T T Mboweni: The global economy and central banking in Africa

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the National Bank of Belgium, Brussels, 9 November 2004.

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1. Introduction

The global economy changed considerably in recent years with important consequences for central banking. During the last half of the previous century the world economy was characterised by a process of liberalisation, deregulation and eventually globalisation, i.e. a process through which an increasingly free flow of ideas, people, goods, services and capital leads to the integration of economies and societies. Globalisation brought increasing prosperity to the countries that became involved in it. The free flow of goods, capital and people boosted incomes and raised living standards in many parts of the world. In addition, new technological advances reduced transportation, telecommunication and computation costs. These developments did not only lead to greater operational effectiveness, but also increased the ease with which national markets could be integrated globally.

The more integrated world economy did not benefit all economies and all the inhabitants of the globe. Mr Horst Köhler, the past Managing Director of the International Monetary Fund recently stated that: "nearly 1,2 billion people - one fifth of humankind - continue to live in absolute poverty, with incomes less than $1 a day. In many countries, durable economic and social progress remains elusive. In most of these countries, trade has decreased in the last 20 years and on average, economic growth has not kept pace with population growth. The situation in Africa is particularly dramatic because it is aggravated by the AIDS pandemic. I believe that the fight against global poverty is the greatest challenge for stability and peace in the 21st century."

It is true that disease, unemployment and poverty reduction remain the major challenges confronting policymakers in Africa. For this reason it is encouraging that African leaders have embraced the New Partnership for Africa's Development (NEPAD) to confront the challenges facing the continent. NEPAD is a strategic development plan that addresses the economic, social and political dimensions of Africa's future development. It is a clear demonstration of the willingness of the leaders in Africa to take responsibility for actions needed to advance development. The vision and way forward basically consist of creating the policy environment and institutions that are necessary to translate the political commitment into economic benefits.

It is further encouraging that there has been some improvement in Africa's growth performance since the mid-1990s, albeit from a low level. The average growth rate in Africa amounted to 3,7 per cent in the period from 1995 to 2004, compared with 1,9 per cent in the preceding 10 years. This improvement was underpinned by some reduction in conflict on the continent and the achievement of greater macroeconomic stability. According to the International Monetary Fund, African economic growth is expected to rise even further to 4,5 per cent this year and to 5,4 per cent next year. While this improvement can be acclaimed, the progress needs to be accelerated. Only seven African countries achieved economic growth rates above 7 per cent during 2003 - the level required to attain the United Nations Millennium Development Goals. A continued concerted effort is therefore still required to raise living standards in Africa.

2. Price stability

An important spin-off of globalisation to the world and to some extent also to Africa has been the contribution that this process has made to the attainment of price stability. In a paper delivered at the Jackson Hole Conference of 2003, Professor Kenneth Rogoff, who was at the time the Economic Councillor and Director of Research of the International Monetary Fund, describes how globalisation has contributed to the drop of global inflation from about 30 per cent to below 4 per cent per year over the past decade. In this paper Rogoff states that although central banks deserve a lot of credit for today's low inflation rates, they cannot claim all the credit. The increased level of competition in product and labour markets, arising from the interplay of globalisation, deregulation and a decreased role for governments in many economies, was also an important factor.

These developments in the rest of the world probably contributed to the increasing emphasis placed in most African countries on the achievement and maintenance of price stability. At a conference on Monetary Policy Frameworks in Africa held at the South African Reserve Bank in Pretoria in September 2001, most of the central banks that attended the conference stated that price stability was the ultimate objective of monetary policy in their countries. Price stability was generally defined as low inflation or single digit inflation. Most of the countries indicated that they had adopted a pragmatic approach in attaining this objective, i.e. to achieve price stability as soon as possible without making policy measures too stringent.

Considerable progress has been made with this approach in bringing inflation down to lower levels. According to estimates made by the International Monetary Fund in the World Economic Outlook in September 2004, consumer price inflation in Africa will average 8,4 per cent this year and 8,1 per cent in 2005. This is a far cry from the upper 40 per cent that was recorded at the beginning of the 1990s. Moreover, the number of countries registering double-digit inflation came down from 32 in 1995 to only 12 in 2003, and 21 countries had inflation rates of less than 5 per cent last year. Monetary policy was assisted considerably by prudent fiscal policy in achieving these more favourable results. The International Monetary Fund calculates that the average budget deficit as a percentage of gross domestic product in Africa has declined from 3,9 per cent in 1995 to 1,5 per cent in 2003.

3. Monetary policy strategy

Although price stability is the overarching objective governing monetary policy decisions in almost every African country, different monetary policy strategies are followed depending on circumstances existing in the various countries. Before the 1980s direct monetary policy measures were generally applied in African countries. These measures consisted of interest rate controls, credit ceilings, foreign exchange restrictions and fixed exchange rates. This changed in the last 20 years with deregulation and financial liberalisation in the rest of the world. Since the beginning of the 1980s, African countries have generally moved to more market-based financial systems with greater autonomy and accountability applying to central banks.

Broadly there are three monetary policy strategies applied by African countries, namely exchange rate targeting, inflation targeting and monetary targeting. Countries forming part of monetary unions have fixed exchange rate regimes with each other. For example, the currencies of Namibia, Lesotho and Swaziland, as members of the Common Monetary Area, are pegged to the South African rand. Some countries that do not form part of monetary unions also prefer to link their currencies to those of other countries or to a basket of currencies. Botswana has been doing this since 1976.

Most African countries still apply monetary targeting. Of the 18 countries represented at the Conference on Monetary Policy Frameworks in Africa that was held in Pretoria, 14 targeted monetary aggregates. The operational variable used by these countries are the management of reserve balances or controlling the balance sheet of the central bank. By managing both the domestic and foreign sources of money, the growth in money supply is controlled. Taking the current financial infrastructure of these countries into consideration, the management of reserve balances to influence monetary aggregates as intermediate targets is probably the most efficient way of conducting monetary policy.

Recently, inflation targeting is becoming more popular in Africa. However, in a Working Paper of the International Monetary Fund that was prepared by Mark R. Stone, South Africa was the only African country that was regarded to have a clear commitment to inflation targeting. South Africa shifted away from monetary targeting to informal inflation targeting in the 1990s, and started to apply formal inflation targeting from February 2000. The inflation target is determined by government and at present is specified as an increase measured over twelve months of between 3 and 6 per cent in the overall consumer price index excluding the interest cost on mortgages. The South African Reserve Bank has complete instrumental independence, but is of course accountable to the citizens of South Africa. Considerable success has been achieved in bringing the inflation rate down to its present level of 3.7 per cent as of September 2004. In fact CPIX has been inside the target now for more than a year.

The instruments of monetary policy in African countries generally agree with those of other emerging-market economies and industrialised countries. In the main they consist of open market operations, treasury bill auctions, transactions in central banks' bills, repurchase agreements, foreign exchange market operations and accommodation facilities. Most of the African countries continue to make use of statutory reserve requirements. Moreover, these reserve requirements are quite high in many of the countries.

4. Banking supervision and regulation

Another important consequence of the globalisation process for central banking has been the rapid pace of consolidation of financial markets and institutions in the world over the past decade. Banks have been merged to become bigger players in the market. This consolidation was also extended to include other financial institutions. The consolidation process was not confined to domestic enterprises. Many mergers and acquisitions transcended national boundaries to create international players in an endeavour to improve profitability. Large international financial conglomerates are now a common feature of the world economy.

Developments in technology, especially the impressive growth of internet banking, have made it possible for banks to use their online operations to expand into international markets, thereby avoiding the costly process of establishing subsidiaries or branches. In this way they have become players in the retail markets of many countries, without having any physical presence. The development of information and communication technology has made it possible for non-bank institutions to obtain funds from and provide credit to the public. Large retailers have become involved in activities closely akin to banking practices. This has blurred the boundaries between a bank and other activities.

Like most other things on earth, the globalisation and consolidation of banking activities has advantages and disadvantages. On the positive side, these developments could lead to cost saving, improved profitability to the benefit of clients and shareholders, facilitating risk diversification and contributing to economic development. On the negative side, consolidation, if taken too far, could lead to abuse of dominant market positions and moral hazard issues. Excessive involvement in international markets without sufficient knowledge of local conditions could increase the vulnerability of individual banks.

One of the most serious negative consequence of financial liberalisation and globalisation is that it has made emerging market economies more prone to sudden withdrawals or inward movements of financial flows. As a result, a number of financial crises have affected the world severely since the beginning of the 1990s. I think here of the crisis in Mexico in 1994/95, East Asia in 1997/98, Russia in 1998, Brazil in 1998/99 and Turkey and Argentina in 2001. Although countries like Chile and South Africa did not experience a financial crisis, substantial reversals in international financial flows complicated the task of central bankers and had a negative impact on economic activities. For example, the substantial financial outflows in 2000 and 2001 from South Africa caused a large depreciation in the exchange rate of the rand and an increase in the rate of inflation. The subsequent reversal in these flows was accompanied by a recovery in the level of the rand above its previous spike in 2000. This forced domestic manufactures and mining companies to make significant adjustments to their development plans in order to protect profitability.

From this brief description of the pros and cons of financial liberalisation and globalisation it should be apparent that these developments have significant implications for prudential and supervisory policy, i.e. for systemic risk and the ability of the appropriate authorities to manage them. Derivatives, off-balance-sheet operations and diversification across countries and sectors have made traditional risk-management techniques obsolete and have increased the scope for and the speed of contagion. A liquidity shortage in a particular market can rapidly spread throughout the global market.

Financial regulators responded by focusing on increased transparency and by strengthening prudential regulation and supervision in a way that takes account of the increased risks. The initiatives that have been taken include addressing the deficiencies of the 1998 Basel accord; developing guidelines to consolidate financial statements; achieving better cross-country harmonisation in disclosing information; developing standards for the compilation of statistical data; and closing gaps in regulations in order to avoid regulatory arbitrage.

At first glance it seems as if the changed international environment had little impact on Africa, with the notable exception of South Africa. A number of African countries attempted to adjust their financial sectors to the changed circumstances, but achieved only limited success. These attempts were hampered by the then high inflation rates that these countries registered. In addition several banks were still publicly owned and the non-performing loans inherited from direct lending programmes before the reforms became were adopted were still very high.

The relevance of globalisation, deregulation and financial liberalisation for central banking in Africa becomes more apparent when three important elements of Africa's policy agenda are considered. As already indicated, Africa has achieved greater macroeconomic stability, and growth has increased significantly in the past ten years. However, for poverty relief, it is firstly of the utmost importance that economic growth should accelerate considerably. Secondly, gross domestic fixed investment must be increased. At a level of about 17 per cent of gross domestic product, domestic investment falls far short of levels needed for higher economic growth. African countries need to establish the economic environment to create investment opportunities for domestic and international investors. Thirdly, African countries need to strengthen their financial sectors by mobilising savings and allocating credit effectively and efficiently so that financial services are available to more people than in the past. The central banks in Africa must play a major part in this third prerequisite for the attainment of higher sustainable economic growth and poverty alleviation.

This task of central banks in Africa is more difficult than in other parts of the world. The number of standards and codes can be overwhelming and highly demanding of human and financial resources, and meeting them may overstretch the capacities of some African countries. Moreover, these standards and codes are formulated mainly for industrialised countries and may not always fully take cognisance of conditions in Africa. It will, for instance, be difficult for banks in Africa to meet international standards for limiting portfolio concentration and exposure to a single client, because in many African countries there is little economic diversification and economies are dominated by a few large enterprises. Constraints on the functioning of markets can also reduce the effectiveness of market discipline and, hence, of transparency.

Despite these kinds of problems, there is a need for fundamental reforms to strengthen institutional capacity, reduce government interference and allow markets to operate efficiently. Further financial liberalisation should lead to an increase in the quality of financial intermediation. Reforms should be undertaken to, among other things, restructure bank balance sheets by removing bad debts, privatising publicly owned banks, and introducing measures to promote competition in the banking sector. Strengthening the management and risk evaluation capabilities of bank managers and staff should also form an integral part of the restructuring process.

In South Africa we are in the fortunate position that our financial system is highly developed and diversified. We have a large number of financial institutions and sophisticated financial markets which perform the function of financial intermediation in an efficient manner. According to assessments made by the International Monetary Fund and other international organisations the banking regulations of the country and supervision of financial institutions conform to high international best practice. Our financial institutions are well managed and non-performing loans are well within the bounds of sound management. Moreover, South Africa subscribes to the Special Data Dissemination Standard of the International Monetary Fund and meets the specifications for the coverage, periodicity and timeliness of all data categories and for the dissemination of advance release calendars. The timeliness of the accounts of the South African Reserve Bank and the banking sector is even better than the due dates prescribed by the Fund.

Other African countries have launched a number of initiatives to implement the new international financial architecture. These initiatives are mainly focused on enhancing transparency and accountability, adhering to international standards and codes and maintaining financial stability. A number of African countries have launched medium-term programmes to restructure weak banks. This included measures to address non-performing loans and accumulated losses of banks. In addition, the authorities have increasingly focused on improving banking regulation and supervision, essentially through greater compliance with the Basel Committee's Core Principles for Effective Banking Supervision.

5. National payment, clearing and settlement systems

The national payment, clearing and settlement systems of central banks in Africa have also been influenced to a considerable extent by the changed global economic environment. Global trade and financial integration have led to substantial increases in cross-border flows, while financial liberalisation, the creation of new financial instruments and the development of financial markets increased the domestic payments which have to be cleared and settled. The resulting increase in the values and volumes that have to be handled by the payment systems increased non-settlement risk exponentially.

Developments in information and communication technology have changed the payments structure considerably. Although it is still in its infancy on the African continent, the volume of transactions undertaken by means of debit and credit cards have increased significantly and there are signs appearing in South Africa that this means of payment may overtake cash payments in the near future. In some African countries mobile banking facilities have come into use. This demands increased security measures and higher standards.

South Africa has put considerable effort into the revision of national payment, clearing and settlement systems. Reforming the national payment system started to receive attention in 1993. By 1995 a plan had been finalised containing the objectives, strategies, fundamental principles and critical issues for payment system reform. The implementation of this plan started off with the introduction of a large value inter-bank real-time gross settlement system in March 1998. The South African National Payment System Act was then promulgated in October 1998, which provided the central bank with the regulatory powers to oversee the safety and integrity of the national payment system. A number of refinements have since been made to the system. Recently arrangements have been finalised to include the South African rand in the Continuous Linked Settlement process before the end of the year, which will link it to the major currencies of the world and eliminate foreign exchange settlement risk through the simultaneous settlement of both legs of foreign exchange transactions.

The South African Reserve Bank not only concentrated on the development of our own domestic payment system, but also encouraged the development of payment and settlement systems in other African countries, particularly countries forming part of the Southern African Development Community. A number of these countries have accordingly modernised their payment systems considerably and many have also reviewed domestic legal frameworks to accommodate these changes.

6. Conclusion

In conclusion, it can be stated that the changes in the world economy in recent years have led to large improvements in central banking in Africa. At the same time, globalisation and financial liberalisation have complicated the task of African central bankers and the general management of the economies on the continent. Our economies are generally small open economies dependent on one or only a few export commodities. This makes them particularly vulnerable to developments in international markets affecting the demand for and the prices of their main exports. With the exception of South Africa, most of the financial markets in Africa are still thin and under-developed. They therefore depend to a large extent on foreign financing for their development needs. This, in turn, makes them vulnerable to fluctuations in international financial flows and complicates monetary policy.

Even in a country with a relatively advanced financial infrastructure, such as South Africa, international financial outflows have seriously disrupted economic developments. Swings in portfolio capital flows and leads and lags in foreign payments and receipts have at times played havoc with the exchange rate of the rand. Turnarounds in international financial flows have also harmed the efficient functioning of domestic money and capital markets and disrupted the implementation of monetary policy.

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