

# Money, near-money and the monetary banking sector

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In the light of recent important changes in banking practice and legislation in South Africa on the one hand, and in monetary and banking theory on the other, the Reserve Bank has decided to effect certain modifications to its formal "monetary analysis", i.e. its analysis of changes in the consolidated assets and liabilities of the "banking sector". This type of analysis has been presented by the Bank in its *Quarterly Bulletin* since 1959<sup>1</sup> and has been adjusted from time to time to take into account changes in banking conditions. To assist in launching the new analysis, three explanatory papers are included in this issue of the *Bulletin*, namely the present article, followed by one by Dr. B. van Staden dealing in detail with the definitions and methods used in the new monetary analysis and one by Mr. J. H. Meijer dealing with the significance of liquid assets, other than money and near-money, held by the private non-financial sector in the South African economy. The first statistical results of the new approach are presented on pp. S-18 to S-20 of this issue.

## New definition of "monetary banking sector"

The first important difference between the new monetary analysis and the former one is that the coverage of the "banking sector" or, more specifically, the "monetary banking sector" has been extended. Twenty years ago the monetary banking sector was (correctly) thought of as consisting of only the Reserve Bank and the commercial banks. Subsequently it was deemed advisable to include also the National Finance Corporation, discount houses, and the short-term activities of the Land Bank. But in view of recent banking developments it is now considered necessary to go even further, and the monetary banking sector has therefore been redefined to include *the South African Reserve Bank, commercial banks, merchant banks, the National Finance Corporation, discount houses, the short-term business of the Land Bank, and all other registered banking institutions of*

*which the monthly average amount of demand deposit liabilities during the preceding calendar year amounted to at least R1 million and of which the monthly average amount of short and medium-term deposit liabilities during the preceding calendar year collectively amounted to at least one-third of the total deposit liabilities of such an institution or at least R30 million.*<sup>2</sup>

At present this means that, in addition to the types of institution specifically named above, five hire-purchase banks and four general banks will be included in the monetary banking sector. The remaining general and hire-purchase banks, together with savings banks, building societies and the Post Office Savings Bank, are therefore excluded. The reasons for adopting this new, broader definition of "monetary banking sector" will be discussed later.

## New definitions of money and near-money

The second major difference between the new monetary analysis and the former one is in respect of the definitions of money and near-money. Money is often defined as "any generally acceptable means of exchange or payment which also serves as unit of account", and in the Reserve Bank's former monetary analysis this was taken to include coin and bank notes outside the banking sector and demand deposits held by the private sector (including the South African Railways and Harbours and local authorities) with commercial banks and the Reserve Bank.<sup>3</sup> In the new

<sup>2</sup>It will be noted that this definition of "monetary banking sector" does not correspond exactly with the definition of "monetary banking institution" given in the Regulations under the Banks Act, 1965. The latter definition includes "South African Reserve Bank, National Finance Corporation of South Africa, discount houses, commercial banks, merchant banks and other banking institutions which are required to maintain a reserve balance with the Reserve Bank". The Banks Act itself prescribes that such reserve balances should be maintained by banking institutions whose short-term liabilities to the public in the Republic, excluding acceptance liabilities and loans from other banking institutions, exceed R500,000.

The difference between these two definitions is, however, small. In practice it merely means that three of the smaller institutions which qualify as monetary banking institutions under the Regulations but which are perhaps better considered as savings intermediaries, are excluded from the banking sector for purposes of monetary analysis, while the short-term business of the Land Bank is included. It would be ideal, of course, if the two definitions were identical, and it may be advisable at a later stage to bring about the necessary small amendment to the Banks Act and the Regulations to achieve this purpose.

<sup>3</sup>For further details, such as the treatment of foreign deposits, see B. van Staden, *loc. cit.*

<sup>1</sup>The pioneers in this specialised field in South Africa were firstly Dr. T. W. de Jongh and, at a later stage, Dr. B. van Staden, both of the Reserve Bank. See T. W. de Jongh, "Economic Review" in the Reserve Bank's *Quarterly Bulletin of Statistics*, March, 1959, to June, 1962, and B. van Staden, "A Monetary Analysis for South Africa", *Quarterly Bulletin of Statistics*, March, 1963.



analysis the coverage of "money" is broadened to include, in addition to coin and bank notes outside the banking sector, all demand or call deposits held by the private sector (again including the Railways and Harbours and local authorities) with institutions in the newly defined monetary banking sector. This means, for example, that call money or demand deposits held by the private (non-bank) sector with the National Finance Corporation, discount houses, merchant banks and the monetary hire-purchase and general banks now constitute part of the money supply. The reasons for this change and the details involved in calculating the money supply on the new basis are discussed in Dr. van Staden's article.

Near-money or quasi-money has no standard definition in the world today. It is often taken to consist of assets held by the private sector which can be monetised *en masse*, conveniently, within a reasonably short period and without significant loss. But this definition can be interpreted in many different ways and, in actual fact, the term near-money is used in widely varying senses, sometimes in a very broad, and sometimes in a very narrow sense.

In the Reserve Bank's former monetary analysis near-money *with the banking sector* was considered to include all time and savings deposits with commercial banks, call money with the National Finance Corporation and discount houses, and deposits with the Land Bank, while Treasury bills, tax redemption certificates and short-term government stock in the hands of the private (non-bank) sector were looked upon as another form of near-money, namely near-money held by the private sector with the government sector.

In the new analysis near-money is simply defined as all short-term deposits<sup>4</sup> other than demand deposits, and all medium-term deposits,<sup>5</sup> including savings deposits, held by the private sector with the monetary banking sector as redefined. This means that long-term deposits with the banking sector, i.e. deposits with an unexpired maturity of six months or longer or which require notice of six months or longer, and liquid assets held by the private non-bank sector with the government, i.e. Treasury bills, short-term government stock, etc., are no longer included under near-money.

Long-term deposits were excluded on the ground that, in view particularly of the new legal restrictions on the repayment of time deposits before maturity,

they are not as close substitutes for money as short and medium-term deposits and cannot be "created" on a multiple basis by banks to the same extent as the latter deposits. The decision to draw the line between near-money and other deposits at six months was, of course, arbitrary and greatly influenced by the statistical convenience attached to the fact that this is also the dividing line drawn between medium and long-term liabilities in the Banks Act. Nevertheless, some such distinction appeared to be desirable. As the following sections will attempt to show, the main use of a monetary analysis of the kind under discussion is to indicate to what extent changes both in the quantity of money and in certain other bank deposits which serve as close substitutes for money, are "caused" by such factors as changes in bank credit and in gold and foreign exchange reserves. And for reasons which will become clearer later on, it does not appear to be useful to look upon changes in long-term deposits as having been "caused" in the first instance by factors such as these.

Similarly, the main reason for confining near-money to close money substitutes *held with the monetary banking sector*, and excluding from it, for example, liquid assets held by the private non-bank sector with the government sector, is because the causes of changes in these other liquid assets cannot be determined from an analysis of changes in the consolidated assets and liabilities of the monetary banking sector by itself, and because it was deemed advisable to keep the banking sector analysis reasonably "pure" and not to integrate it with other elements in a broader analysis of causes of changes in the total liquid assets of either the private non-bank or the private non-financial sector.

These are, of course, largely terminological matters and there is no logical reason why the term "near-money" could not have been used in a broader sense if so preferred. But of all the various possible solutions to this problem of terminology, it seemed the simplest to restrict near-money to those close substitutes for money which are held by the private sector with the institutions included in the monetary banking sector and which can be created on a multiple basis by the latter sector. This also has the merit that changes in the supply of "money" and "near-money" can now be analysed in full in the official "monetary" analysis or survey, which simplifies the presentation.

This choice of terminology, of course, by no means implies that money and near-money, as defined, are the only liquid assets in the hands of the private non-financial sector. On the contrary, in addition to liquid assets held with the government and long-term deposits with monetary banking institutions, account must be taken of such other liquid assets as short, medium and long-term deposits with banking institutions not included in the monetary banking

<sup>4</sup>"Short-term liability", in relation to any date, is defined in the Banks Act as a liability which is payable within thirty days as from that date or which on that date is subject to less than thirty days' notice before becoming payable.

<sup>5</sup>"Medium-term liability", in relation to any date, is defined in the Banks Act as a liability which is payable after the expiration of a period of not less than thirty days but less than six months as from that date, or which on that date is subject to not less than thirty days' but less than six months' notice before becoming payable, and includes savings deposits.



sector, and deposits and shares with building societies. The importance of the various kinds of liquid assets other than money and near-money is dealt with in some detail in Mr. Meijer's article.

### **Significance of monetary banking sector: its ability to create money and near-money**

Why is it considered necessary to distinguish between the monetary banking sector and other financial institutions, including other deposit-receiving institutions such as savings banks and building societies? The main justification for this distinction is that the monetary banking sector can, under certain conditions, create money or near-money by extending additional credit to the private and public sectors. In other words, by expanding their assets, they can, as a group, create their own liabilities. This creation of money or near-money is something other financial institutions cannot emulate to any significant extent. They generally first have to obtain deposits or other resources before they can grant loans, make investments or expand their assets in some other way.

The reason why monetary banking institutions as a sector possess this special ability is the very fact that their short and medium-term liabilities serve as the money and near-money of the private sector. This explains why, when they increase their total advances, discounts and investments, they experience a large and fairly automatic "return flow" in the form of deposits. When insurance companies invest in stocks or shares, the funds do not automatically flow back to them in the form of insurance premiums. Similarly, when genuine savings banks grant mortgage loans, the recipients of the funds do not automatically save more in the form of deposits with savings banks. But when monetary banks expand their credit, most of the recipients of the disbursed funds tend to "bank" the money again with the banking sector.

Normally, of course, as is well known, there are limits to the extent that the monetary banks can create additional money or near-money. In the case of monetary banking institutions other than the central bank, their ability to do this is limited not only by the extent of the "return flow" referred to above, but also by the minimum percentage of their liabilities to the public which they have to keep in the form of balances with the central bank. It is true that the central bank can, by expanding its credit, supply the other monetary banks with additional cash reserves and thereby sustain their ability to create more money or near-money. But presumably the central bank will not want to do this if it has inflationary consequences, and in any event even the central bank's ability to create credit may be limited by balance of payments and other considerations.

Nevertheless, the fact remains that since the monetary banks as a group have to maintain only a

small proportion of their assets in the form of minimum balances with the central bank, any given increase in their cash base as a result of, say, a balance of payments surplus or a decline in government deposits with the central bank, can enable them to expand their credit and thereby the supply of money and near-money by a much greater amount, assuming, of course, that the demand for their credit facilities is strong enough. In other words, a "credit multiplier" is brought into operation.

The significance of all of this is that the monetary banking sector can, *in a very special sense and to a considerable extent*, increase the supply of loanable funds without any increase in (ex-ante) saving by individuals, companies or any other sector of the economy. Under conditions of full employment they can, therefore, allow or facilitate excessive expenditure on both capital and consumer goods, and thereby contribute to inflation and balance of payments disequilibrium in a way which other financial institutions cannot do.

### **Monetary banking sector as holder of gold and foreign exchange reserves**

A further consideration in distinguishing between the monetary banking sector and other financial institutions is that the same banking sector to which the private sector entrusts its money and near-money also includes those institutions (other than the government itself) which hold the official gold and foreign exchange reserves of the country, namely the Reserve Bank, the commercial banks and the other banks which are authorised exchange dealers. This means that a change in the official gold and foreign exchange reserves normally tends, *ceteris paribus*, to be accompanied by a similar change in money and near-money.

### **Analysis of "causes" of changes in money and near-money**

From all of this it follows that an analysis of changes in the consolidated assets and liabilities of the monetary banking sector between two dates will afford an indication of the "causes" (in an accounting sense) of any change in total money and near-money during this period. This is because the change in total money and near-money liabilities must equal the sum of the changes in assets and the changes (with the opposite algebraic sign) in those liability items not included under money and near-money. Dr. van Staden's paper explains this aspect of the matter in greater detail and indicates how changes in total money and near-money can be "caused" by such factors as changes in gold and foreign exchange reserves, changes in the claims of the banking sector on the private and public sectors, and changes in government deposits with the banking sector.

Although these "causes" are, of course, only



"accounting" or "statistical" causes and need further analysis to determine real cause and effect, the information provided by this type of analysis may be of considerable value to the monetary authorities in framing the appropriate monetary policy. If, for example, the supply of money and near-money rises significantly in relation to gross domestic product or expenditure, it may make a great difference to policy whether this is the net result of a surplus on the balance of payments and a decline in bank credit or of an increase in bank credit and a deficit on the balance of payments.

### **Reasons for broadening scope of monetary banking sector**

If, however, a monetary analysis of the above kind is to be really useful under present conditions, the monetary banking sector must be broadly defined so as to include *all* the banking institutions capable of significantly expanding the supply of money and near-money by increasing their credit. Twenty years ago in South Africa, as mentioned earlier, it would have been sufficient to include only the Reserve Bank and the commercial banks. But today these institutions are by no means the only ones which create money and near-money and in this way help to finance additional investment and consumption expenditure. Other banking institutions such as merchant banks, discount houses and certain hire-purchase and general banks also possess this ability, i.e. they also have "monetary significance" in this sense.

This stems from the fact that a large proportion of the deposits held with these other institutions today serves as money or near-money in the hands of the private sector. The "moneyness" of these deposits, in turn, is indicated mainly by their liquidity, high velocity of circulation and the fact that many of them are held by companies and other forms of business enterprise. It is also significant that some of these institutions have direct access to Reserve Bank credit, while others can make indirect use of Reserve Bank credit by borrowing from an institution which is in a position to obtain financial accommodation from the Bank.

Together with the Reserve Bank and the commercial banks, these other monetary banks therefore constitute a sector which, given the necessary cash reserves, can under certain conditions create money and near-money on a large scale and thereby facilitate inflationary overspending in a particularly dangerous way. It is probably true that the "credit multiplier" of these other monetary banks taken as an isolated group is considerably smaller than that of the commercial banks themselves, partly because the commercial banks have proportionately more short-term deposits than most of these other institutions, but partly also because commercial bank cheque deposits have, after all, more of the attributes of money than the short-term deposit

liabilities of these other institutions, so that the "return flow" in the case of the commercial banks is greater and more automatic. But this difference is one of degree rather than principle and does not justify excluding the other monetary banks from the banking sector.

If the banking sector is defined too narrowly, i.e. if institutions such as merchant banks, discount houses and those hire-purchase or general banks which operate on a relatively large scale with short and medium-term deposits are excluded from it, which would mean *inter alia* that they would not be required to maintain minimum balances with the central bank, the extent to which inflationary financing can occur outside this restricted banking sector is greatly increased. If, for example, funds previously held in the form of deposits with commercial banks and still required to satisfy the desire of the holders to be liquid are shifted to these other institutions, perhaps in response to more attractive interest rates, this would mean an increase in the deposits and cash balances of the latter and therefore in their ability to extend credit, without necessarily a corresponding decrease in the credit-creating ability of the commercial banks.<sup>6</sup> Funds can, of course, also be shifted to genuine savings institutions which properly belong outside the monetary banking sector. But to the extent that this kind of shift represents increased current saving, it is not likely to have significant inflationary effects. And to the extent that it does not emanate from increased saving, it is less likely to occur than transfers of money or near-money from commercial banks to those other banking institutions which should really be included in the monetary banking sector.

### **Criterion for inclusion in banking sector**

The main problem encountered in deciding upon the most suitable criterion for the inclusion of institutions in the monetary banking sector was the fact that many

<sup>6</sup>The reason why the ability of the commercial banks to extend credit would not necessarily be reduced by such a shift of deposits, is because a large proportion of these funds normally returns to the commercial banking system almost immediately, since the great majority of banking institutions outside the banking sector, as well as most of the people to whom they disburse funds, bank with commercial banks. In the normal course of events, the cash reserves of the commercial banks as a group, and thus their capacity to create money and near-money, can therefore only be reduced by shifts of deposits to other financial institutions if such shifts are accompanied, in one way or another, by a deterioration in the balance of payments or a net reduction in Reserve Bank credit, i.e. after allowing for changes in government and other deposits with the Reserve Bank.

This does not mean that commercial banks cannot be adversely affected by competition from other banking institutions. For the very reason that shifts of deposits from commercial banks to these other banking institutions can facilitate additional expenditure, such shifts can lead to a deterioration in the balance of payments and/or a restriction of net Reserve Bank credit (or a smaller increase therein than would otherwise have been the case), and in this way adversely affect the cash reserves and credit-creating ability of the commercial banks. See also *Report of the Technical Committee on Banking and Building Society Legislation*, R.P. 50/1964, paragraphs 30–32.



of the banking institutions, including the commercial banks, operate with a variety of short, medium and long-term deposits, many of which do not serve as money or close substitutes for money but which are held by the owners as invested savings and which, under the new Banks Act, cannot be withdrawn before maturity. In other words, many banking institutions combine under one roof the functions of money and near-money creation and mere intermediation between savers and borrowers. One part of their operations can justifiably be described as "assets creating liabilities", but another part is better classified under the heading of "liabilities creating assets", i.e. they first have to acquire deposits or other resources before they can grant loans or make investments.

This meant that the banking sector would be hopelessly too small if it included only banking institutions which accept exclusively short and medium-term deposits, and far too large if it included all institutions which, in addition to their other business, also happened to accept small amounts of short or medium-term deposits.

Some arbitrary criterion was therefore inevitable, and after considerable statistical research it was decided, as mentioned earlier, that only those banking institutions would be included which had *demand* deposit liabilities of at least R1 million *and* of which the short and medium-term deposit liabilities amounted to at least one-third of their total deposit liabilities or at least R30 million. Under South African conditions this criterion would appear to give the most meaningful coverage for the monetary banking sector.

### **Treatment of long-term deposits with monetary banks**

The decision to define the monetary banking sector in the above way must be seen in conjunction not only with the decision to restrict the definition of near-money to short and medium-term deposits (other than demand deposits) with the banking sector, but also with another related decision, namely the decision to treat changes in long-term deposits as an independent "cause" of changes in money and near-money. This was done because it was felt that changes in these long-term deposits, just like changes in long-term deposits with building societies and other savings intermediaries, tend to be associated mainly with changes in planned (ex-ante) saving and are not in the first instance "caused" by changes in bank credit, changes in gold and foreign exchange reserves, etc. For this reason some central bank analysts go as far as to subtract any change in long-term deposits from the change in claims on the private sector, implying that only the *net* change in these claims can be considered a cause of any change in total money and near-money. To have included long-term deposits with monetary banking institutions under near-money

in the above type of analysis would, therefore, have tended to over-emphasise the extent to which the banking sector creates its own deposits and would have exaggerated the difference between monetary banking institutions and other financial institutions.

### **Building societies in or out of the monetary banking sector?**

Serious consideration was given to the question whether building societies should not also be included in the monetary banking sector, but in the end it was decided to exclude them. It is true that a few years ago some building societies in South Africa, unlike their counterparts in most other countries, increasingly tended to perform certain monetary banking functions and that some of their deposit liabilities came to serve as close substitutes for money.<sup>7</sup> If they had developed much further in this direction they would probably have qualified for inclusion in the monetary banking sector before long, which would have meant that they would have had to comply with much stricter financial requirements than at present. It is, however, one of the main aims of the new Building Societies Act to preserve the true character of building societies as savings intermediaries and to prevent their becoming near-banks with considerable inflationary potential, and since this aim shows signs of being realised, the building societies are probably best excluded from the banking sector. Dr. van Staden returns to this point in his article and Mr. Meijer devotes some attention to the liquidity of deposits with building societies.

### **Significance of money and near-money**

The importance attached in this paper to money, near-money and the activities of the monetary banking sector does not imply acceptance of the "quantity theory of money" in its crude form, i.e. of any simple, direct relationship between, on the one hand, changes in the supply of money and near-money and, on the other, changes in prices or income. It is merely accepted, in accordance with most modern monetary theories, that the supply of money and near-money is an important factor affecting actual investment and consumption expenditure and, therefore, gross domestic product, prices and general economic activity. The velocity of circulation of money and near-money may show significant fluctuations, but the *quantity* of money and near-money remains significant. Not only may an increase in money and near-money, under certain circumstances, form a necessary condition for a further increase in total investment and consumption expenditure, but changes in the supply of money and near-money may, through their influence on interest rates, the availability of credit and the propensity to

<sup>7</sup>See *Report of the Technical Committee on Banking and Building Society Legislation*, pp. 18-19.



consume, as well as in other ways, exert an important stimulating or restraining influence on the economy.

### **Significance of other liquid assets and other financial institutions**

The emphasis placed here on the usefulness of monetary analysis of the kind under discussion must also not be interpreted to mean that other forms of liquid assets in the hands of the private sector are not considered important or that financial institutions outside the monetary banking sector are not deemed capable of making any significant contribution to inflation or other financial disturbances. On the contrary, it is fully accepted that these other liquid assets and other financial institutions can exert an important influence on the velocity of circulation of money and near-money and therefore on total capital and consumption spending, as indicated also in Mr. Meijer's article. At the same time, for the reasons mentioned earlier, it is considered analytically useful to distinguish between the monetary banking sector and other financial institutions.

### **Conclusion**

One of the major developments in the field of money and banking during the past decade has been the increased interest shown by both monetary economists and central bankers in the activities of financial institutions other than commercial or cheque deposit banks. In this respect the pendulum would appear to have swung from the one extreme to the other. Formerly the special position of the commercial banks as money-creating institutions which can cause or facilitate inflation tended to be over-emphasised, and the potential inflationary influence of other banking and financial institutions to be underrated. Now some observers go as far as maintaining that there is little if any fundamental difference between the potential destabilising influence of commercial banks and that of other financial institutions, and that if commercial banks are important from the point of view of economic stability, it is not because they are creators of money but because they happen to be large strategic lenders in the market.

The position taken in this paper is that if the monetary banking sector is defined broadly enough to include all banking institutions which serve as repositories of the money and near-money of the private sector and which can, as a group, create money and near-money, then the more orthodox view that the monetary banking sector differs in a funda-

mental way from other financial institutions can still be upheld. The conventional approach need not be scrapped. It only has to be modernised and adapted to take into account the existence of near-money and near-commercial banks. Then it probably still represents the most useful and practical way of analysing monetary and financial conditions with a view to framing appropriate monetary and fiscal policies.

But if this type of monetary analysis is to yield the required results, it is important that *all* monetary banking institutions, and not just the central and commercial banks, be included in the banking sector. An unduly narrow definition of the monetary banking sector seriously detracts from the value of the more conventional approach and even from the usefulness of the concept of money itself. It leaves too much to be explained in terms of changes in the velocity of circulation of money. For this reason it adds fuel to the fire of those who wish to scrap the whole idea of distinguishing between money-creating banking institutions and other financial institutions and who prefer to work with concepts such as the "state of liquidity of the whole economy", in the sense of "the ease or difficulty encountered by spenders in their efforts to raise money for the purpose of spending on goods and services".<sup>8</sup>

If, however, the monetary banking sector has an adequate coverage and changes in near-money as well as in money are taken into account, a formal monetary analysis of the type under discussion can provide the monetary authorities with extremely useful information on which to base their stabilisation policy. And if the money and near-money-creating activities of the monetary banking institutions, including the Reserve Bank, can be reasonably controlled by means of traditional methods such as interest rate changes, open-market operations, variable cash reserve or liquidity requirements, etc., while the government at the same time finances both its current and capital expenditures in a non-inflationary manner, then a major contribution to price stability and balance of payments equilibrium will have been made. Under such conditions the inflationary influence of financial institutions outside the monetary banking sector, and of other factors producing short-term increases in the velocity of circulation of total money and near-money, should not in the normal course of events present unmanageable problems to the monetary authorities.

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<sup>8</sup>See, for example, *Report of the Committee on the Working of the Monetary System* (Radcliffe Report), pp. 132–133 and 337.