Mr. Stals considers the role of monetary policy in stabilising the business cycle during the pre- and post-election period Address by the Governor of the Reserve Bank of South Africa, Dr. Chris Stals, at the Annual Conference of the Bureau for Economic Research, in Cape Town, on 7/11/97.

1. Introduction

In the implementation of monetary policy the Reserve Bank should not be influenced by the fact that an election will take place in South Africa in May 1999. The reference to the "pre- and post-election period" in the title of this address should therefore be regarded as coincidental. As always, monetary policy should be guided by developments in financial aggregates such as the money supply and bank credit extension, with the obvious objective of protecting the value of the currency.

In contemporary monetary policy, central banks are normally also not guided by the objective of "stabilising the business cycle". It is the task of monetary policy to promote a stable financial environment at all times, irrespective of the current phase of the business cycle. There is, however, a definite relationship between developments in real economic activity ("the business cycle") and in the financial aggregates relevant for monetary policy. By concentrating on the trends in the financial aggregates, and not in real economic activity, monetary policy, however, has a better chance of maintaining financial stability that will, in the longer term, be conducive for sustainable economic growth at a higher level.

A former Governor of the Reserve Bank of Australia once said the following:

"There was a recognition that (monetary) policy had to do more than stabilise the cycle: the problem with an exclusive focus on the business cycle was that we may well stabilise the real side of the economy without stabilising the price side of the economy". (Governor M.J. Phillips, When the Music Stops, Reserve Bank of Australia Bulletin, July 1990).

A slowdown in the business cycle will normally also include a slowdown in real gross domestic expenditure, incorporating declines in the growth rates of both consumption and investment expenditure. Such slowdowns, however, may not yet at the time of the decline in expenditure justify the relaxation of monetary policy. The slowdown in real expenditure will after some normal time-lags be followed by a decrease in the demand for bank credit, which will also lead to a decline in the rate of growth in the money supply. Timing monetary policy decisions to coincide rather with changes in the monetary aggregates and not with changes in real economic activity reduces the danger of a premature re-stimulation of the demand for bank credit, and a too early injection of excessive amounts of additional money. A monetary policy linked to changes in the business cycle could easily lead to the re-emergence of the harmful stop-go policies so often pursued by central banks in the 1960s.

2. 1997 - A year of macroeconomic consolidation

Developments in the South African economy in the early months of 1996, and particularly the currency crisis of February last year, exposed certain weaknesses that were developing in the South African economy at that time, and that needed early correction. The signs were already there in the first half of 1996 that the calendar year of 1997 would turn out to be a year of macroeconomic consolidation.

Now, eighteen months later, we can look back with some satisfaction on the progress that has been made in restoring overall economic equilibrium. Firstly, in the area of real economic activity, equilibrium has been restored not only in the growth rates but also in the absolute levels of total gross

domestic product and total gross domestic expenditure. After increases of about 6 per cent per year in 1994 and 1995, the growth in gross domestic expenditure slowed down to 3 per cent in 1996, and to almost zero so far in 1997. The rate of growth in total production also slowed down marginally, but was still maintained at a positive level of about 2 per cent in the first nine months of 1997.

These developments in real economic activity over the past eighteen months were reflected in an improvement in the overall balance of payments. The seasonally adjusted and annualised rate of the current account deficit declined from R13 billion in the second quarter of 1996 to R3½ billion in the second quarter of 1997. This improvement contributed to the adoption of a more positive attitude by foreign investors and the net capital inflow increased from less than R4 billion in the full year of 1996 to more than R16 billion in the first half of 1997. In light of the surplus that emerged on the overall balance of payments, the total gross gold and foreign exchange reserves held by the banking sector increased by R14 billion from about R17 billion at the end of December 1996 to about R31 billion at the end of June 1997.

Thirdly, the excessive rates of increase in the money supply and in bank credit extension in 1995 and 1996 also marginally slowed down in 1997. In the third quarter of 1997, the seasonally adjusted amount of the money supply increased at an annual rate of 12.2 per cent, and that of total domestic credit extension by the banking sector by only 6.3 per cent.

Finally, in the consolidation process, South Africa succeeded in absorbing the unavoidable increase in inflation in the aftermath of the depreciation of last year. As was expected, the rate of increase in consumer prices accelerated from 5.5 per cent in April 1996 to 9.9 per cent in April 1997 but then declined again to 8 per cent in September 1997. In the third quarter of 1997, inflation was indeed running at an annualised rate of 6.6 per cent, back on track again towards the medium-term objective of bringing the rate of inflation in South Africa more in line with the average rate of inflation in the economies of our major international trading partners and competitors.

The parts played by changes in the exchange rate of the rand, and in interest rates, in bringing about better equilibrium should not be underestimated. The average weighted value of the rand against a basket of currencies first depreciated by about 23 per cent during the first ten months of last year, before it appreciated again by 11 per cent from 31 October 1996 to 13 March 1997. Since then it followed a more steady path and depreciated by about 10 per cent in the next seven months. At the end of October 1997, the average weighted value of the rand was only marginally down from its level of 31 December 1996.

Liquidity was initially drained from the money market after the foreign capital inflows subsided in February 1996, and the money market shortage gradually increased to reach a peak of more than R10 billion in March 1997. Since then, the situation eased again to an average daily shortage of only about R5 billion in October 1997. Interest rates obviously followed these trends and increased quite sharply during the course of 1996 but then declined again in 1997. The rate on three months bankers' acceptances for example reached a peak of almost 17 per cent at the end of November 1996, before declining to 14.9 per cent at the end of October 1997.

The macroeconomic consolidation process therefore without any doubt created a sounder and better balanced overall economic basis on which a next phase of more rapid economic expansion can now develop.

3. The role of monetary policy

After the exchange rate crash of February 1996, the monetary policy approach was to let market forces work with some intervention by the Reserve Bank in the foreign exchange and in the money markets, but mainly with the intention of supporting an orderly adjustment in market prices. It

was never the intention to try and fix the exchange rate of the rand at any predetermined artificial level, neither did the Bank try to keep interest rates unrealistically low.

It was furthermore accepted that, after the relatively large depreciation in the exchange rate and taking account also of the "openness" of the South African economy, the rate of inflation would rise. The challenge for monetary policy was, however, to constrain the rate of increase in inflation to a first round effect only, and to prevent prices from going into an uncontrollable and perpetuating inflationary spiral.

In retrospect, the policy seemed to have worked quite well. The restrictive monetary policy, and particularly the rise in interest rates, were not received with unanimous support by all sectors of the South African community. Interest rates, however, remain one of the main disciplines of the market economy and countries that are not prepared to bear the effects of this discipline from time to time will be punished by the markets. This basic lesson is now being learned again by a number of countries in the East Asia region where interest rates recently soared to a much higher level than ever experienced by South Africa.

Now that the overall macroeconomic consolidation process has made good progress, there are some impatient pressures building up on the Reserve Bank to relax monetary policy quickly and decisively. Some of these pressures are still based on the now defunct Phillips curve or an assumed trade-off between inflation and growth -- an argument that was buried in most countries of the world already in the 1980s when macroeconomic policy switched the emphasis from a demand-management approach to a supply-side solution. The rapid expansion of communications and the increase in electronically driven capacity for economic analyses further contributed to the more effective implementation of pre-empting expectations, and reduced the opportunity for central bankers to stimulate economies in the short term by applying over-expansionary monetary policies.

The South African Reserve Bank now follows the lead of many other central banks in the world to base monetary policy decisions on developments in financial or monetary aggregates, and not on changes in real economic activity. Indeed, the latest fashion is for central banks, together with governments, to target inflation more directly. Taking account of typical time-lags that exist between the implementation of monetary policies and their eventual effect on prices, monetary policy adjustments are based on the expectation of what the rate of inflation may turn out to be twelve to eighteen months downstream. Reliable forecasting therefore has become as important for the monetary authorities as they are for private sector operators in the markets. For this purpose, the familiar monetary aggregates such as the money supply, bank credit extension, the level of interest rates and the shape of the yield curve and changes in the exchange rate provide the best indicators available in the short term to guide monetary policy decisions.

What will be important for the stance of monetary policy over the next year will not be the approaching election in 1999, but rather current developments in these well-known basic financial aggregates. Apart from contending with the after-effects of the depreciation of the rand last year, the major concern for the Reserve Bank recently has been the continuous increase at a high rate in the total amount of bank credit extended to the private sector. Over the past few months there has been a significant slowdown in the annualised rate of increase in bank credit extended to the private sector which amounted to 21.2 per cent in the second quarter of 1997, before declining to 9.5 per cent in the third quarter. After the recent downward adjustment in the financial markets in South Africa, we may find some further slowdown in the rate of increase in bank credit extension, to reflect more truly the slowdown which already occurred in real economic activity.

Recent events in the international currency markets proved once again that the forecasting of possible future developments in financial aggregates can be very perilous. As South Africa liberalises its financial markets further and as the South African financial system gets more integrated into an extremely volatile international environment, the hazards of forecasting will increase. For the central bank, this unfortunately reduces the value of strictly defined monetary policy models, and makes

the task of implementing policies more discretionary. Market participants prefer a monetary policy based on pre-announced rules and want to be in a position where they can pre-empt important changes in monetary policy for their own advantage, and for the sake of giving good advice to their clients. This, however, is not possible in the present environment where unpredictable events in far-away places such as Thailand can have profound influences on monetary developments in South Africa.

Forecasting possible developments in the exchange rate of the rand, for example, must not only take account of developments in South Africa, but also of possible changes in the cross exchange rates of major currencies, developments in international capital markets, economic and political developments in a number of emerging economies and a multitude of other possible global developments. As illustrated over the past year, changes in the effective exchange rate of the rand in turn can have many effects on monetary policy decisions in South Africa. In this multi-complex environment it is just unreasonable to expect of any governor of any central bank anywhere in the world to signal to markets in advance what adjustments in interest rates or other monetary policies could be expected over the next year.

4. A greater reliance on markets

In the situation, it is advisable to rely more on market forces for the necessary correction of imbalances that may develop from time to time in the macro economy. Markets must therefore be encouraged to become more flexible, more efficient and more responsive to changes in underlying supply and demand conditions.

In the case of South Africa, three important changes will be introduced in the structure of financial markets over the next few months:

- Firstly, the existing national payment, clearing and settlement system will be upgraded in March 1998 to pave the way for real-time on-line settlement of large transactions on a gross basis, and for the daily settlement on a net basis of other (smaller) transactions between banking institutions. This versatile new system will provide challenging opportunities for the development of a more active interbank funds market.

- Secondly, the Reserve Bank will introduce a new system for providing liquidity to banking institutions through daily repurchase transactions that will establish a floating interest rate for central bank accommodation.

- Thirdly, the Department of Finance intends to introduce a new system for the primary sale of and secondary market making in government bonds by the appointment of a number of securities dealers from the private banking sector to operate as authorised dealers on behalf of the Treasury.

These changes are all intended to serve the needs of more liberalised and free financial markets in South Africa. At the same time, they should open up the way for further exchange control relaxations and encourage greater integration of the South African financial markets in the global financial system.

5. Concluding remarks

Next year holds the prospects for being an interesting one for the South African economy.

- Firstly, there is the prospect for better economic growth in South Africa, following upon the macroeconomic consolidation of the past year.

- Secondly, important structural adjustments, particularly in the financial markets, will introduce interesting new challenges for all participants in the markets.

- Thirdly, we shall have to contend with the continuing turmoil in the international currency markets, and possibly also with the adverse effects of the El Nino phenomenon.