

A Historical Perspective on Monetary and Fiscal Policy Progression in South Africa

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The views expressed are those of the author/presenter and do not necessarily represent those of the South African Reserve Bank or Reserve Bank policy.

Outline

- Introduction
- Inflation in South Africa and in other regions
- Policy regimes in South Africa
- What brought about the regime changes?
- Conclusion

Introduction

- **You never know whether “it works or not” unless you try it!** If it does not work you try something else. Hence, evolution in economic policies
- You never know whether it works or not unless you try it. If it does not work you try something else. Hence, evolution in economic policies
- Different policy options are taken to address inflation problems
- What policies did South Africa implement over the past decades?

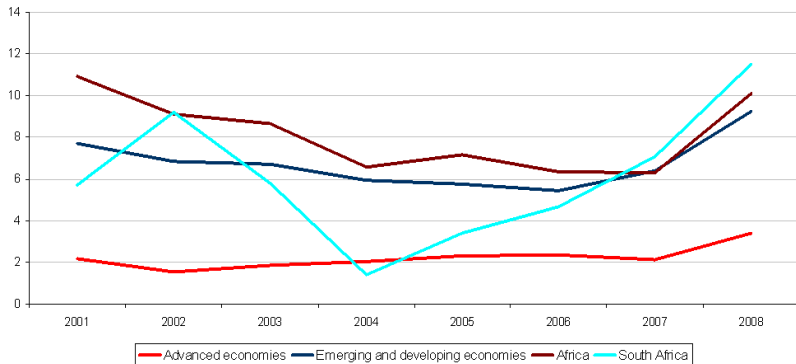
Average inflation in RSA as compared to other regions: 1961 to 2008

	1961-1970	1971-1980	1981-1990	1991-2000	2000-2008
Advanced economies	4.0	10.8	10.9	3.9	2.5
Selected developing economies	18.3	29.8	142.7	51.9	6.4
South Africa	2.7	10.6	14.7	9.0	6.1

Source: IMF, World Economic Outlook

Average inflation in RSA as compared to other regions: 2001 to 2008

Per cent



Source: IMF, World Economic Outlook

Policy regimes

Years	Monetary Policy Regime
1960-1982	Liquid asset ratio-based system with quantitative controls on interest rates and credit
1983-1985	Mixed system during transition
1986-1998	Cost of cash reserves-based system with pre-announced monetary targets (M3)
1998-1999	Daily tenders of liquidity through repurchase transactions (repo system), plus pre-announced M3 targets and targets for core inflation
2000- current	Repo system with inflation targeting

Source: Aron and Muellbauer (2001) with some modifications

Policy regimes

1960-1982	Non-market approach policies (characterized by direct controls by authorities)
1983-2008	Market based policies (indirect influence on targeted economic variables)

Direct, non-market approach

Non-market policy options can be summarised as:

“an upper limit on the **rates** banks could pay on deposits; an upper limit on the amount of **credit** that could be granted by each bank; a requirement for banks to hold **liquid assets** in an unnaturally high ratio to their deposit liabilities”

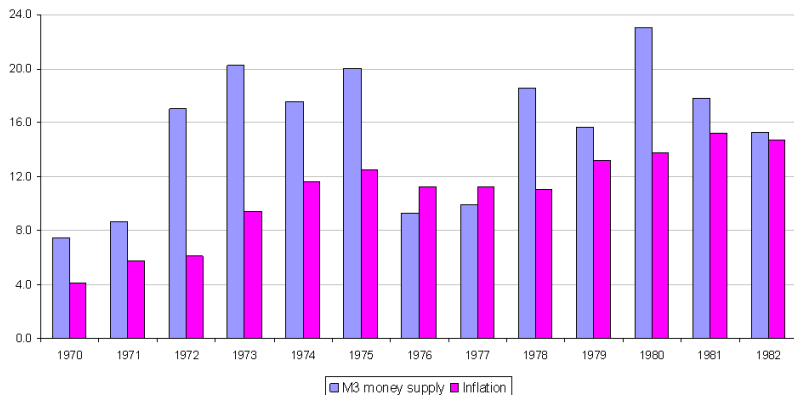
(Goedhuys, 1994)

Disadvantages of direct control approach

- Price ceiling and quantity rationing impact on both supply and equilibrium price (Cotta and Wallace, 1983)
- If ceiling price is below market based price, supply may drop and there will be a switch to alternative market resulting in economic inefficiency
- “direct controls were used until the end of the decade (1970s), without satisfactory results, as the **banking sector kept on finding ways around the controls**” (Jones and Muller, 1992)

M3 money supply growth and Inflation: direct control era

Per cent



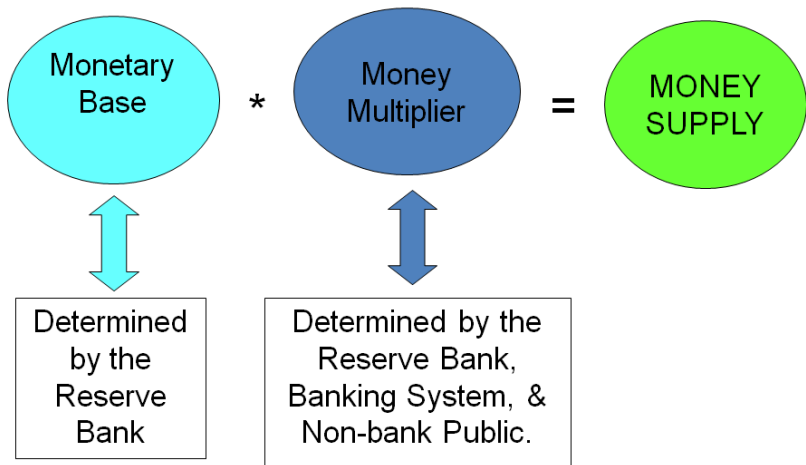
Indirect, market based approach

- Transition to market oriented policies followed recommendations of the De Kock Commission
- Interest rates became effective under this approach
- The approach allows for banks and other financial institutions to facilitate lending and borrowing under market conditions willing seller willing buyer
- Note that the approach does not imply the absence of regulation and supervision
- The market based regime evolved from targeting money supply (implicitly targeting inflation) to explicitly targeting inflation

Indirect, market based approach

- Market-oriented monetary policy instruments were used to ensure a continuous shortage of cash reserves in the money market
- It forced the banks to seek accommodation from the Reserve Bank (which it provided), making effective the impact of a change in banks lending rate on market interest rates.
- The resultant change in short-term market rates affected the quantity of money demanded
- Hence, monetary growth targets became the intermediate objective of the monetary authorities.

Money supply process



Source: Hubbard (2000) and Walsh (2003) with some modification

M3 growth targeting

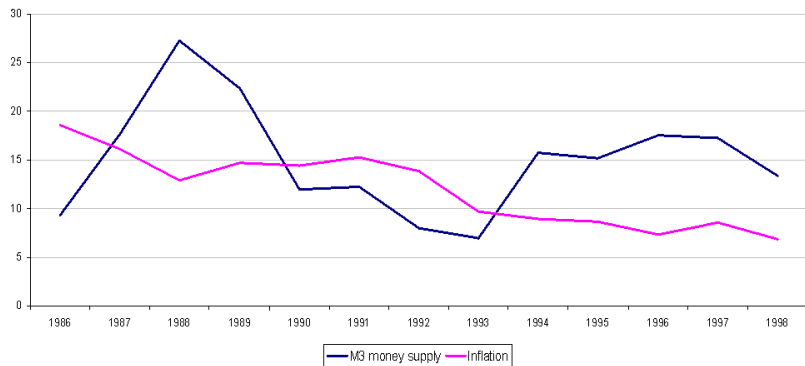
- Policy was announced in 1985
- M3 growth was targeted with a band that was revised annually
- Target met in four of the eleven years.
- For six years: Actual Growth $>$ Target Band
- For one year: Actual Growth $<$ Target Band
- But Inflation fell during this period.

M3 Growth targets and Inflation

Year	Money Growth Guidelines (%)	Money Growth Actual (%)	Inflation Total
1986	16 - 20	9.3	18.6
1987	14 - 18	17.6	16.1
1988	12 - 16	27.3	12.2
1989	14 - 18	22.3	14.7
1990	11 - 15	12.0	14.4
1991	8 - 12	12.3	15.3
1992	7 - 10	8.0	13.9
1993	6 - 9	7.0	9.7
1994	6 - 9	15.7	9.0
1995	6 - 10	15.2	8.7
1996	6 - 10	17.5	7.4

M3 money supply growth and Inflation: 1986 - 1998 (YoY growth)

Per cent



M3 money supply growth and Inflation: 1970 - 2008 (YoY growth)

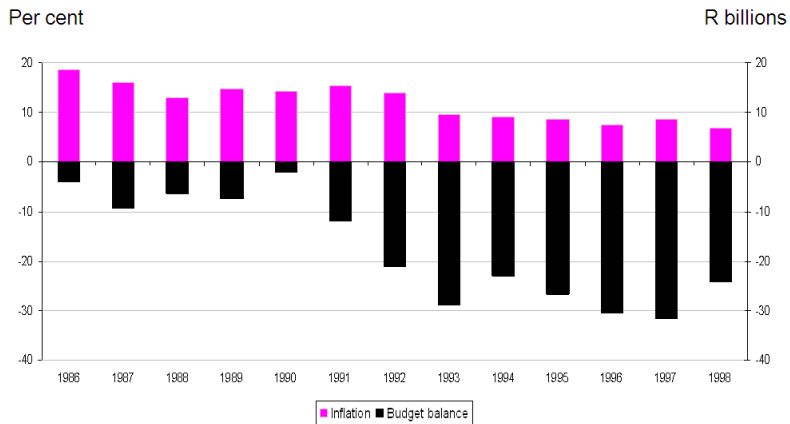
Per cent



Budget deficit and inflation

- Continuous and unsustainable budget deficit is harmful for the total operation of the economy
- During shortfall period, government can either issue debt to finance deficit or monetise the deficit
- If debt is monetised, this implies excess money supply in the economy

Inflation and budget balance



Moving towards inflation targeting

- In 1998 policy shifted to implicit inflation target, i.e., “Daily tenders of liquidity through repurchase transactions (repo system), plus pre-announced M3 targets and targets for core inflation”
- Minister of finance announced explicit inflation (CPI-X) target range of 3 to 6 per cent on February 2000

Why target inflation?

- **It distorts the allocation of resources** and often directs the efforts of entrepreneurs and investors into hedging operations instead of productive activity;
- **It discourages saving:** people spend money now rather than save for investment and future consumption if the expected value is much less;
- **It discriminates against fixed salaried workers**, pensioners and low-income earners who cannot protect themselves against the impact of inflation; and
- It usually leads to an even more **unequal distribution of income and wealth**

Inflation targeting era: 2002 to 2008

- Target was not met until June 2003 (6 per cent for the month)
- Exchange rate shock contributed to higher inflation prior to 2002Q2
- Inflation target was met in 45 months over a 7 year period
- It was an improvement from the money supply targeting era
- Credibility and transparency improved

Conclusion

- There is a clear distinction between market and non-market approaches when implementing policies
- Non-market approach was inefficient and had to be abandoned
- Although money supply targets were mostly missed than achieved, inflation trended down over the period
- Explicit inflation targeting resulted in inflation falling to single digits for a longer period

Thank you