Monetary Policy in South Africa — the Reserve Bank View in November 1981[1]

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South Africa Out of Step with the World Economy : A Serious Transitional Problem

If ever there was a time when South Africa needed to rely on close co-ordination between the Treasury and the Reserve Bank in framing and applying fiscal and monetary policy, it is now. It is common knowledge that South Africa has a strong economy and that the policy of fiscal discipline applied during the past five years has yielded handsome dividends. On balance, the structural changes in the world economy of the past decade, including the enormous increases in the prices of oil, gold and various other commodities, have also favoured South Africa. Looking ahead, there is general agreement among the experts that the long-term growth prospects in South Africa are excellent. And yet, as 1981 draws to a close, we find ourselves with a serious transitional economic problem on our hands — a problem which requires co-ordinated fiscal and monetary remedial action.

The problem stems basically from the fact that we are at present out of step with our main trading partners in a number of ways. Firstly, for more than two years now our rate of real economic growth has been much higher than theirs. Secondly, our rate of inflation has been in excess of theirs. Thirdly, and paradoxically, our interest rates have been much lower than theirs in real terms. And fourthly, while all of this would normally imply a gradual depreciation of the rand against the US dollar and the other currencies in question, and therefore a **premium** on forward US dollars, the Reserve Bank's "administered" rate for forward dollars has for some time now been quoted at either a considerable discount or an unrealistically low premium, with a view, of course, to reducing or neutralising the differential between domestic and foreign interest rates.

Since it was clear to the authorities from the beginning that this was not a situation which could be maintained indefinitely, monetary policy during the past year has been directed at bringing the South African financial situation more into line with overseas developments and realities. And, as I shall attempt to show, much progress has already been made in this direction. But our attempts to get back into step have been temporarily frustrated by a series of unexpected overseas economic developments over which we obviously had no control. These include the sharper than expected decline in the dollar price of gold, the marked deterioration during recent months in the world economic situation and prospects, and the maintenance of tight money policies and high real rates of interest in the main industrial countries for longer than had generally been anticipated.

1) Address delivered in Johannesburg on 20 November 1981.

The Economy in 1981: "Too Warm" rather than "Too Cold"

In the meantime, "back at the ranch", the South African economy paid little heed to these external developments and continued to press on regardless on virtually all fronts. Earlier predictions that the economy would move into a sharp downturn in the first half of 1981 have been proven wrong. Total monetary demand continued to expand rapidly throughout the first ten months of 1981 and to exert undue pressure on available resources. This continued state of demand inflation not only exerted upward pressure on prices and costs but also contributed to the emergence of a reasonably large deficit on the balance of payments on current account.

Ever since January this year, economists have been straining their eyes scanning all available time series and other economic information in search of an upper turning point in the South African business cycle. Because virtually all the slack in the economy had been taken up by the end of 1980, it was, of course, inevitable that the rate of growth of real gross domestic product in 1981 would decline below the abnormally high rate of 8 per cent achieved in 1980 — it now looks as if it will amount to about 4½ or 5 per cent for 1981 as a whole. But since this moderation of the real growth rate was largely the result of physical constraints, it did not by itself signify an immediate recessionary downturn in total monetary demand. In fact, the economy remained extremely buoyant and a number of economic indicators, including sales of motor vehicles, retail sales, manufacturing output, employment, imports and the demand for credit, which were supposed to level off or decline during the course of 1981, have continued to rise strongly, showing in some cases at most a moderation of their rates of increase. Certainly, 1981 will go down in South African economic history as a year of rapid growth, prosperity and rising standards of living, and as a period in which the economy was still "too warm" rather than "too cold".

For much of this, of course, we should be thankful. The trouble, as I have indicated, is that we were marching out of step with our main trading partners. While we were experiencing rapid growth and demand inflation, they were all struggling with "stagflation" and applying tight monetary policies inevitably involving high real rates of interest.

Pressure on the Balance of Payments and the Price Level

The buoyancy of the South African economy in 1981, at a time when economic conditions in the major industrial countries were deteriorating rapidly, has understandably aggravated the cyclical balance of payments deficit which South Africa would in any event have tended to experience near the upper turning point of its domestic business cycle. The sharper than expected decline in the gold price has, of course, also taken its toll. If the present expectation that the current deficit for 1981 will exceed R4 billion is fulfilled, there will have been a "swing" of nearly R7 billion in the current account between 1980 and 1981, namely from the surplus of about R2,8 billion in 1980 to a deficit of over R4 billion in 1981. In the third quarter of 1981 the current deficit was actually running at a seasonally adjusted annual rate of nearly R5,9 billion, which was equivalent to about 8 per cent of gross domestic product.

Since the net inflow of capital (excluding changes in liabilities related to reserves) amounted to only about R360 million during the first nine months of 1981, this naturally placed considerable pressure on the exchange rate and the gold and other foreign reserves. To deal with this situation, the Reserve Bank and the other banks together availed themselves of short-term foreign credits to an amount of R2,1 billion during this period, and it was largely as a result of this increase in "liabilities related to reserves", that the **net** gold and other foreign reserves declined by about R2,4 billion during the first three quarters of 1981. Despite the intervention in the foreign exchange market in support of the rand which this implies, the commercial rand has since January depreciated against the US dollar by 23 per cent and against a weighted basket of foreign currencies by about 14 per cent.

As far as our domestic inflation is concerned, the facts are well known. After reaching an annual rate of 22 per cent in the fourth quarter of 1980, the seasonally adjusted increase in consumer prices declined to an annual rate of 10,4 per cent in the second quarter of 1981, before rising again to 17,7 per cent during the third quarter. Between September 1980 and September 1981 the seasonally adjusted consumer price index rose by 15,5 per cent.

There will be those who would agree with this broad analysis of how South Africa is marching out of step with its trading partners and why this is creating short-term problems for the monetary authorities, but who see the whole situation as self-correcting and who are therefore less concerned about it than the monetary authorities. Now that the economy has entered a downward phase of the business cycle, they believe that imports will decline sharply and that the balance of payments deficit on current account will shrink considerably.

Up to a point there is merit in this assessment. It does appear as if the economy has now moved into a downward phase of the cycle, and there is certainly every reason to expect that the volume of imports will level off and then actually decline during the course of 1982. This is indeed the normal pattern. It is how the "balance of payments adjustment process" is supposed to work. For this to happen, however, monetary and fiscal policies will have to be applied in a manner which will assist and not hinder the balance of payments adjustment process. This is an absolute prerequisite. The need to curb inflation also implies that the depreciation of the rand in terms of other currencies cannot be viewed with equanimity. We **do** therefore have a problem on our hands which requires remedial monetary and fiscal treatment.

Monetary Developments

One does not have to be a devout monetarist to accept that the monetary developments in South Africa during the past three years have had much to do with the development of the problem I have just outlined. Quite clearly, the inordinate rise in total monetary demand during 1980 and the first four months of 1981 was fuelled by an excessive rate of increase in the broadly defined money supply (M2). This monetary aggregate accelerated from an annual rate of 17 per cent in the first quarter of 1980 to 41 per cent in the third quarter, 25 per cent in the fourth quarter and 46 per cent in the first quarter of 1981, before declining to 26 per cent in the second quarter and 10 per cent in the third quarter.

To say that this excessive increase in M2 was mainly "caused" by an undue rise in bank credit to the private sector, does not go to the root of the problem. The fundamental cause of the monetary expansion was the simultaneous existence during 1979 and 1980 of a record surplus on the current account of the balance of payments and the continued application, despite a number of relaxations, of extensive exchange control. This brought about not only an accumulation of money in the hands of the private sector but also a substantial increase in the liquidity base of the banks, which naturally enabled them to create vast amounts of additional money by expanding their credit to the private sector.

These same circumstances also resulted in interest rates declining sharply during 1979 and remaining at abnormally low levels during the first three quarters of 1980. The **structure** of interest rates also became distorted as the accumulation of liquidity, together with the existence of ceilings on bank credit to the private sector, helped to reduce interest rates on call money, Treasury bills, bank acceptances, trade bills and promissory notes to levels which were out of line with the then existing Bank rate of 7 per cent and the prime overdraft rate of 9½ per cent. Throughout the first three quarters of 1980, for example, the Treasury bill rate remained in the vicinity of 4½ per cent and acceptance credits could be arranged freely at an all-inclusive cost of between 6 and 7½ per cent.

The monetary events in South Africa during 1979-80 serve as a good practical illustration of the ineffectiveness of non-market-oriented or "direct" methods of monetary policy such as bank credit ceilings, exchange controls and "administered" interest rates, in an economy with reasonably developed financial markets. Thus, in the prevailing conditions the natural working of market forces quite logically brought about large scale "disintermediation" or borrowing and lending "outside the banking system", including "off-balance sheet lending", i.e. credit intermediated by banks off the balance sheet. This phenomenon took several different forms. One was simply increased inter-company borrowing and lending. Another was the selling by banks of assets under repurchase agreements to the private non-banking sector. A third form was a sharp increase in the utilisation of acceptance facilities and the rediscounting of such acceptances **outside** the banking system by companies seeking to invest their liquid funds. A fourth form of disintermediation which was widely used, was the discounting of bank endorsed trade bills with large depositors, rather than by banks for their own accounts. The low interest rates on these acceptances and bills relative to prime overdraft rates naturally encouraged their use, while the credit ceilings prevented the banks from greatly increasing their own holdings of money market paper.

The result of this extensive disintermediation was a marked increase during 1979 and the early part of 1980 in the velocity of circulation of money (V). This was an abnormal development, since velocity normally increases during periods of **tightening** financial conditions and **rising** interest rates. The disturbing implication of this was that MV was, in fact, rising even more rapidly than the money supply (M) during that period. Looking back now, it is clear that this all added up to an over-expansionary monetary environment. To make matters worse, there was a sharp, although temporary, increase in bank credit to the government sector in the second quarter of 1980, and then a sudden large increase in the net foreign reserves during the third quarter. These developments were doubly inflationary, since they not only increased the money supply directly but also added to the liquidity base of the banking system.

The underlying situation only began to change fundamentally after the abolition of bank credit ceilings in September 1980 and the commencement in October of the downward trend in the net gold and other foreign reserves. Although both the money supply and total monetary demand still continued to rise at an excessive rate until April 1981, conditions in most domestic financial markets began to tighten and both short and long-term interest rates began their upward movement from the end of September 1980. These tendencies gained considerable momentum during the first ten months of 1981.

The Reserve Bank's Restrictive Policy Stance of 1981

The transformation of the monetary and interest rate situation since September 1980 was partly attributable to natural economic forces and partly to the restrictive policy stance adopted by the Reserve Bank. In South Africa, as in most developed economies, central banking today consists largely of operations by the Reserve Bank in the financial markets - operations designed to **accept**, **counteract** or **reinforce** the effects of natural economic forces. A decision to **accept** or **reinforce** developments in the financial markets is just as much a policy decision as a decision to **counteract** these developments. What happened early in 1981, was that the Reserve Bank took the major policy decision to permit natural economic forces, including the decline in the value of South Africa's gold output and other exports, to bring about a tightening in the financial markets and a marked rise in interest rates. If the Bank had wanted to adopt a more expansionary policy stance, it would have prevented or counteracted this tightening in the markets and the consequent rise in interest rates by open-market purchases of securities, by rediscounting paper for banking institutions on favourable terms, by extending cheap credit directly to the Land Bank, by taking up more Treasury bills at the weekly tender at low rates of interest, and by various other means. Such a more expansionary policy would, no doubt, have been popular, but was rejected out of hand by the Reserve Bank in favour of the conservative approach I have outlined.

As an integral part of this policy, the Reserve Bank gave the upward movement of interest rates its official endorsement by raising the Bank rate in four stages from 7 per cent in the beginning of 1981 to its present level of 12½ per cent. Given the existing "link" between Bank rate and the clearing banks' prime overdraft rate, this permitted the latter rate to rise from 9½ to 16 per cent. The Reserve Bank also made increased use of open-market sales of securities. In addition, the Treasury made successful new issues of government stock in May and October, which the Reserve Bank supplemented extensively with sales of stock issued to it on tap by the Treasury.

Not surprisingly, one of the first effects of the Reserve Bank's restrictive policy was the replacement of "disintermediation" by the opposite movement of "re-intermediation", including a return to "on-balance sheet lending". Thus, although the utilisation of acceptance facilities remained large because the rates on acceptances were at that stage still low relative to overdraft rates, an increasing proportion of acceptances outstanding were taken up **by the banks themselves**. This is illustrated by the fact that the banks' holdings of acceptances as a percentage of total utilised acceptance facilities, which had declined from 68 per cent at the end of 1975 to below 6 per cent in May 1980, subsequently increased again to 47 per cent at the end of June 1981.

Another form of re-intermediation was the substitution of bank credit for the discounting of bank endorsed trade bills outside the banking system. In addition, the banks also curtailed their practice of selling assets under repurchase agreements to the private non-banking sector. At the same time, the bank overdraft, which had nearly gone out of fashion earlier in 1980, came back into its own, particularly after the cost of acceptance and bill financing increased to levels in excess of the prime overdraft rate.

This re-intermediation process naturally resulted in a particularly sharp increase in bank credit to the private sector, and therefore in the money supply, during the first four months of 1981. Since this increase was, however, accompanied by a marked decline in the velocity of circulation of money, it greatly exaggerated monetary expansion at the time.

Interest Rates and Monetary Policy

A basic feature of monetary policy during the past year, and certainly one that has attracted considerable public interest, has been the sharp increase in both short and long-term interest rates. By and large, the necessity for these increases has been well accepted by businessmen, financial commentators and the general public, and we in the Reserve Bank appreciate their support. However, here and there one still encounters some misunderstanding about the role of interest rates in recent South African monetary policy, and I would therefore like to address myself to this issue today.

In the past, monetary policy in South Africa has at times been characterised by the absence of a clearly defined approach to either monetary aggregates or interest rates and therefore also to the relationship between them. Until recently, no use was made of either published or unpublished targets for M1, M2, cash base or any other monetary aggregate, except in one instance where this was a precondition for a drawing on the International Monetary Fund. Nor were any specific targets set for interest rates. Indeed, for long periods, interest rates did not feature prominently in monetary policy at all. There was the occasional change in Bank rate, and at times penalty rates were charged for accommodation to discount houses and other banking institutions. But there was rarely a clear commitment to any kind of interest rate policy as an integral part of monetary policy. Critics accordingly from time to time picked up the point that the monetary authorities appeared to be taking action in the interest rate field which conflicted with their objectives in the money supply field, and **vice versa**. There were, for example, periods when the authorities used deposit rate control to keep deposit rates below market levels, partly to assist the building societies, at a time when it was official policy to **reduce** monetary expansion. Naturally, this kind of conflict between the objectives of money supply and interest rate policy often created a strong incentive for disintermediation or other increases in velocity-based credit.

The precise approach to be adopted in future towards the monetary aggregates and interest rates is at present the subject of investigation by The Commission of Inquiry into the Monetary System and Monetary Policy in South Africa. There are those - the monetarists - who favour the application of a "money rule", i.e. the setting of publicly announced targets for one or more of the monetary aggregates, leaving interest rates free to fluctuate and to find their own market-determined levels. Others believe it to be more appropriate to operate, in the first instance, on interest rates, but then with full acceptance of the implications of such actions for the money supply. Since the Monetary Commission is at present looking closely at all these alternatives, I shall not take the matter any further today, except to express the absolute conviction that the successful application of monetary policy in South Africa requires full recognition of the interrelationship between the monetary aggregates and interest rates, and of the folly of trying to determine these two sets of variables independently.

It is probably an inadequate appreciation of this basic point which has given rise to some misunderstanding about the role of interest rates in South Africa during the past year. There are apparently still some commentators who see little connection between money supply and interest rates, and who believe that restrictive monetary policy consists mainly of **arbitrarily** raising Bank rate, prime overdraft rates, the yields on government stock, building society mortgage rates and various other interest rates, on the theory that this, by itself, will discourage investment and consumption and encourage saving, and in this way bring about a lower rate of inflation and a stronger balance of payments - a theory which many of them find difficult to accept.

This, of course, is not an accurate description of the way restrictive monetary policy is meant to work. The reality is that, in any situation of demand inflation, a policy of curbing money supply expansion will almost inevitably, particularly if it is successful, **result** in a tightening of financial markets and a rise in interest rates in the short term. In a developed free enterprise economy like that of South Africa, the one is not possible without the other. Indeed, in the situation of the past year, the only effective way of preventing interest rates from rising would have been for the Reserve Bank to have arranged the creation of even more credit and money - something which would, of course, have defeated the whole object of the exercise.

Another misunderstanding is the notion that interest rates in South Africa are now "high". Some important businessmen and other commentators have even described the present level of interest rates in South Africa as "traumatic". This is simply not true. Certainly, our interest rates have risen sharply during the past year. But this increase occurred from a level in 1979 and most of 1980 which was artificially and abnormally, and I would add dangerously, low. At their present levels, South African interest rates are "high" neither in relation to the domestic rate of inflation nor to real interest rates abroad. One does not need a calculator to appreciate that with our present rate of inflation of around 15 per cent, most interest rates in South Africa are relatively low, if not negative, when measured in real terms. And to measure the burden of any interest rate, one must look at the **real** rate.

Our present Bank rate of 12½ per cent, for example, may be a record for South Africa **in nominal terms**, but Bank rate has on numerous past occasions been much higher in real terms. In 1968, for example, it was about 4 per cent in real terms, compared with the present **minus** 2½ per cent. In the same year, to take a further example, the **real** building society mortgage rate was about 6 per cent, as against the present negative rate.

In addition, quite apart from whether our interest rates are "high" or "low", the fact remains that they are still **lower**, even in nominal terms, than those of some of our main trading partners. Because of its effects on foreign trade financing and the inflow of foreign capital generally, this in itself creates problems for a country that is developing rapidly and running a large current account deficit which has to be financed one way or another.

These general comments should not be interpreted as an indication that the monetary authorities at this point in time expect or favour any significant further increase in the general level of interest rates. If I knew what South African interest rates were going to do in the coming weeks and months, I would not refer to the matter in a public speech. The truth is that nobody knows for certain whether South African interest rates are going to rise or fall in the period ahead. In recent weeks, interest rates in the United States and several other industrial countries have declined quite sharply and appear to be on a downward path for the time being. In the domestic financial markets the demand for funds may be tapering off to some extent, thereby also easing the pressure on interest rates. These and many other developments and considerations will influence the future behaviour of interest rates in South Africa, which makes it difficult to predict.

All that I am prepared to say today is that the importance for South Africa of maintaining realistic market-related interest rates cannot be stressed enough. Neither the present deficit on our balance of payments on current account nor the "deficit before borrowing" in the Budget is unduly large in relation to gross domestic product. In themselves they need not cause us any concern, particularly since they can confidently be expected to decline again in due course. But they are nevertheless **deficits**, and deficits have to be financed. Appropriate financing of these two deficits should be attainable without too much difficulty in the period ahead. But then our interest rates must at all times be kept at realistic levels.

Need for a Continued Tight Money Policy

As I have indicated earlier, the efforts of the monetary authorities to reduce the rate of increase of the money supply have met with a measure of success in recent months. The extent of the decline in the rate of increase of the broad money supply (M2) becomes clear if one compares the seasonally adjusted annual rate of increase of 53 per cent during the first four months of 1981 with that of only about 9 per cent during the subsequent five months. This is most gratifying. For the time being, of course, we are still suffering from the delayed inflationary effects of the earlier excessive monetary expansion. But given the normal time lags involved, we should begin to feel the favourable disinflationary effects of the lower rate of increase of the money supply in due course.

As yet, however, there can be no question of relaxing the present tight money policy. The economy may have entered a downward phase of business cycle, but for the time being it is still suffering from excess demand. Moreover, given the adverse external developments to which I have referred and the extent to which we are still out of step with our main trading partners, we have no option but to continue with measures designed to cool down the economy and to permit the balance of payments adjustment process to work.

Although the Reserve Bank has adopted a restrictive stance throughout 1981, it has, if anything, erred on the side of shielding the domestic economy too much against the adverse effects of external developments, rather than on the side of "over-kill". Although continuing to accord a high priority to the need to curb inflation, the Bank has, in fact, sought a compromise between this aim and the objectives of maintaining a sound balance of payments and a high rate of economic growth. It was in pursuance of such a compromise that the Bank permitted the rand to depreciate against the US dollar and most other major currencies. Although this obviously made it more difficult for the authorities to curb inflation, it served to cushion the adverse effects on the mining industry and other exporters of the sharp decline in the dollar price of gold and in the foreign currency proceeds of our exports in general. Allowing for the so-called "J-curve effect", this depreciation of the rand should in due course also help to strengthen the balance of payments.

Furthermore, when in early August this year the gold price fell below $400 per ounce and additional pressure was exerted on the Reserve Bank's foreign reserves at a time when South African interest rates were still considerably below those in the United States, the Bank resorted to the artificial device of quoting much larger discounts on forward dollars with the specific aim of neutralising the interest rate differential and thereby encouraging South African banks and some of their clients to make relatively more use of foreign financing.

This step immediately achieved its objectives. Covered against exchange losses and protected against the high overseas interest rates by the Reserve Bank's generosity, the banks and some of their clients switched to overseas financing on quite a meaningful scale. This had the desired effect of easing the pressure on the official foreign reserves. Unfortunately, it also eased the domestic financial situation, reversed the upward tendency in certain short-term interest rates, and thereby weakened the restrictive impact of the Bank's domestic monetary policy.

In opting for the use of artificial forward dollar discounts rather than permitting a further rise in domestic interest rates at that stage, the Bank was therefore again shielding the domestic economy from the cold winds of overseas recession and, in effect, facilitating the postponement of essential adjustments in the domestic economic situation and the balance of payments. In recent weeks, however, following the decline in American interest rates and the negotiation of substantial new gold swaps designed to give the Bank more latitude in managing its foreign reserves, the discounts on forward dollars have been phased out completely and replaced by premiums.

In the meantime, the Reserve Bank has also been active in arranging the extension of record amounts of bank advances to the Land Bank, at relatively low rates of interest, to finance the record maize and other crops through the agricultural co-operatives. The anomaly that these advances to the Land Bank rank as full "liquid assets" in terms of the Banks Act greatly eases the liquidity position of the banks and therefore undermines the effectiveness of the Reserve Bank's monetary policy. In addition, whenever called upon to do so, the Bank has been taking up Treasury bills at the weekly tender and extending credit to official extra-budgetary funds. Throughout 1981 the Bank has also gone out of its way to perform its function as "lender of last resort" by granting accommodation to discount houses and other banking institutions at times of seasonal or other exceptional financial tightening. There can be no doubt therefore that the monetary authorities have leaned over backwards to protect the domestic economy and to ease the process of adjustment. I believe that in doing so we have erred on the side of leniency. Others will say we have done well in ensuring a "soft landing". But enough is enough. To proceed further along this road would run the risk of exacerbating inflation, weakening the balance of payments and jeopardising South Africa's economic stability.

The time has come to take a firm stand in defence of the internal and external value of the South African rand and to carry the policy of consolidation and adjustment to its logical conclusion. This means maintaining tight control over government spending, banking liquidity and the money supply. It also means permitting financial markets to tighten further if necessary and accepting both realistic interest rates and premiums on forward dollars. More fundamentally, it means facing up to economic realities, living within our means and making the adjustments essential to the preservation of one of South Africa's greatest assets - its strong and fundamentally sound economy.