supply and demand. When a good or service is in short supply, or when demand increases relative to the supply of a good or service, the price will rise. This signals to suppliers that they must shift resources in response to the change in relative prices, or to buyers that they must economise on their purchases. The productive allocation of resources needs clear signals about relative price changes.

This is where monetary policy really comes into the picture. Sound monetary policy makes price signals clearer. In an environment of overall price stability, it is much easier to detect changes in relative prices. Bad monetary policy clouds the picture. When prices are always in a state of flux, it is hard to make out whether a particular price change is signalling a change in relative scarcity or whether it is simply part of an inflationary process where all prices keep on rising.

The uncertainties that inflation creates make the problem worse. The mere possibility of inflation creates uncertainty about the true meaning of changes in the prices of individual goods and services. This uncertainty could lead to the misallocation of resources, which would reduce economic growth. This problem is nowhere more serious than in the capital market. Inflation uncertainty raises the risk premium that investors require and increases the cost of capital, thus lowering fixed capital formation. Lower investment means lower future growth and less future income.

If producers and consumers feel confident that the average price level will remain stable, they can be more certain that price changes indicate true shifts in demand and supply. Obviously a monetary policy that maintains price stability can improve the efficient functioning of markets. This promotes the full and productive employment of resources. As Alan Greenspan once stated, a monetary policy that prevents inflation from being a factor in the decision making of businesses and consumers, is a monetary policy that best promotes economic growth.

Empirical evidence shows that high inflation has a negative correlation with economic growth. In countries where inflation is high, economic growth is normally low. Many economists are therefore convinced that inflation is undesirable and should be avoided at all costs. Recent economic research has cast some doubt on this argument. In principle, there is likely to be a reversal somewhere in the inverse relationship between inflation and growth as there are no grounds for believing that continuously declining prices, i.e. deflation, are good for growth.

Stanley Fischer of the International Monetary Fund (IMF) found that the inverse relationship would hold, even at low rates of inflation. Another study by Barro confirmed this inverse relationship, but found that it was relatively weak. Increasing inflation by 1% led to only a small reduction of less than 0.03% in growth, according to Barro. A range of other studies found no effects from inflation on growth. Sarel, a researcher at the IMF, came to the conclusion that: "When inflation is low, it has no significant negative effect on economic growth: the effect may even be positive. But when inflation is high, it has a powerful negative effect on growth. The structural break is estimated to occur where the average annual rate of inflation is 8%."

Despite this uncertainty about the negative correlation between inflation and growth at inflation rates below 8%, there is still no evidence of a positive correlation between inflation and growth over any long period of time. In any case, if the inflation rate is close to 8%, it still seems wise to follow a policy countering a general increase in prices, because it could easily move to levels above 8% and accelerate further.

In South Africa the 1970s were a decade of high inflation compared with the 1960s. Inflation had averaged 2.6% per year between 1960 and 1970. In 1974 inflation moved to higher than 10% and averaged 10.2% per year from 1970 to 1980. If inflation was good for growth, one would have expected faster growth in the 1970s than in the 1960s. This did not happen. Quite the contrary happened. Economic growth slowed down from 5.7% per year in the 1960s to 3.4% in the 1970s.

There were broadly similar slowdowns in growth and accelerations in inflation in other parts of the world during the 1970s. In the 1980s inflation in South Africa accelerated to 14.6% per year, and growth fell back further to 1.5%. By contrast, most of the advanced countries brought inflation under control and their economic performance generally started to improve. A striking example is the United States, which now seems to be cruising along a path of strong and sustained economic growth with low inflation. In South Africa inflation slowed down to about 7½% between 1993 and 1999. Although there were many other factors conducive to higher economic growth over this period, it seems to be more than pure coincidence that the growth in domestic production averaged 2½% per year.

3. Other major disadvantages of inflation

Apart from the negative impact that inflation has on growth and wealth creation, inflation also affects income distribution and worsens inequality in a number of ways. Inflation can have a direct impact on income distribution where wage increases are below the inflation rate or where marginal tax rates are not adjusted to take account of nominal adjustments in wages. Inflation can indirectly also affect income distribution by slowing output growth and hence job opportunities. What is more, the rich can invest their surplus income in assets such as real estate and tradeable securities, and in many instances benefit from non-taxed inflation-induced capital gains. The poor are usually not able to do this and may see their saving at banks being whittled away by high inflation.

A perhaps even more important argument against an artificial stimulation of the economy through the creation of money, lower interest rates and higher inflation, is that in a globalised economic environment this may lead to the withdrawal of foreign capital. If non-residents start expecting a depreciation in a country's currency, they will probably immediately react by withdrawing the funds that they have invested in such a country. Foreign investors can do this easily now that world financial markets are better integrated. If large amounts of capital are withdrawn this could even lead to an exchange rate crisis with a sharp rise in inflation.

Inflation has many other disadvantages which, all in all, can only lead to the conclusion that the central bank must always carefully monitor economic developments to maintain price and financial stability. No country can afford to move out of line with the inflation rates in the rest of the world.

4. Monetary policy and business cycles

If it is so obvious that excessive money creation does not contribute to sustained economic growth, why do we hear from supposedly well-informed opinion makers that monetary policy is too tight and that it is putting a lid on real economic growth? My considered view is that some of these commentators often expect more from monetary policy than it can deliver. They tend to confuse short-term accelerations in output growth with long-term sustainable economic growth.

This confusion arises because monetary policy affects aggregate domestic spending, and under certain circumstances a rise in spending can push output higher. Such an increase in output will show up in growth in the short run that will be higher than the potential growth rate of the economy.

Such a short-term growth acceleration can be attained when there is an under-utilisation of resources. If there is a great deal of slack in the economy, then increased spending can raise the level of output. However, both the level and the growth rate of production are limited by the supply and quality of productive resources. If the employable resources are of poor quality, then output cannot increase unless there is a strong increase in the productivity of the resources already being used. At full utilisation of productive capacity, and here one recognises that in our modern technology-driven economy some resources are simply not employable in the short run, higher spending will lead to higher prices but no increase in output.

Under some circumstances, faster monetary growth and lower interest rates can increase demand. This in turn can lead to higher sales and output with little change in prices. Under slightly different conditions, increased demand leads to inflation with little or no boost in output. The impact that a change in monetary policy will have on spending and production is uncertain at best. Determining whether such a change would affect production instead of inflation will depend to a large extent on the stage of the business cycle.

Everyone involved in economic analysis will immediately agree that it is extremely difficult to determine the business cycle stance. The Reserve Bank compiles business cycle indicators for this purpose, but usually it is only possible to determine where the economy is in the business cycle a long time after the event because there is a delay in the compilation of statistics. Moreover, clear trends are needed in information before deductions can be made about turning points in the business cycle.

Even if we were able to determine accurately the business cycle stance and the extent that the production capacity of the economy is being used, it is still doubtful that monetary policy would be useful in active business-cycle management. Changes in monetary policy instruments have a long and variable lag before they have an effect on economic conditions. These lags and the fact that their length could change over time prevent any effective fine-tuning of real economic activity. To be effective, changes in monetary policy would require a forecast of the business cycle stance in the next 18 to 24 months. If it is difficult to determine the current business cycle stance, one can safely assume that it is even more difficult, if not impossible, to forecast accurately whether there will be surplus production capacity or excessive demand conditions in the economy in two years' time.

Monetary policy affects prices not only through the impact of changes in the money stock on aggregate demand, but also through inflation expectations. A major advantage of a medium to longer-term monetary policy approach is the credibility that it gives to the actions of the monetary authorities. By operating over a longer time frame, it creates a basis for its own success because of its effects on inflation expectations. The active business-cycle management of monetary policy is usually less credible.

5. Monetary policy and inflation

So far I have indicated that low inflation can make a significant contribution to growth and prosperity through its effects on resource allocation in a market-based economic system. This conclusion does not mean much if monetary policy cannot achieve and maintain low inflation. Fortunately, evidence and opinion largely agree on this issue.

One of the few topics that macroeconomists generally agree on is that inflation is first and foremost a monetary phenomenon. Inflation results from a long-term expansion of the money supply which is greater than the economy's ability to increase the production of goods and services. Furthermore, there is widespread agreement that the supply of money is determined in the long run by central banks. Thus, the South African Reserve Bank can regulate its own balance sheet and the growth in the money supply, achieve low inflation and maintain it. In fact, the Bank is expected to do just that.

An important indicator that the Reserve Bank should have available in pursuing the objective of price stability is estimates of the stock of money supply over time. To this end, the Bank's Research Department meticulously consolidates the balance sheets of banks at the end of each month. The consolidated deposit liabilities of the banks, along with the value of notes and coin in circulation, are summarised in the monetary aggregates labelled M1A, M1, M2 and M3.

In the past, the change in the broad monetary aggregate M3, relative to a pre-announced desired or guideline rate of change, was used for policy making. This approach to monetary policy making was based on the assumption that there was a fairly stable short-run relationship between changes in M3 and changes in nominal aggregate spending. Unfortunately this relationship became less reliable over time. As a result the Reserve Bank started to monitor a wider variety of economic indicators and, from the beginning of this year, shifted to formal inflation targeting. At present, monetary policy decisions are anchored directly to the achievement of a specified average inflation rate of between 3 and 6% in 2002.

It is important to note that monetary policy decision making is not an exact science, and possibly never will be, even with the most accurate macroeconomic measurements imaginable. This is why the Bank cannot base a policy decision on the deviation of a rather uncertain inflation forecast from a targeted future rate. But neither can policy decisions be a matter of sweeping, broad impressions based upon anecdotal evidence and partial information. What the members of the Monetary Policy Committee of the Bank do is to make the best professionally informed analysis they can of all the sources of information at their disposal, relating to every important market in the economy. Then they constantly review and modify their judgements, in the light of new information as it becomes available.

Policy decisions are highly complex and the Monetary Policy Committee does not take them lightly. Decisions are definitely not two-dimensional and take far more factors into consideration than an inflation and growth perspective. The committee uses a vast array of official economic statistics and financial market data, and all the publicly available and some private surveys and commentaries, to make a decision about the monetary policy stance. What is more, the Bank openly releases the facts as they are available to us, as well as the analyses made by the Monetary Policy Committee and by the research staff, regularly through the statements of the committee and in the publication of the Quarterly Bulletin and the Annual Economic Report. All policy decisions are nevertheless always taken with a view to achieving and maintaining financial stability.

6. Concluding remarks

Some commentators have rather dated views that monetary policy decisions should be aimed at maximising economic growth in the short run. I believe that the primary role of monetary policy is to preserve the purchasing value of the rand by keeping inflation low. This is also the mandate given to the Bank. To achieve this mandate, a medium to long-term approach to monetary policy formulation is followed in the form of inflation targets. Such a well-defined objective of monetary policy provides a clear understanding of the objective of monetary policy so that our economy can operate efficiently. This will promote a return to full employment and strong economic growth.

Price stability is an essential ingredient in the recipe for maximum sustainable economic growth, and it is the only contribution that monetary policy can make. There is no more important task for the South African Reserve Bank than pursuing a policy aimed at preserving the value of the rand.