Mr. Stals elucidates monetary policy objectives in South Africa in the environment of financial globalisation Address by the Governor of the Reserve Bank of South Africa, Mr. C. Stals, at the Monthly Meeting of the Bank for International Settlements in Basle on 11/5/98.

1. Background

Major political and social reforms in South Africa in recent years created new expectations, and many demands are being made on the Government for the social upliftment of the people. In defining its macroeconomic strategy, the South African Government first produced a **Reconstruction and Development Programme** (RDP) in 1994 in which legitimate needs were identified. The total cost of implementation of the RDP, however, as could have been expected, by far exceeded what was affordable. This was confirmed by the publication in mid-1996 of a **Macroeconomic Strategy for Growth, Employment and Redistribution** (GEAR), which concentrated more on the supply-side of the economy. GEAR provided a programme for macro-economic restructuring that is intended to raise the growth potential of the country over a five-year period from 3 to 4 per cent to 6 per cent per annum.

In the Government's macroeconomic strategy, monetary policy was tasked with the responsibility of maintaining overall financial stability, or of protecting the value of the currency. It was assumed that the objectives of neither the RDP nor GEAR would be attainable unless overall financial stability is maintained.

The instruction to the Reserve Bank to secure financial stability also appears in the South African Reserve Bank Act, and was recently written into the new Constitution of the Republic of South Africa. In terms of Section 224(1) of the Constitution:

> "The primary object of the South African Reserve Bank is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic".

The Constitution also provides for the protection of the independence of the Reserve Bank:

> "224(2) The South African Reserve Bank, in pursuit of its primary object, 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".

The macroeconomic strategy of the Government, and particularly the GEAR part of it, is often criticised and there are strong pressures, emanating mainly from labour organisations, for the total rejection of this programme. The disciplined monetary policies applied in terms of the above mandates from the Government are also often denounced by these pressure groups. The Reserve Bank is from time to time castigated for not following a policy that will provide more money at lower interest rates for the purpose of financing the social upliftment programmes of the country.

2. The main objective of monetary policy

The mandate from Parliament to the Reserve Bank is not explicit on what "protection of the value of the currency" really means. This obviously opens up the way for malignant attacks on the Bank, whatever objectives might be pursued.

The main objective of the Bank, however, is to bring inflation down. Over the twenty years from 1972 until 1992, inflation in South Africa fluctuated between 10 and 20 per cent per annum, with an average of about 15 per cent. This was obviously too high, and there was general public support for determined efforts by the Bank since 1990 to reduce inflation to a single digit level. Since 1992, the rate of inflation has been contained within the single digit level, fluctuating between 5 and 10 per cent. Over the twelve months up to March 1998, the consumer price inflation equalled 5.4 per cent, and at the production level, prices rose on average by 2.3 per cent.

In the absence of a formal quantified guideline from the Government, the Reserve Bank defined its goal for inflation as a rate that will be more or less in line with the average rate of inflation in the economies of South Africa's major trading partners and competitors. In the present world environment, this will require a rate of inflation of even lower than 5 per cent.

The Reserve Bank is often criticised for being obsessed with inflation, and for unnecessarily depressing the domestic economy, in its efforts to reduce inflation. Studies like those recently produced by Michael Sarel, an economist at the International Monetary Fund, are thrown against the Bank.

3. The monetary policy model of the Reserve Bank

In 1986, South Africa introduced the **M3** money supply as an anchor for monetary policy. Annual targets, or guidelines, for an acceptable rate of growth in **M3** were announced by the Bank, and decisions to influence overall liquidity in the banking sector, or to change the Bank rate, were triggered by substantial deviations in actual money supply growth from the predetermined guidelines.

To control the money supply, the Reserve Bank obviously had to manage the amount of liquidity available within the banking sector, and had to accept realistic interest rates. With fairly stable relationships between the money supply and aggregate demand, the model served South Africa well for a relatively long period of time. In 1987/88, for example, the rate of growth in **M3** was close to 30 per cent, and the rate of inflation 20 per cent. In 1992, growth in **M3** was reduced to 8 per cent, and inflation declined to a single digit figure for the first time in 1993.

In recent years, however, with the major changes particularly in South Africa's international financial relationships, the money supply model lost some of its usefulness. Over the past four years, the rate of increase in the money supply has persistently stayed around the level of about 15 per cent, being about 5 full percentage points above the annual guidelines of the Reserve Bank. Over the same period, total bank credit extension increased by about 16 per cent per annum, a rate of growth that is also regarded as excessive by the Reserve Bank.

And yet, gross domestic expenditure declined from 5 per cent growth in 1995 to 1½ per cent last year, and inflation remained well under control. After a depreciation of the rand

of 22 per cent in 1996, inflation rose correspondingly from 5 per cent to almost 10 per cent a year later. Over the past twelve months, however, inflation has come down again to the level of about 5 per cent per annum.

These developments forced the Reserve Bank to reconsider its monetary policy model and to follow a more eclectic approach in which a strict financial (monetary) package is used as a basis for monetary policy decisions. This financial package includes:

- movements in the money supply and its components **M1, M2** and **M3**;
- changes in total bank credit extension, both to the Government and the private sector;
- the level of interest rates and the structure of the yield curve;
- changes in the gold and foreign exchange reserves; and
- movements in the exchange rate of the rand.

In terms of Reserve Bank analyses, the main reasons for the breakdown in the money supply model in recent years have been:

- the almost explosive increases in volumes on the various financial markets;
- the reintermediation in the banking sector of certain financial transactions, such as direct lending by foreign banks to South African non-bank private sector institutions;
- the absorption of many new workers from the subsistence sector in the market economy; and
- the effects of large and volatile international capital flows on bank liquidity, interest rates and the money supply.

The debate in South Africa at this stage about the monetary policy model is whether South Africa should not, at this juncture, follow the example of many other countries and introduce a formal inflation target as an anchor for its monetary policy.

4. Other objectives of monetary policy

Effective monetary policy is, for obvious reasons, not only dependent on sound principles applied by the central bank, but also on the infrastructure or the architecture within which we operate. In summary, over the past few years, we had to restructure our banking sector, our financial markets, and the national payment, clearing and settlement system to support the process of gradually introducing the South African financial system in the global markets.

Bank regulation and supervision are, at this stage, a responsibility of the Reserve Bank, but there are serious proposals for following the recent examples of the United Kingdom and Australia to remove these functions from the central bank. The present regulatory system is very much based on the risk management approach as prescribed by the Basle Committee, and on the Core Principles. The major change in the South African banking sector in recent years was the introduction of more than 20 new foreign banks and additional foreign competition by the opening of more than 60 representative offices of foreign banks in South Africa.

The financial markets were also encouraged to modernise. The Johannesburg Stock Exchange (JSE) introduced major reforms to provide for corporate ownership, foreign

ownership (of stockbrokers), dual capacity trading, negotiated commissions, and electronic screen trading. It is continuing to improve its facilities by providing for the immobilisation and dematerialisation of stock, and for improved clearing and settlement arrangements. The total turnover on the JSE last year amounted to about US $45 billion.

Major changes were also introduced in bond trading, and the total turnover in the Bond Exchange of South Africa last year amounted to the equivalent of US $927 billion. Non-residents accounted for $257 billion.

The daily turnover in the market for foreign exchange in South Africa now exceeds $10 billion.

A Euro-rand market developed in Europe where the total amount of outstanding Euro-rand bonds now exceeds R37 billion.

To stay in step with the financial globalisation process, the Reserve Bank recently also upgraded the national payment, clearing and settlement system. The new system now provides for:

- an electronic on-line real-time link between participating banks;
- secure fund transfers between banks through Reserve Bank settlement accounts;
- a better management on a continuous basis of the liquidity positions of banks;
- electronically managed end-of-day settlement of interbank transactions; and
- from the beginning of October, settlement of large transactions on a gross basis as and when instructions are received by the system.

5. The financial globalisation process

The implementation of sound monetary policies and the establishment of a sound and well-managed banking sector, effective financial markets, and an efficient national payment, clearing and settlement system, were regarded as important preconditions for the extension of South Africa’s participation in the process of financial globalisation.

As a further important element of the process, South Africa is also removing exchange controls on a gradual and structured basis. There are, at this stage, no more exchange controls on any current account transactions; all controls were removed on non-residents who are now free to bring funds into South Africa and to repatriate funds for any purpose; restrictions on residents to make investments outside of the country have been eased for corporates, institutional investors and private individuals, who may make foreign investments within fairly generous prescribed limits. These limits are being raised gradually until they will become ineffective.

The South African approach on financial globalisation is that it is in the interest of the country to have access to foreign funds, and that we must therefore apply domestic financial and other macroeconomic policies that will make the country attractive to the foreign investor.

Furthermore, policies in South Africa must be flexible enough to adjust quickly and decisively to changes in foreign investor sentiment. When capital inflows subside, or switch into outflows, as a minimum:

- the exchange rate must be allowed to absorb part of the shock;
- an outflow of capital must reduce liquidity in the banking sector;
- interest rates must be allowed to rise; and
- some inflationary pressures will develop that will require, almost immediately, more restrictive monetary and fiscal policies.

These adjustments will obviously not be painless, but will provide a basis for re-establishing confidence in the shortest possible time.