Mr. Stals looks at the effects of the changing financial environment on monetary policy in South Africa Address by the Governor of the South African Reserve Bank, Dr. C. Stals, at the Annual Dinner of the Pretoria branch of the Economic Society of South Africa held in Pretoria on 15/5/97.

1. The objectives of monetary policy

The Gerhard de Kock Commission of Inquiry into the Monetary System and Monetary Policy in South Africa laid the foundation for the monetary policy model applied in South Africa over the past decade. Although the De Kock Commission's final report on monetary policy was submitted in May 1985, it was only since 1986, when money supply targets were first introduced, that the implementation of the model took its course. Indeed, full implementation only came about after the untimely death of Gerhard de Kock in August 1989.

In line with monetary policies applied in most developed economies, the South African monetary policy model is firmly directed towards the overall objective of creating and maintaining a stable financial environment. For central bankers, the ultimate price of a stable financial environment is a low rate of inflation -- a rate that, in the words of Alan Greenspan, will have no material effects on the macroeconomic decisions of consumers, investors, traders, producers and all other participants in total economic activity.

This monetarist approach to monetary policy does not imply that central bankers have no interest in or sympathy for the national objectives of economic growth, job creation and the improvement of the living conditions of the people. On the contrary, central bankers believe that maximum economic development can only be achieved and sustained in an environment of stable financial conditions. The efforts of monetary policy must therefore be directed towards what central bankers can do best in support of the national objectives, and that is to manage the money system of the country in the interest of overall economic development.

A stable financial environment is a precondition for sustainable economic development, but provides no guarantee that the real economy will indeed perform at maximum capacity. There are too many other macroeconomic (and non-economic) factors that will in the end determine the actual economic growth performance. There is, however, convincing theoretical logic and much empirical evidence to confirm that persistent unstable financial conditions are detrimental for growth, particularly in a country with an economy based on the principles of the market mechanism.

The De Kock Commission therefore in 1985 summarised its findings as follows:

"(The Commission) does not believe, for example, that anything can be gained in the long run in terms of real growth or employment by accepting higher inflation rates. The opposite is more likely to be true. Higher inflation will in the long run militate against growth and job creation. The objectives of external balance, growth and employment will over time be served best by creating and maintaining a climate of reasonable domestic price stability". (Par 47)

2. The changing financial environment

The deliberations of the De Kock Commission took place in an overall socio-political and economic environment that was completely different from what we have to contend with in South Africa today. With his wisdom and his foresight, Gerhard de Kock may have envisaged, and surely wished for, an environment in which monetary policy could be applied without the shackles of sanctions, boycotts, exchange controls, high inflation, social unrest and political distortions that characterised the period of his domain.

Over the past decade, the situation has changed dramatically. The major socio-political reforms of the early 1990's opened up the way for a normalisation of South Africa's position in the world environment. Also in the field of economic and financial relations, South Africa has been reintegrated in the international community from which it was excluded over the preceding two decades. The international economic punitive actions against South Africa were repealed in great haste after the Government of National Unity took power in April 1994, and South Africa took its rightful place again in international forums such as the United Nations, the Bretton Woods Institutions (IMF and World Bank), the Organisation of African Unity, and the British Commonwealth of Nations.

South Africa became reintegrated into a world financial system that was vastly different from the one it had left in the late 1970's and early 1980's. The explosive developments during its absence in electronics and in communications, and the revolutionary trans-formation from mainly manufacturing/trading economies to a new service/information based culture, led to a strong movement of globalisation in financial market activity. This process forced the liberalisation of domestic and international financial markets in many countries, led to the abolition of exchange controls and exposed countries more directly to the disciplines of international markets.

Today in South Africa, there are more than 60 foreign banks that compete through representative offices, branches and subsidiaries with the domestic banks to provide financial services to the South African community. We are in the process of gradually removing our exchange controls to join the other approximately 60 (out of 185) countries of the world, that have already succeeded in removing all restrictions on current and capital account international transactions. Non-residents participate very actively in the South African market for foreign exchange and in the domestic money and capital markets. Prices on the Johannesburg Stock Exchange and the Bond Exchange of South Africa are affected almost instantaneously by developments in the rest of the world. Volumes in these markets have exploded to a level that a De Kock Commission of fifteen years ago could not anticipate, not even in the wildest flight of the imagination.

Recent changes in the South African community led to the more active absorption of many South Africans in the market economy. Latent demands were stimulated by the reforms and many expectations were created by the new political dispensation. The emphasis in fiscal policy has changed dramatically, with the retention, fortunately, of basic sound disciplines.

The South African banking sector had to be restructured to provide for thousands of informal savings clubs (Stokvels) and for community banking. There is even pressure on the Reserve Bank to legalise fraudulent pyramid schemes such as those that recently brought the country of Albania to anarchy.

3. The implications for monetary policy

The question does arise whether all these changes did not make the findings of the De Kock Commission irrelevant. Should monetary policy still hold onto the same objective, and has the task and the functions of the central bank perhaps not also changed over the past few years?

The Reserve Bank believes, however, that the main objective of monetary policy as defined by the De Kock Commission is as important and warranted today as it was in the mid-1980s. Indeed, in the environment of a greater involvement of international participants in the South African financial markets, it is of even greater importance that South Africa shall maintain overall financial stability, that our rate of inflation shall be brought more in line with the average rate of inflation in the economies of our major trading partners, and that internationally recognised sound monetary and fiscal policies shall be applied at all times. The main objective of monetary policy in the new South Africa must remain to protect the value of the currency.

Critics of this unbending attitude of the Reserve Bank often confuse the objective of monetary policy with three other aspects of Reserve Bank operations, namely the strategy followed by the Bank in pursuance of its objective, the operational procedures applied by the Bank, and the instruments used to achieve its objective. There may be a need at this juncture, in light of the major changes of the past few years, to reconsider some of these aspects of monetary policy that have more to do with the implementation of the policy, and not with the objective.

The strategy of a central bank can be described as the model it uses to pursue the non-negotiable objective of protecting the value of the currency. On recommendation of the De Kock Commission, the South African monetary policy model was based on monetary targeting which anchors monetary policy decisions to changes in the money supply. This model worked extremely well, particularly in the times of South Africa’s economic isolation from the outside world. It is doubtful, however, if this model is still the most effective strategy to maintain in the new environment. It has, for example, become much more difficult for the Reserve Bank to control the money supply in a situation where so many foreign banks operate in South Africa, and where South African banks have so much easier access to financial resources from correspondent banks in the rest of the world.

It is also a debatable issue whether the demand for credit in South Africa is not in the new environment less sensitive to interest rate changes than before. And, furthermore, the relationship between changes in the money supply and eventual price changes may have become much weaker now that the volumes of transactions in the financial markets have increased so much relative to turnovers in the markets for goods and services.

There is no doubt that the money supply has lost some of its usefulness as an anchor for monetary policy. With South Africa not yet being ready for direct inflation targeting, and with our inability to fix the exchange rate of the rand because of a lack of foreign reserves, the Reserve Bank is gradually moving to a more ecclesiastic approach where a wider range of monetary indicators are being used as a basis for monetary policy decisions. This wider range of indicators includes changes in bank credit extension, the overall liquidity in the banking system, the level and the yield curve of interest rates, changes in the official foreign reserves and in the exchange rate of the rand and, of course, actual and expected movements in the rate of inflation.

The operational procedures of the central bank include the methods used for providing accommodation to banking institutions, open market operations, intervention in the foreign exchange market, the manipulation of interest rates, and the signalling to markets of policy intentions. The South African Reserve Bank’s main operational procedures over recent years have been what the De Kock Commission described as the “classical cash reserve system as a means of controlling bank credit creation, rather than the socalled American cash reserve system”. (Par. 76)

Without going into the details, in the South African system the Reserve Bank uses its open market operations and other instruments of monetary policy to force banking institutions to borrow more from the discount window whenever it is regarded as necessary to apply a more restrictive policy. At some stage, the Reserve Bank will then also raise the Bank rate which, in a situation of great dependence on the central bank, will force the private banks to follow with increases in their lending and deposit rates.

Many other central banks operating in sophisticated financial markets are now influencing short-term interest rates more directly with their operations in the markets. Instead of overnight loans provided at the discount window, they enter into repurchase transactions with banking institutions, with the added advantage that it can be coupled with a tender system for central bank money, and a variable Bank rate.

The South African Reserve Bank will also have to introduce greater flexibility in the operating procedures for the implementation of monetary policy if we want to cope with the volatile international capital flows, exchange rate changes, and financial assets price movements. It is of some concern to the Reserve Bank that over the past year interest rates in the South African money market seem to have become more rigid. In the present system, the Bank no longer gets reliable signals from market interest rates on changes in the underlying financial conditions. If necessary, the operational procedures of the Bank will have to change to bring more interest rate flexibility into the money market.

Finally, the instruments used for monetary policy may also have to be adapted to the changing financial environment. In the past, the Reserve Bank, for example, often used the Exchequer Account of the Government for the short-term withdrawal of surplus funds from the money market. The recent introduction of an improved system for tax and loan accounts held by Government with private banks, rules out the extensive use of this instrument for monetary policy purposes. Similarly, arrangements now under negotiation with the Department of Finance to relieve the Reserve Bank of the responsibilities for the primary issue of Government bonds, and for the development of the secondary market in these bonds, will also change the Bank's position in the capital market. It opens up the way for the Bank to have a more single-minded open market policy approach.

The introduction of repurchase transactions in strictly defined acceptable underlying financial assets will also provide an instrument of monetary policy that is more malleable and can be adapted easier to the needs of the new financial environment of which South Africa is now rapidly becoming an integral part.

4. Conclusion

There is much room for a continuing debate in South Africa on monetary policy, but not so much on the issue of what the objectives of monetary policy should be, or whether inflation is bad or good for the overriding objective of creating more jobs in the country. The debate should rather concentrate on the effectiveness of the strategy, the operational procedures and the instruments used in the pursuance of a monetary policy objective that has in any case been casted in iron in the Constitution of the Republic of South Africa.