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The Role of Monetary Policy

Address by Dr X P Guma, Deputy Governor, South African Reserve Bank to the IPM Annual Business Conference in association with NKR Nedbank Auditorium, 90 Ordnance Rd, Kingsmead, Durban, South Africa, 18 May 2009

1. Introduction

Mr Chairman, ladies and gentlemen, let me begin by thanking you for your invitation to me to participate in this meeting today: for me it is usually better to speak when asked than to ask to speak.

The title of my talk today is well known to those who have an interest in and may be well versed in the precepts of that component of public policy which is known as “monetary policy”: that is, the use of monetary instruments to influence macro-economic outcomes. This is so because it was the topic chosen for the Presidential address delivered at the Eightieth Annual Meeting of the American Economic Association on December 29, 1967¹: an Association which remains one of the foremost scholarly associations of the Economic(s) profession; and has been the scale upon which many nuggets of theoretical insight have been assayed.

Theoretical elegance within the confines of the spaces occupied by trained economists is one thing: relevance to, and understanding by, a broader public whose lives are affected by the actions of Central Banks is another. My purpose today is to speak to the latter.

¹ M. Friedman (1967) “The Role of Monetary Policy”; The American Economic Review, Vol. 58, No. 1 (Mar., 1968), pp. 1-17

- 2 -

2. The Friedman Statement

For my purpose today, the questions to which answers are required are, in the main, those to which the 1967 - address was directed, namely:

- i) what monetary policy cannot do.
- ii) what monetary policy can do.

A paraphrasing of Friedman would indicate that the course adopted by Central Banks in order to achieve a particular objective, cannot:

- (1) peg interest rates for more than very limited periods;
- (2) ... peg the rate of unemployment for more than very limited periods.

These are, as stated in the address, only two of the limitations of monetary policy which can be drawn from the “infinite world of negation”. To the list could be added many others: for example, easy finance for SMME’s, secure and guaranteed employment for all job seekers including graduates of tertiary institutions, full capacity utilisation for airline companies, unlimited connections for the cellular-less and infinite airtime for the connected².

But, monetary policy can:

- iii) prevent money itself from being a major source of economic disturbance.
- iv) Provide a stable background for the economy, such policy being the primary responsibility of national central banks.

Logically, therefore, if monetary policy is to provide a stable background for the

economy, it must do so by deliberately employing its powers to that end.

² Those who attend the Monetary Policy Forums of the South African Reserve Bank (SARB) will have heard requests, indeed demands, for such interventions at various times.

- 3 -

3. In all places: at all times?

In stating the foregoing, in free translation, I should not be misunderstood. I do not wish to imply that one monetary policy is always and everywhere appropriate. Such a rendition of this narrative would do injustice not only to the principal author to whom I have referred but also to his antecedents, contemporaries and successors most of whom had and have, respectively, a keen sense of history. For it is the case that the political, economic, social and international environment of central banks is in constant flux. At the same time central banks are quite dissimilar in their constitutions. No two Banks are exactly alike³. Nor is it the case that the issues to be addressed are identical at all times in all places.

The central proposition remains, however: it is that monetary policy can do certain things; in particular, provide a stable background for the economy. In so doing, this policy will enable producers and consumers, employers and employees to proceed with full confidence that one aspect of an otherwise unknowable future is predictable: namely, the rate of price inflation, or its mathematical inverse, the purchasing power of money⁴. In these conditions, entrepreneurs can plan and act; savers can save without fear that their savings will be wiped out by inflation and borrowers can borrow in orderly markets at interest rates that are not unduly raised by inflation risk premia.

Resolution of challenges in the real sector; for example skills shortages or drought – induced agricultural losses requires other policies: stated differently as old people here used to say “nobody can use another person’s teeth to smile”. So to end the analogy, the teeth which will bring a smile to the resolution of those issues cannot be drawn from the mouth of monetary policy.

³ Courtney N. Blackman (1999) Central Banking in Theory and Practice Caribbean Cent for Monetary Studies, St. Augustine, Trinidad.

⁴ In the Address, Friedman discussed the average level of prices; not the rate of price inflation.

- 4 -

4. Is Price Stability enough?

But this surely cannot be enough. For we all are aware of the strained circumstances of the international economy in 2009: and are no doubt cognisant of the impact of these developments on the prospects for the domestic economy. So, as William White asked two years ago, “Is Price Stability enough?⁵ And, the short response to this could be, in my view, “yes, in normal circumstances. No, in extra-ordinary times”. That, after all, is why policy affords some discretion to the policy-maker. Slave-like adherence to an invariant policy stance is unlikely to yield optimal outcomes when circumstances change dramatically – as they have in recent times.

For this reason, principally, many central banks have accepted the distinction that may need to be drawn between price stability and financial stability. That these are not synonyms is evident from the evidence: the worst financial crisis in history has erupted to the detriment of global, real economic activity; and did so in the United States of America despite the low rates of inflation that had been recorded there for some time⁶.

On the other hand, the proposition that price stability and financial stability are

not mutually exclusive, indeed are linked is intuitively appealing. This is so because the transmission mechanism of monetary policy in contemporary, market-oriented economic systems is based on the assumptions that:

- 1) credit markets exist and operate efficiently;
- 2) the policy rate of the central bank is the primary determinant of interest rates in the market for credit;
- 3) there exist stable, rational and predictable relationships between money and credit, on the one hand; and a host of macro-economic variables on the other; and

⁵ William R White (2008) in Bank for International Settlements (BIS) Papers No 45, March 2009

⁶ For further discussion, see for example, Bernanke, Ben S. (2004) "The Great Moderation", speech delivered at the meetings of the Eastern Economic Association, Washington, D.C., February 20.

- 5 -

- 4) the demand for and supply of credit are brought into equilibrium, in part, by "the" interest rate.

When credit markets cease to operate, or operate inefficiently, one of the channels through which conventional monetary policy operates ceases to be, or becomes increasingly less, effective.

There then arises a need to regain financial stability because financial instability has the potential to cause significant macro-economic costs: it interferes negatively with production, consumption and investment and is detrimental to broader goals of sustainable and sustained economic growth, full or rising employment and societal development.

It may be necessary, therefore, for some institution, or college of institutions, to validate the often unstated assumptions stated above, in order to avoid or limit financial instability: to enhance the efficiency of monetary policy.

Such an authority should be able to, at minimum,

- identify systemic threats at an early stage;
- promote measures to reduce these threats;
- develop and test contingency plans and crisis preparedness;
- in extreme cases, implement safety-net measures to support systematically important financial institutions;
- maintain confidence in financial markets and resolve the efficient functioning of markets,

according to the International Monetary Forum (IMF); the Bank for International Settlements (BIS); and the G-20 – of which South Africa is a member⁷.

⁷ See Mnyande, M. (2009): Remarks at the launch of the Financial Stability Review, South African Reserve Bank (SARB), 6 March.

SARB (2009) Financial Stability Review, March.

- 6 -

5. In South Africa

Many countries – which differ in size, structural features and development level - have selected inflation-targeting-with-floating as their preferred framework for pursuing a more independent and effective monetary policy. According to Frederic S. Mishkin and Klaus Schmidt-Hebbel⁸, this choice has been made, typically, by instrument-independent central banks in open economies with a history of inflation, which need to establish a credible monetary anchor to promote price stability.

This framework, typically, coincided with the end of experimentation with alternatives: including, in particular intermediate exchange rate regimes, and

monetary aggregates, as an intermediate target.

Historically, the most common nominal anchor for policy involved linking the value of the currency to gold (under the gold standard) or to a major currency. There followed a period, in the 1970's, during which monetary aggregates became the prevalent nominal anchor for policy. When these became an increasingly unreliable anchor, some countries attempted to target the exchange rate – with mixed success⁸.

At present, in the case of the South African Reserve Bank (SARB), as is well known, the primary goal of monetary policy is the achievement of price stability. Stated in the words of Section 224(1) of the Constitution of the Republic of South African, 1996, “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”. And South Africa has had experience of most alternatives – including the gold standard, the gold-dollar standard, monetary aggregates and an eclectic approach. To use the intemperate language of the younger generation: been there, done that; got the T-shirt.

⁸ See F.S. Mishkin and K. Schmidt-Hebbel (eds) *Monetary Policy Under Inflation Targeting*, Central Bank of Chile: 2005.

⁹ A useful review in this regard may be found in Charles Freedman and Douglas Laxton (2009) “Why Inflation Targeting?”, IMF Working Paper WP/09/86.

- 7 -

As has been stated above, it is possible to pursue price stability using alternative approaches: and, many have been tried.

As has been observed elsewhere in this regard, “take away inflation targeting and we will still have monetary policy, we will still have the same instruments of monetary policy, and the Bank will still have a constitutional mandate to maintain low inflation”¹⁰, in the interest of balanced and sustainable economic growth in the Republic.

6. Conclusion

In conclusion, permit me to emphasise the following points: - The proposition stated in the Address, to which I have made reference, that our economic system will work best when economic agents can proceed with full confidence that the purchasing power of money will be protected remains central to the role that has to be assigned to monetary policy. In South Africa, this is a constitutional imperative.

Recent developments have thrown into sharp relief the importance of financial stability: and some broad guidelines have been suggested, in particular, by the G-20 – of which South Africa is a member – at the Summit held in London early in April 2009. At that Summit, the former Financial Stability Forum was transformed into the Financial Stability Board: and was enjoined, *inter alia*, to “pursue the maintenance of financial stability, enhance the openness and transparency of the financial sector, implement international financial standards ... and agree to undergo periodic peer reviews”¹¹.

The institutional arrangements for accomplishing this will, clearly, differ from country to country but will certainly not be onerous for South Africa as a great deal has already been done in this regard. Two IMF/World Bank Financial Sector Assessment Program Studies have been concluded; the first in 2000

¹⁰ Mboweni, T.T. (2008) “Monetary Policy, Inflation Targeting and Inflation Pressures”; Address to the Bureau for Economic Research Annual Conference, Johannesburg: 22 May.

¹¹ Declaration on strengthening the financial system. G-20 London Summit, 2 April 2009.

- 8 -

and the second in 2008. Supervision of banks has been undertaken consistently and the Basle II framework was implemented on the due date. Moreover, within the SARB, the Financial Stability Department (FSD) has existed since the year 2000, its task being to identify possible threats to financial stability and suggest ways in which these could be mitigated. Although its existence cannot guarantee that financial stability will be maintained, taken together with the existing framework which exists for the regulation and supervision of financial institutions, its work will assist the authorities to reduce the probability of systemic instability.

Finally, financial markets are likely to remain volatile as risk aversion and optimism about growth prospects fluctuate in response to emerging data and conflicting signals, as the most recent Monetary Policy Review of the SARB indicates. Dealing with this will require resolute application of monetary policy in accordance with the mandate to achieve price stability, within an inflation-targeting framework.

Thank you for your attention.

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