South African Reserve Bank

The role of monetary policy in influencing savings behaviour in the South African economy

Address by Dr Monde Mnyande, Advisor to the Governor and Chief Economist, South African Reserve Bank (SARB), at the Annual Savings Workshop, hosted by the South African Savings Institute at the South African Reserve Bank Conference Centre in Pretoria, 2 September 2010

Introduction

It is an honour for me to partake in the proceedings of the day at this Annual Savings Workshop for 2010 which marks the climax of the National Savings Awareness campaign for this year. My primary objective today is to elaborate on the role that monetary policy play and can play in influencing savings behaviour in the South African economy. I will also highlight some pertinent issues pertaining to fiscal policy in shaping the savings environment.

My presentation today will commence with a description of the concept of savings, followed by a discussion of the longer-term evolution of savings behaviour in the South African economy, focussing not only on the overall savings rate, but also dealing with

savings outcomes of the private sector and general government. I will furthermore deal with savings behaviour of economic agents in their effort to maximise utility over their life-cycle, against the background of monetary policy intervention in contributing to a sound financial system. Being critically important in shaping the environment within which savings behaviour takes place, the role of fiscal policy will be dealt with. My presentation will thus conclude with some general thoughts on how to raise the absolute level of savings in the country.

The concept of savings defined

In national accounts terminology, savings is the net surplus of income over consumption, or stated differently, the amount of resources or income produced in the economy in a given period, that is not consumed immediately but put to use in a way that will provide returns to the economy in future. A relatively moderate level of domestic savings could reduce a country's rate of investment, restrain the rate of economic growth and increase a country's vulnerability to international capital movements of the type that was experienced during the most recent global financial crisis.

In an open economy such as South Africa's, investment equals the sum of national savings and the net surplus of imports over exports. The import surplus represents the gap between the value of South Africa's overall spending and its overall production, or the amount of investment not financed by domestic savings. The import surplus is in essence the accumulation of foreign claims on

South Africa's assets, or the degree to which non-residents purchase new domestic capital.

In general, the spending and saving behaviour of individuals is determined by various factors such as their material and social needs, traditions, standard of living, existing indebtedness, net worth, disposable income, the stance of the business cycle, institutional and regulatory considerations and fiscal and monetary policy. In a savings deficit country such as ours, where domestic absorption is in excess of income, a deficit on the current account of the balance of payments is recorded. Conversely, a savings surplus country exports its surplus by running a current account surplus.

The evolution of savings outcomes in the South African economy

When expressed as a percentage of gross domestic product, gross saving in the South African economy averaged around 22 per cent in the period from 1960 to 1999. However, a clear downward trend became evident in the aggregate saving rate since the 1990s. The average saving rate in the period 1985 to 1999 fell to around 18 per cent from around 23 per cent in the period from 1960 to 1972 and 25 per cent in the period from 1973 to 1978. During the period 1979 to 1984 the average savings rate amounted to 27 per cent when savings behaviour was strongly

influenced by wind-fall profits of gold-mining companies when the price of gold reached exceptionally high levels. By contrast, the national savings performance during the 1990s deteriorated substantially to around 16 per cent, remaining broadly at this level in recent years.

Various reasons can be advanced for the decline in the saving rate. The decline in the saving rate in the 1980s and 1990s resulted primarily from slow economic growth and rising tax and real interest burdens. In an effort by individuals to maintain their lifestyles, they saved less. When income growth picked up slowly from the mid-1990s, it was accompanied by an increased redistribution drive, working in favour of higher consumption, preventing much of a savings revival. Only from 2003 has much more vigorous economic and income growth been restored, but still this was not accompanied by much of a savings renewal. Two main reasons can be advanced for the savings rate remaining suppressed. Firstly, the increase in tax burdens as well as increased government spending with a redistribution bias, favoured household consumption rather than savings. Secondly, the unfriendly tax regime towards savings encouraged the middle class households to rather channel income to corporate entities.

Also, capital gains tax encouraged middle class households to accumulate their investments in asset markets i.e. houses and equities. Instead of liquidating such assets to finance consumption, they escape capital gains tax by not selling their assets. In the process households boost their net worth, which can be used to negotiate access to credit. Thus households still

save, except they no longer do so out of income but rather in ways which fall outside the national accounting sense of savings.

In the years leading up to 2008 foreign capital inflows and an improving fiscal balance, enabled a significant increase in investment's share of GDP. While gross national saving as a share of GDP has declined to an average of 14,6 per cent since 2005, gross capital formation has risen to an average of about 20 per cent of GDP over the same period. The difference, after accounting for the change in gold and other foreign reserves, is foreign saving or the so-called net capital inflow from the rest of the world that finances the remainder of South Africa's capital formation. Net capital inflow from the rest of the world has in our view enabled South Africa to finance significantly greater levels of capital formation than would have been the case if it were relying solely on national savings.

A country's most important source of financing usually comes from national saving in the domestic economy that originates in both the private and government sectors. Gross private saving, being the sum of saving by households and businesses, declined significantly in recent years, dropping from a ratio of 19,1 per cent of GDP in 1996 to only 10,6 per cent of GDP in 2007 before recovering to 15,9 per cent in 2009. The main reason for the decline between 1996 and 2007 was the significant decline in household saving.

A rising propensity to consume over the past two decades was reversed somewhat in 2008 and 2009 as the declines in

employment, home values, investor portfolios and uncertainties surrounding retirement plans contributed to a marked improvement in household saving.

A strong increase in the ratio of household debt to disposable income of households occurred in recent years. Empirical evidence reveals that up until 2008, both households and non-financial corporations in South Africa built up their financial balance sheets via increased borrowing. This led to more pronounced financial exposure of households and companies alike. The increased borrowing has financed both higher financial investment and a growing net financing requirement, reflecting continued investment in excess of savings. In 2008, the tide turned, and borrowing by both households and companies fell back somewhat. The expansion of the financial balance sheets has however led to more exposure to financial market developments. In turn, this has increased the interplay between the financial and real sides of the economy. Moreover, it also influences the transmission of monetary policy to the real economy.

Sound saving decisions, like all resource allocation decisions, are best taken in an environment of price and financial stability. The contribution of monetary policy to saving lies in ensuring price stability and financial stability in the interest of balanced and sustainable growth and development. Domestic saving and capital inflows from abroad tend to thrive in economies that are characterised by price stability such as ours.

When analysing the relationship between gross saving as a ratio of GDP and the prime overdraft rate, it is clear that the trend in the saving ratio does not appear to have reacted much to shorter-term movements in interest rates. However, when interest rates are kept too low for too long - about which the Bank of International Settlements sounded a warning in its 2009/2010 annual report – it will inevitably distort economic activity, as was the case in a number of countries during the period of rapid global growth. Too low interest rates slow the process of restoring balance sheets by keeping asset prices artificially inflated. If interest rates are kept at levels that are too low they also penalise saving, thus prolonging the process of rebuilding balance sheets.

Monetary policy and savings behaviour

The impact of monetary policy on saving is unpredictable and at times perverse. For instance, when lowering the policy rate, economic activity could be stimulated, leading to increased incomes and saving. Persons saving to accumulate a certain amount at a certain time, i.e. target savers, will have to save **more** of their current income to compensate for lost interest when interest rate are lowered. Conversely, higher interest rates may not necessarily lead to increased saving over the short term if growth and incomes are constrained in the process. Saving is best promoted through lasting coherent structures and sound mix of policies than through short-term orientated interventions.

Though monetary policy can influence real economic activity in several ways, changes in household’s balance sheets may have

implications for the way that a change in policy-controlled interest rates affects output and the Reserve Bank's ultimate objective, namely price stability. Monetary policy affects the economy directly through the impact of market interest rates on expenditure. However, changes in the repurchase rate can have additional effects through the movements induced in asset values and balance sheets. When long-term interest rates decline in response to a change in the monetary policy stance, this will result in an increase in asset values and, accordingly, in household wealth. Consequently, a higher level of wealth should enable households to reduce their saving and increase their consumption.

Fiscal policy shaping the savings landscape

Turning now to fiscal policy and its contribution to establishing an environment which is conducive to increased savings behaviour. During the years leading up to the global financial crisis when the economy was performing well, South Africa's national debt obligation was meaningfully reduced. This enabled a significant countercyclical response to the recessionary conditions that prevailed during the latter half of 2008 and the first half of 2009.

In an effort to act in a countercyclical manner during 2008 and 2009, fiscal policy focused almost exclusively on stimulating gross domestic expenditure. As a consequence, the downward trend in total national government debt as a percentage of gross domestic product increased in 2009, following an extended period of decline.

During the past two years, countercyclical expenditure growth has been particularly strong as indicated by government's share of GDP rising from 28,5 per cent in 2007/08 to 34,1 per cent in 2009/10. Relatively low public debt levels created the so-called fiscal space, that enabled the country to sustain public spending and raise infrastructure investment within an environment of reduced tax revenues.

Government's stated intention in the 2010 budget is to manage public finances along a trajectory that will return the fiscus to a sustainable position. The deficit is projected to continue trending downwards as spending growth moderates and revenue continues to rise. Over the next three years public spending is projected to grow by about 2 per cent on average in real terms compared with average real growth of 7,2 per cent in the preceding three years. Non-interest expenditure is projected to decline over the forecast period and rising budget revenue is envisaged to lead to a narrowing of the primary budget deficit over the next three fiscal years.

The public sector borrowing requirement remains at significantly higher levels than in recent years over the forecast period due to countercyclical widening of the general government deficit and increased infrastructure spending. Most of the borrowing requirement is to be financed by domestic savings over the forecast period. Borrowing in the foreign capital market is, nevertheless, to be stepped up to between US$2 billion and US$3 billion per year.

Based on National Treasury's real GDP growth estimates, the central forecast is for South Africa's net loan debt to rise to 44 per cent of GDP in 2015/16 and to decline gradually thereafter. While National Treasury's assumptions produce a reasonably favourable fiscal outlook, lower economic growth outcomes and higher fiscal deficits pose significant risks to the outlook, and could be viewed as negative for savings going forward.

In the years leading up to 2008, foreign capital inflows and an improving fiscal balance, enabled a significant increase in the investment's share of GDP. To ensure that a growing debt burden does not crowd out spending on development priorities, government has embarked on a controlled reduction of the deficit. Tax and spending plans have accordingly been adjusted significantly to achieve a sustainable fiscal balance. The solution required for ensuring a durable economic recovery, lies in the restoration of balance sheets.

Thoughts on how to raise the absolute level of savings in the country

The savings behaviour of economic agents is to a large extend subject to institutional and structural factors within an economy. Key to any environment which is conducive to positive savings behaviour is the absence of negative real interest rates, giving rise to consumption behaviour being financed by "cheap" money. An environment which is characterised by low and stable inflation gives rise to more sound savings decisions, and accordingly enables better resource allocation. Pertinent to the promotion of

saving is the absence of punitive taxation on the returns to saving. The excessive reliance on short-term monetary policy measures to control savings should be avoided, due to possible perverse reaction to such measures, as already indicated earlier in my presentation.

The earlier implementation of the National Credit Act provides for the protection of consumers in the sense that it guards them from the excessive uptake of credit, steering them away from over-indebtedness, motivating own savings behaviour. The establishment of a compulsory social security and retirement savings scheme for all citizens will greatly enhance the accumulation of savings in the country. The avoidance of large budget deficits by government will be conducive to prudent savings behaviour. Furthermore, the establishment of investment-friendly savings tools such as the RSA Retail Bonds initiative should be encouraged and supported. It goes without saying that sound and trustworthy saving institutions form the back bone of any sustainable savings drive in a country.

In summary, in order to ensure sufficient financing for higher levels of investment associated with robust economic growth, the domestic saving ratio must improve significantly in coming years. For consumers and businesses alike, it implies that they will have to borrow or emulate the “Asian saving culture” and save more of their incomes. A higher domestic saving ratio will ensure that capital formation will prove more sustainable than in the past. To this end, monetary policy will have to continue to play the ever

important role of stabilising output at high but non-inflationary levels.

I thank you.

A brief explanation of real interest rates

The real interest rate is more accurately defined by the *Fisher equation,* named for Irvin Fisher, one of the great monetary economists of the twentieth century. The Fisher equation states that the nominal interest rate i equals the real interest rate i_r plus the expected rate of inflation π^e.

$$i = i_r + \pi^e$$

Rearranging the terms, we find that the real interest rate equals the nominal interest rate minus the expected inflation rate:

$$i_r = i - \pi^e$$

The distinction between real and nominal interest rate is important because the real interest rate, which reflects the real cost of lending and borrowing, is a better indicator of the incentives to borrow and lend (save) and is a more accurate indicator of how borrowers and savers will be affected by what is happening in the financial markets, than the nominal interest rate.

The South African Reserve bank constructs the real interest rate measure by adjusting the nominal rate by the Reuters forward-looking or one-year-ahead targeted inflation forecast (quarterly forecast data interpolated to obtain monthly data). From the beginning of the monetary policy tightening cycle in June 2006, the repurchase rate has been raised by a cumulative 500 basis points. Accordingly, the real repurchase rate initially declined before increasing sharply from the second half of 2007 and reached a high of 6,64 per cent in November 2008 as analysts expected future inflation to moderate in the wake of the progressive monetary policy tightening. Alongside the improvement in inflation expectation and relaxation of monetary policy stance from December 2008, the real interest rates trended downwards and reached a low of 0,73 per cent in August 2010.

Simultaneously, the real interest rate on 12-month fixed deposits at banks also declined and reached a low of 1,52 in June 2010. As a saver one may be less eager to lend or make a deposit in such a case, because in terms of real goods and services (inflation of 5,4 per cent) one will actually be earning a lower rate of interest.