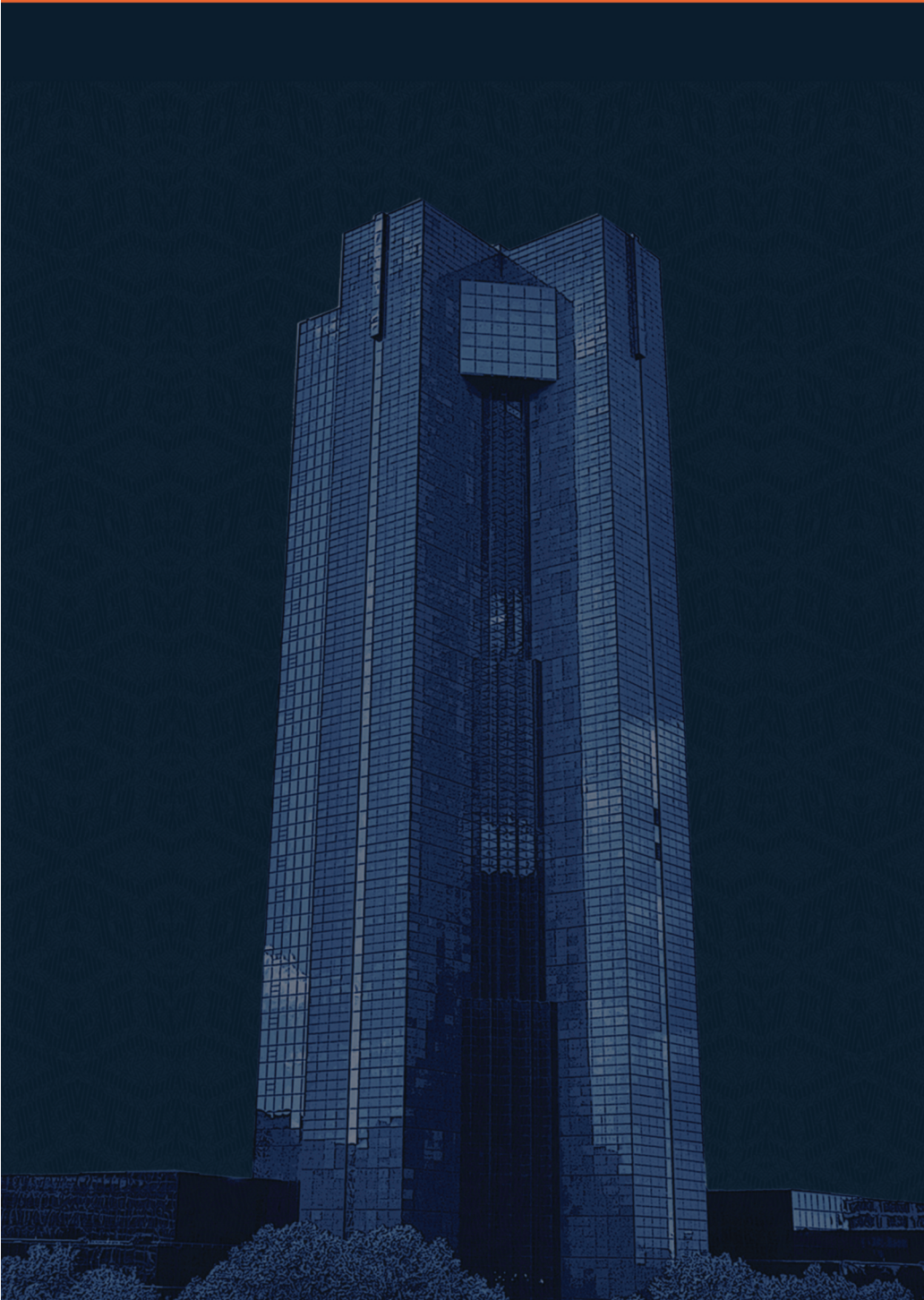




South African Reserve Bank

Factors leading to the founding of the South African Reserve Bank



Introduction

The South African Reserve Bank (the Bank) was founded in 1921. What follows are the reasons for the founding of the Bank.

Lack of uniformity in the banking system

Although the legislation for the establishment of a central bank in South Africa was not enacted until August 1920, the need for a bank of issue with special privileges had been strongly advocated as far back as 1879. Before this time there was no clear definition of central banking as such. Banks were all more or less on a par with one another and undertook much the same functions. Many of these banks, also in South Africa, printed their own banknotes which were all legal tender in the country. Even large corporations, such as De Beers Mining, started paying their employees partially in money and partially with their so-called "good fors", a special credit (or exchange) coupon that could be redeemed against goods in stores owned by De Beers. This situation, of course, led to a lack of uniformity with the issuing of banknotes and the possibility of an over-issuing of notes under the laws of certain provinces.

The situation was much the same in countries all over the world. However, a gradual evolution started taking place in many countries over a long period. In some countries one bank gradually started assuming the position of a central bank, and adopted the sole or principal right to issue banknotes and acted as banker for the government. At this stage they came to be known as 'national banks' or 'banks of issue', instead of central banks. The banks of issue gradually assumed other functions and duties, which led to the general use of the term 'central bank'.

Bank of England

One of the first banks to be established was the Bank of England, which gradually assumed responsibilities that would later resemble the characteristics of a central bank. The Bank of England was founded in 1694, with the express purpose of advancing money to government. In return, it enjoyed the right of issuing banknotes; a right conferred on it by Parliament. In addition to being an issuer of banknotes, the Bank of England expanded its other functions and by the early nineteenth century other commercial banks started to hold accounts with the Bank. As a result, by the 1850s the Bank had come to accept the position of being the "lender of last resort" to other banks, thereby helping to stabilise the banking system.

Establishment of other central banks

The success and prestige derived by the Bank of England stimulated the development of central banking in other parts of the world. The nineteenth century saw the founding of central banks in various European countries. An existing bank was given the sole or principal right to issue banknotes, or a new bank was founded with special powers and privileges – all with varying degrees of state control. Governments benefited from this arrangement because they could share in the income generated by issuing notes (known as 'seigniorage').

Establishment of the South African Reserve Bank

In South Africa people started advocating a national bank as early as 1879, stating that this was not only desirable, but in fact necessary. This opinion was voiced repeatedly in later years. The financial crisis of 1890/91, when all but one bank in the then Cape Province failed or were absorbed by overseas banks, once again raised the question of a national or central bank. The government did not do much about the matter, although a newspaper, *De Paarl*, published a series of articles on the issue. These articles pointed out the advantages of a strong central bank, claiming that it would ensure a stable note circulation, that interest rates would be more stable, that trade would be fostered and that in times of crisis only a strong central bank could serve the State and the public. The author went as far as drafting a complete charter for a proposed central bank for South Africa.

Still, the issue was not considered by the government. In 1911 a Frenchman by the name of M Grosclaude proposed that the newly formed Union of South Africa should establish a national bank that would have practically the monopoly of issuing banknotes, and would conduct the monetary and financial business of the government.

The next person to raise the issue of a central bank was an Inspector of the Netherlands Bank of South Africa, Mr Postmus who, in 1912, gave a lecture in which he stressed the importance of a sound central bank in a well-organised banking system. He cited as examples the Bank of the Netherlands and the Bank of Java, and expressed the opinion that the Netherlands and Java owed much gratitude to their central banks for the stimulus and encouragement given to commerce and industry.

The Union Government did not heed these pleas or

proposals until abnormal conditions forced it to respond. These abnormal conditions were caused by the fact that the currency and banking laws previously in force in the various colonies had not been changed after unification in 1910, and were applicable in the relevant provinces. In the Cape Province, under the Bank Act of 1891, a bank could issue a total sum of notes limited to the amount of its paid-up capital and reserve fund. All notes issued in the Cape were payable in gold on demand at certain places, but the necessary amount of the gold reserve was left to each bank's discretion. Moreover, banks with head offices outside the Cape Province were required to deposit government securities with the Union Treasury to the full amount of their note issues in the Cape.

In the then Transvaal, under Law No. 2 of 1893, banks could issue notes to the amount of their paid-up capital. All notes issued in that province were payable in legal coin at the issuing bank's head office, branches and agencies in the Transvaal but, unlike the notes issued in the Cape, had to be secured by a minimum reserve of $33\frac{1}{3}$ per cent in legal coin and for the balance by other available assets in the Transvaal.

Banks in the Orange Free State were required, by Ordinance No. 20 of 1902, to hold a minimum specie reserve of one-third against their note issues, but the maximum amount that could be issued was not restricted to their paid-up capital as in the Transvaal. All notes issued in the Free State were payable in gold at the issuing banks' main offices in that province.

In the then Natal the issue of banknotes was not subject to any general legislation. However, notes of the Natal Bank were not to exceed its paid-up capital and had to be covered by a minimum specie reserve of one-third.

No province had made any legal provision that the banks should keep minimum reserves against their deposit liabilities.

This situation remained unchanged until the outbreak of World War I. South Africa's participation in the allied war effort necessitated an embargo on the export of gold to prevent it from falling into enemy hands. Banknotes were still convertible into gold on demand. The disruption caused by the war led directly to the founding of the South African Reserve Bank, (the Bank) and formed part of a more comprehensive set of measures meant to deal with the unsatisfactory monetary and financial conditions of that time. More directly, it came about because of a large illegal outflow of gold from South Africa, which arose in response to the premium that could be earned on gold sales on the London market—after the

abandonment of the pegged wartime sterling-dollar exchange rate by the United Kingdom in March 1919. The South African commercial banks therefore had to obtain gold at a premium in London, but pay gold out in South Africa at a par in terms of their obligation to convert their banknotes into gold on demand.

Gold conference

The commercial banks appealed to the government to be released from the obligation to convert their banknotes into gold on demand. This led to the so-called Gold Conference of October 1919 to consider the best ways of safeguarding the interests of South Africa and of placing its currency on a sound footing. This conference did not express itself on the desirability of establishing a central bank, but did recommend that a uniform banking Act should replace the separate banking laws in force in the four provinces. A Select Committee of Parliament supported the establishment of a central bank, based on the view that only by centralising the issuing of banknotes in a single, non-commercial banking institution would it be possible to prevent a recurrence of an unduly rapid and inflationary increase in the note circulation, as had been experienced during the war and the immediate post-war period. This led to the Currency and Banking Act of 1920, which provided for the establishment of the Bank. This Act was promulgated in December 1920, and effect was given to its various provisions in the course of the next six months. The Bank opened its doors for business for the first time on 30 June 1921. The first Governor of the Bank was Mr W H Clegg, a former Chief Accountant of the Bank of England.

The establishment of the Bank did not meet with universal approval. A fairly prevalent view was that, because of the highly centralised nature of South African banking at the time, a central bank would serve no useful purpose. Another opinion was that the establishment of a central bank should wait for a return to more normal monetary conditions.

The Currency and Banking Act was not solely concerned with the constitution of the proposed South African Reserve Bank. It was promulgated "to conserve the specie supplies of the Union by providing for the issue of gold certificates; to provide for the establishment of a central reserve bank for the Union; to regulate the issue of banknotes; and the keeping of reserves with a view to securing greater stability in the monetary system of the Union; and generally to make provision for matters incidental thereto".

The Bank's constitution, as set forth in the above-mentioned Act, closely followed certain widely accepted central-banking precepts and was in

general based on the theory and practice of central banking as it had developed up to that stage. The Bank's statutes were in several respects modelled on the laws pertaining to the Federal Reserve Bank in the United States of America and the Bank of Java.

Of the various functions customarily performed by central banks, five were carried out by the Bank virtually from the beginning. These functions were those of custodian of the cash reserves of other banking institutions, bank of rediscount, lender of last resort, bank of central clearance and settlement of interbank claims, and custodian of the major part of the country's gold and other foreign reserves. The function of issuing banknotes was assumed some ten months after it had started operations.

Role of custodian

The Bank's role of custodian of much of other banks' cash reserves automatically arose from the fact that, in terms of the Act, a minimum credit balance, calculated in proportion to the banks' demand deposit and time liabilities, had to be maintained with the Bank by other banking institutions. As the commercial banks had for many years had a mutual agreement for the clearing of cheques and had opened current accounts at the Bank, the Bank also offered the most convenient facilities for this purpose. As from September 1921, the banks actually made use of premises at the Bank for effecting their daily clearances.

The cash reserve requirement applicable to banking institutions also caused the Bank to act as lender of last resort. This provided the Bank with a substantial gold reserve as the banks had to obtain most of their required balances by depositing gold certificates or coin with the Bank. The Bank's position as principal custodian of the country's gold and other foreign reserves was strengthened further by an arrangement with the gold producers, according to which the Bank would buy all the gold offered to it by the mines.

From its inception the Bank has acted as custodian of the greater part of the country's gold and other foreign-exchange holdings. These reserves are held by the Bank and are used by the Bank as a means to augment payments in foreign transactions.

Sole issuer of banknotes

The Bank was to be the sole issuer of banknotes in the Union. Initially the right to issue banknotes was granted for 25 years, but since 1944 the Bank has had the sole right to issue banknotes in South Africa. Initially, these notes were printed in England. The notes issued by the Bank were redeemable on demand in gold specie or gold certificates at the office of issue. The convertability of notes into gold was abolished on 28 December 1932 owing to abnormal conditions during the Great Depression.

The Bank had to keep certain minimum gold reserves, amounting to at least 40 per cent of its notes and deposits, to secure part of its note issue. The remainder had to be secured by commercial paper and trade bills. The Bank could also, subject to the consent of the Treasury, suspend the gold reserve backing for a period of not more than 30 days.

The Bank was permitted to make loans or advances on current account, against specified security. It could only invest up to an amount not exceeding its paid-up capital and reserve fund.

Within three years of starting its operations, the Bank had become the sole bank of issue, bank of central clearance, bank of rediscount, lender of last resort, the principal custodian of foreign reserves and the custodian of cash reserves of other banks. Some three years later, in 1927, the transfer of the accounts of the Union Government to the Bank also firmly established it as the government's banker in all major respects.

This is the sixth in a series of fact sheets on the South African Reserve Bank, compiled by the Research Department: Information Division and distributed by the Strategy and Communications Department.

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Last updated: March 2015