T T Mboweni: The Reserve Bank and the rand: some historic reflections

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Alberton Chamber of Commerce and Industry Christmas Lunch, Johannesburg, 27 November 2001.

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1. Introduction

Ladies and Gentlemen. It gives me great pleasure to be here with you today and I thank you for inviting me to attend this end of year celebration. As you look back upon the year, I hope that you can say with confidence that you have achieved what you set out to achieve. And I hope, too, that the year ahead holds many opportunities for you to build on the good work you have done thus far.

The Reserve Bank celebrates its eightieth birthday this year, making it one of the oldest central banks in the world. In 1920, when the enabling legislation for the establishment of the Reserve Bank was promulgated, central banks existed only in three other countries outside Europe: the United States, Java and Japan. Prior to the Bank's establishment, commercial banks in South Africa issued banknotes. There was, however, no uniformity in the legislation providing for the issuing of banknotes, except that the issuing banks were obliged in terms of the gold standard to convert notes held by the public into gold when tendered at their branches.

2. The gold standard

After the First World War (1914 to 1918) the price of gold in the United Kingdom rose above its price in South Africa, and a profit could be made by converting banknotes into gold in South Africa and selling it in London. This price difference put the financial future of commercial banks in jeopardy, and the commercial banks requested the Government to release them from the obligation to convert their banknotes into gold on demand. This request gave rise to a Gold Conference in 1919 and following its recommendations, a Select Committee of Parliament recommended the establishment of a central bank. The Bank opened its doors for business for the first time on 30 June 1921.

The Bank was, *inter alia*, entrusted with the responsibility of issuing banknotes, with its first notes being issued to the public on 19 April 1922. At the time the local currency was the South African pound and it traded on par with the British pound sterling (£), while the value of one pound in the 1920s was equal to approximately US$ 4,85. The Bank was supported in the issuing of banknotes by a series of measures to ensure that it would not be confronted by a problem similar to the one faced previously by the commercial banks. The convertibility of banknotes into gold was temporarily suspended and an embargo was placed on gold exports.

The suspension of the gold standard, however, was generally viewed as an anomalous and purely temporary arrangement. Following the reintroduction of the gold standard in Great Britain, the South African Government re-introduced the convertibility of banknotes into gold, and therefore the gold standard, on 18 May 1925. Although the reintroduction of the gold standard corresponded with conventional wisdom at the time, it did not ensure the end of the controversy surrounding the gold standard which was a characteristic of the Bank's early history.

Adverse economic conditions owing to the Great Depression forced Great Britain off the gold standard on 21 September 1931, while the South African authorities decided not to follow suit. The British decision came as a shock to the South African authorities and an appropriate policy reaction had to be formulated in great haste. After considering available alternatives, the authorities decided not only to keep the currency on the gold standard at its existing parity with full convertibility into gold, but also to retain the unrestricted import and export of gold. Not surprisingly, this resulted in a large speculative outflow of capital from South Africa, and the Reserve Bank was forced to sell most of its foreign reserves in a matter of days in an effort to protect the exchange rate of the currency at the gold standard parity. As the exchange rate losses wiped out the Bank's reserve funds and some of its capital, the Minister of Finance had to announce towards the end of October 1931 that "the Government would stand behind the Bank".

By December 1932 a fresh wave of speculation against the currency forced a reconsideration of the policy decision to remain on the gold standard, as the Bank found itself in a position where it could not handle the sustained demand. This brings us to a key lesson: no single central bank can resist market forces on its own.

On 28 December 1932 a proclamation by Government ended the convertibility of South African banknotes into gold. This is still the case, as the gold standard has never been reintroduced in South Africa. The decision in 1931 to stay on the gold standard at the prevailing value put South Africa through one of the two most significant currency crises in its history – the second was the rescheduling of South Africa's foreign debt in 1985.

The outbreak of the Second World War and South Africa's role at the time as a member of the Sterling Area implied that the country had to dovetail its exchange control regulations with that of other member countries of the Sterling Area. The administration of exchange control was entrusted to the Bank, while policy decisions on exchange control remained the responsibility of the Government.

3. Exchange rate systems

An international system of stable but adjustable exchange rates was introduced under the International Monetary Fund Agreement at Bretton Woods in 1944. This system introduced formal devaluations or revaluations to adjust the exchange rate values of currencies vis-à-vis one another, with the US dollar as the main international reserve currency. This system remained in place until the early 1970s, although its flaws started becoming clear in the 1960s owing to the development of balance of payments deficits in the United States. In terms of the 1944 Agreement, the South African pound was fixed at an exchange rate equal to £1 and US$ 4,03.

When the British pound was devalued on 18 September 1949 by some 30 per cent from US$ 4,03 to US$ 2,80, the South African authorities followed the devaluation.

In 1956 a Decimal Coinage Commission was appointed which submitted a report on 8 August 1958 recommending the introduction of a decimal system for South Africa. On 14 February 1961 a new system of rands and cents was introduced, with £1 equal to R2,00 and US$1,00 equal to R0,714. With the exception of the gold standard crisis in the early 1930s, the local exchange rate retained its value against the pound sterling for the forty-year period from the Bank's inception to 1961.

Concerns about increasing inflation were raised by the middle 1960s and anti-inflation measures were announced in July, August and December 1966. These measures were indeed successful as is evidenced by a slowdown in inflation in 1967, and confirms a second lesson: containing inflation is not a new challenge facing South Africa.

In November 1968 the British Government devalued its currency by 14,3 per cent but on this occasion the South African authorities decided not to follow with a similar devaluation. This implied that the value of the rand appreciated against the value of the sterling. The British devaluation, however, reinforced widespread international uncertainties regarding exchange rate levels and the official international price of gold at US$ 35 per ounce at the time. This culminated in the Government of the United States announcing on 15 August 1971 the ending the convertibility of the US dollar into gold and therefore, for all intents and purposes, the ending of the Bretton Woods Agreement.

The major industrialised countries reached an agreement on the realignment of the exchange rates of their currencies on 18 December 1971, and South Africa's reaction was to devalue the rand by 12,28 per cent - $1 was equal to 71,34c. This was despite clear indications that such a devaluation would aggravate inflationary pressures. This confirms the next lesson: international events can force decisions on a relatively small economy.

The realignment of 1971 was, however, followed by some uncertainty about appropriate exchange rate levels. This is evidenced by a decision of the British government to allow their currency to float downward against other currencies from June 1972, and the rand was linked to this float. After four months, however, the rand was pegged to the US dollar and it remained pegged against the dollar until 1974. At that time 67,12 South African cents bought $1.

In June 1974 the South African authorities decided to delink the rand from the dollar, and a policy of independent managed floating was introduced. In June 1975 this was replaced by a fix against the dollar, although the rand was devalued by 17,9 per cent on 22 September to protect the balance of payments. At this point in time, $1 was equal to 86,96 South African cents.

By April 1978 it was agreed that member countries of the IMF could exercise a free choice between the free floating, managed floating or pegged exchange rate of their currencies in an effort to bring order into the international system of exchange rates.

In summary, however, it should be noted that in the period following the breakdown of the Bretton Woods Agreement, the exchange rate of the rand has, in turn, been pegged to the dollar, the pound sterling, the dollar, a basket of currencies, and again against the dollar. Moreover, during this period the level at which the rand was pegged to the dollar has been changed six times. Benefits, if any, of these many realignments, are questionable. This confirms lesson number four: once an exchange rate policy is formulated, it should not be changed without careful prior consideration.

South Africa experienced a gold price boom after 1978, with the price of gold reaching a high of US$850 per ounce on 21 January 1980. One result of this increase in the gold price was a sharp increase in export earnings, which supported the exchange rate of the rand. However, the subsequent decline in the gold price triggered a declining trend in the external value of the rand, and this trend has remained evident over the past 20 years.

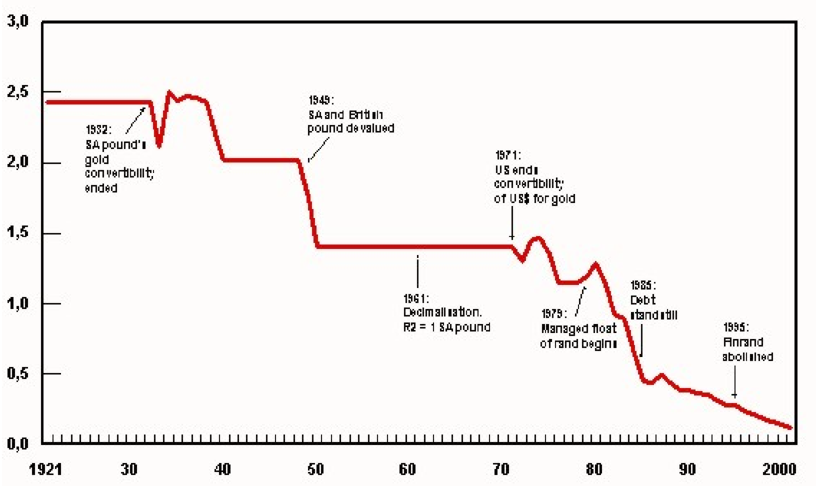
The South African Government announced the abolition of the financial rand exchange rate system with effect from 7 February 1983. It now took R1,8520 to buy $1. However, this relaxation of exchange control over non-residents could not be sustained, as the refusal of key international banks to renew credit lines for South Africa forced the authorities to announce the temporary closure of the foreign-exchange market six months later. On 1 September 1985 a standstill on South Africa's international debt repayments was announced, while exchange controls over non-residents were reintroduced.

A major feature of exchange rate management in the period from September 1985 until the period running up to democratic elections in the 1990s, was the overriding objective of maintaining a surplus on the current account of the balance of payments. Since democratic elections in 1994 normality has returned to South Africa's international relations, but the exchange rate of the rand against the US dollar has remained in the long-term downward trend that commenced in the early 1980s. This gives rise to a question: judged over a period of eighty years, what should the current exchange rate of the rand be?

4. Exchange rate comparisons

Over the past 80 years, the cost in United States currency of a South African rand has fallen from $2,43 to marginally above $0,10 at present. The movements up to 1949, when the level of $1,40 to the rand was established, took place under circumstances which limited the South African authorities' room for manoeuvre quite severely. These circumstances, and the $1,40 exchange rate, persisted until the Bretton Woods system came to an end in the early 1970s. In the subsequent 30 years, the South African authorities adopted various foreign exchange regimes, no longer constrained by the Bretton Woods rules. For most of this period the rand floated with various degrees of official intervention – and floated downwards.

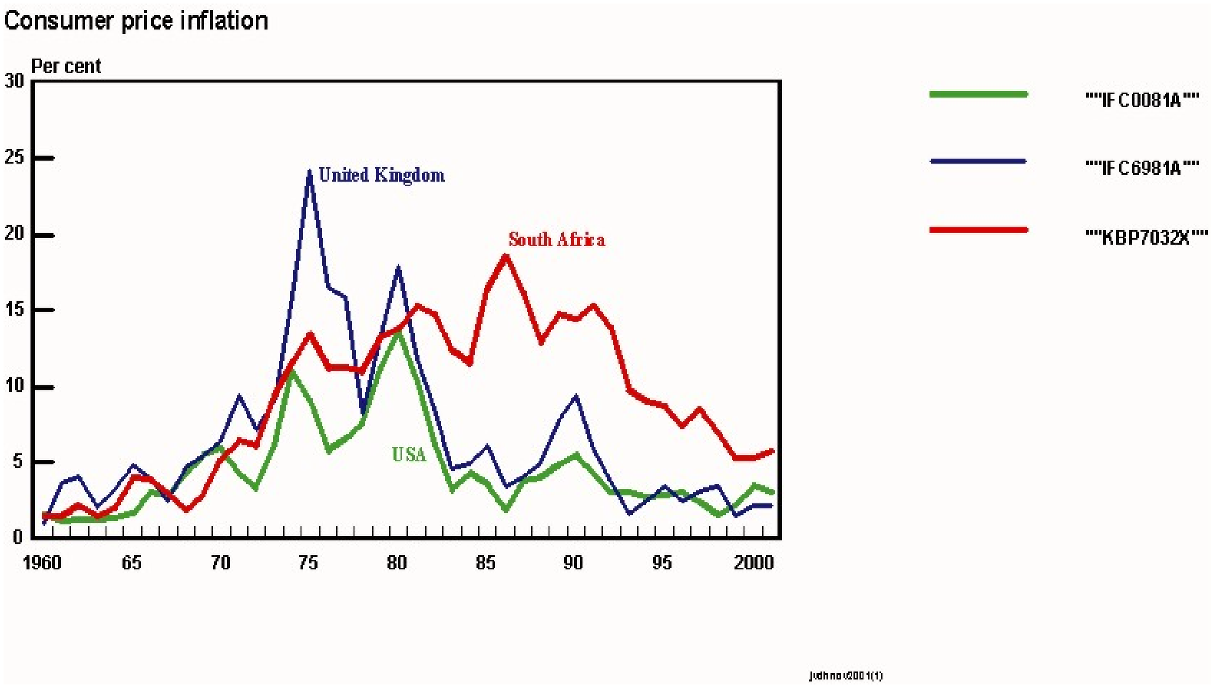
Exchange rate: US dollar per SA rand[1)]



[1)] US dollar per 10 SA shilling before 1961

Why this stubborn downward tendency of the rand? A multitude of events is customarily presented to explain each movement, every day, month or year in the foreign currency market. Many of these analyses are quite valid. However, one should not just see the trees without the wood. A golden thread that runs through the entire period is the existence of higher inflation in South Africa than in the United States and in South Africa's other main trading partner countries. Prices in South Africa are today approximately 70 times as high as in 1921. Over the same period, prices in the United States have only increased tenfold. Higher domestic inflation partly explains the exchange rate weakness of the rand; if the rand did not depreciate our exports would have been priced out of the world markets.

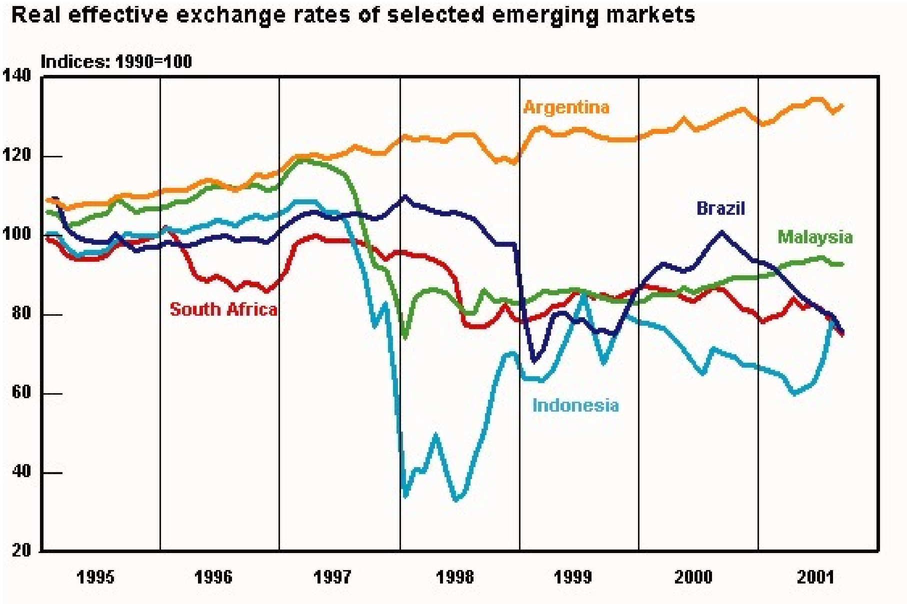
Focusing on the last 40 years only, let us now compare South Africa's inflation rate with that of the United States and the United Kingdom. Up to about 1980 South Africa's inflation rate was roughly in line with those of the United States and the United Kingdom, but subsequently local inflation remained stubbornly high while price increases were firmly brought under control in the two overseas economies. No wonder, then, that the exchange rate of the rand came under downward pressure. A positive dimension that should be highlighted is that the inflation differential has narrowed appreciably over the past decade on account of disciplined monetary and fiscal policies, and currently stands at roughly 3 percentage points.



This, of course, begs the question why South Africa had inflation. Some economists bluntly state that a rapidly expanding money supply causes inflation. Others feel that an expanding money supply merely accommodates inflation that was initiated by other factors. However, a process of inflation cannot be sustained unless accompanied by an excessive increase in the money supply. And of that South Africa has had its fair share. When the Reserve Bank opened its doors for business 80 years ago, the total value of notes and coin in South Africa was less than R30 million. It is now R31 billion. For wider monetary aggregates, roughly the same order of magnitude for growth as for notes and coin applies over the period. This thousandfold increase in the money supply could not be absorbed by the twentyfold increase in the quantity of goods and services produced over the same period, but largely fed inflation.

However, various other activities and processes in the economy also reflect the origins of inflation. Among these are excess demand as reflected by the output gap (i.e. the difference between potential and actual real gross domestic product), supply shortages, cost increases (i.e. increasing unit labour costs) and inflation expectations. Although it is not easy to provide empirical evidence of the precise magnitude of the economic costs of inflation, recent studies indicate that inflation is not generally helpful for countries in their efforts to promote economic growth. With so little to be gained from continuing inflation, and the unavoidable reduction in current national income because of it, the cumulative gains in future income should be sufficient motivation for governments to reduce inflation to levels where it no longer has an influence on the decisions that individuals and businesses make.

While it is sometimes interesting, and certainly safer, to talk about events in the long run, it was the great economist, John Maynard Keynes, who reminded us that in the long run we are all dead. Let me shorten my horizon to the past six years only, and again focus on the exchange rate of the rand.



If we look at the so-called real effective exchange rate of the rand and a handful of other currencies, it is clear that the rand has depreciated considerably over the past six years – by more than 25 per cent in real terms. However, this is not out of line with the fortunes of several other emerging market economies. (The "real" refers to the fact that it is corrected for inflation, and "effective" means that it looks at the exchange rate against a relevant basket of currencies.) In the wake of the 1997/98 emerging markets crises, Indonesia with its fragile financial system was clearly the worst effected. At the other extreme, Argentina's exchange rate has been pegged to the (strong) US dollar, which caused it to appreciate over time. This forced Argentina to run very tight monetary policies to the point of having negative inflation, i.e. declining prices. Their appreciating exchange rate eroded their export competitiveness and dragged down their domestic production levels. It must be pointed out that in the latest few months the rand has been weak relative to most other emerging market currencies.

Looking ahead, I am grateful that I need not predict the future course of the exchange rate. However, it is clear that our exporters' price competitiveness has been strongly boosted by the depreciated level of the rand.

South Africa has on occasion experienced negative real interest rates. From 1950 to 1969, South Africa's real interest rates were relatively low, but positive, with the short-term real interest rate averaging 1,15 per cent. Between 1970 and 1979, in many countries inflation rates increased relative to nominal bond yields, resulting in lower measured real rates. In South Africa, in line with the experience of other countries, the increases in inflation appear to have been sufficiently large to generate negative real interest rates. South Africa experienced negative real prime interest rates in 1973 to 1975, in 1979 to 1981 and again in 1985 to 1988. But since 1980, the country has experienced an era of positive real interest rates.

Conclusion

Let me wrap up by emphasising that the Reserve Bank does not have a target value for the exchange rate of the rand in mind. We have an inflation targeting framework for monetary policy, which means that we must steer CPIX inflation to within the target area of 6 to 3 per cent in 2002 and 2003, and of 5 to 3 per cent in 2004 and 2005. We are only interested in the exchange rate in so far as its movements may ignite (or counter) a domestic inflation spiral. If strong exchange rate depreciation, for example, leads to higher “imported” inflation, the second-round effect, which would push CPIX inflation above the 6 per cent threshold, the Reserve Bank would have to raise short-term interest rates in order to brake the inflation spiral. Exchange rate targeting and intervention in the foreign exchange market do not feature in the Reserve Bank’s way of conducting monetary policy.

Let me take this opportunity to wish you all the best for the festive season and congratulate you, once again, on your achievements. Thank you.

Note:

Taking 1921’s exchange rate of $2,43 per rand as the basis, and projecting the course of the exchange rate purely according to inflation differentials, the current exchange rate should be roughly US$0,35 per rand. (The rand is undervalued by approximately 70 per cent.)