Dr. Stals elucidates the functions of the South African Reserve Bank
Presentation by the Governor of the South African Reserve Bank, Dr. C.Stals, to the NEDLAC Executive Council in Johannesburg on 28/2/97.

1. The mandate to the South African Reserve Bank

The South African Reserve Bank was established in 1921 in terms of a special Act of Parliament. At that time, central banks existed mainly in Europe, and the SA Reserve Bank was only the fourth central bank founded outside Europe. There already existed central banks in the United States of America, Japan and Java.

Since its establishment, the Reserve Bank was always privately owned. Today, the Bank has more than 700 shareholders. The shares of the Bank are listed on the Johannesburg Stock Exchange and, in terms of the Act, no individual shareholder is allowed to hold more than one-half per cent of the capital of the Bank. The Bank may also never pay a dividend of more than 10 per cent per annum on the nominal value of its capital. The market price of the share therefore behaves like a government bond with a 10 per cent coupon.

The Bank is managed by a Board of 14 Directors, seven of whom are elected by the shareholders to represent them on the Board. Without holding any shares in the Bank, the Government (President) has the right to appoint the other seven Board members. The seven appointed by the President includes the Governor and three Deputy Governors, who are full-time executive members, plus three part-time Directors.

The functions of the Bank changed over time. When the Bank was originally established in 1921, its main task was to develop money and capital markets and a banking system in South Africa that would be independent of London. Today its main task, as defined in terms of the South African Reserve Bank Act and in the Constitution of the Republic of South Africa, is to defend the value of the rand, that is, to keep inflation as low as possible. This is very much in line with contemporary central banking all over the world. Since 1980, most central banks have accepted a similar mission. The latest example is perhaps the People's Bank of China, whose mandate has been changed as from March 1995 to maintain the stability of the Chinese yuan, and in this way to promote economic growth.

The Board of the Reserve Bank has been given an important degree of autonomy for the execution of its duties. In terms of the Constitution:

> "The South African Reserve Bank, in pursuit of its primary objective, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters".

In terms of Section 32 of the Reserve Bank Act, the Bank must submit a monthly statement of its assets and liabilities and an annual report to Parliament. The Bank is therefore accountable to Parliament. The Governor of the Reserve Bank holds regular discussions with the Minister of Finance, and appears before the Parliamentary Standing Committee on Finance from time to time.

The Board of the Bank has delegated its powers on important monetary policy decisions to a sub-committee of the Board, known as the Governors' Committee and comprising the Governor and three Deputy Governors. There is also an Audit Committee and a Human

Resources Committee of the Board that meet regularly on aspects of internal finance and administration. The full Board meets four times a year.

The Bank has a total staff of about 1900 people and operates from its Head Office in Pretoria and seven branches maintained in the major cities of South Africa.

2. Why must inflation be controlled?

The main task of the Reserve Bank is to protect the value of the currency. The business of a modern central bank is the business of money. Central banks are given the right to issue money by their governments. That is why the Reserve Bank is accountable to Parliament and why its surplus profits are paid over to the Treasury. The right to issue money (bank notes and coin) makes the central bank a very powerful institution that can easily be misused for sectoral interests. That is why it must be able to act in the national interest -- what is good for the total economy is important, and not what any specific group or sector may desire.

In modern sophisticated financial systems, surrogates for real money (bank notes and coin) developed, such as bank cheque accounts, credit cards and electronic transfers. Private banking institutions now create more money (means of payment) than the central bank. In order to fulfil its task of protecting the value of the currency, the Reserve Bank must therefore also have some powers to control the money creation capacity of the banking sector. In South Africa today, bank notes and coin in circulation account for less than 5 per cent of the money supply. The rest is money created by banking institutions over which the Reserve Bank has but an indirect control.

Money serves the purpose of a means of payment. It is also a unit of account in terms of which the value of goods and services are measured. It serves thirdly as a store of value for the savings of the community. These three functions of money make it essential that the value of money shall remain as stable as possible. No modern market-oriented economy can function well if the value of its currency is not kept stable.

Inflation is a continuous decline in the value of money. This will be reflected in a continuous rise in the prices of goods and services. In a market economy, certain prices of specific goods and services will always change to reflect changes in underlying forces of demand and supply. It is indeed essential that relative prices of goods and services will change in a market economy to bring about equilibrium and support maximum economic growth. It becomes a problem for the efficient functioning of the economy if all prices generally increase over time, because this will confuse the signals emitted by the market system through the mechanism of relative price changes. The many disadvantages of inflation therefore include: the distortion of the efficient working of the market system through its disruptive effects on the price mechanism; a reduction in the usefulness of money as a unit of account. You cannot properly measure and compare values of goods and services if you have to use a variable or elastic yardstick; and an erosion of the value of money as a store of wealth. Savers will not be prepared to accumulate wealth in an asset that loses its value over time.

Because of these effects of a decline in the value of money, high rates of inflation inevitably lead to a decline in the efficiency of the market economy, a decline in savings and, in the longer term, a lower rate of growth for the economy as a whole. Other more direct disadvantages of inflation can be summarised as follows:

People with fixed incomes, for example salaries or pensions, are affected more by inflation than the wealthy who can partly protect themselves against inflation, for example by investing in property or equities. Inflation therefore leads to an increase in the disparity between the “haves” and the “have-nots”. Inflation makes forward planning more difficult. A person may, for example, save for his whole working life for a pension, just to find at the end of his career that his savings have been eroded by inflation. Inflation in one country at a level higher than inflation in other countries create many difficulties for international financial relations. The exchange rate of the country that becomes out of line because of this difference, must depreciate continuously to keep local industries and other producers (e.g. gold mines) competitive. Depreciation in itself can lead to more inflation and a vicious circle of more-inflation-more-depreciation can easily get out of control and destroy the whole economy. Inflation is inclined to feed on itself. It is almost impossible to keep a little bit of inflation always just a little bit. As long as there is inflation in the economy, monetary authorities must remain on their guard. Even if relatively low inflation can be tolerated, there is always a danger that the rate of price rises will increase.

Because of all these adverse characteristics of inflation, this illness of the market economy often leads to serious social disruption which brings with it political instability. It is therefore in the interest of the economy, the social structure and the political system that a government and its people shall always be prepared and ready to fight inflation.

3. The causes of inflation

Inflation is a rather complex phenomenon of the economy. There is no single cause of inflation. It can find its origin in the rest of the world, and can therefore be imported from abroad. It can be caused by excess demand, that is, by a desire of an economy to absorb more goods and services than it can afford to supply (from domestic production plus imports). The excessive demand can emanate from government expenditure, private sector consumption expenditure, or even fixed investment. It can be caused by wage increases in excess of productivity rises that will lead to an increase in the labour cost per unit of production. It can be generated by monopolistic practices that can be misused to generate surplus profits for entrepreneurs.

Whatever the basic causes of inflation might be, it is normally accompanied or accommodated by excessive increases in the money supply. Indeed, inflation may often find its origin in excessive increases in the money supply when monetary policy is used as a deliberate instrument to provide artificial stimulation to the economy. In any national programme to keep inflation down, the control of the money supply must be included as an indispensable component of the total package. Restricting the growth in the money supply will make it impossible for inflationary impulses, even of a non-monetary origin, to escalate and permeate in continuous price rises.

In the South African economy, there are many inflationary forces at work at all times. The task of the South African Reserve Bank is therefore not an easy one. Because of these many inflationary forces, the Bank must apply a policy that at times seems to be over-restrictive -- an approach that is necessary in order to neutralise the inflationary effects of many non-monetary actions that are exerting upward pressure on prices all the time.

4. The monetary policy model of the Reserve Bank

Most central banks in the world pursue the same prime objective of protecting the value of their currencies. Not all central banks, however, follow the same model in the implementation of monetary policy. The Reserve Bank's policy is a "monetarist" approach based on the direct control of the money supply. Controlling the money supply is seen as an intermediate objective in reaching the ultimate objective of controlling inflation.

Some countries target inflation directly in the monetary policy model. Taking account of the many causes of inflation, direct targeting of inflation requires broad co-ordination of macroeconomic policies such as fiscal policy, trade and industrial policies, labour policies, and international economic relations policies. It should indeed be based on a broad accord of a consistent macroeconomic policy framework that will support the need for keeping inflation down. Low inflation is no guarantee for higher economic growth and development, but it is an important precondition for attaining better standards of living for all the people of the country on a sustainable basis.

In some other countries, monetary policy is anchored to a fixed or stable exchange rate formula, instead of to the money supply. This is perhaps good for countries with a relatively open economy (such as South Africa is now becoming). It is a precondition for the successful implementation of this type of model that the country will be able to stabilise the exchange rate through regular intervention in the foreign exchange market. To begin with, the central bank must have access to a substantial amount of foreign reserves to enable it to intervene in the market for foreign exchange in a meaningful way.

The South African model for monetary policy is, however, based on controlling the money supply. Within the family of monetarists, there will always be differences of opinion on what the most appropriate definition is for the money supply, on how this money supply should best be controlled, on when and how actions by the central bank must be triggered, etcetera. The basic objective remains, however, to keep the rate of increase in the money supply within reasonable limits.

The Reserve Bank's policy is seen to be rather accommodative and does not comply with the strict money rule of not tolerating any inflation. Guidelines for an acceptable rate of increase in the M3 money supply are announced at the beginning of each year on what growth in the money supply will be good or tolerable in the South African economy. For 1996, guidelines were set at between 6 and 10 per cent, providing for real growth of 3 to 4 per cent, and inflation of 6 to 7 per cent. Pure monetarists would have required growth in the money supply of not more than 4 per cent (the growth in the real economy in a similar situation).

The money supply guidelines set by the Reserve Bank should not be seen as targets that must be achieved at all cost. They only serve as guidelines and contribute towards making monetary policy more transparent. As long as the actual growth in the money supply exceeds the guidelines, monetary policy must remain restrictive. Scope for an easier monetary policy develops only as and when actual growth in the money supply moves to within the guideline range.

As previously indicated, money is created in South Africa mainly through the actions of private banking institutions. When they give credit to their clients, they create money. The Reserve Bank's obligation to control the money supply, therefore, extends to a control over the total amount of new credit extended by banking institutions.

The rate of increase in the total amount of bank credit outstanding is determined by two sides of a market formula: the amount of credit that banks can supply at any time, and the total demand of funds emanating from the borrowers of funds. The supply side of the formula depends on how much liquidity the banks have at their disposal for funding their lending operations. The Reserve Bank therefore has a vested interest in influencing or managing the amount of liquidity available to the banks. The Reserve Bank has a number of instruments at its disposal to influence the liquidity of the banking system, such as open-market operations, discount window facilities, and cash reserve requirements.

The demand side of the formula is very much interest rate driven. Higher interest rates will depress the demand, and lower interest rates will increase demand. The level of interest rates is to an important extent determined by forces of demand and supply operating through financial markets, but can also be influenced by the Reserve Bank's own intervention in the markets. To meet its obligation of controlling the money supply, the Reserve Bank must ensure that the amount of liquidity available in the banking system and the level of interest rates will be such that there will be no excessive increase in the money supply. Excessive increases in the money supply will eventually, after a time lag which can be as long as two years, accommodate rising, or cause higher, inflation with all the disadvantages thereof.

Interest rates therefore play a vital role in the fight against inflation. It is one of the main operational instruments used by central banks to ensure an acceptable rate of growth in the money supply.

In summary, the monetary policy model followed by the Reserve Bank can be seen as follows:

> To support maximum sustainable economic growth and development; the rate of inflation must be kept low (the value of the currency must be protected); to achieve this objective, the rate of growth in the money supply must be kept within an acceptable range (the guidelines); as money is created, mainly through bank credit extension, monetary policy must be directed towards some control over bank credit extension, which requires some management of the amount of funds available in the banking system, and a consistent interest rate policy.

If this model is applied consistently and with success, the rate of inflation will be low, which will lead to a more stable exchange rate of the rand. The exchange rate therefore becomes a result of the model and not a starting point.

In such an environment of overall financial stability, it will be possible to achieve and sustain a maximum real rate of growth and development in the economy.

5. Successes achieved in the past

The present model of monetary policy was designed by the Commission of Inquiry into the Monetary System and Monetary Policy (De Kock Commission) during the course of the 1980's and was implemented in South Africa more vigorously since 1989. The results achieved since then can be summarised as follows:

In 1988 total credit extended to the private sector increased by 28 per cent which was, of course, far out of line with growth in the nominal value of the total gross domestic production of South Africa. The M3 money supply increased by 27 per cent and released massive inflationary pressures in the economy.

Through a continuous and consistent restrictive monetary policy, the rate of increase in bank credit extension was gradually reduced, and in 1992 and 1993 it dropped below 10 per cent per annum. The rate of increase in the money supply also declined to 8 per cent in 1992 and 7 per cent in 1993. The rate of inflation followed and declined to below 10 per cent for the first time in 20 years in 1993. For the past four years, the average annual rate of inflation has now stayed below the 10 per cent level, and last year inflation of 7.4 per cent (average for the twelve months) represented the lowest annual average rate of inflation in South Africa for the past 24 years.

Ominous signs developed over the past two years, however, with the rate of increase in bank credit extension escalating again to 18.7 per cent in June 1996. The rate of increase in the M3 money supply also rose to 16 per cent in October 1996, while inflation gradually crept up from a low of 5.5 per cent over the twelve months up to April 1996, to 9.4 per cent over the twelve months up to December 1996.

The current stimulus for inflation emanated mainly from the depreciation of the rand last year, but there is a danger that, if not checked at this stage, it could easily be converted into a new cycle of a continuous rise in the rate of inflation. The Reserve Bank was therefore forced once again during the past year to pursue a more restrictive monetary policy that led to an increase of approximately 3 percentage points in the level of interest rates.

Towards the end of 1996, the more restrictive policies began to produce results when both the rates of increase in bank credit extension and in the money supply slowed down. Over the twelve months up to December 1996, bank credit extension to the private sector rose by 15.7 per cent, and the M3 money supply by 13.7 per cent, both marginally down from the peaks established earlier in the year.

Inflation is, however, still creeping upwards and it will take some time before the full effect of the depreciation of the rand will work itself out. In the meantime, it is of great importance that all other inflationary impulses in the economy, such as excessive rises in government expenditure or real wage rises in excess of productivity increases, and of course, a continuation of the excessive rates of increase in the monetary aggregates, must be avoided.

The depreciation of the rand can bring many benefits for economic growth and development, provided the advantages for international competitiveness will not be dissipated very quickly by rising costs of production and a rising rate of inflation in the domestic economy. The year 1997 is indeed a testing period for the Reserve Bank and for the monetary policy applied by the Bank. Should the Bank fail in its efforts to protect the value of the currency at this stage, the goals set by Government for economic reconstruction and development, and the implementation of the Government's Strategy for Growth, Employment and Redistribution will not be attainable.