

CHAPTER SIX

MONETARY POLICY APPLICATION IN SOUTH AFRICA PRIOR TO 1994: AN OVERVIEW

6.1 INTRODUCTION

The purpose of this chapter is to examine the historical application of monetary policy in South Africa, over different time periods marking policy shifts, and to determine its effectiveness or lack thereof in stimulating growth. This background will serve as an input for formulating an ideal model for monetary policy in South Africa, which is the topic of the next chapter. This chapter will therefore cover a historical account of application of monetary policy in South Africa prior to the first democratic elections in 1994. The objectives of monetary policy in South Africa; the techniques and mechanics of monetary policy; the instruments of monetary policy, as well as, the controversy over the use of the monetary base ("high powered money") or the interest rate in controlling money supply in South Africa; and the South African financial structure within which monetary policy is implemented will be discussed. This chapter will also deal with the definition of economic growth, which will serve as a framework within which the formulated monetary policy model for South Africa is empirically tested in Part 3.

6.2 THE HISTORY OF MONETARY POLICY IN SOUTH AFRICA

Over the years, monetary policy application in South Africa has shifted its focus between interest rate stabilisation and control of money supply. In the 1960s, the Keynesian approach, which focuses attention on fiscal policy for the achievement of macro-economic policy objectives, that is economic growth, was pursued in South Africa. Monetary policy played a more passive role, in that interest rates were stabilised at relatively low levels, with extensive use of credit ceilings, changes in liquid asset requirements and direct or indirect interest rate subsidies to selected sectors like agriculture, home owners and exporters (Franzsen, 1970: 113-114). A distinctive shift in focus by monetary authorities took place in the 1970s, tending towards a monetarist approach, as inflation rates soared.

However, the Keynesian inclination lingered, and in the 1980s, monetarist enthusiasm subsided somewhat, with the monetary authorities tempering the Keynesian approach with some features of monetarism. Demand management was applied, that is the control of spending in order to control inflation and maintain a sound balance of payments, together with a monetarist element of money supply control. Thus the blend of monetary policy followed in South Africa is described as a "conservative Keynesian demand management and pragmatic monetarism" (De Kock Commission 1985:13). In the 1990s, protection of the value of Rand both at home and abroad took place via control of the money supply as well as through the bank rate. In the 1990s, attention shifted to the independence of the SARB, notwithstanding its accountability to the government (Stals 1993a:25-27; Mollentze 2000: S 18 -20).

According to the Bank Act of 1942, cash reserve requirements were used as instruments for safeguarding the interests of depositors, requiring 10 percent and 3 percent to be held by commercial banks against demand and time deposits respectively. These cash reserves were to be held with the SARB. This was the policy up to 1965. Furthermore, in 1965, as an additional credit policy instrument, the Bank Act was amended to give the SARB the power to impose supplementary reserve requirements for purposes of monetary stability (Lombard, 1993:41-55).

In terms of this amendment, commercial banks could deduct from any supplementary reserve balance they were required to hold with the SARB any net increase after a specified date in the aggregate amount of their holdings of treasury bills, government stock with a maturity not exceeding 3 years, bills or advances to the Land Bank and other approved assets. This instrument was a variable liquid asset requirement rather than a variable cash reserve requirement. In 1961, the Bank Act was further amended to empower the SARB to reduce commercial banks' minimum cash reserve balance against demand liabilities to not less than 6 percent, to stimulate the economy. The use of required minimum liquid assets was predicated upon the supposition that the limited supply and/or low yield of these assets would serve to curtail bank lending, money growth and inflation (Whittaker 1992:68-72).

The consequence of the recommendations of the Technical Committee was the Reserve Bank Act of 1965, which now included all banking institutions, and not only

the commercial banks. One uniform set of legal requirements was set, the only distinctions being with respect to "short", "medium" and "long" term liabilities, and thereby bringing "near-banks" under the control of SARB. Previously, these "near-banks", financial institutions, which competed with commercial banks for deposits, were not subject to minimum reserve requirements, which tended to render the SARB's efforts to control the money supply ineffective, so that stabilisation in South Africa proved ineffective. The period was marked by inflationary financing of Government expenditure, which could not be curbed by restrictive policies based on liquidity or cash requirements. Credit ceilings and other credit controls were then chosen (Franzsen Commission, 1970: 592). During this period of increasing inflation, the use of interest rates as the target of monetary policy fell into disrepute, since they could no longer give an indication of the real cost of borrowing. Emphasis came to be placed on fixing a target for the money supply and allowing interest rates to find their own market-determined levels. The proclaimed policy reflected the belief in the quantity theory of money, which views monetary growth as the sole cause of inflation, together with the associated belief that the economy is self-adjusting, tending towards the natural rate of unemployment in the long run. However, in practice, instead of fixing the monetary base as the quantity theory of money purports, monetary authorities in South Africa set target ranges for the growth of one or other of the monetary aggregates, like M1, which they sought to achieve by a suitable adjustment of the interest rate (Dornbusch, Fischer, Mohr & Rogers, 1996:417-420).

In 1972, existing ceilings on bank credit were abolished and liquid asset requirements were revised in South Africa, in an attempt to stimulate the economy. While banks were given more freedom to extend credit, they were urged by the SARB to give preference to the extension of credit for production and export purposes. However, there was rapid growth in monetary aggregates, especially M2, and a deficit on the balance of payments during 1975. Again monetary policy was to keep interest rates relatively stable, with the prime overdraft rate fluctuating between 8 and 12,5 percent over the period 1970-1979. After 1979, the prime overdraft rate fluctuated between 9,5 and 24 percent, with monetary aggregates achieving record growth rates, especially the growth rate of M1 in 1981, 1984 and 1988 (SARB Quarterly Bulletin, several issues). This reflected the change in policy to allow interest rates to adjust to market forces, in an attempt to control the growth rate of

monetary aggregates without using direct controls. But foreign interest rates and the balance of payments problems put pressure on South African monetary authorities, forcing them to revert to the previous policy of fixing the interest rate as in 1986. During the 1990s the SARB has once again reverted to a market-oriented approach, controlling money supply relative to prevailing economic conditions. As an indication of the flexibility that the monetary authorities have, a change in terminology is used, moving away from "monetary targets" to "monetary guidelines" (Nattrass 2000:231-233) This is to reflect the current policy, which is captured by the use of "monetary guidelines", suggesting no commitment or fixation of attaining a certain rate of expansion or contraction of the money supply. With "monetary guidelines", monetary authorities are said to be able to deviate from forecast of the rate of monetary expansion: "The Reserve Bank will therefore at this juncture continue with the existing policy of using changes in the money supply as the most important monitor for its decisions regarding the implementation of monetary policy" (Stals, 1994: 25).

The experience of money supply and interest rates in South Africa, up to 1993, prior to the democratic elections discussed above is reflected in table 23.

6.3 MONETARY POLICY APPLICATION IN SOUTH AFRICA PRIOR TO 1994

6.3.1 Objectives of monetary policy in South Africa

"For the last twenty years the South African economy has suffered from a rate of price inflation which has been higher than that of its trading partners. Amongst other ills, it has also experienced wide fluctuations in nominal and real interest rates, and a weakening foreign exchange value for its Rand currency. These conditions have not being conducive to durable growth of the economy" (Whittaker 1992:55). In South Africa, the South African Reserve Bank and the Treasury are the monetary authorities charged with the responsibility for implementing monetary policy. The Treasury's main responsibility is to take charge of the annual budget, which is the main vehicle for the government's fiscal policy, ensuring that the necessary controls are in place to spend the

budgeted money prudently and for the approved purposes (Fourie 2001:25). While the Treasury is also part of monetary authorities, and a central bank cannot be completely independent, the South African Reserve Bank should be free from political interference in exercising its monetary policy responsibility. This calls for the Governor of the South African Reserve Bank to be independent, in the narrow sense, accountable to the government, which restricts absolute independence (Stals 1993:25-27).

Accordingly, the broad objectives of monetary policy, as part of total public economic policy, include promotion of economic growth, raising levels of employment and achieving domestic and external monetary stability. Monetary policy may become expansionary in times of underemployment of available resources. At full employment, while certain expansion of the monetary base is still required, the degree is lesser, for otherwise inflation and balance of payments problems set in, as demand for goods and services exceeds supply. This situation would arise as a result of high liquidity, the easy availability of credit, low interest, etcetera. Increases in cost and prices as well as imports are bound to occur as a result of such expansionary policies, are bound to occur (De Jongh 1970:11). Presently the overall objective or mission of the South African Reserve Bank, is "the protection of the domestic and external value of the Rand" (Stals 1993:28-30).

While previous monetary policies differed from the current one, all policies have included attempts to curb inflation. According to De Kock (1985:13), inflation causes reduced investment inefficient allocation of source labour and other resources. And if it is not curbed, inflation is also said to lead to the imposition of price and other direct controls, which in turn worsen such inefficient allocation of resources. Inflation is also said to reduce the propensity to save, having a tendency to escalate if not countered. Furthermore, De Kock (1985:13), also points out the detrimental impact of inflation on economic growth by stating that if the country's inflation rate is higher than that of trading partners, the result leads to balance of payments problems. Such problems are said to have a tendency to result in the imposition of import control, exchange controls, etcetera, which under full employment conditions put pressure on resources, escalating the inflation rate. The effects of balances of payments problems, it is further asserted, may lead to devaluation or a series of devaluations.

**TABLE 20: MONEY SUPPLY AND INTEREST RATES
 IN SOUTH AFRICA: 1970-1993 (PRE-1994 ELECTION)**

Year	Annual percentage increase in money supply (%)		Interest Rate at end of year(%)	
	M1	M2	Prime Overdraft Rate	BA rate
1970	3,2	9,4	8,5	7,30
1971	5,1	5,9	9,0	8,50
1972	12,8	9,1	8,5	5,40
1973	15,1	22,3	8,0	7,20
1974	22,6	19,9	12,0	11,00
1975	13,4	20,7	12,0	8,50
1976	6,1	14,9	12,5	9,65
1977	3,1	-2,0	12,5	8,80
1978	6,1	19,0	11,5	7,60
1979	19,1	12,6	9,5	4,60
1980	29,7	21,8	17,0	7,00
1981	34,2	28,5	18,0	15,25
1982	21,3	15,7	20,0	14,25
1983	29,0	22,5	24,0	18,10
1984	39,9	23,5	16,5	21,75
1985	13,7	18,8	12,0	13,60
1986	-3,5	7,9	12,5	8,90
1987	23,2	10,0	18,0	9,50
1988	30,5	32,4	21,0	15,65
1989	15,3	30,6	21,0	18,00
1990	12,7	17,7	20,25	17,70
1991	17,7	19,1	20,25	16,40
1992	14,2	12,5	17,25	12,40
1993	8,0	3,2	15,25	10,15

NOTES: Changes in money supply calculated as a percentage increase in annual averages of month-end balances.

Prime overdraft rate is that charged by major commercial banks. BA rate is the rate on three-month bankers' acceptances.

SOURCES: Franzsen (1983); South African Reserve Bank Quarterly Bulletins.

From the above, it can be stated that prior to the Stals focus on the preservation of the value of the Rand, both at home and abroad, as the primary objective of monetary policy in South Africa, the broad-based or traditional objectives can be seen as: "relative stability of general price level; a high and stable level of employment of labour; a satisfactory high rate of expansion of total output, i.e. satisfactory rate of economic growth; and satisfactory balance-of-payments, foreign reserves and exchange position" (De Kock 1985: par 13.15).

Given that protection of the value of the Rand is the primary or "ultimate" monetary policy objective for monetary policy authorities, this does not mean that monetary authorities are most reluctant to attain such a goal by mandatory price controls. Instead, the authorities may adopt an "intermediate" objective like a certain target rate of growth of the money supply. Also, the authorities cannot simply fix the size or the rate of growth of money supply. This, does not imply, however, that monetary authorities never interfere in the activities of banking institutions. Instead authorities are bound to create conditions in which the money supply will "spontaneously" be neither too large nor too small and will be growing neither too rapidly nor too slowly, relative to the "ultimate" goal of protecting the value of the Rand. Governing the rate of growth of money supply is the banks' ability and desire to create and accept monetary liabilities, that is the supply side of the money-creation process, on the one hand, and on the other hand, the non-bank public's willingness to hold such liabilities, that is the demand side of money-creation process. As such, monetary authorities can hope to control the money-creation process from the supply side by reducing or expanding the amount of reserves of the private banking institutions, for example. Another assumption is that such an amount can be closely managed by the monetary authorities. For the demand side, authorities can achieve their money supply target by bringing about a particular level of interest rates at which the domestic non-bank public will wish to hold money in line with the set target size (Fourie, Falkena & Kok 1996:291). To operationalise both the amount of reserve assets available to the banking sector and the level of market interest rates, the monetary authorities have a number of instruments at their disposal, which they have been applying since the inception of the South African Reserve Bank (SARB). These instruments are discussed in the next section.

6.3.2 Monetary policy instruments

In its role as facilitator or promoter of economic growth, monetary policy seeks to influence variables such as the money supply, the level and structure of interest rates and the general availability of credit in the economy, by exercising control over the financial system. The South African Reserve Bank (SARB), which was established in 1921, uses policy instruments in performing five main functions, that is controlling the issue of notes, being a banker to other banks, serving as custodian of the country's gold and other foreign exchange reserves; and formulating and implementing monetary policy (Fourie & Van den Bogaerde 1997:232-233).

The SARB has the sole right to issue bank notes and coins. This cash is circulated through purchases of assets from the government and the commercial banks, thereby creating credit availability by SARB to these sellers of financial assets. In performing this function, the SARB is constrained by the public's cash requirements, that is "till money requirements". As a banker of bankers, the SARB is the custodian of minimum banks. This is a process through which the banking sector can create money, since they do not have to keep all deposits in reserve. The control of money supply by the monetary authorities is at the heart of this study. By controlling the composition and levels of their required reserves, the SARB can control the supply of money. Banks also use these reserves to clear mutual claims and obligations, thus rendering the SARB a clearing bank as well. The SARB clears one bank's debit balance against other banks credit balances. The SARB also acts as lender of last resort, in that the cash balance shortage experienced on the money market by the Corporation for Public Deposits (formerly the National Finance Corporation), the discount houses and commercial banks, can be obtained from the SARB. Usually, the discount houses obtain the required cash balances for shortfalls from the SARB, on behalf of commercial banks, by rediscounting land bank bills, treasury bills, bankers' acceptances, etcetera. The determination of rates, terms and conditions under which the SARB executes its rediscounting is called its discount policy.

As the custodian of the country's gold and other foreign exchange reserves, the SARB is also the government's banker, handling all financial receipts and payments of the state. The SARB also deals with the weekly issue of treasury bills on behalf of the treasury,

advising the government with regard to monetary and financial matters, including the administration of exchange controls. And with regard to formulation and implementation of monetary policy, as stated above, the SARB co-operates with the Department of Finance, while maintaining its independence (Fourie 1991:232-233).

To perform its main functions, the policy instruments used by the SARB can be divided into four broad categories, namely "market-oriented" policy instruments, "semi-direct" policy instruments, "direct" policy instruments, and instruments with "external" dimension (Fourie, Falkena & Kok 1996:216-220). "Market-oriented" policy instruments are of two types, the discount policy or refinancing policy and instruments that support the SARB's refinancing policy, namely public-debt management, open-market operations, the operation of Tax and Loan accounts, variations in reserve-asset requirements, and other measures for influencing the money-market shortage. "Semi-direct" policy instruments take the form of variations in reserve-asset requirements, while credit ceilings, selective credit controls; reserve-asset requirements, capital requirements, deposit and/or lending interest rate controls, "moral suasion", hire-purchase credit controls, and import deposit schemes constitute "direct" policy instruments. Under policy instruments with "external" dimension fall official foreign borrowing; changes in exchange control regulations; and central-bank intervention in the spot and forward foreign-exchange markets (Fourie, Falkena & Kok 1996: 251).

These policy instruments are used in accordance with the classical principle of economic management, which seeks never to control the endogenous variables of the market mechanism directly, but to influence them indirectly through those elements of the market which are naturally subject to outside influence. As stated above, these policy instruments are related to the main functions of the SARB in its formulation and implementation of monetary policy; this relationship is discussed in the next section as techniques of monetary control.

6.4 THE TECHNIQUES OF MONETARY CONTROL

On the basis of the main functions of the SARB discussed above, the control of the cash reserve requirements of private banks, rediscounting operations, intervention in spot and

forward foreign exchange markets and open market operations, that is the selling and buying of securities, are instruments used to sharply focus the Rand value protection binoculars of SARB. Open market operations consists of decisions regarding the timing, volume and nature of the SARB's sales or purchases of financial assets, to supply or absorb cash reserves. The financial assets involved are commonly and traditionally government securities. Like public-debt management, open-market operations are "supporting" instruments of the present South African monetary control system, used to increase or reduce the money-market shortage which serves to make the refinancing or discount policy effective. Public-debt management and open-market operations are used in a more direct manner, by setting limits to the banks' powers to extend credit and to create money. For the SARB to operate effectively from the supply side precludes automatic and unconditional refinancing at the "discount window" is precluded. Variations in reserve requirements are not effective for the day-to-day management of money-market conditions, because of the "lag-effect" from the time these requirements are announced in the Government Gazette to the time they are implement by the banks. Besides this "announcement effect", opponents of their use consider them an unfair "tax", since no interest is earned on them. But those in favour find them useful in reinforcing the role of the SARB, because of the tendency that expansion of the banking system cannot normally take place without a rise in the need for high-powered money, that is all domestic bank notes and coins plus all balances of the private banks with the SARB. Also, proponents maintain that variable cash requirements can be useful in controlling sudden, large and substantial increases or decreases in banks' actual cash reserve holdings, which cannot be corrected via open-market operations. With regard to intervention in the spot and forward foreign-exchange markets, the SARB may enter the foreign-exchange market as a seller or buyer of foreign exchange to influence maintenance of the exchange value of the Rand (Fourie, Falkena & Kok 1996:303-308).

Interaction in the spot and forward foreign exchange markets is conducted in the light of official foreign borrowing, and exchange controls, which are used to maintain sufficient foreign reserves to manage the floating exchange rate. Quotes of foreign exchange rate are employed to attract or repel inflows of foreign capital and to discourage or encourage capital outflows. Foreign investors in considering the desirability of investing in a claim, denominated in Rands, on a South African resident, will consider the interest rate per

annum to be earned, plus the expected percentage per annum of the Rand. These will be compared with rate of interest earned by the foreign investor at home, allowing for transaction costs.

If the investment would earn more in South Africa, this will result in capital inflows to South Africa. Without forward cover, the percentage rate of appreciation or depreciation of the Rand would necessarily be uncertain, and the average expected rate of the Rand appreciation or depreciation would then be used to factor in the risk element. This risk is removed when the foreign investor sells the amount of Rands to be accrued at the end of the claim in the forward exchange marked at the exchange rate quoted "today". The same is the case with a South Africa importer considering financing imports. When foreign interest rates are lower relative to South African rates, overseas financing will be attractive as long as the future rate of depreciation of the Rand vis-à-vis the spot rate does not offset the interest differential.

The SARB's offering of its forward-cover facilities is aimed at approximate interest-rate parity, whereby the total cost of foreign financing of imports is approximately equal to the interest cost of financing these imports in South Africa (Barr and Kantor 1983:19-20). Due to the fact that it is almost impossible for the SARB to determine the movement in the effective exchange rate, and given the limited level of foreign exchange reserves of the Bank, the approach of gradually dismantling exchange control measures was implemented during the Stals era (Mollentze 2000: S 40 –41).

6.5 CONCLUSION

This chapter covered monetary policy application in South Africa, up to 1993, before the new democratic government, as a prelude to this study's empirical analysis. The objectives of monetary policy in South Africa and monetary policy instruments were discussed. The chapter also dealt with techniques of monetary control and policy instrument used in South Africa over time, as well the tendency to stabilise interest rates via direct or indirect measures by South African monetary authorities

**TABLE 20: MONEY SUPPLY AND INTEREST RATES
 IN SOUTH AFRICA: 1970-1993 (PRE-1994 ELECTION)**

Year	Annual percentage increase in money supply (%)		Interest Rate at end of year(%)	
	M1	M2	Prime Overdraft Rate	BA rate
1970	3,2	9,4	8,5	7,30
1971	5,1	5,9	9,0	8,50
1972	12,8	9,1	8,5	5,40
1973	15,1	22,3	8,0	7,20
1974	22,6	19,9	12,0	11,00
1975	13,4	20,7	12,0	8,50
1976	6,1	14,9	12,5	9,65
1977	3,1	-2,0	12,5	8,80
1978	6,1	19,0	11,5	7,60
1979	19,1	12,6	9,5	4,60
1980	29,7	21,8	17,0	7,00
1981	34,2	28,5	18,0	15,25
1982	21,3	15,7	20,0	14,25
1983	29,0	22,5	24,0	18,10
1984	39,9	23,5	16,5	21,75
1985	13,7	18,8	12,0	13,60
1986	-3,5	7,9	12,5	8,90
1987	23,2	10,0	18,0	9,50
1988	30,5	32,4	21,0	15,65
1989	15,3	30,6	21,0	18,00
1990	12,7	17,7	20,25	17,70
1991	17,7	19,1	20,25	16,40
1992	14,2	12,5	17,25	12,40
1993	8,0	3,2	15,25	10,15

NOTES: Changes in Money Supply calculated as percentage increase in annual averages of month-end balances.
 Prime Overdraft Rate is that charged by major commercial banks. BA rate is the rate on three-month banker's acceptances.

SOURCES: Franzsen (1983); South African Reserve Bank Quarterly Bulletins.

The historical account given in this chapter covers the application of monetary policy in South Africa for the period up to 1993. Also covered is the new macroeconomic policy called GEAR (Growth, Employment and Redistribution), and the unique South African economic features that constitute the environment within which monetary policy is applied. The next chapter covers monetary policy and money supply in South Africa.