

## CHAPTER 5

### **SOUTH AFRICA'S EXPERIENCE WITH INFLATION: A CENTRAL BANK PERSPECTIVE**

#### 5.1 Introduction

Although a country's experience with inflation can be reviewed from different perspectives (e.g. the government, the statistical agency responsible for recording inflation, producers, consumers or savers), this chapter reviews South Africa's experience with inflation from the perspective of the SA Reserve Bank. The SA Reserve Bank was chosen because this study focuses on inflation from a monetary perspective. Reliable inflation data for South Africa are published as far back as 1921<sup>53</sup>, co-inciding with the establishment of the SA Reserve Bank, although rudimentary data on price levels are available as far back as 1895.

South Africa's problems with accelerating inflation since the 1970s are well documented (see for instance De Kock, 1981; De Kock, 1984; Republiek van Suid-Afrika, 1985; Rupert, 1974a; Rupert, 1974b; or Stals, 1989), but various parts (or regions) of what constitutes today the Republic of South Africa have experienced problems with inflation, rising prices or currency depreciation well before 1921. The first example of early inflation in South Africa was caused by currency depreciation. At the time of the second British annexation of the Cape in 1806, the Dutch riksdaalder ("riksdollar") served as the major local currency in circulation. During the tenure of Caledon, Governor of the Cape Colony from 1807 to 1811, and Cradock, Governor from 1811 to 1814, riksdollar notes in circulation were increased by nearly 50 per cent (Engelbrecht, 1987: 29). As could be expected under circumstances of increasing currency in circulation, the value of the riksdollar in comparison to the British pound sterling and in terms of its purchasing power declined from 4 shillings in 1806 to 1 shilling and 5½ pennies in 1825 (or

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<sup>53</sup> Tables A1 to C1 in Appendices A to C highlight South Africa's experience with inflation, as measured by changes in the CPI since 1921.

1/6, according to *Die Huisgenoot*, 1938: 43), a decline in value of 4,86 per cent per annum, with a concomitant increase in the prices of consumer goods (Engelbrecht, 1987: 29).

Secondly, domestic spending financed by bank credit during World War I resulted in domestic price increases in South Africa (De Kock, 1954: 9). De Kock (1954: 9) mentions that the index of retail prices covering food, fuel, light, rent and sundries increased at an average rate of nearly 15 per cent per annum in the period 1914 to 1920. Whereas the main focus of this study is the period commencing in 1921, which co-incides with the establishment of the SA Reserve Bank and the comprehensive measurement of inflation by means of changes in the CPI, these two examples show that domestic inflation is not a problem limited only to the period under review.

This chapter commences with a discussion of the establishment of the SA Reserve Bank in Section 5.2. Sections 5.3 to 5.14 consider various phases since 1921 and the SA Reserve Bank's successes (or otherwise) in containing inflation. Section 5.15 highlights initiatives of the SA Reserve Bank aimed at improving communication since the adoption of an inflation target in 2000. The conclusions follow in Section 5.16.

## 5.2 Establishment of the SA Reserve Bank<sup>54</sup>

The earliest proposals for the establishment of a central bank in South Africa were made as far back as 1879 by the Afrikaner Bond, a political party in the then Cape Colony (D'Assonville, 1999: 203; De Kock, 1954: 3; SA Reserve Bank, 1971: 9)<sup>55</sup>. Financial and economic turmoil in

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<sup>54</sup> The first bank established in South Africa was the Lombaard Bank in Cape Town, which opened its doors for business on 23 April 1793 (Arndt, 1928: 191). Although this bank was fully-owned by the Cape Colonial Government, it was established with commercial activities in mind (Arndt, 1928: 191), and was not envisaged to function in any way as a central bank. This bank was closed in 1842, *inter alia*, as it did not meet the banking requirements of the Cape Colony at the time.

<sup>55</sup> In the period between 1897 and the establishment of the SA Reserve Bank in 1921, various calls were made for its establishment (SA Reserve Bank, [S.a.]: 1). Examples are a series of articles in the early 1890s in a newspaper, *De Paarl*, at the time edited by du Toit, the founding leader of the Afrikaner Bond (D'Assonville, 1999: 125); calls for the establishment of a central bank to co-incide with Unification in South Africa in 1910 (SA Reserve Bank, [S.a.]: 1); and a speech in 1912 by Postmus of De Nederlandsche Bank voor Zuid-Afrika, who was appointed as Governor of the SA Reserve Bank in 1932 (SA Reserve Bank, [S.a.]: 1).

the period after the Great War (later known World War I) accelerated the establishment of the SA Reserve Bank.

Before the establishment of the central bank, commercial banks in South Africa printed their own banknotes for issue (SA Reserve Bank, [S.a.]: 1). These notes were backed fully by gold in terms of a gold standard, i.e. the notes could be exchanged for gold. At the time of the establishment of the SA Reserve Bank, the power of commercial banks to issue banknotes was internationally a long-established practice, albeit under “review”, as banks of issue (as central banks were initially known) were established in various countries, particularly in Europe, in the nineteenth century (SA Reserve Bank, [S.a.]: 1).

During the Great War the South African currency remained on a gold standard and commercial banks were obliged to redeem their notes for gold (De Kock, 1954: 11) in terms of an arrangement where the domestic currency was pegged to the British currency (pound sterling), which in turn was pegged to the US dollar and, therefore, the gold price, in each instance at a fixed exchange rate. This arrangement ended in March 1919 when the peg of pound sterling to the US dollar came to an end, with pound sterling depreciating against the US dollar and gold (Gelb, 1989: 54). As a result, gold obtained in South Africa through the conversion of banknotes at commercial banks could be sold at a premium in London (SA Reserve Bank, 1971: 10). At the same time, domestic commercial banks had to buy gold at the same premium in London to provide the necessary backing for their banknotes in issue in terms of the gold standard applied in South Africa. In reaction to the call on government by the commercial banks to be released of this obligation to “trade at a loss”, a Gold Conference was convened in Pretoria in October 1919 (De Kock, 1954: 11).

One of the resolutions of the Gold Conference was to request government to introduce one uniform Bank Act for the country (De Kock, 1954: 13), as no such legislation had been introduced since the unification of the country in 1910. Following on this proposal, the Government engaged the services of Strakosch (later Sir Henry), a British banker, who was instrumental in a proposal that a domestic central bank should be established (De Kock, 1954: 14;

see also Gelb, 1989: 48). This culminated in the Currency and Banking Act, No 31 of 1920, which provided, *inter alia*, for the establishment of a central bank with the power to issue domestic banknotes<sup>56</sup> (De Kock, 1954: 23; Engelbrecht, 1987: 95 and 96; Mboweni, 2000b: 1; SA Reserve Bank, 1971: 11 and 12). The SA Reserve Bank opened on 30 June 1921 (SA Reserve Bank, 1971: 12) and issued its first banknotes to the public on 19 April 1922 (SA Reserve Bank, 1971: 22). Commercial banks were accordingly instructed to cease issuing or re-issuing their own banknotes with effect from 30 June 1922.

The name chosen for the central bank of South Africa, the SA *Reserve* Bank, reflects reference to the Federal *Reserve* System. De Kock states that “[t]he features which the South African Reserve Bank had in common with the Federal Reserve Banks at that time were ... [t]he designation of Reserve Bank, which had previously been adopted only in the United States ...” (1954: 38). Subsequently, the word *Reserve* has been used in the names of the central banks of Peru (albeit in Spanish, *Reserva*), established in 1922; New Zealand, established in 1933; El Salvador (albeit in Spanish, *Reserva*), established in 1934; India (1935); Australia (1945); Malawi (1964); Zimbabwe (originally the central bank of Rhodesia) (1964); Fiji (1973); Vanuatu (1980); and Tonga (1989).

By 1921 the majority of central banks had private shareholders (or stockholders as they were occasionally called), and a similar structure was introduced for the SA Reserve Bank. This approach changed internationally in the 1930s, when certain governments started nationalising the central banks in their countries (De Kock, 1956: 312). Since its inception, the ownership structure of the SA Reserve Bank has not been amended, i.e. it remains a juristic person in terms of its own Act, which provides for private shareholders. The support of the Select Committee of Parliament with responsibility for the promulgation of the Currency and Banking Act for establishing a central bank “... seems to have been based to an important extent on its view that only by centralising the issuing of banknotes in a single non-commercial banking institution

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<sup>56</sup> The establishment of a central bank was not supported unanimously (see for instance SA Reserve Bank, 1971: 12). It is of interest to note that Jorrison of De Nederlandsche Bank voor Zuid-Afrika who opposed the timing of its establishment, nevertheless accepted the position as the first Deputy Governor of the SA Reserve Bank in January 1921 (De Kock, 1954: 13; Meiring, 1994: 125).

would it be possible to prevent a recurrence of an unduly rapid and inflationary increase in note circulation” (SA Reserve Bank, 1971: 11). De Kock (1956: 123) states that central banks have increased their focus on the control of credit to stabilise the price level after the abolition of the gold standard<sup>57</sup>.

At the time of its inception, the SA Reserve Bank had to deal with a situation in terms of which the country was nominally on a gold standard, but the system was effectively suspended. Government could issue gold certificates in exchange for gold bullion or specie or banknotes, but declare the certificates non-convertible, albeit for a limit period of time only (SA Reserve Bank, 1971: 26). Clegg, the first Governor, did not only find (understandably so) a lack of people knowledgeable in central banking, but the SA Reserve Bank also had to encourage “... the further development of a local money market in South Africa and made strenuous efforts to secure the more widespread use of trade bills and other money market instruments, partly with a view to enabling it to apply its discount rate policy and open-market operations in a more effective manner” (SA Reserve Bank, 1971: 21). The problem of underdeveloped money and capital markets and a lack of suitable instruments to use for open-market operations, remained a problem in the implementation of monetary policy in South Africa until deliberate steps were taken by the authorities to ensure the development of these markets after World War II.

Over the period 1921 to 2006 average prices, as reflected by changes in the CPI, increased considerably in South Africa. In terms of an index with 1922 = 100, the index value for 2006 is 9 083,5, or an increase of 5,51 per cent per annum on average. Put differently, the implication is that the purchasing power of R1,00 in 1922 was only some 1,1 cents in 2006. At the same time, an average basket of goods and services that sold for the equivalent of R1,00 in 1922, will cost about R90,84 today.

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<sup>57</sup> Although this historic overview confirms an implicit or explicit focus on inflation in the conduct of central banking since the 1930s, the SA Reserve Bank’s enabling legislation was changed only in 1989 to make provision for this objective. From the literature, however, it transpires that the SA Reserve Bank focused attention on mitigating inflation well before 1989 (see for instance De Kock, 1954; De Kock, 1956; or SA Reserve Bank, 1971).

In the analysis of domestic monetary policy since 1921 it is important to note that “[r]eadily available information on South African interest rates dates back to the period following Unionisation in 1910. Interest rate statistics for this early period are, however, very limited and coverage was only slightly expanded between then and the end of the Second World War” (Republic of South Africa, 1985: 105). As far back as 1921, the Fed and the Bank of Finland were the only two central banks in the world with regular statistics publications, and the publication of such a report by the SA Reserve Bank commenced only in 1946 (Meiring, 1996: 32). The SA Reserve Bank’s first “... *Quarterly Bulletin of Statistics* was dated 12 September 1946 but, according to the annals, appeared on 8 October 1946” (Meiring, 1996: 32), comprising monthly data of the SA Reserve Bank’s assets and liabilities. Its publication followed on the appointment of De Jongh, a later Governor of the Reserve Bank, as its first Statistician on 1 January 1946 (Meiring, 1994: 45). In ensuing issues, the data included in the *Quarterly Bulletin* increased considerably, to the extent that by 1974 the *Quarterly Bulletin* “... received the highest ranking among all economic periodicals used by South African researchers” (Meiring, 1996: 59).

From its small beginnings, the SA Reserve Bank grew to its current position, where it “... performs virtually the full range of functions and duties that are customarily carried out by central banks” (Mboweni, 2000b: 1). In its growth over many years, the statute of the SA Reserve Bank was not only replaced by new legislation on two occasions (1944 and 1989), but the legislation was also amended on numerous occasions to cater for changing circumstances challenging the implementation of monetary policy. The following 12 sections deal with various phases and periods in South Africa’s monetary policy and changes in the inflation rate since 1921.

### 5.3 Gold standard: 1921 to 1931<sup>58</sup>

The SA Reserve Bank’s approach to monetary policy after its inception in 1921 was the application of credit and interest rate policies aimed, in orthodox gold standard fashion, at bringing about the necessary conditions for an eventual return to such a standard. At the time non-convertibility (in the true sense of the word, i.e. into gold specie or coin) was seen as merely

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<sup>58</sup> Except where stated otherwise, this section draws on De Kock, 1954.

a temporary measure, and policy debates focused on the embargo on gold exports and the acceptability of not linking the South African pound to the British pound sterling. South Africa reintroduced the gold standard at the pre-war conversion rate on 18 May 1925. This put the South African pound on par value with the UK pound sterling, as the UK returned to a gold standard on 25 April 1925, also at the pre-war conversion rate (Sloman, 1994: 607)<sup>59</sup>.

For purposes of analysing the SA Reserve Bank's credit policy during 1921 to 1931, the period could be split into two sub-periods. During the first sub-period, the SA Reserve Bank applied its credit policy with the restoration of the gold standard in mind. During the second sub-period, the aim of the SA Reserve Bank's credit policy was to maintain the gold standard. The aim of its policy was therefore to maintain stability between the exchange rate of the domestic currency and those of other countries on a gold standard, rather than to stabilise the general price level. The SA Reserve Bank not only successfully restored the gold standard and currency convertibility, but also succeeded in establishing a reasonably close relationship between Bank rate, used for discounting purposes, and the lending rates of commercial banks, which ensured that the SA Reserve Bank had an influence over domestic interest rates and credit conditions, necessary to apply effective monetary policy. The use of a gold standard domestically and internationally was underscored at the time, by " ... the general belief and conviction ... that exchange rate stability was of paramount importance for the maintenance of international confidence and the conduct of international trade ... " (De Kock, 1956: 123).

As is evident in tables A1 to C1 in Appendices A to C, South Africa experienced deflation from 1921 to 1931, with prices declining on average by some 3,2 per cent per annum. However, when analysing the movement in prices, it is interesting to note the level of and changes in domestic interest rates over the same period (Republic of South Africa, 1985). The prime overdraft rate of commercial banks fluctuated around 7 per cent (Republic of South Africa, 1985: 106). Moreover, "[f]rom 1922 to 1932 the margin between Bank rate ... [i.e. the rediscount rate for commercial banks at the SA Reserve Bank] ... and the commercial banks' minimum overdraft

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<sup>59</sup> Sloman (1994: 607) is highly critical of the decision of the UK to restore the gold standard, as its adoption required the introduction of deflationary policies in the UK. Similar conditions applied to South Africa.

rate ranged from 0,75 to 1,6 per cent ... ” (Republic of South Africa, 1985: 106). As the rate of inflation over the period 1921 to 1931 declined by an average of some 3,2 per cent per annum, it implies that the real average minimum overdraft rate was slightly above 10 per cent per annum. Low inflation or relative price stability were not achieved, but rather moderate deflation – which was the objective of the policy, i.e. to restore price levels to those prevailing before the Great War.

#### 5.4 Abolition of the gold standard: 1932<sup>60</sup>

Following a crash in the prices of shares on the New York Stock Exchange in October 1929, first the United States and thereafter many other countries entered a period of sharp contraction in economic activity and price deflation (Parkin, 2003: 722). This period is referred to as the Great Depression, and lasted until 1933. Whereas a recession is defined as “[a] downturn in real GDP for two or more successive quarters” (Samuelson and Nordhaus, 2001: 774), no formal definition exists in economics for a depression. According to Samuelson and Nordhaus, “[d]epression is said to have been used first by President Herbert Hoover around 1930, because it sounded less frightening than words such as panic or crisis. But the Great Depression of the 1930s gave that word ugly associations, and it was replaced by yet another euphemism, recession” (1985: 902). Keynes (1930) initially referred to this downturn as a slump.

In the midst of these depressing economic conditions, the UK suspended the gold standard on 21 September 1931 (De Kock, 1956: 142). As South Africa also suffered the consequences of the world-wide depression at the time, it was necessary for the country to consider whether it should retain or abandon its own gold standard. The three alternatives available to South Africa were to (i) retain the gold standard independently from the UK – which was the option chosen by the authorities; (ii) allow the domestic currency to depreciate, i.e. to link it to a higher gold price; or (iii) peg the domestic currency to the British pound sterling, rather than to gold. Full convertibility of banknotes for gold was retained and no restrictions were placed on the export or import of gold. Retaining full convertibility and free exportation caused an immediate large

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<sup>60</sup> Except where stated otherwise, this section draws on De Kock, 1954.



speculative capital outflow from South Africa. This capital outflow exacerbated the domestic consequences of the depression and raised questions about the continued viability of the SA Reserve Bank<sup>61</sup>.

The gold standard controversy duly developed into a political issue, with government supporting it and the opposition arguing that the gold standard should be abandoned and the domestic currency should follow the British pound sterling (SA Reserve Bank: 1971: 34). Owing to the depressed conditions, the mining (other than gold mining), manufacturing and agricultural sectors, as well as many private individuals, suffered severe hardship owing to declines in international demand and the appreciation of the domestic currency, relative to the value of British pound sterling, the currency of South Africa's major trading-partner country (see for instance Dommissie, 2005: 40 and 41; or SA Reserve Bank, 1971: 36)

The economic hardship resulted in dwindling support for the Government, evidenced by election results in by-elections during the course of 1932, in constituencies falling vacant and filled in terms of the electoral system then used in South Africa. Roos, a former leader in the then Transvaal of the National Party which was in power at the time of the controversy in 1931 and 1932, announced on 21 December 1932 that he would return to politics with the goal of establishing a coalition party aiming at the abolition of the gold standard. This led to a renewed demand for the conversion of domestic banknotes into gold at the SA Reserve Bank, which soon became untenable. The Government duly issued a proclamation on 28 December 1932 in terms of the Finance Emergency Regulations Act of 1932, abolishing the convertibility of banknotes into gold from that date (SA Reserve Bank, 1971: 37). This was considered a temporary emergency measure. Until a new note series was issued in 1992, known owing to the serving Governor at the time as the second Stals-issue (Van Rensburg, 2003: 295), South African banknotes continued to carry a promise of convertibility.

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<sup>61</sup> Owing to questions about the financial position of the SA Reserve Bank, the Minister of Finance confirmed towards the end of October 1931 in a statement that government would ensure the SA Reserve Bank's continued financial viability. The need for issuing a statement of this nature places central bank autonomy in jeopardy. If a central bank cannot ensure its own financial viability, it can hardly be argued that it should be afforded the autonomy to conduct its operations without interference of the government, for whose account those operations will be.

Looking back after more than 70 years on the brief period between the announcement by Roos and South Africa leaving the gold standard which finally ended the convertability of gold, it might be with some surprise that the reader realises the speed at which developments took place. The necessary decisions to leave the gold standard were taken and the announcements were made within seven days from the announcement by Roos without technology and equipment employed in the twenty-first century. Moreover, this period included Christmas and Boxing Day (currently 26 December is known as the *Day of Goodwill* public holiday in South Africa), which were at the time also two public holidays in South Africa. From a twenty-first century perspective, the observation has to be made that the central bank and Government must have had some prior contingency planning in place which could simply be implemented after the announcement by Roos. This makes the lack of clear policy direction after the abolition of the gold standard, explained in the next section, even less understandable.

Analysing the situation with the benefit of hindsight shows that South Africa should have followed the UK in the abolition of the gold standard in September 1931. The policy of maintaining the gold standard exacerbated the domestic depression, thereby aggravating economic hardship. This is evident in Tables A1 to C1 in Appendices A to C, showing that South Africa experienced sharp price deflation in 1932, with prices declining by 4,5 per cent. By 1932 the minimum lending rate of the commercial banks was 7,3 per cent (Republic of South Africa, 1985: 106), implying that the real minimum lending rate was 11,8 per cent, which aggravated the difficulties caused by the Great Depression and the maintenance of the gold standard. Relative price stability was therefore not achieved, and the country experienced sharp deflation.

## 5.5 After the gold standard: 1933 to 1938<sup>62</sup>

After the abolition of the gold standard on 28 December 1932, it was necessary to consider the issue of adopting an alternative policy approach. However, under the circumstances it was

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<sup>62</sup> Except where stated otherwise, this section draws on SA Reserve Bank, 1971.

decided by the monetary authorities<sup>63</sup> “ ... to leave the future monetary policy of the country to be determined by Parliament ... ” (De Kock, 1954: 191), due to reconvene early in 1933. Today such a decision would certainly be viewed as abandoning responsibility for policy formulation and implementation by the relevant authorities.

In the period between the abolition of the gold standard and the finalisation of a new policy by Parliament, the SA Reserve Bank withdrew from the foreign exchange market, therefore allowing the domestic currency to find its own level in the foreign exchange market. Parliament passed the Currency and Exchanges Act, No 9 of 1933, early in March 1933 and, as was widely expected, the value of the domestic currency was linked to that of British pound sterling.

De Kock states that “[i]n considering the transition from the abandonment of the gold standard to the adoption of the policy of linking the South African pound with sterling, it would appear that the Union’s monetary authorities ... allowed an unnecessary amount of confusion and uncertainty ... through hesitancy and lack of leadership. Taking into account the fact that the Government and the Reserve Bank had been actively involved with exchange rate problems during the previous fifteen months ... it is difficult to understand why, following South Africa’s departure from gold, matters were again allowed to drift, even for a short while” (1954: 194). The most appropriate approach would have been to link the domestic currency in terms of the Finance Emergency Regulations Act of 1932 to sterling at the time of announcing the abolition of the gold standard.

From an analysis of South Africa’s domestic economic conditions and international economic relations, the finding is that “... the abandonment of the gold standard and the depreciation of the South African pound to the level of sterling were decidedly beneficial to the Union” (De Kock, 1954: 212). Moreover, the abolition of the gold standard provided the SA Reserve Bank with the leeway to ease monetary policy, with the first reduction in Bank rate announced on 20 February 1933, after the Treasury reduced the Treasury bill rate and commercial banks reduced deposit rates already on 11 January 1933.

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<sup>63</sup> The Treasury (as it was known at the time) and the SA Reserve Bank.

The improvement in general economic conditions gave rise to the question whether the SA Reserve Bank would be able to control inflation successfully, particularly in view of increasing domestic liquidity after the abolition of the gold standard, as “... commercial banks ... no longer had to avail themselves of the credit facilities of the Reserve Bank. Had the Bank deemed it necessary to raise its discount rate in order to restrict credit, it would ... have experienced great difficulty in making the higher rate effective” (De Kock: 1954: 233). The Government came to the aid of the SA Reserve Bank by mopping up surplus domestic liquidity by means of loans and even small budget surpluses, and by redeeming foreign loans. De Kock states that “... the prestige of the Bank and the degree of co-operation between it and the commercial banks had risen to a point where the Bank’s moral influence on monetary conditions was by no means negligible” (1954: 233). Despite the concerns, South Africa experienced only mild inflation between 1933 and 1938, as is evident from Tables A1 to C1 in Appendices A to C, with prices increasing on average by 0,6 per cent per annum. The average price level returned to the level of 1931 only by 1939.

The average minimum overdraft rate of commercial banks was about 5,5 per cent, with a constant margin of 2 percentage points between this rate and Bank rate maintained for a period of 10 years from 1935 (Republic of South Africa, 1985: 106), whereas the average real minimum lending rate was about 5 per cent. Despite the problems of the SA Reserve Bank in restricting credit, it achieved the maintenance of relative price stability.

## 5.6 World War II: 1939 to 1945<sup>64</sup>

As the exchange rate of the domestic currency traded at a fixed rate to British pound sterling, South Africa elected to remain a member of the Sterling Area at the outbreak of World War II. This implied that South Africa accepted the exchange control measures introduced in respect of the Area. In terms of these control measures, free international payments were permitted

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<sup>64</sup> Except where stated otherwise, this section draws on SA Reserve Bank, 1971.

between countries comprising the Area, but permission was required from the exchange control authorities to make payments to countries outside the Area.

This arrangement, i.e. the first introduction of a form of exchange control in South Africa, forms the foundation of the subsequent system of exchange control adopted in 1961 and still in place in one form or another at the time of completion of this study. The exchange control regulations empower the National Treasury to control all dealings in gold and foreign currency and to control the export of gold. The administration of these powers was delegated to the SA Reserve Bank, an arrangement that remains in place. However, since democratic elections in South Africa in 1994, considerable progress has been made with the gradual liberalisation of exchange control.

Owing to a surplus on the current account of South Africa's balance of payments during World War II, the domestic "... monetary situation ... was characterised by even greater liquidity than the 1933-39 period" (De Kock, 1954: 257), which resulted in a reduction in Bank rate on 2 June 1941. This reduction brought domestic interest rates down to their lowest level from the inception of the SA Reserve Bank. However, the country's favourable balance-of-payments position, rather than the monetary policy stance, resulted in the easing of the domestic liquidity position.

In an effort to reduce domestic liquidity and contain the development of increasing inflationary pressures, the SA Reserve Bank and the Treasury, "... with the co-operation of the British authorities, initiated their special wartime scheme of external debt repatriation and redemption. This arrangement was successful in reducing the quantity of money and in helping to prevent any further decline in interest rates, and to that extent at least diminished the internal inflationary pressure" (De Kock, 1954: 273). As the possibility of open-market operations, particularly the sale of securities, by the SA Reserve Bank was still very limited owing to the underdevelopment of the money and capital markets in South Africa at the time and the limited stock of securities held by the SA Reserve Bank that it could sell, the only alternative at the time would have been an increase in taxes, i.e. a tightening of fiscal policy.

Rather than relying solely on monetary policy to curb the inflationary pressure building up in the economy, the South African Government elected to curtail it through the use of an extensive system of control measures, e.g. price, rent, wage and building controls and food subsidies. Under these circumstances, the inflation suffered by South Africa at the time is described by De Kock as “ ... the suppressed rather than the open variety ... [which] ... brought with it the disadvantages of the former rather than the latter” (1954: 268). As could be expected with a system of extensive controls, inflation as measured in terms of actual price increases, rather than as measured in terms of shortages, increased substantially in the period after the relaxation or abolition of the control measures, as discussed in the next section.

The SA Reserve Bank’s enabling legislation, the Currency and Banking Act, No 31 of 1920, as amended, was replaced by the SA Reserve Bank Act, No 29 of 1944, which consolidated matters pertaining to the SA Reserve Bank. At the time the National Party was in opposition in Parliament and advocated a limitation of the autonomy of the SA Reserve Bank, arguing in favour of it being controlled directly by the Government. However, this view did not receive the Parliamentary majority and the SA Reserve Bank’s autonomy was retained in the Act of 1944.

Following an adjustment in 1941, the minimum overdraft rate of commercial banks was 5,5 per cent during the remainder of the war period, with a constant margin of 2 percentage points between this rate and Bank rate, which was adopted in 1935, retained until 1945 (Republic of South Africa, 1985: 106). Inflation was at an average annual rate of about 4,1 per cent, implying that the average real minimum lending rate was about 1,4 per cent. Owing to the limited scope for the application of monetary policy over this period, the authorities were generally not successful in achieving the overarching objective of relative price stability. Moreover, price increases were suppressed by control measures, implying that the rate of inflation cannot be used as a reflection of inflationary conditions in the economy.

### 5.7 The immediate post-war period: 1946 to 1954<sup>65</sup>

The domestic economy was generally sound at the end of World War II, with a favourable current-account balance supporting sound fiscal policy, but South Africa experienced some consequences of inflationary pressures emanating from policies adopted during the War. At the time monetary policy was based on two conventional premises, i.e. money “ ... was a unique financial asset which played a strategic role in the determination of the total demand for goods and services. And the second was that the SA Reserve Bank and the commercial banks ... were the only financial institutions which could create money ... [while] ... bank credit and money exerted an important influence on ... prices and the balance of payments, and needed to be controlled in the interests of general economic stability and ... to maintain stable exchange rates under the Bretton Woods system” (Republic of South Africa, 1985: 144).

The Bretton Woods system of fixed but adjustable exchange rates, introduced after World War II, emanated from a meeting of 730 delegates, representing all 44 Allied nations participating in the War, in July 1944 at the Mount Washington Hotel, situated in the New Hampshire resort town of Bretton Woods (see for instance Braithwaite and Drahos, 2000; or McAleese, 2004). The delegates discussed the envisaged economic system to be introduced after the War and finally signed the Bretton Woods Agreement on 22 July 1944. Apart from providing for the establishment of the International Bank for Reconstruction and Development (the World Bank) and the IMF, the agreement imposed on each country the obligation to follow a monetary policy course that maintained the exchange rate of its currency within a fixed value (plus or minus one percent) in terms of gold (with the US dollar convertible into gold at a fixed price); but in terms of which participating countries had the option to devalue or revalue these fixed values. The system eventually collapsed in 1971 when the United States suspended the convertibility of the US dollar into gold (see for instance Braithwaite and Drahos, 2000; or McAleese, 2004: 5).

When the UK decided to devalue British pound sterling by some 30 per cent against the US dollar on 18 September 1949, the South African Government followed the devaluation, with the

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<sup>65</sup> Except where stated otherwise, this section draws on De Kock, 1954.

link in the value between the domestic currency and sterling retained, but the value in terms of the US dollar declining from £1 = \$4,03 to £1 = \$2,80. The main reasons driving the decision to devalue were the gradual deterioration in the balance-of-payments position from 1946; to restimulate capital inflow for investment; and to increase the prospective lives of the gold mines (SA Reserve Bank, 1971: 52). The devaluation was preceded by the reintroduction in 1948 of controls on imports from non-Sterling Area countries by means of foreign exchange rationing and by the reintroduction of extensive import controls on 24 February 1949, to take care of the deterioration of South Africa's balance-of-payments position, which started some three years earlier, i.e. in 1946.

At the time of the devaluation it was clear to the Government and the SA Reserve Bank that continued inflationary pressures would be one consequence of such a step, but it was the prevailing view that the consequences of not devaluing the currency outweighed the dangers of an increasing build-up of inflationary pressures. Moreover, the devaluation allowed South Africa to retain its membership of the Sterling Area, which was considered beneficial to the country at the time. Following the devaluation of the currency, the SA Reserve Bank increased in October 1949 its interest rates for the first time since 1941, when Bank rate was increased from 3 per cent to 3,5 per cent. However, despite this increase in interest rates, the SA Reserve Bank still had to apply anti-inflationary policies, and “ ... from 1951 repeatedly stressed the desirability of a contraction of bank credit ... ” (SA Reserve Bank, 1971: 55). This resulted in a further increase of Bank rate to 4 per cent in March 1952, a level retained until September 1955.

A significant step in the development of South Africa's financial structure occurred in 1949, with the establishment of the National Finance Corporation (NFC), which commenced operations on 20 September 1949 (Republiek van Suid-Afrika, 1985: 113; see also De Kock, 1956: 171). The NFC aimed at developing a domestic money market and the utilisation of capital in the best economic interests of South Africa. Its liquidity was guaranteed in terms of an agreement that the SA Reserve Bank will discount its Treasury bills as and when required, at the rates at which the NFC acquired the bills. This implied that the SA Reserve Bank performed a “ ... function of lender of last resort, being called upon to grant accommodation to the Government and the



commercial banks only after all the other sources have been exhausted through the medium of the National Finance Corporation” (De Kock, 1956: 171). The function of lender of last resort<sup>66</sup> is described by De Kock as a function that was flowing from the central bank’s function as bank of rediscount, and is defined as “ ... the assumption of the responsibility of meeting, directly or indirectly, all reasonable demands for accommodation from commercial banks, discount houses and other credit institutions, subject to certain terms and conditions which constitute the discount rate policy of the central bank” (1956: 98).

The SA Reserve Bank’s main focus in the decade following on World War II was disinflation in view of increasing inflationary pressures, as the Governor pointed out as early as 1948 that domestic economic expansion proceeded at too rapid a rate and called for a consolidation of economic progress. However, by 1954 the Governor reported that considerable progress had been made in restoring internal and external economic stability and declared in 1955 that the need for consolidation no longer required special emphasis (SA Reserve Bank, 1971: 56).

In assessing monetary policy in the decade after World War II, special reference should be made to the establishment of the NFC as an initiative to develop a formal money market, the lack of which has severely hampered the SA Reserve Bank in the execution of monetary policy since its inception in 1921. Government and quasi-government institutions reverting to central bank credit severely hampered the implementation of disinflationary policies by the SA Reserve Bank, with the Governor calling on occasion for the need to consolidate economic progress in the wake of inflationary pressures.

The minimum overdraft rate of commercial banks fluctuated between 4,5 per cent until 1949, 5 per cent in 1950 and 5,5 per cent until 1955, with a constant margin of 1,5 percentage points

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<sup>66</sup> This description of the lender-of-last-resort function seems to describe normal central banking discounting to qualifying institutions. The meaning of *lender of last resort* has seemingly changed over time, and has recently been described by Mishkin as a system of providing “ ... reserves to banks when no one else would, thereby preventing bank and financial panics” (2004: 402). This happened in South Africa as early as early as 1921, when the SA Reserve Bank provided special assistance to the National Bank (SA Reserve Bank, 1971: 23). Although outside the scope of this study, it seems that a clear understanding of *lender-of-last-resort* assistance is necessary. The terminology *emergency liquidity assistance* might be a more appropriate description of this responsibility of central banks.

between this rate and Bank rate maintained for a period of 12 years from 1946 (Republiek van Suid-Afrika, 1985: 113). Inflation averaged 4,4 per cent per annum, implying that the average real minimum lending rate was about 1 per cent, depending on the specific year in the period considered. As was pointed out by the Governor at the time, monetary policy was generally less than successful in supporting relative price stability, and higher real interest rates were perhaps necessary.

#### 5.8 The late fifties: 1955 to 1960<sup>67</sup>

The late fifties is characterised by the implementation of Keynesian policies aimed at stabilising economic activity, as was the case in the rest of the world. In the case of South Africa, “... the official approach ... was, in effect, a form of conservative Keynesianism which contained important elements of what later came to be known as monetarism. This was evident, for example, from the important role assigned to the money supply” (Republic of South Africa, 1985: 144). Despite the importance attached to changes in the money supply and its influence on investment and spending, “... no thought was given during this phase to setting either published or unpublished targets for M1, M2, cash base or any other monetary aggregate” (Republic of South Africa, 1985: 144).

Taking cognisance of the fact that South Africa was still part of the world-wide Bretton Woods system of fixed but adjustable exchange rates and the Sterling Area, the SA Reserve Bank based monetary policy decisions on its assessment of all available economic data, but with exchange rate stability enjoying a high priority among the goals set for monetary policy. Certain exchange control measures dealing with the transferability of capital abroad by residents were introduced in reaction to increasing interest rates in the UK vis-à-vis South African rates.

From 1946 the minimum overdraft rates of commercial banks were set at a margin of 1,5 percentage points above Bank rate, in terms of an agreement between the SA Reserve Bank and the commercial banks. This margin was changed to 2 percentage points in March 1958.

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<sup>67</sup> Except where stated otherwise, this section draws on SA Reserve Bank, 1971.

Maintaining this margin enabled the SA Reserve Bank to exert a direct influence over the rates charged by commercial banks. Bank rate moved between 4 per cent and 4,5 per cent, with the average minimum overdraft rate at 6 per cent for this period. Inflation was at an average annual rate of about 2,3 per cent, implying that the average real minimum lending rate was about 3,7 per cent. Monetary policy therefore achieved the objective of relative price stability.

### 5.9 The early sixties<sup>68</sup>

South Africa introduced a new decimal currency system in 1961, replacing the previous system comprising pounds, shillings and pennies (£/s/d). The SA Reserve Bank assumed a leading role in decimalisation, with Arndt, the Deputy Governor of the Reserve Bank, heading “ ... the task force to convert the South African currency and payments arrangements to a decimal system. The work of *Daan Desimaal* culminated in the issue of token quantities of new bank notes in Rand currency by the SA Reserve Bank on 14 February 1961 ... ” (Stals, 1996). South Africa introduced a system of rands and cents, with an official conversion rate of £1 = R2. This followed on the report of the Decimal Coinage Commission submitted on 1 August 1958 and the acceptance of its recommendation of the introduction of a 10-shilling (= R1) and cent system, owing to the fact that it would allow easier conversion from the previous system. The rand as name for the currency comes from Witwatersrand (the *White Water Ridge*), the shelf of gold in the Transvaal on which Johannesburg was established (Wordorigins Archive, [S.a.]).

Following political events in Sharpeville on 21 March 1960 (see for instance Reeves, [S.a.]), South Africa experienced large outflows of foreign capital, mainly in the form of the sale of shares of local companies listed on the domestic securities exchange, that could not be covered by the small surplus on the current account of the balance of payments. Owing to this outflow, the country’s gold and foreign exchange reserves declined by more than 50 per cent between January 1960 and May 1961 and the SA Reserve Bank adopted a monetary policy stance aimed, *inter alia*, at protecting the country’s official gold and foreign exchange reserves. In formulating monetary policy, “ ... the need to maintain stable exchange rates under the prevailing Bretton

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<sup>68</sup> Except where stated otherwise, this section draws on SA Reserve Bank, 1971.

Woods par value system remained a major consideration” (Republic of South Africa, 1985: 146). Bank rate was increased to 4,5 per cent in August 1960, followed by an increase to 5 per cent in May 1961. Bank rate was subsequently dropped to 3,75 per cent, but was increased in July and December 1964, when it again reached the level of 4,5 per cent.

Exchange control measures were expanded as South Africa left not only the Commonwealth when the country became the independent Republic of South Africa on 31 May 1961, but also the Sterling Area. Restrictions were placed on foreign investment by residents to limit the outflow of capital, accompanied by the introduction of the securities rand in terms of which the sales proceeds of domestic securities had to be retained in South Africa, and could only be used for reinvestment in domestic securities. The securities rand system evolved over time into the financial rand system, which became the cornerstone of a system of exchange control over non-residents. This system was abolished briefly between 1983 and 1985, and retained until final abolition in 1995. In addition, import control was tightened and customs and excise duties on imported luxury and semi-luxury items and on motor vehicles were also increased. These measures had the desired results and, owing to sustained surpluses on the current account of the balance of payments, the country’s gold and foreign exchange reserves exceeded the level of January 1960 by 1962. The SA Reserve Bank and the Government applied a successful mix of policies to retain domestic economic stability.

This period is also characterised by a unique development at the SA Reserve Bank. Currently the SA Reserve Bank Act, No 90 of 1989, as amended, stipulates in Section 7 that “[t]he Governor shall preside at the meetings of the Board ... [but] ... the Minister ... [of Finance] ... may designate any other director to act as chairman of the Board during the Minister’s pleasure”. Similar provision was made in the SA Reserve Bank Act of 1944, and Donges, the Minister of Finance, exercised this option in 1962 (Rossouw, 2004: 1101). During the latter part of 1962 and most of 1963, Rissik, the Governor, did not serve as chair of the Board of the SA Reserve Bank, as De Kock, the previous Governor, was appointed as Chairperson of the Board after stepping down from his previous position on 30 June 1962. This decision to split the responsibilities was soon found not to be in the best interests of the SA Reserve Bank and this practise was ended in

1963 (Rossouw, 2004: 1102). Complicating factors, for instance, were (i) the question whether the Governor or the Chairperson should address the annual general meeting of the SA Reserve Bank's stockholders on monetary policy; and (ii) a lack of clarity on the split in decision-making authority between the Chairperson and the Governor. The option of such a split in responsibilities is still available to the Minister of Finance, but has since not been used.

The report of a Technical Committee on banking and building society legislation was published in 1964 (Republic of South Africa, 1964). Although monetary policy fell outside the mandate of the Committee, "[t]he Technical Committee recommended two major modernisations of the earlier conventional approach to monetary policy. The first was the recognition that, in addition to money, there were also significant amounts of what was in those days called near-money, i.e. deposits or other financial assets which served as close substitutes for money ... [and, secondly] ... in addition to the Reserve Bank and commercial banks, there were several other kinds of deposit-taking institutions in South Africa ... which could also participate in the process of creating money or near-money on a multiple basis" (Republic of South Africa, 1985: 145). The Committee accordingly recommended uniform legislation for all banking institutions, which was embodied in the Banks Act of 1965 (Republic of South Africa, 1985: 146). In analysing the approach of the Committee and its recommendations, it is noteworthy that " ... changes in the rate of growth of the money supply were not regarded as necessarily the main source of changes in economic activity or in the rate of inflation ... [implying that] ... the Committee did not recommend the use of monetary targets, but favoured a policy of demand management based on a broad assessment of current and expected economic and financial conditions" (Republic of South Africa, 1985: 146).

The minimum overdraft rates of commercial banks were retained at a margin of 2 percentage points above Bank rate adopted in March 1958. As in the preceding period, the maintenance of this margin enabled the SA Reserve Bank to exert direct influence over the rates of commercial banks. Bank rate averaged about 4 per cent, but moved between 3,75 per cent and 5 per cent, with a concomitant movement in the minimum overdraft rate, averaging at 6 per cent. Inflation was at an average annual rate of about 1,6 per cent, implying that the average real minimum

lending rate was about 4,4 per cent. Relative price stability was therefore achieved during this period.

#### 5.10 Direct controls: 1965 to 1980<sup>69</sup>

By 1965 the world was still characterised by the Bretton Woods system of fixed (but adjustable) exchange rates, with the US dollar as anchor for the exchange rate system and convertible into gold at a fixed price. The exchange rates of various countries could be adjusted in terms of the Bretton Woods system by means of devaluations or revaluations (Mohr and Fourie, 2004: 436). However, this “ ... system came under immense pressure during the late 1960s and eventually broke down in 1971, when the major industrialised countries switched to a system of floating currencies ... ” (Mohr and Fourie, 2004: 436).

The United States suffered the inflationary consequences of the Vietnamese War and a deficit on the current account of its balance of payments. As its currency served as the reserve currency in terms of the Bretton Woods system, it was the one currency that could not adjust its value by means of a formal devaluation to help the adjustment of the domestic economy. Consequently, “[o]n August 15, 1971, President Nixon formally severed the link between the dollar and gold, bringing the Bretton Woods era to an end” (Samuelson and Nordhaus, 2001: 628). The abolition of the Bretton Woods system introduced the current era of floating exchange rates, with market forces of supply and demand largely determining the exchange rate of a currency, although governments and central banks can adopt exchange rate regimes such as managed floating, pegging or even an explicit nominal anchor for the exchange rate of the currency.

In the aftermath of the abolition of the Bretton Woods system, the Group of 10 major industrial countries “ ... succeeded on 18 December 1971 in reaching agreement on the realignment of their exchange rates ... [with] ... a devaluation of the US dollar of 7,89 per cent in terms of gold, i.e. for an increase in the official dollar price of gold from \$35 to \$38 per fine ounce ... South Africa

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<sup>69</sup> Except where stated otherwise, this section draws on Republic of South Africa, 1985.

reacted to this currency realignment by devaluing the rand on 21 December 1971 by 12,28 per cent” (SA Reserve Bank, 1971: 81).

Following the breakdown of the Bretton Woods system, the SA Reserve Bank had to establish a new exchange rate framework for the country. The authorities pegged the exchange rate, albeit at varying levels after formal devaluations in December 1971 and in September 1975, initially to pound sterling, then to the US dollar, then a peg to a basket of currencies, and again to the US dollar before a system of managed floating was introduced from January 1979. The SA Reserve Bank increased Bank rate to 5 per cent in March 1965 in an attempt to curb domestic demand. This increase “ ... was part of a more comprehensive set of restrictive measures involving fiscal changes such as the imposition of a loan levy and a surcharge on income tax ... ” (SA Reserve Bank, 1971: 65). In addition, “[f]rom November 1965 the Bank also began to employ a new form of credit control never used before in South Africa, namely the imposition of credit ceilings ... ” (SA Reserve Bank, 1971: 66). Credit rationing by means of control measures was employed as an instrument of credit control by the Bank of England in the latter part of the eighteenth century, as the Bank of England was prohibited at the time by British usury legislation to increase its discount rate beyond 5 per cent (De Kock, 1974: 237). The Bank of England abolished such controls after legislative amendments in 1844, which enabled it to rely upon its Bank rate to ration credit effectively, and direct credit rationing by means of credit controls was employed again (albeit not by the Bank of England) only after World War I, mainly by Germany, Mexico and the Soviet Union (De Kock, 1974: 238). Credit rationing was also employed by certain central banks after World War II.

In the case of South Africa, credit controls and related measures were used, despite many disadvantages, “ ... because of the difficulties of controlling bank liquidity at a time when the government sector was financing its expenditure in an inflationary manner and thereby providing the banks with additional cash or liquid assets” (SA Reserve Bank, 1971: 66). As inflationary pressures continued to increase, new initiatives were introduced in July and August 1966 to curb inflation. These initiatives included, *inter alia*, fiscal measures aimed at curbing demand, the

relaxation of import control, an increase in Bank rate to 6 per cent and an extension of credit ceilings on banks (SA Reserve Bank, 1971: 67).

The SA Reserve Bank's use of quantitative measures (mainly credit ceilings) from 1965 to 1972 and again from 1976 to 1980 to limit the supply of bank credit by commercial banks to the private sector, was supported by an array of other measures. Deposit rate control, prescribing the maximum interest rate on bank deposits, was used from March 1965 to July 1966, December 1969 to August 1970 and March 1972 to March 1980, *inter alia*, to contain interest rates (Republiek van Suid-Afrika, 1985: A5). This system of direct controls in South Africa was supported by a comprehensive system of exchange control (SA Reserve Bank, 2005a), highlighted in Chapter 4. Interest rates were adjusted on a number of occasions, but owing to the extensive use of direct controls, rates were not at the market clearing level, i.e. where the demand for loanable funds were in equilibrium with the supply of such funds. The use of direct controls implies that the demand for loanable funds was artificially contained and interest rates accordingly did not reflect the market equilibrium position.

Direct controls and the general approach to monetary policy, including adjustments to Bank rate, did not achieve the desired outcome: low inflation as measured by changes in the CPI. Inflation accelerated between 1965 and 1980: “[i]nflation established itself firmly between the levels of 10 and 20 percent, and the natural development of financial markets was suppressed by the need for direct controls over banks and other financial institutions” (Stals, 1996). Although 1965 to 1980 are taken as a period owing to the use of direct controls, in respect of inflation it should be split into to sub-periods: up to 1973, when inflation was at single digits, and from 1974 to 1980, when South Africa suffered sustained double-digit inflation, which continued in the 1980s.

Between 1965 and 1973, Bank rate moved between 5,75 per cent and 6,25 per cent, with an average of 6 per cent. At the same time the minimum overdraft rate of banks were no longer fixed at a constant margin above Bank rate, although a semi-formal link between Bank rate and the prime rate of banks was retained until 1982 (Stals, 1996). The link was subsequently reintroduced, *inter alia*, because the actual rediscount rate charged for SA Reserve Bank



accommodation frequently differed from the official Bank rate, implying that the minimum lending rate rather followed other money market rates. Banks' minimum lending rate averaged about 8 per cent during the first sub-period (1965 to 1973), but varied between 6 per cent and 9 per cent. Inflation was at an average annual rate of about 4,6 per cent, but accelerated sharply from 1968 to the end of this sub-period, implying that the average real minimum lending rate was about 3,4 per cent. Monetary policy therefore supported relative price stability during this sub-period, but failed to address the acceleration in inflation. This is confirmed by the fact that the domestic inflation problem already received attention by the mid-sixties, as well as by the analysis of the next sub-period below.

Increasing domestic inflationary pressures gave rise to a decision of the Council of the Economic Society of South Africa on 1 April 1966 to arrange a conference on the matter (Richards, 1967: 278). The conference was hosted on 24 and 25 August 1967 in Johannesburg and six papers on various aspects pertaining to inflation were considered (Richards, 1967: 278). Some debate on the definition to be used for inflation is recorded in the conference proceedings, as different delegates used different definitions (see for instance Du Plessis, 1967: 365; Samuels, 1967: 341; or Van der Horst, 1967: 323).

At the conference, Hobart Houghton stated that “[t]he main strength of the inflation of our time was that we expected it to continue ...” (1967: 292). This view was supported by Samuels, who stated that “... once the market's expectations ... are broken, the problems of the transition to a non-inflationary era will become progressively easier. The eradication of inflationary expectations will not be easy” (1967: 355). Reflecting on this conference some 40 years later, the reaction is that *the issues remain the same, only the names of the conferences considering them change*.

The second sub-period (1974 to 1980) deals with inflation accelerating to a level above 10 per cent per annum and staying at that level for a sustained period – in this event until 1992, as is highlighted below. Between 1974 and 1980, banks' minimum lending rates moved between 8 per cent and 12,25 per cent, with an average of 10 per cent. As was the case in the first sub-

period, the minimum overdraft rate of banks was no longer fixed at a constant margin above Bank rate, but some semi-formal link was nevertheless retained. Bank rate averaged about 8 per cent during this sub-period, but moved between 5,75 per cent and 9 per cent. Inflation was at an average annual rate of about 12,1 per cent, but continued to accelerate sharply towards the end of this sub-period, implying that the average real minimum lending rate was about minus 4,1 per cent. Monetary policy, therefore, did not contain inflation during this sub-period, while direct controls resulted in the adoption of interest rates obviously too low in comparison to the general rate of increase in the price level.

The major monetary policy changes associated with 1981 discussed in the next section (i.e. the movement from direct controls to a market-oriented monetary policy associated with the appointment of De Kock as Governor with effect from 1 January 1981), were indeed announced by De Jongh, his predecessor, in 1980. At the SA Reserve Bank's sixtieth ordinary meeting of stockholders held on Tuesday, 26 August 1980, it was announced that credit ceilings would be abolished with effect from 1 September 1980 (De Jongh, 1980: 10).

#### 5.11 Stubbornly high inflation: 1981 to 1985<sup>70</sup>

After the unsatisfactory experience with direct controls between 1965 and 1980, at the beginning of the 1980s the SA Reserve Bank decided to revert to more market-oriented economic policies. This period can be described as a transition phase in monetary policy (Nel, 1993: 120) after the extensive use of direct controls. Casteleijn describes monetary policy as a “ ... mixed system during transition ... ” (2001: 5), while Gidlow describes this period (and the period 1985 to 1989) as one of a market-oriented mixture of conservative Keynesian demand management and monetarism, with the focus on discretionary demand management (Gidlow, 1995: 4).

Owing to the distortions caused by direct controls, the De Kock Commission's interim recommendation that South Africa should follow market-oriented monetary policy was adopted and implemented (Republiek van Suid-Afrika, 1985: A14). Money-supply growth targets served

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<sup>70</sup> Except where stated otherwise, this section draws on Stals, 1996.

as anchor for market-oriented monetary policy. For this purpose, a broadly defined money supply figure, M3 (notes and coin in circulation; cheque, transmission and savings deposits; and call, short, medium and long-term deposits) was selected, as narrower definitions of the money supply are subject to seasonal movements. This new policy approach resulted in more flexible and frequent adjustments in interest rates, as rates had to reflect changes in the growth of the M3 money supply. As a consequence, the domestic economy faced the challenge of adjusting not only to higher interest rates than before, but also to more frequent interest rate movements.

In the historic assessment of the conduct of monetary policy in South Africa, the adoption of the recommendations of the De Kock Commission was indeed an important philosophical change. Market forces, rather than direct controls, determine interest rates and therefore the conduct of monetary policy. Despite further amendments to the conduct of monetary policy in South Africa since 1981, the SA Reserve Bank has not departed from the principle of market-oriented monetary policy.

The period under review is characterised by three remarkable occurrences. First, the world experienced a large surge in the gold price, with concomitant major advantages for the domestic economy, as the price of gold reached a record of US\$850 per fine ounce in January 1980. This resulted in rapid domestic economic growth, large increases in domestic liquidity, increased tax collection by the Government and an appreciation in the exchange rate, as the rand was allowed at the time to float on the foreign exchange market against foreign currencies. However, the gold price thereafter declined to below US\$300 per ounce by June 1982. This decline forced difficult adjustments onto the domestic economy, as it had to cope with problems such as smaller real tax collections, declining exports, declining domestic liquidity and a depreciating exchange rate. As the price of gold again recovered towards the end of 1982 and in early 1983, the financial rand, which replaced the securities rand as the main measure of exchange control over non-residents, was abolished in February 1983, and with it exchange control over non-residents (Republic of South Africa, 1985: 131). However, as is shown below, the financial rand was reintroduced in 1985.

Secondly, in terms of the political system with constituencies electing representatives to Parliament used in South Africa at the time, the Government faced a crucial by-election in the Primrose constituency on Thursday, 29 November 1984. From August 1984, interest rates were at a new record-high level, with the prime overdraft rate at 25 per cent (SA Reserwebank, 1985: 26), which resulted in widespread domestic unhappiness about the macroeconomic management of the economy and, in particular, the conduct of monetary policy. The SA Reserve Bank dropped interest rates shortly before the by-election, on 19 November 1984 (SA Reserwebank, 1985: 26), seen at the time as a move to alleviate pressure on the Government and the governing party at the time, the National Party (see for instance *Finweek*, 2006: 8). The SA Reserve Bank's justification at the time for the drop in rates was, according to its *Quarterly Bulletin* of December 1984 " ... the cooling-down of the economy and the improvement in the balance of payments and the exchange rate of the rand ... [and] ... a general downward movement in short-term rates" (SA Reserve Bank, 1985: 13 and 14). Shortly after the by-election (on 8 January 1985), the SA Reserve Bank increased rates to their previous levels *inter alia*, " ... in response to a marked further decline in the price of gold and an accompanying sharp depreciation of the rand" (SA Reserve Bank, 1986: 16).

This temporary drop of interest rates subsequently became known as the Primrose prime incident. Already at the time of the drop in rates, it was stated that " ... there is no escaping the fact that ... [the] ... cut in prime interest rates was most likely the opportunity cost of the National Party winning the Primrose by-election. Despite Reserve Bank Governor Gerhard de Kock's firm denial, this obvious political manoeuvre has all the signs of a quick fix ... " (*Financial Mail*, 1984: 35). At the time, this incident placed in serious jeopardy the ability and autonomy of the SA Reserve Bank to conduct monetary policy in the best interests of all the people of the country. This gave rise to serious doubts about the future conduct of monetary policy, owing to uncertainty whether statements by the SA Reserve Bank could be taken on face value after this incident: evidence therefore of a time consistency problem, as explained in an earlier chapter of this study, with the subsequent negative consequences for the conduct of monetary policy and central bank credibility. It also reminds of the existence of a political business cycle (Nordhaus, 1975).

Thirdly, up to the middle of 1985, South Africa's balance-of-payments situation deteriorated progressively, and capital outflows increased substantially after the Rubicon<sup>71</sup> speech of Botha, the President of the country at the time (see for instance *Finweek*, 2006: 21). The country did not exercise exchange control over non-residents at the time, owing to the abolition of the financial rand in February 1983. Botha made the speech on 15 August 1985 at the National Party Conference in Durban, at a time when the South African situation attracted wide international attention. Expectations were raised before the time that important announcements would be made that would change the South African political dispensation, at the time characterised by a system of apartheid.

The speech was described by the African National Conference, at the time the major liberation movement in exile, as “... an arrogant reaffirmation by P. W. Botha that the apartheid system will continue unchanged. At a time when every thinking person in our country and abroad is saying apartheid must end now, the ruling group could not help but show itself for what it is – a clique of diehard racists, hidebound reactionaries and bloodthirsty fascist braggarts who will heed nobody except themselves. Systematically, Botha rejected each and every measure whose implementation could be construed by some as possibly contributing to the solution of the South African problem. He prescribed the same solutions which have produced the crisis that is now devouring the lives of our people daily. In particular, while falsely and cynically claiming to be a democrat, he scorned the very notion of the right of all South Africans to vote for the government of their choice. He pledged to perpetuate the criminal bantustan system, further to balkanise our country and to continue the land dispossession of the African majority, which is confined to a little more than ten per cent of South Africa” (Tambo, 1985).

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<sup>71</sup> Reference was made to the proverbial crossing of the Rubicon in the speech (the name by which it subsequently became known); a reference to Julius Caesar's crossing of the Rubicon river in 49 BC. By crossing the Rubicon with his army without permission for a triumphal march through the streets of Rome, Caesar committed a grave crime against the state, viewed as an attack on the city. The phrase *crossing the Rubicon* has survived to refer to any person committing irrevocably to a risky course of action (Encyclopaedia Britannica, 2005). However, in the instance of the infamous Rubicon speech, the reference to the crossing of the Rubicon was viewed as an entrenchment of an unacceptable political system, rather than a new dawn for South Africa.

From an economic perspective, the Rubicon speech was a turning point for the worse, as it resulted not only in an outflow of foreign capital from South Africa, but foreign credit lines were also withdrawn, with South African borrowers unable to refinance their foreign short-term borrowing. On 28 August 1985, the temporary closure of the foreign exchange market was announced and on 1 September 1985 South Africa announced a standstill on the repayment of its foreign debts and the reintroduction of the financial rand. This was followed by debt rescheduling agreements, with the final tranche of rescheduled debt repaid only on 15 August 2001, when “ ... the arrangements for the repayment of loans in terms of the Debt Standstill Agreements concluded from 1985 onwards, were ended. On that date, the final authorisation was issued for the repayment of all the outstanding capital on loans in the standstill net. This brought to an end an unfortunate part of our history. South Africa has, however, meticulously honoured all the capital redemption schedules and interest payments on this indebtedness in accordance with the agreements made with foreign creditors” (Mboweni, 2001).

In 1985 the final report of *The Commission of inquiry into the monetary system and monetary policy of South Africa* (De Kock Commission) was published (Republic of South Africa, 1985). The Commission recommended far-reaching amendments to the conduct of monetary policy, which was adopted and implemented from 1986. In view of the Primrose prime incident described above, it is noteworthy that Chapter 25 of the report of the Commission covered the autonomy of the central bank in the implementation of monetary policy (Republic of South Africa, 1985: 251 to 255). In its analysis of the position of the SA Reserve Bank, the Commission’s assessment was that the intention of the legislator in establishing the SA Reserve Bank was “[t]o ensure the Bank’s independence and particularly its freedom from party political pressure. In this respect the Commission has found no evidence that the intentions of the legislator have not been realised. The Bank jealously guards its reputation for objectively formulating and applying monetary policy in the interest of the whole community” (Republic of South Africa, 1985: 253). Stating this less than one year after the Primrose prime incident implies that the commissioners either had selective memory or no memory at all.

The Commission made a number of recommendations on the autonomy of the SA Reserve Bank, the most noteworthy of which is that “[w]hile the Reserve Bank and the Treasury acting tighter as the *monetary authorities* [own emphasis] should jointly share the responsibility for broad monetary policy ... the Reserve Bank ... should primarily be charged with the responsibility for maintaining monetary stability and protecting the internal and external value of the currency. To perform this task effectively, the Bank should be ensured of considerable independence in matters of monetary policy – subject to only the constraints of the broad policy framework laid down by the Government” (Republic of South Africa, 1985: 253). Two issues in this quotation justify further comment:

- the Commission propagated the notion of the *monetary authorities* with joint responsibility for monetary policy, whereas better policy results are obtained in the long run with a policy approach in terms of which the government (or the Minister of Finance) sets, or sets jointly with the central bank, the monetary policy objective, but leaves the implementation of policy to the central bank for achievement through the implementation of monetary policy; and
- the Commission recommended that the SA Reserve Bank “ ... should primarily be charged with ... protecting the internal and external value of the currency” (Republic of South Africa, 1985: 253). When a mission for the SA Reserve Bank was formulated for the first time in 1990, it referred to the objective of protecting the internal and external value of the rand. This objective, albeit in a revised format (protect the value of the currency) is also contained in the Constitution of South Africa, Act 108 of 1996.

Not only was the SA Reserve Bank’s lending rates changed frequently, with concomitant changes in wholesale and retail interest rate patterns, but the domestic economy was also characterised by nominal rates at a higher level than before. Although these changes should be expected in view of a policy focus changing from direct controls to a market approach, such movements made financial planning increasingly difficult for businesses and households, with claims that the SA Reserve Bank kept rates at artificially high levels. This matter was addressed as early as in the *Governor’s Address* of 1981, when it was stated that “[a] basic feature of the monetary developments of the past year has certainly been the sharp increase in both short and long-term interest rates. The point must nevertheless be made that, even after these increases, the present

level of South African interest rates is not high in relation to either the domestic rate of inflation or real interest rates abroad. If the rate of inflation in South Africa is taken at 14,5 per cent, Bank rate in real terms is still minus 2 per cent ... [compared to] ... a Bank rate in real terms of 7,7 per cent in Canada, 4,4 per cent in the United States and 1,5 per cent in Germany ... Moreover, although the present Bank rate of 12½ per cent is a record for South Africa in nominal terms, it has on various past occasions been much higher in real terms. In 1968, for example, it was about 4 per cent in real terms ... ” (De Kock, 1981: 10). Bank rate did not play the role normally associated with such a rate at the time of this statement by the Governor, but merely served as a signalling mechanism for the SA Reserve Bank, i.e. adjusted to signal to the market that the SA Reserve Bank expects rates to move in a particular direction. From 1921 to 1932, when Bank rate indeed played the role normally associated with such a rate, it was much higher in real terms.

A further characteristic of the period was the difficulties for monetary policy implementation owing to inappropriate fiscal policy. De Kock mentioned in November 1984 that “ ... the mix of fiscal and monetary policy during the past two years has not been ideal” (1984: 1). Whereas the prevailing economic conditions called for disinflationary or contractory fiscal policy, the fiscal policy turned out to be unduly expansionary (De Kock: 1984: 4). The central government’s budget for the 1983/84 fiscal year provided for an increase of 10,3 per cent in expenditure which, compared to actual and projected inflation at the time at over 11 per cent, represented declining real expenditure. In addition, the deficit before borrowing was budgeted to be 2,4 per cent of GDP. Actual expenditure increased by 16 per cent, combined with an actual deficit before borrowing of 3,5 per cent of GDP (Gidlow, 1995: 13). The same tendency repeated itself in the 1984/85 fiscal year, with a budgeted deficit before borrowing of 3 per cent of GDP increasing to an actual deficit of 3,4 per cent, owing to an expenditure overrun (De Kock, 1985a: 7).

The SA Reserve Bank used two distinctly different approaches to monetary policy and the discounting facility to accommodate liquidity shortages in the market. From 1978 the SA Reserve Bank used a structure of refinancing rates, set at various margins above the Treasury bill rate, for different classes of discountable assets (Van der Merwe, 1999: 234). Bank rate in the true sense of the word played no meaningful part in refinancing operations or the structure of



domestic interest rates, and the refinancing rates were determined truly by market forces, as the SA Reserve Bank merely followed changes in the Treasury bill rate in setting the rediscount rate.

The approach changed in December 1983, with “... Bank rate and the other refinancing rates ... set by and varied at the discretion of the Reserve Bank. Changes in Bank rate and associated refinancing rates were then used to influence the general level of interest rates in the economy and, through the transmission mechanism, other economic aggregates such as money supply, bank credit extension and the rate of inflation” (Van der Merwe, 1999: 234). Bank rate once again became the SA Reserve Bank's basic rate for rediscounting Treasury Bills in 1985, thereby reassuming the classical role normally associated with such a rate. This change preceded the adoption of money-supply targeting as a new anchor for monetary policy.

In January 1985 it was announced that “... the Reserve Bank will in future limit its accommodation to discount houses to the discounting of assets owned by them, and overnight loans to these institutions will only be granted against the collateral of assets owned by them. Banking institutions wishing to make use of temporary Reserve Bank credit will therefore have to come directly to the SA Reserve Bank for such assistance” (De Kock, 1985b: 1). One of the aims of the new discount policy was to “... enable the Reserve Bank to penalise institutions which, in its opinion, expand their credit excessively and then need abnormally large amounts of Reserve Bank credit, by applying higher rediscount and interest rates, without compelling the Bank to raise all its discount rates” (De Kock, 1985b: 2). This role of Bank rate at the time restored its position as the single most important price in the financial system, as changes in Bank rate resulted in concomitant changes in interest rates in the domestic economy and, therefore, total domestic demand (Gidlow, 1995: 79 and 80). As inflation was at an average annual rate of about 14 per cent, monetary policy did not achieve the objective of relative price stability.

5.12 The period 1986 to 1989<sup>72</sup>

In the 1986 budget speech it was announced that Government had accepted the recommendations of the De Kock Commission. One of the implications was that the SA Reserve Bank would set specific growth targets for one or more of the money supply aggregates (Du Plessis, 1986). It is important to note, in view of the discussion in the preceding chapter of the available monetary policy targets, that the money-supply targets were set by the central bank, rather than the government or jointly by the central bank and the government. In a sense this policy approach exonerates the government from the obligation to follow policies supporting the target, because it does not have primary responsibility for the target, as is the case with an inflation target set by the government for achievement by the central bank.

Table 5.1 Money-supply growth targets, 1986 to 1989

	1986	1987	1988	1989
Target (% change)	16 – 20	14 – 18	12 – 16	14 - 18
Actual % change	10,1	15,5	26,5	23,5
Change in velocity	+ 7,6	+ 0,5	- 7,3	- 5,7
Effective % change				
in money supply	18,4	16,1	17,3	16,5

Source: Gidlow, 1995: 36

The SA Reserve Bank adopted low-profile, adjustable money-supply growth targets rather than fixed targets, as the latter would not have allowed discretion in the application of monetary policy if not achieved. The target set by March 1986 was to keep the growth rate of the broadly-defined M3 money supply between 16 and 20 per cent between the fourth quarter of 1983 and the fourth quarter of 1984 (Gidlow, 1995: 25). However, in the first year of following a money-supply

<sup>72</sup> Except where stated otherwise, this section draws on Stals, 1996.

growth target, the SA Reserve Bank already realised that the growth rates of the M3 money supply is subject to large swings in the velocity of circulation of money. Whereas the growth in M3 over the period was 10,1 per cent, its effective growth, i.e. M3 multiplied with its velocity, amounted to 18,4 per cent. The M3 growth targets and the effective change in the money supply for the period 1986 to 1989 are highlighted in Table 5.1.

This period is characterised by a problem similar in nature (but slightly different in application) to the Primrose prime incident, although this latter occurrence is not as well known. In 1988 Government accepted the *Proposed Action Plan for Combating Inflation*, prepared by the Economic Advisory Council of the State President (Stals, 1989: 10). In terms of this action plan, inflation had to be addressed with a broad spectrum of measures, including restraint in respect of government expenditure. The implicit understanding was that all important prices in the economy and wages should be retained at current levels, rather than be increased – in effect therefore a low-key control approach. The wage focus naturally included salaries and wages of civil servants, and the focus on important prices not to be increased also encompassed the level of interest rates. Gidlow mentions that the discretionary policy followed at the time by the SA Reserve Bank “... kan op die mees doeltreffende wyse toegepas word in ‘n milieu waar die sentrale bank volkome onafhanklik is. Dit was in 1988 byvoorbeeld nie die geval nie toe die owerhede moeilikheid ondervind het om rentekoerse hoër op te stoot op ‘n tydstip toe die betalingsbalansposisie en inflasionistiese druk versleg het” [... can be applied most effectively if the central bank has completely autonomy. This was for instance not the case in 1988 when the authorities experienced difficulty to increase interest rates at a time when the balance-of-payments position deteriorated and inflationary pressures increased<sup>73</sup>] (Gidlow, 1995: 9).

As inflation was at an average annual rate of about 15,6 per cent, monetary policy did not achieve the objective of relative price stability between 1986 and 1989. The final pronouncement on the period 1985 to 1989 indeed comes in the form of a statement in the *Governor's Address* of 1989, i.e. “[d]uring the period 1985 – 1987 ... [i]nflation was ... not regarded as South Africa's main economic problem” (Stals, 1989: 9).

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<sup>73</sup> Author's translation.

The SA Reserve Bank's enabling legislation, the SA Reserve Bank Act, No 29 of 1944, as amended, was replaced by the SA Reserve Bank Act, No 90 of 1989.

### 5.13 A new beginning: 1990 to 1999<sup>74</sup>

The tone for monetary policy in the 1990s was actually set by the Governor on Tuesday, 29 August 1989. Stals was appointed Governor of the SA Reserve Bank on 8 August 1989, after the previous Governor passed away on 7 August 1989. The SA Reserve Bank's sixty-ninth ordinary general meeting of shareholders was held on 29 August 1989. This meeting was the first ever referred to as a meeting of *shareholders* of the SA Reserve Bank. Use of this term was brought about by the SA Reserve Bank Act of 1989, as Sections 1 and 14 of the SA Reserve Bank Act of 1944, as well as the regulations framed under Section 23 of that Act, referred to *stockholders* of the SA Reserve Bank, and it had ordinary general meetings of stockholders, rather than shareholders, until 1988.

The Governor announced a renewed initiative to contain inflation, which remained stubbornly high during the 1980s. It was explained that “[a]t a time when most of the industrial countries of the world pursued strong anti-inflationary policies, South Africa was pre-occupied with short-term economic problems ... [and] ... [i]nflation was at that stage not regarded as South Africa's main economic problem ... [but] ... the main emphasis of monetary policy has ... [now] ... been switched to the curtailment of inflation ... In the circumstances it can no longer be regarded as appropriate to continue to accommodate price increases through large increases in SA Reserve Bank credit and in the monetary policy” (Stals, 1989: 10). The view was that “[t]hrough a disciplined monetary and fiscal policy approach ... it will be possible to reduce the rate of inflation in South Africa over the next few years” (Stals, 1989: 10). Padayachee (2001: 753) refers to the fact that the SA Reserve Bank had no real autonomy before 1989, as it “ ... was largely subservient to political agendas ... ” (Padayachee, 2000: 500). The implication is

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<sup>74</sup> Except where stated otherwise, this section draws on Van der Merwe, 1999.

therefore that the SA Reserve Bank managed to regain its autonomy in monetary policy after 1989, as indicated by the analysis in this section.

The renewed focus on containing inflation resulted in a typical time consistency problem in South Africa. Given a period of double-digit inflation that commenced in 1974 and numerous announcements of intentions to contain inflation in the ensuing period that was not implemented successfully, public economic agents reacted with skepticism to the announcement of 1989. To put it bluntly: the market did not believe the new Governor. The result was sustained double-digit inflation until 1992, i.e. for more than three years after the announcement that the SA Reserve Bank will conduct policy aimed at containing inflation. The result of the time consistency problem was a very painful adjustment period in the domestic economy, with negative economic growth rates in 1990, 1991 and 1992. However, by 1993 the policy focus started bearing fruit, with a general declining trend in inflation since that date.

Owing to factors such as international financial integration, growth in the money supply lost its usefulness domestically and internationally as an anchor for money policy by the early 1990s (Casteleijn 2001: 6; see also Rossouw, 2005). It was time for a new approach. South Africa replaced money supply growth targets with money-supply growth guidelines in the early 1990s, which was replaced, in turn, by eclectic monetary policy in 1996. In terms of the latter policy approach, broad economic indicators, e.g. changes in bank credit extension, overall liquidity in the banking system, the yield curve, the overall balance-of-payments position, the foreign reserve position, the exchange rate and movements in the rate of inflation, were considered in the formulation of monetary policy (Van der Merwe, 1997: 2).

The SA Reserve Bank adopted (and still follows today) the classical cash reserve system after the abolition of direct control measures at the beginning of the 1980s. In terms of this system the SA Reserve Bank refinances the money-market shortage fully on certain predetermined terms, conditions and costs, e.g. banks requiring refinancing providing the required collateral (Van der Merwe, 1997: 2 and 3). By 1997 the refinancing system used by the SA Reserve Bank started to show certain shortcomings that had to be addressed. A cornerstone of the new approach,

introduced on 13 March 1998, was a variable repurchase (repo) rate system, in terms of which the SA Reserve Bank would be able to signal its intentions to the market, which would enhance the transparency of monetary policy. However, under exceptional conditions, the SA Reserve Bank retained the right to fix the repo rate and use it as a tool to give the market a clear interest rate signal. Banks could tender on a regular basis for central bank liquidity, with the aim of making domestic liquidity management the most important operational tool of monetary policy (Van der Merwe, 1997: 15). An additional aim was to improve the functioning of the interbank market for liquidity.

When liquidity problems started developing in South Africa during May 1998, following similar problems in other emerging-market economies, it became obvious that the variable repo rate did not respond with enough flexibility to the changed circumstances. The SA Reserve Bank accordingly fixed the repo rate, but after a discussion of the signalling mechanism with the major banks, it was allowed to fluctuate again. It was clear, however, that the banking sector had difficulty interpreting the signalled intentions of the SA Reserve Bank in offering liquidity to the market. To prevent nervousness over the millennium change-over period, the SA Reserve Bank again fixed the repo rate late in 1999, and as this approach has delivered the desired result since then, the policy of fixing the repo rate has been retained.

In March 1998 it was decided that the SA Reserve Bank would strive to align domestic inflation with the rates of inflation in South Africa's major trading-partner countries, with an informal inflation target range of 1 to 5 per cent to be followed (Casteleijn, 2001: 6), together with eclectic monetary policy and money growth guidelines. The main disadvantage of this targeting approach was "... that it could not be expected to elicit the same commitment to policy co-ordination that would follow if the government had formally endorsed or set the target" (Casteleijn, 2001: 6).

Inflation was at an average annual rate of about 9,9 per cent during the period 1990 to 1999, while the prime overdraft rates of banks were retained at a level of 3,5 percentage points, initially above Bank rate and subsequently above the repo rate. The average annual real prime rate was at a level of 8,3 per cent. Despite the level of real prime rate, monetary policy seemingly did not

achieve the overarching objective of relative price stability, but it is important to analyse the SA Reserve Bank's performance in more detail before making a final pronouncement. Inflation started off at a level of 14,4 per cent per annum, as the central bank had to deal with a time consistency problem. Although the Governor clearly announced the intention to follow sound policy aimed at containing inflation during the 1990s in the *Governor's Address* in August 1989, private economic agents expected the SA Reserve Bank to act in accordance with previous examples, i.e. announcing a renewed tough policy against inflation, but conducting a different and altogether more accommodating policy. The trend in inflation, rather than the actual level, is therefore a better indication of the success of monetary policy. Based on this criterion, monetary policy achieved its goal of a new beginning, as inflation ended the period at an annual rate of 5,2 per cent, a level not seen since 1967 when annual inflation was 5,7 per cent.

Since 1990 the autonomy of the central bank was also restored, as problems such as the Primrose prime incident were not repeated, as is evident by the fact that the SA Reserve Bank refrained from adjusting interest rates to coincide with general elections. Neither at the time of the first democratic elections in April 1994, nor at the time of subsequent elections in April 1999 and April 2004, did the SA Reserve Bank lower interest rates.

After democratic elections in 1994, South Africa embarked on a policy of gradually abolishing exchange control. The dual-exchange-rate (financial rand) system was abolished in 1995, thereby removing the major exchange control arrangements in respect of non-residents. This was subsequently followed by the introduction of foreign investment allowances for residents and domestic companies, and numerous other steps aimed at the eventual complete removal of exchange controls. In as much as sound monetary policy is pursued, exchange control is no longer required to protect the economy against the negative consequences of bad policy.

This policy of gradually abolishing exchange control is not universally supported. Epstein (2002) argues for the stricter enforcement of the system of exchange control by the SA Reserve Bank and the South African Government, rather than any gradual relaxation of the policy. Epstein (2002) also favours the introduction of other measures to insulate the domestic economy from

global pressures, e.g. the introduction of transaction taxes on international transactions. The best known of such proposals is a Tobin tax, i.e. the introduction of a small tax on capital transactions in foreign currencies, aimed at reducing the attractiveness of such transactions for speculative purposes.

The SA Reserve Bank applied consistently since 1990 sound policies that contained inflation over time and reduced it structurally. It also reasserted its autonomy in the implementation of monetary policy since 1990. It is nevertheless important to note the conclusion of Khabo that “... while Chris Stals was successful in fighting inflation, he was accused of lack of transparency. This was because inflation-targeting did not make the goal or the target rate clear. The time frame he used to target reducing inflation was in line with that of major trading partners, namely bringing inflation within the 1 to 5 per cent band, but that was never given” (2002: 151). Casteleijn (2001: 6) states that this approach was not confirmed by government.

#### 5.14 Inflation targeting: monetary policy since 2000

On 23 February 2000, the Minister of Finance announced a new monetary policy framework for South Africa: inflation targeting (South Africa, 2000). This announcement confirms beyond any doubt that the Government sets the target to be achieved by a central bank with operational autonomy through the application of sound monetary policy. As highlighted in an earlier chapter, this is indeed one of the advantages of inflation targeting over money-supply targets as an anchor for monetary policy: the government cannot distance itself from the policy or follow other economic policies that will put the target in jeopardy, as it is indeed its own target.

In South Africa’s instance the target is specified in terms of changes in CPIX, which has the somewhat cumbersome definition of changes in the CPI for metropolitan and other urban areas excluding changes in the interest costs of mortgage bonds<sup>75</sup> (Mboweni, 2005c; see also Van der Merwe, 2004). At the time of the announcement of the target, it was set for achievement for the

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<sup>75</sup> The use of the word *bonds* in this definition might be somewhat problematic in certain English-speaking countries, as a bond can also be defined as “... a certificate issued by a government or a public company promising to repay borrowed money at a fixed rate of interest at a specified time” (Soanes and Stevenson, 2004: 157).



first time by 2002. The main difference between CPI and CPIX is the exclusion of changes in the interest costs of mortgage bonds, with a weight of 10,32 per cent in the overall CPI (Statistics SA, 2001). It is noteworthy that this exclusion is aimed at limiting the immediate effect of interest rate changes on the inflation figure used for targeting purposes, but that all changes in interest costs are not excluded. Changes in interest costs (of loans other than mortgage bonds) and bank charges account for a weight of 1,05 per cent in the CPI (Statistics SA, 2001), although no clear split is provided. Ideally these components should be split and published separately by Statistics SA. Moreover, CPIX does not cover rural areas.

In its specification of the target, the South African government selected a target range rather than a specific point. Setting a specific point as a target “... is clear and straightforward and focuses attention, expectations and policy actions on a single numerical value ... [but] ... implies a degree of precision which cannot realistically be expected of monetary policy, especially in a small, open economy” (Casteleijn, 2001: 8). Under the circumstances the announcement of a target range was more appropriate for South Africa, as it improved the probability of achievement by the central bank: an important precondition for the announcement of a credible inflation target. The advantage of the specification of the inflation target as a range rather than a specific point is the discretion available to the central bank under such an approach (see for instance Van der Merwe, 2004). If the target is specified as a specific point, the central bank is expected to change course whenever the rate is not on target, despite expectations of movements in the rate in the near future.

The Governor stated at the time that “[i]nflation targeting is a monetary policy framework characterised by an announcement of a numerical target for the inflation rate that is intended to be achieved over a specified time period” (Mboweni, 2000a: 3), but added that “[t]he objective of the exercise is, after all, to achieve the target range” (Mboweni, 2000a: 3). The target in terms of CPIX was specified as an average annual rate of increase of between 3 and 6 per cent per annum in the CPIX in 2002. At the time of the announcement it was necessary to “... use this medium-term target in view of long lags between monetary policy steps and their impact on inflation.

Changes in interest rates in South Africa generally take from 18 to 24 months to have a material influence on the underlying rate of inflation” (Mboweni, 2000a: 4).

In 2001 the Minister of Finance announced that “[t]he inflation target will remain an annual average increase of between 3 and 6 per cent in CPIX in 2003. For the 2004 and 2005 year, the target will be 3 to 5 per cent” (Manuel, 2001: 6). Owing to negative inflation movements emanating from a depreciating exchange rate of the rand, rising oil prices and sharp increases in food prices in the period following the respecification of the target in 2001, the Minister of Finance announced in 2002 that “... Governor Mboweni and I have agreed that the inflation target should remain 3 to 6 per cent for 2004. The 3 to 5 per cent target falls away until further notice” (Manuel, 2002: 4). The target of 3 to 6 per cent was still in use at the time of the completion of this study.

A further amendment to the specification was announced in 2003, when the Minister of Finance said that “I am pleased to report that we have agreed on a number of amendments to the inflation targeting framework within which the SA Reserve Bank conducts its monetary policy responsibilities. Rather than expressing the target as an annual average for each calendar year, the 3 to 6 per cent range will now be a continuous target within which the SA Reserve Bank will seek to maintain the monthly rate of CPIX inflation, as measured on a year-on-year basis. This range will remain in place for 2006 and future years, until a revised target is set” (Manuel, 2003b: 6).

With the introduction of the inflation-targeting monetary policy framework, “... the monetary authorities ... [target] ... the rate of inflation directly in stead of following the previously applied eclectic monetary policy approach in which intermediate objectives still played an important role” (Mboweni, 2000a: 1). Since the adoption of inflation targeting, the SA Reserve Bank also announced modifications to the repo system, aimed at increasing the effectiveness of monetary policy (see for instance Casteleijn, 2001: 13; De Angelis et al., 2005: 658; Mboweni, 2001; or SA Reserve Bank, 2001a: 2) The most recent of these changes was announced in May 2005, aimed at reducing “... [t]he daily involvement of the Bank in influencing money-market liquidity in

order to facilitate a better functioning interbank market and liquidity management by banks” (Mboweni, 2005a: 6), and to make the Bank’s refinancing operations simpler and more transparent. The more important changes can be summarised as (Mboweni, 2005a: 7):

- the estimated average liquidity requirement for the week, as well as the estimated range within which the daily liquidity requirement is expected to fluctuate, are announced prior to the weekly repurchase auctions on Wednesdays;
- the use of supplementary square-off auctions is limited to exceptional circumstances; and
- final clearing facilities have been replaced by standing facilities at the SA Reserve Bank, providing access to overnight repurchase facilities for all banks at 50 basis points below or above the repurchase rate for surplus or deficit positions, respectively.

The adoption of the inflation-targeting policy framework was preceded by the establishment of an MPC for the SA Reserve Bank in 1999, entrusted with the responsibility to set and adjust monetary policy. The MPC, chaired by the Governor, considers a broad selection of economic data in its deliberations, e.g. projections about economic trends and expected movements in the rate of inflation (CPIX, the rate used for targeting purposes), and macroeconomic and financial market reviews. The MPC also reviews the monetary policy statement released after each MPC meeting. On the basis of the comprehensive analysis and deliberations of the MPC, the SA Reserve Bank announces its monetary policy stance and, if necessary, the change to its repo rate.

In assessing the use of an inflation-targeting framework, Casteleijn states that “... [t]he inflation-targeting policy framework provides a fair measure of flexibility for the Bank ... [as] ... the policy allows for some discretion in the case of serious supply shocks to avoid costly losses in terms of output and jobs” (2001: 15). This is indeed still the case, and currently the policy of using an inflation target as a nominal anchor for monetary policy serves South Africa’s best interests. Since the adoption of an inflation target the minimum overdraft rates of commercial banks were retained at a margin of 3,5 percentage points above the repo rate. As was the case in the preceding period, the maintenance of this margin enabled the SA Reserve Bank to exert a direct influence over the rates charged by commercial banks. The real repo rate averaged about 4,7 per cent between 2000 and 2006, and inflation measured in terms of changes in the CPI was

at an average annual rate of about 5,2 per cent, implying that the average nominal minimum lending rate was about 13,4 per cent. Monetary policy achieved the overarching objective of relative price stability, confirmed by the fact that CPIX remained within the target range of 3 to 6 per cent between September 2003 and April 2007. As was the case in the 1990s, the SA Reserve Bank retained its autonomy in the implementation of monetary policy after the adoption of an inflation-targeting monetary policy. The Governor has “... stressed that the days of the Primrose prime are gone, such as when then President P W Botha called Gerhard de Kock on the eve of a crucial by-election requesting a cut in interest rates, and the late governor was happy to oblige” (Garrow, 1999).

Despite the transparency of an inflation-targeting policy and the central bank’s best efforts to improve communication as is explained below, private economic agents, journalists and market watchers nevertheless remain susceptible to misinterpretation of policy actions of the SA Reserve Bank. A case in point highlighting this matter is the decrease in the repo rate announced by the SA Reserve Bank in April 2005. At the time some commentators interpreted the change in the repo rate as a change in the objective of the SA Reserve Bank from its inflation anchor to an exchange rate target or anchor of some or another sort. The Governor, however, explained later that “... changes in the exchange rate are important in the inflation process in South Africa. The stronger rand (at the time of the announcement in April 2005) was expected to have a direct impact on inflation through the price of imports. At the same time, there is an indirect effect through the negative impact of the strong exchange rate on the export and import-competing sectors of the economy. This resultant widening in the gap between actual and potential output would also have a moderating effect on the inflation outlook. The reduction in the repurchase rate was, therefore, not a result of a focus on the strong rand, but on the favourable inflation outlook” (Mboweni, 2005a: 6). The fundamental point is that the SA Reserve Bank does not have goal independence: the Government has entrusted the achievement of the inflation target to the SA Reserve Bank. The inflation target is not the SA Reserve Bank’s to change, e.g. from relative price stability to an exchange rate target. It can only be changed (or even adjusted) by the South African Government by means of public announcement. Given the misinterpretation in

April 2005, it is fair to conclude that the SA Reserve Bank faces a formidable communication challenge, as is explained in the next section.

#### 5.15 Improved communication by the SA Reserve Bank<sup>76</sup>

Since the announcement of an inflation target in South Africa, any ambiguity about the conduct of monetary policy has, in theory, been removed owing to the adoption of a nominal anchor. The smooth conduct of an inflation-targeting framework implies a good deal of trust and confidence on the part of the public in a central bank's ability and determination to achieve the target. Without this credibility in the eyes of the public, a central bank's policy goal might be unachievable. Credibility is enhanced by communication. Mishkin states that "[i]nflation targeting involves ... increased transparency of the monetary policy strategy through communication with the public and the markets about the plans and objectives of monetary policy makers ..." (2004: 501). Moreover, "[b]ecause the central bank's intentions are clearly stated, the public is able to understand and monitor central bank actions. This improves the transparency of monetary policy, making communication with the public more effective, while providing increased discipline and accountability for central bank activities" (Aninat, 2000).

Despite the lack of uniformity in central banks' communication strategies explained in Chapter 3, the SA Reserve Bank has introduced a number of initiatives to improve communication with all its stakeholders since the introduction of an inflation targeting policy framework in 2000. Wessels observes that "... the introduction of a numerical inflation target increased the transparency of the Bank's policy objectives substantially, and contributed to the public's understanding of what the Bank is explicitly held accountable for" (2002: 978). The Governor pointed out in 2002 that "[i]nflation targeting has also been accompanied by major improvements in the Bank's communication with the public and markets and there has been a significant upgrade in monetary policy transparency" (Mboweni, 2002). In the case of the SA Reserve Bank, the most important stakeholders are (in alphabetical order) government, labour, media, Parliament, public, and shareholders and staff members of the SA Reserve Bank.

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<sup>76</sup> This section was presented as a conference paper in Nicosia in March 2007 (Rossouw, 2007a).

The most important initiative to improve communication about the formulation of monetary policy was the establishment of an MPC with responsibility for setting the repurchase rate, i.e. the rate at which the SA Reserve Bank provides liquidity to domestic banks. The establishment of the MPC, which held its first meeting on 13 October 1999 (Mboweni, 1999; SA Reserve Bank, 1999), was indeed a precursor in the period running up to the formal introduction of an inflation-targeting policy framework. Since its inception, the composition and frequency of meetings of the MPC have on a number of occasions been revised to serve the best interests of the SA Reserve Bank and its various stakeholders. However, the MPC introduced certainty about adjustments in monetary policy in as much as:

- (i) responsibility for monetary policy decision-making is entrusted to the Committee, rather than an individual who can surprise the public and markets with adjustments in interest rates;
- (ii) the Committee meets at predetermined intervals and on predetermined dates, published up to a year in advance;
- (iii) any element of surprise about the timing of monetary policy decisions (although not about the decision itself) is removed;
- (iv) a detailed statement accompanies the announcement of the MPC's decision. Although not formal minutes of the MPC meeting, the statement details the rationale and assessment of economic conditions that led to the decision; and
- (v) the Committee's decision is announced after each meeting at a media conference and in a media statement. In conjunction with a local national television network, the SA Reserve Bank broadcasts the MPC announcement after each meeting live to ensure that everyone receives the information about the decision on interest rates at the same time.

In addition to the improvement in communication owing to the role of the MPC, and through its statements, the Governor highlighted in 2002 as further examples of an upgrade in monetary policy transparency and communication “ ... the biannual *Monetary Policy Review* ... and the national and regional Monetary Policy Forums” (Mboweni, 2002).

The first *Monetary Policy Review* (the *Review*) of the SA Reserve Bank was published in March 2001, as “... part of the Reserve Bank’s attempt to broaden the understanding of the aims and conduct of monetary policy” (SA Reserve Bank, 2001b). By and large the *Review* analyses developments in and factors influencing inflation, assesses recent policy developments and considers the outlook for inflation (SA Reserve Bank, 2005b). The *Review* reports on the MPC’s assessment of inflation and the SA Reserve Bank’s inflation forecast, hence providing an *ex post* insight into matters deliberated by the MPC.

The first meeting of a Monetary Policy Forum was held in Pretoria on 20 March 2000 (SA Reserve Bank, 2000). Currently the SA Reserve Bank hosts Forums biannually in Bloemfontein, Cape Town, Durban, East London, Kimberley, Mafikeng, Polokwane, Port Elizabeth, Pretoria and Nelspruit. These forums provide for discussions on monetary policy over a broad geographical spectrum involving a large cross-section of stakeholders, including trade union representatives, analysts, academics and the media.

The SA Reserve Bank also improved its statutory reporting. The SA Reserve Bank Act stipulates in Section 32(1)(b) that “[t]he Bank shall ... within three months after the close of its financial year, transmit to the Department of Finance ... [known as the National Treasury since the merger of the Departments of Finance and State Expenditure] ... two copies of its financial statements ...” (1989), for subsequent tabling in Parliament. In addition, regulations 67 to 70 (SA Reserve Bank Act, 1989) stipulate that the SA Reserve Bank must keep accounts, including an income statement and a balance sheet, that must be approved by its shareholders at the annual meeting of shareholders.

The SA Reserve Bank published *Annual Financial Statements* until 2002, but reporting and disclosure in the statements increased and improved to the extent that its name was changed to *Annual Report and Financial Statements* in 2003 and to *Annual Report* in 2006. The revised name reflects its nature: the SA Reserve Bank reports on matters much broader than only its financial affairs. Owing to its approval by shareholders and its tabling in Parliament, the *Annual Report* attracts considerable media attention, enhancing the accuracy of reporting on the SA

Reserve Bank.

During 2004 the SA Reserve Bank introduced biennial shareholder briefings. The SA Reserve Bank is one of a small group of central banks that still has private shareholders. Lybek and Morris (2004: 7) identified the central banks of Austria, Belgium, Greece, Italy, Japan, Pakistan, South Africa, Switzerland and the United States as institutions with shareholders other than their respective governments. The management of the SA Reserve Bank identified the importance of briefing this group of stakeholders on occasions other than at annual ordinary general meetings. Shareholders are invited by the Governor to these briefings, which are hosted in three or four major cities in South Africa. These briefing sessions are, *inter alia*, used to brief shareholders informally on the conduct of monetary policy and the implementation of an inflation-targeting monetary policy.

For many years the SA Reserve Bank has published the abridged version of the *Governor's Address* to shareholders in a variety of publications in Afrikaans and English. Since 1999 the SA Reserve Bank has proceeded to publish the *Governor's Address* in additional official languages. In 1999 the *Governor's Address* was published in five languages and since then in six languages, in both instances including English and Afrikaans, in a variety of newspapers and magazines so as to broaden its reach and make it more accessible to the public.

The SA Reserve Bank is ultimately accountable to Parliament as the representative body of all the people in South Africa, and submits its *Annual Report* to Parliament. The Governor meets periodically with members of the Parliamentary Portfolio Committee on Finance. In addition, during March 2007 the Board of Directors of the SA Reserve Bank (as represented by its Remuneration Committee chaired by a non-executive director) met with this same Parliamentary Committee to enhance accountability (Ensor, 2007: 2).

Apart from the formal external communication approaches followed by the SA Reserve Bank, a number of other communication channels are also employed. These include briefing sessions with media representatives and speeches by the Governor, deputy governors and other senior



officials. As a case in point, the Internet website of the SA Reserve Bank (online: <http://www.reservebank.co.za>) reports 10 public addresses by the Governor during 2005 and 16 addresses during 2006, excluding the *Governor's Address* at the annual general meeting of shareholders and the announcements of the MPC's decisions. In addition, the SA Reserve Bank's website is used extensively to alert the media and staff to various happenings.

The SA Reserve Bank has also introduced steps to improve communication with its staff members and former (i.e. retired) staff members since 2000. An annual general management conference, comprising the Governor, the deputy governors, all staff at the level of assistant general manager and above, and branch managers, was introduced by the SA Reserve Bank in 2004. The aim of the conference is to ensure that the general management and branch managers are briefed about new developments, which enables them to communicate with staff. Moreover, they are also briefed at the conference about the SA Reserve Bank's successes in containing inflation and achieving the target. Retired staff members are invited to discussions with the SA Reserve Bank's executive management on an *ad hoc* basis.

Judging from these initiatives, it seems that the SA Reserve Bank values the importance of communication supporting a policy of inflation targeting, despite the lack of international benchmarks for successful central bank communication (see for instance Blinder, [S.a.]; or Ehrmann and Fratzcher, 2004).

#### 5.16 Conclusions about South Africa's experience with inflation

The central finding of this chapter is that the problem of inflation in South Africa has occurred in different forms and has occupied the attention of monetary authorities over many years. Inappropriate economic policy, and monetary policy in particular, contributed to conditions conducive for the development of inflationary conditions. In containing inflation there is no single solution that could be applied universally, except to state the obvious: countries should prevent unsound policies that will foster inflation.

Since the establishment of the SA Reserve Bank in 1921, South Africa has experienced varying degrees of success in containing or combating inflation. In the period before World War II, the SA Reserve Bank achieved remarkable success in containing inflation, although inappropriate policies were followed on occasion, albeit with the support of the Government or even in support of the policy stance of the Government. During and immediately after World War II the SA Reserve Bank was less successful in containing inflation, but regained monetary control by the late 1950s and the 1960s.

From 1968 domestic inflation started accelerating, and in the ensuing years the SA Reserve Bank seemed incapable of controlling it effectively. Reviewing the 20-year period from 1974 to 1993, however, reveals that the SA Reserve Bank was one of very few central banks in the world that managed to contain inflation between 10 per cent and 20 per cent per annum, without it developing into runaway inflation (see for instance Table 3.5). An *ex post* analysis gives the impression that the SA Reserve Bank followed an inflation target of between 10 and 15 per cent per annum, with monetary tightening whenever inflation breached 15 per cent, and monetary relaxation whenever inflation declined to levels slightly above 10 per cent. This was indeed not due to the policy approach, but the result of inconsistent policy application. It nevertheless confirms that the SA Reserve Bank all along had the tools and knowledge to contain inflation, but lacked the autonomy during this period to follow consistently policies aimed at achieving this goal.

A comprehensive system of exchange controls, at least applied to residents, is a precondition for inappropriate monetary policy causing sustained high domestic inflation. Without such controls domestic investors would have reverted to foreign investments with a concomitant demand for foreign currency, leaving the central bank no choice but to adapt sound monetary policy to lower inflation to a level commensurable with the levels of inflation in industrialised countries.

Since the 1990s the SA Reserve Bank has again been successful in containing inflation, albeit with the use of different policy models. Moreover, coinciding with an inflation-targeting policy from 2000, the SA Reserve Bank has embarked on major initiatives to improve communication

with its stakeholders. Owing to a lack of benchmarks for assessing the communication strategies of central banks and the different approaches followed by different banks, the challenge for the SA Reserve Bank is to ensure maximum efficiency and consistency of its communication within the ever-present economic constraint of limited resources.

The adoption of an inflation target set by Government for achievement by the SA Reserve Bank implies a clear commitment to low inflation and relative price stability, therefore removing any time consistency problems from the application of monetary policy. An important question, however, is whether the rate of inflation reflects accurately over time average increases in the prices of goods and services in an economy. This question is addressed in respect of South Africa in the next chapter.

In the interest of easier communication and in clarifying the exact reasons for excluding interest rates from the inflation rate used for targeting purposes, South African authorities should reconsider its somewhat cumbersome definition. It is questionable whether the CPIX, defined as changes in the CPI for metropolitan and other urban areas excluding changes in the interest costs of mortgage bonds, serves South Africa's best interests from the perspective of ease of communication. The definition is particularly problematic in as much as it does not exclude all interest rates and does not cover rural areas.