Dr. Stals looks at the options and strategies for monetary policy in South Africa Address by the Governor of the South African Reserve Bank, Dr. C.S. Stals, at the Twentieth Annual Investment Conference of Société Générale Frankel Pollak (Pty) Ltd. in Johannesburg on 18/2/97.

1. A sharp decline in the net capital inflow from abroad set the financial scene for 1996

The most important change in the financial situation in South Africa last year was the sudden decline in the net inflow of capital from abroad that occurred in the first quarter. A number of adverse developments at the time combined to trigger an outflow of short-term capital. Coming after three years of rather strong rises in total domestic expenditure and a growing deficit in the current account of the balance of payments, the deterioration in the capital account led to an overall balance of payments deficit that created immediate shortages in the market for foreign exchange.

After a record net capital inflow of more than R6 billion occurred in the fourth quarter of 1995, to bring the total net inflow for the year close to R20 billion, there was a small net outflow in the first quarter of 1996. The current account deficit was no longer covered by a net capital inflow and the exchange rate of the rand came under immediate pressure. With a low level of official foreign reserves, a growing deficit in the current account of the balance of payments and deteriorating prospects for a renewed inflow of capital into the country, participants in the market for foreign exchange became very nervous and reacted wildly to rumours, adverse political developments and negative news about the balance of payments, the foreign reserves, and domestic economic developments.

The initial depreciation of the rand created negative expectations which became self-fulfilling, particularly as leads and lags in short-term trade financing also moved strongly against South Africa, and South Africans became more reluctant to enter into new foreign currency denominated commitments.

The exchange rate of the rand, which in nominal terms showed an effective appreciation of 4.4 per cent from May 1995 up to the end of December 1995, then depreciated by 8 per cent in the first quarter of 1996, by 7.2 per cent in the second quarter, and by a further 9.5 per cent in the four months up to the end of October 1996. Over the first ten months of 1996, the effective depreciation of the rand in nominal terms exceeded 22 per cent. In real terms, this represented a depreciation of about 15 per cent.

An ex post analysis of the composition of the capital in- and outflows of last year provides interesting information for a better understanding of the changes that took place. Initially, it was mainly a sudden reversal in the inflow of short-term capital in the form of inter-bank and trade related financing arrangements that triggered the shortages in the market for foreign exchange. As the exchange rate depreciated and South African residents became more concerned about possible losses on foreign currency exposures, long-term foreign loans were repaid without replacement or extensions. South Africans with existing short- and long-term foreign currency commitments covered their positions forward, and the Reserve Bank's forward exchange book showed a sharp increase of the net oversold position. In the fourth quarter of last year, when short-term capital began to flow back again, there was a net outflow from the private sector of R6 billion in the form of longer-term capital, mostly for the repayment of maturing loans.

Another interesting feature of the international capital flows last year was that foreigners remained important net portfolio investors in South African securities. Non-residents increased their holdings of South African equities listed on the Johannesburg Stock Exchange by R5.3 billion, and added a net amount of R3.4 billion to their holdings of South African bonds acquired through the South African bond market. This ostensibly “volatile” element of the capital flows was therefore not responsible for the problems that developed in the South African balance of payments last year.

2. Monetary policy faced with new challenges in a situation of a deteriorating balance of payments

The abrupt decline in the capital inflows from abroad in the first quarter of 1996 confronted the monetary policy authorities with an unexpected new challenge. Since 1994, the Reserve Bank’s policy on international financial relations was to rebuild the country’s depleted official foreign reserves gradually, to relax the exchange controls on a step-by-step basis, and to restructure the market in foreign exchange gradually with the objective of enabling a more efficient market to determine not only the spot foreign exchange rate of the rand, but also the forward rate.

Good progress was made on this road during 1994 and 1995, but the country was surely not yet in a position to withstand the adverse developments of early 1996, or to protect the exchange rate of the rand against a series of determined attacks in a rather vulnerable situation. The Reserve Bank realised that it was not in a position to defend the exchange rate of the rand by providing large amounts of foreign exchange from the official foreign reserves. At the time of the dramatic decline in the net capital inflow in February 1996, the Reserve Bank held about R15 billion in official foreign reserves, while the private banking sector held an additional amount of about R4 billion in liquid foreign assets. The total of R19 billion was the equivalent of about 8 weeks’ imports. Taking account of the growing deficit in the current account of the balance of payments, the Bank could only make limited amounts of foreign exchange available to ensure that no serious shortage of liquidity would develop that could create a panic on its own.

The longer-term objectives of building up the foreign reserves to a more comfortable level, of reducing the role of the Reserve Bank in the forward foreign exchange market, and of phasing out the remaining foreign exchange controls were temporarily forced on the backburner, whilst monetary policy had to be directed more decisively towards an adjustment programme that would gradually restore stability in the market for foreign exchange.

3. The monetary policy adjustment programme

Three basic deficiencies in the underlying economic fundamentals were identified at the time that contributed to the lack of confidence in the South African economy, and in the ability of the South African authorities to restore stability in the market for foreign exchange.

Firstly, the growing deficit in the current account of the balance of payments had to be reversed, particularly after it became evident that the country could not rely on a permanent and sustainable large capital inflow from the rest of the world to cover an ever-increasing current deficit.

Secondly, the imminent danger of escalating inflation, particularly after some depreciation in the exchange rate of the rand, had to be avoided. There was a real and perceived danger that South Africa was destined for a new vicious circle of depreciation-inflation-depreciation that would unavoidably lead to a further erosion of the country's competitive position in the world markets.

Thirdly, the escalating growth rates in the domestic monetary aggregates, such as the money supply and bank credit extension, had to be reversed. By accommodating the new inflationary pressures emanating from the depreciation of the rand on a continuous basis, monetary policy would obviously aggravate the situation.

With only limited means at its disposal to finance the external deficit, South Africa had no alternative but to adjust the disequilibrium, mainly by reducing or eliminating the current account deficit. To achieve this objective, the following monetary policy strategy was followed:

Not being in a position to fix the exchange rate at any predetermined level, a depreciation of the rand was unavoidable and had to be accepted as part of the solution to the problem. The Bank sold some foreign exchange from its official reserves, not with the intention to fix the exchange rate, but rather to provide liquidity to the market and to smooth the adjustment process. As the Reserve Bank sold foreign exchange to the market to partly finance the overall balance of payments deficit, domestic rand liquidity was drained from the banking system. It was imperative for the effective working of the adjustment process that the Reserve Bank would not replace the lost liquidity through, for example, purchases of financial assets from the banks through more active open-market operations. The decline in the domestic liquidity had to be reflected in the level of interest rates. Higher interest rates would not only serve to discourage the outflow of capital, but would also reduce the domestic demand for bank credit. The market trend for interest rates to rise could not be resisted.

Monetary policy was therefore directed towards a reinforcement of and active support for a market adjustment process that would eventually restore equilibrium to the balance of payments. It was well understood that this process would not be painless, that the depreciation of the currency, the drainage of liquidity and the rising interest rates would all demand costs and sacrifices that would not be popular, and that the monetary authorities would be blamed by some ill-disposed observers for the dilemma. Any country that had established a good economic performance in one year on the basis of net capital inflow of R20 billion, and is then in the next year forced to perform on a net inflow of only R4 billion, is bound to go through some painful adjustment. South Africa was no exception.

4. The success of the monetary adjustment programme

Important changes took place towards the end of last year, and particularly after October, in the underlying economic conditions that contributed to the financial disturbances of the preceding nine months.

There was a marked slow-down in the rate of increase in real gross domestic expenditure. Official national accounts statistics for the fourth quarter are not yet available, but preliminary indications are that all the major components of gross domestic expenditure increased at lower rates in the second half than in the first half of last year. Total real gross domestic expenditure indeed declined somewhat from the first half to bring the rate of increase for the year more or less in line with the established growth rate of about 3 per cent in gross domestic product. The deficit in the current account of the balance of payments progressively declined from a seasonally adjusted annualised peak of R13 billion in the second quarter to about R9 billion in the third, and R5 billion in the fourth quarter of the year. The rates of increase in both bank credit extension to the private sector and in the money supply peaked in October 1996, before declining marginally in both November and December. The quarter-to-quarter growth in credit extension to the private sector (at seasonally adjusted and annualised rates), decelerated from 22.4 per cent in the second quarter of 1996 to 16.6 per cent in the third quarter, and 11.8 per cent in the fourth quarter. In the case of the M3 money supply, the deceleration was from 21.2 per cent in the second, to 18.6 per cent in the third, and a mere 7.6 per cent in the fourth quarter. Not only the current account of the balance of payments improved, but also the capital account. In the first nine months of the year, capital inflows and outflows almost cancelled out, to leave a small net inflow of less than R1 billion for the nine months' period. In the fourth quarter, however, the net capital inflow increased again to an estimated R3 billion. This capital inflow once again exceeded the unadjusted current account deficit with the result that the country's net foreign reserves recovered some of the losses of the first nine months of the year. The pressure in the foreign exchange market receded slightly and the rand started appreciating in November last year. Over the two months November and December 1996, the effective nominal exchange rate of the rand appreciated by 1 per cent, and during the first six weeks of 1997 by a further 9.2 per cent. This appreciation therefore partly neutralised the adverse effects of the sharp depreciation of last year.

It will, of course, not only be premature but also preposterous to claim the successes achieved in this process so far for monetary policy alone. Many other changes also took place in South Africa over the past year. There is now more political stability than a year ago; much progress has been made with the framing and implementation of the Government's Macroeconomic Strategy for Growth, Employment and Redistribution (GEAR); the Minister of Finance has confirmed and showed his determination to continue with the required policy of financial discipline that will gradually reduce the deficit in the Budget as a percentage of gross domestic product.

There is, however, still the danger of escalating inflation that cannot be swept under the carpet at this juncture. After reaching an acceptable low level of only 5.5 per cent over the twelve months up to April 1996, the rate of increase in the consumer price index escalated to 9.4 per cent in December 1996. Inflation, however, lags behind changes in the monetary aggregates and is, at this stage, still stimulated by the depreciation of the rand last year, and the relatively large increases in the money supply during the 1995/96 period. It is of the utmost importance, however, that a restrictive monetary policy shall now be retained to make sure that the rate of inflation will also gradually be tamed again.

5. Monetary policy options for 1997

It remains the main task and priority of monetary policy in South Africa to fight against inflation. During 1996, the disturbances in the foreign exchange market temporarily diverted the attention from this prime objective of monetary policy. Indeed, in the longer term, greater stability in the foreign exchange market will only become sustainable once the rate of inflation has been brought more or less in line with the average rate of inflation in the economies of our major trading partners and international competitors.

Despite the periodic efforts of media reporters to extort a commitment from the authorities to a certain pre-defined exchange rate for the rand, it remains our view that in the contemporary complex market for foreign exchange, it is not possible to define an equilibrium exchange rate a priori, or, in the case of the South African Reserve Bank, with the limited amount of foreign exchange at its disposal, to manipulate the exchange rate of the rand permanently in any direction against market forces.

As far as the Bank’s policy on foreign exchange is concerned, it is hoped that the more favourable conditions now experienced in the market will continue throughout 1997, and will enable us to pursue the longer-term objectives of:

building up the total foreign reserves to a more comfortable level; reducing the Reserve Bank’s role in the forward foreign exchange market; and gradually phasing out the remaining exchange controls.

To the extent that these three objectives provide conflicts within themselves, important policy decisions will have to be taken between the Bank and the Minister of Finance on the relative importance that should be attached to each one of the objectives in an appropriate policy matrix.

With the attention now being refocused on domestic policy objectives, the rising rate of inflation has become a matter of major concern. In this situation, the Reserve Bank regards it as a minimum precondition for arresting this imminent threat to financial stability that the rates of increase in bank credit extension and in the money supply will be reduced soon to more acceptable levels.

With the prospects for real growth in the economy at a rate of between 2 and 3 per cent, and the desire to keep inflation to below 10 per cent, the money supply should obviously not increase by more than about 10 per cent during the current calendar year. This will require the Reserve Bank to persist with a relatively restrictive monetary policy for the time being.