

MONETARY AND FINANCIAL POLICY IN SOUTH AFRICA: REDISTRIBUTION THROUGH THE FINANCIAL SYSTEM?

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1 INTRODUCTION

South Africa's sophisticated financial system resembles that of wealthy economies, and the focus of monetary policy has, in recent years, increasingly taken its cue from developed countries. This well-developed, market-oriented financial system provides South Africa with a much greater opportunity than in the rest of Africa to use monetary policy for macroeconomic objectives. However, South Africa also faces many problems common to the less developed countries of sub-Saharan Africa. This raises the question of the appropriateness of current financial structures for future economic policy. Of necessity, this will be required to redistribute resources towards those sectors of the economy which suffer from underdevelopment and poverty. However, interventions in response to political pressures for redistribution may cause a future government to implement changes that could weaken existing financial institutions.

This article focuses on two issues: the depth of capital markets and their role in macroeconomic policy; and the likely desire of the new government to shift the direction of credit in favour of those previously excluded, or perceived to have been excluded, from credit.

South Africa's financial system has responded to liberalized interest rates during the 1980s, enabling the government to finance persistent budget deficits without borrowing from the central bank, and to use intervention in financial markets to control inflation and the balance of payments. Prolonged recession has meant that this can be achieved without crowding out the private sector. Budget deficits of less than 5 per cent of GDP (until very recently) have meant that financing requirements have been manageable. When the economy begins to grow, or if government spending increases more rapidly than tax revenue, the use of monetary policy for macroeconomic objectives will become more difficult (See Section 2).

Although it would reverse the recent trend towards financial liberalization, the new govern-

ment will be under considerable pressure to find ways of getting financial institutions to lend to neglected sectors and to the African population, more cheaply and for longer terms. The record of similar interventions in other countries in Africa is mixed, but mostly bad. There is thus a real risk that currently sound financial institutions will be rendered unsound (Section 3).

Demands for redistribution will have to be met by the new government. However, some policy alternatives will be very costly. Increasing government spending (without adequate tax increases) will expand budget deficits and make the use of monetary policy in achieving macroeconomic objectives less feasible. Reforming the financial sector so as to push credit towards those previously excluded can wreck sound institutions, without achieving any redistribution of wealth or income. The value of a functioning financial system with sound commercial banks and specialized financial institutions is very great. Care should be taken not to undermine this legacy (Section 4).

2 MONETARY POLICY REFORMS

Policy-makers in South Africa have generally favoured using monetary policy to manage inflation and the balance of payments (Franzsen 1983:89). This was true even in the period after the Second World War, when Keynesian ideas led to a focus on fiscal policy for the achievement of macroeconomic policy objectives.

This changed during the 1960s, when the government consciously imposed a greater degree of control on every aspect of the economy, both because it believed in the superiority of planned development and because it was systematically implementing apartheid. Monetary policy consequently consisted of direct measures aimed at achieving specific goals: interest rates were stabilized at relatively low levels to stimulate investment, and direct or indirect interest rate subsidies were paid to selected sectors like agriculture, exporters and homeowners. Simultaneously, attempts were made

to control growth in the money supply by credit ceilings and changes in liquid asset requirements. In general, these policies were not successful.

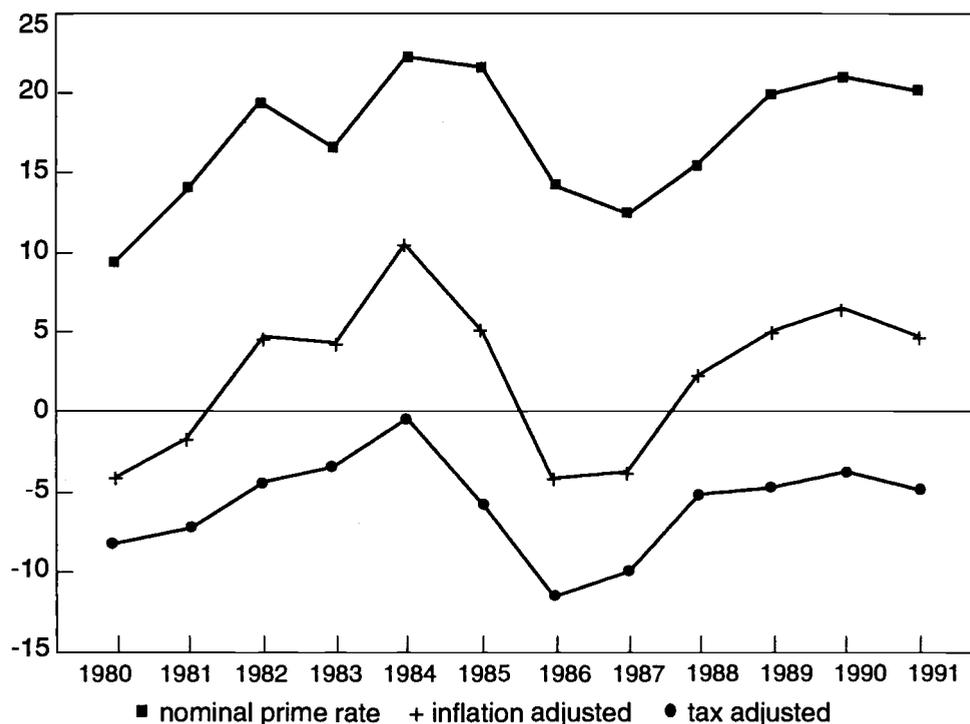
During the 1970s the unsatisfactory results of the non- or semi-market oriented methods, changing world monetary conditions, and a shift towards monetarism led policy makers to believe that fundamental reform in monetary policy had become necessary. A commission of inquiry into monetary policy was appointed under the chairmanship of Gerhard de Kock, later Governor of the South African Reserve Bank (SARB). The Commission reported initially in 1979, and many of its recommendations were implemented within two years. The final report was published in 1985.

The Commission recommended the replacement of direct controls with market determined prices in monetary and exchange rate policy (RSA 1985). It was also recommended that monetary policy play a role in a comprehensive strategy of macroeconomic policy, providing the stability which would allow

other forms of policy to address employment creation more effectively, to promote exports, and to pursue redistribution and other priorities. The reform of financial policy was seen as important for stabilization.

Since the 1979 policy shift, central bank policy has focused on interest rates, even after low profile targeting of the growth of M3 was introduced in 1986 (Meijer 1988). Interest rate policy has had several objectives. These include stifling the demand for credit in order to contain both inflation and expenditure on imports, switching borrowing off-shore in order to finance trade (and so staunch an outflow of short term capital), and inducing the voluntary holding of government debt. In order to achieve these aims, nominal rates have been sustained at levels above inflation except in the 1986-87 recession. However, when the effects of tax rules are taken into account, the cost of borrowing (and the return to saving) remained negative throughout the 1980s (Harvey and Jenkins 1993a), as shown in Figure 1, undermining to some extent the anti-inflationary aims of the SARB.

Figure 1: South African lending rates



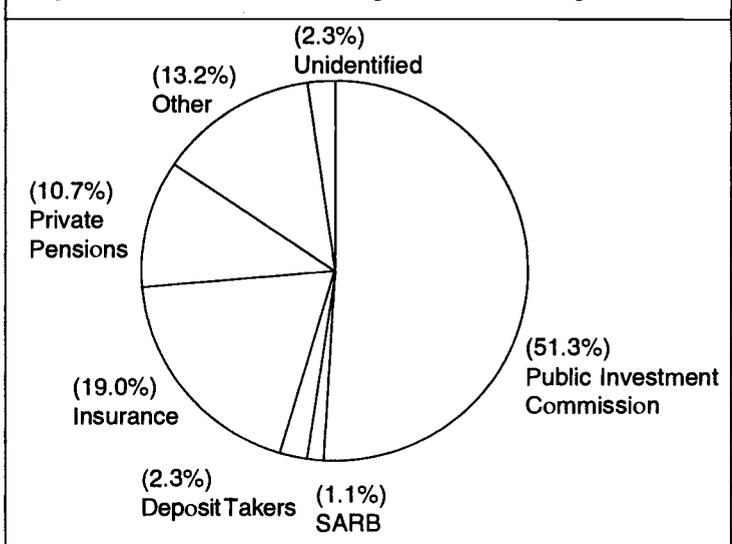
Source: IMF, *International Financial Statistics*

During the 1980s tight monetary policy proved to be successful in dealing with problems on the balance of payments, suppressing domestic demand for imports and switching off-shore borrowing to finance trade. Although the rate of inflation was not reduced, anti-inflationary policy was at least partially successful: the depreciation of the exchange rate resulted in only a small increase in inflation, and this relative stability was achieved in spite of political upheaval and international sanctions. On the other hand, it was achieved at high cost. The economy did not grow when controls were loosened and there was an absolute decline in formal sector employment. Extraordinary pressure on the capital account of the balance of payments necessitated a reversal of one aspect of liberalization, namely the re-imposition of exchange controls (Harvey and Jenkins 1993b).

Since Dr Stals became Governor of the SARB in 1989, the primary objective of monetary policy has been medium term financial stability. Short term goals are limited to price stability and a stable trade-weighted real exchange rate. The use of monetary policy for short term stimulation of the economy has explicitly been rejected. Although lower targets for the growth of M3 have been set, interest rate policy remains the most important policy instrument (Ramos 1993). The undershooting of targets in 1990-92 and accompanying fall in the inflation rate may simply be the effects of recession, rather than of improved financial stability. If this is the case, both M3 and domestic prices will rise more rapidly when economic activity increases.

An important function of any country's financial sector is to facilitate the financing of government spending in excess of revenue. Unlike most countries in sub-Saharan Africa, the depth of capital markets in South Africa has presented an opportunity for the financing of government deficits in a non-inflationary manner. Very little of South Africa's public sector debt is held abroad, a result of exclusion from international capital markets under sanctions. The bulk

Figure 2: Distribution of SA government long term debt



Source: SARB, *Quarterly Bulletin*, various issues

Notes: The graph shows the average ownership distribution of the government's long term domestic marketable stock debt over the years 1985-92, when the long term debt was, on average, 85 per cent of the total financed domestically.

of public debt is taken up by the non-bank private sector and the Public Investment Commissioners (PIC), who receive long term funds from the public sector (pension, trust and deposit monies) and lend them to the state, local authorities and public bodies. The central bank takes up a negligible proportion of public debt (despite being allowed to hold more), while the rest of the banking sector buys an average of 17.5 per cent of short term issues, mainly to satisfy statutory liquid asset requirements. This is in sharp contrast to, for example, Zambia, where the central bank financed 64 per cent of budget deficits between 1980 and 1990, and 99 per cent in 1990.

The captive market for government stock is by and large limited to the PIC. However, the raising of interest rates during the 1980s deepened financial markets: private pension funds willingly held government debt, even after the abolition of prescribed asset requirements in 1984; insurance companies were willing to hold long-term government debt in excess of the legal requirements (15 per cent of cash inflows into life assurance policies); and

non-financial investors increased their holdings of public sector debt from 3 per cent of the total in 1980 to 30 per cent in 1992. The ownership distribution of the domestic marketable long term stock debt of the government (an average of 84 per cent of the total during 1985-92) is shown in Figure 2.

The private sector has retained the lion's share of domestic credit. In 1992 the claims of the monetary sector on the government sector were equal to about 10 per cent of its claims on the private sector (11.5 per cent in 1984). Net credit extended to the government sector (gross claims minus government deposits) was only about 4 per cent of total credit extended by monetary institutions. The private sector is also financed by bond and share issues. Not only does this imply that inflationary financing has been largely avoided, but the domestic private sector has not been crowded out of access to domestic credit.

Moreover the government has consistently stated that its policy is to limit the size of the budget deficit to the IMF guideline of 5 per cent of GDP. This should further assist the avoidance of inflationary finance and limit the crowding out of the private sector.

However, on at least two occasions the budget deficit was not held down to 5 per cent of GDP; and a large component of public sector spending is outside the scope of the budget, the funding of which is difficult to trace. This may contribute to inflation if the funding comes from the banking sector. Nevertheless the ownership distribution and maturity structure of the central government debt has responded to the greater use of market instruments, and is consequently less inflationary than in most African countries. This may explain why inflation was contained in the 1980s (it remained below 20 per cent) but not reduced (it remained stubbornly above 10 per cent).

Because of uncertainty about South Africa's political and economic future, the reluctance of the private sector to undertake new investment during the 1980s has reduced its demand for credit. Consequently the absorption of domestic savings by the public sector has not deprived the private sector of credit. However, when (and if) economic growth accelerates, competition for domestic savings will effectively crowd out private sector investment, unless the budget deficit is reduced or private savings increase.

The damage of higher budget deficits cannot be contained by monetary policy. The SARB has only been able to deal successfully with currently large deficits because of the prolonged recession. Even the present situation will prove unsustainable if the private sector needs more credit for investment and working capital when the economy begins to grow.

3 FINANCIAL SECTOR REFORMS

The belief that would-be (African) borrowers are being excluded from access to credit because of prejudice or the lack of suitable institutions is very strong. This will put the same pressure on the new South African government as those pressures which led to the various attempts at reform by new governments in Africa after independence. The ANC's policy document of May 1993 contains the following statement:

The democratic state will ensure that financial institutions in both the public and private sector participate fully in the proposed new path of growth and development. In particular, their activities should help transform social power relationships and build institutional capacity in the historically oppressed communities in order to break the cycle of dependency.

To achieve this, it is suggested that amongst other things, private sector institutions be encouraged to direct resources into productive investment and the development of a basic needs sector, and to end discrimination in lending against Africans, women, the informal sector and small scale producers.

Most countries in Africa inherited at independence financial sectors which seemed to serve large-scale businesses, urban areas, settlers (White, Asian, Lebanese or Greek), foreign businesses and foreign trade. The only financial institution which catered to a significant number of Africans was the Post Office Savings Bank, which accepted savings deposits, but did not provide credit. Otherwise, Africans were totally excluded. After independence therefore the governments of all countries in sub-Saharan Africa set out to reform their financial systems. The fundamental objective of reform was to redirect the flow of credit to those previously excluded, more cheaply and longer term, by increasing the number of loans to small businesses, to small-scale farmers and to other proxies for African borrowers.

Reform initiatives were of three main types:

- macroeconomic measures, including interest rate policy and exchange controls;
- attempts to make commercial banks behave differently;
- the creation of specialized financial institutions.

Not only did these reforms work badly, but in case after case the reforms had unintended and often perverse effects.

Low interest rates were intended to make credit affordable for small scale borrowers. However, this policy reduces the flow of savings into financial institutions, induces capital flight, and increases the demand for credit. The available resources must be rationed, which favours those best able to fill in forms, or those best able to pressure the administrators. From the lenders' point of view, low lending rates increase the need to reduce costs, which are lowest for large loans. In practice, banks need to be able to charge higher interest rates to small scale borrowers, to cover higher administrative costs, and the higher risks created by lack of information about new types of borrower. Low interest rates tend therefore to exclude small scale borrowers, or make it impossible for banks to continue lending to them without subsidy. In the long run, small scale borrowers are better served by banks able to charge interest rates high enough to cover all costs (Adams *et al.* 1984). Furthermore, higher interest rates are a more effective means of getting those who can borrow abroad to do so, which leaves more of the domestic savings available for smaller scale borrowers.

Exchange controls supported attempts to redirect credit by including rules which limited the use of local finance by foreign owned companies. The objectives were twofold: to increase the finance available to local borrowers, and to encourage foreign companies to bring in more equity and to borrow abroad. However, since many banks had spare liquidity, it is clear that it was a shortage of creditworthy local borrowers that was the problem and not the fact that they were being crowded out by foreign firms. Indeed, exchange controls can have the perverse effect of discouraging capital inflows by limiting the availability of imported inputs and by restricting the remittance abroad of dividends.

Attempts to change the lending of commercial banks have been largely unsuccessful. Forcing banks to

open branches in the rural areas before they are willing to do so does benefit rural savers (by making banking services more accessible), but does not necessarily increase lending to rural borrowers. In fact lending to rural producers may fall if funds are transferred from informal lenders to formal sector commercial banks, by channelling rural savings into urban lending.

Long-established commercial banks have consistently resisted measures designed to increase their longer term lending and to direct credit to chosen categories of borrower. As an alternative, governments have created their own commercial banks, as in Ghana and Zambia, or nationalized the former expatriate banks, as in Tanzania and Malawi. In most cases, great pressure was put on the government-owned bank to lend to local people, to local businesses and to parastatals, on less restrictive criteria than those used by the existing commercial banks. The results were disastrous. In Ghana, Tanzania and Uganda, for example, where the government-owned commercial banks had more than 50 per cent of commercial bank lending (90 per cent in Tanzania), they had bad debts (in the 1980s) ranging from 33 per cent to 80 per cent of loans outstanding. In Zambia, on the other hand, where there was relatively little pressure to lend on non commercial criteria, the government-owned commercial bank was reported to have no more bad debts than other commercial banks (Harvey 1993: 11).

African governments also created development finance institutions (DFIs) to fill perceived gaps in the supply of financial services. The overall record of DFIs in Africa is poor: the reported situation is serious, with a high proportion of loans in arrears (World Bank 1989; Kitchen 1986), and the actual situation is frequently worse, because arrears are nominally reduced by rescheduling or by accounting sleight of hand (Fry 1988:276; Maynard 1992). Furthermore, almost no DFIs have raised money from the market, receiving their funds from governments and donors on concessionary terms. Sooner or later these sources of funds have dried up, and, if the DFI has been made uncreditworthy by being pushed into lending on non-commercial criteria, it is unable to replace donor funds with deposits or commercial loans.

Even with excellent administration and lots of good luck with exogenous events, an argument can be made that many if not all of the changes were bound

to have perverse consequences (Harvey 1991). Yet it seems likely that the same or similar policies will be used in pursuit of the same objectives in South Africa when it acquires a new government. So the African experience is very relevant: the political circumstances will be very similar even if the economy of South Africa, and its financial sector, are very different from those of African countries 30 years ago.

By the time liberalization started, South Africa already had a complex, well-developed and competitive financial system, relatively deep capital markets, a functioning (albeit highly concentrated in terms of ownership) stock exchange, and an independent central bank. With the exception of parastatal development banks, most financial institutions are privately owned. Moreover, most of these institutions are as far as is known well run, solvent and profitable.

The new government in South Africa will not face, therefore, the need to create so many new financial institutions as did other new governments in Africa after independence. The new government will, though, certainly be under pressure to redirect the flow of credit to those previously excluded from access to credit, whether that exclusion was because of irrational prejudice or their being uncreditworthy. There is a real risk, therefore, that sound financial institutions will be rendered unsound, at high cost. This suggests that it is far better to devote resources to making potential borrowers more creditworthy, by for example lowering their costs through provision of better infrastructure and training, while protecting the right and duty of lenders to lend on commercial criteria, than to endanger financial institutions by forcing them by one means or another to lend to uncreditworthy borrowers.

4 CONCLUSIONS

4.1 On monetary policy

A sophisticated financial sector, with relatively deep financial markets, has been of real value in implementing macroeconomic policy in South Africa, especially in preventing inflation from accelerating and in managing the balance of payments in difficult circumstances. At the same time the government has been able to finance persistent budget deficits

without crowding out the private sector. It has worked because domestic markets are sufficiently well-developed, because the budget deficit has been of a manageable size for most of the period, and because the economy has been through a prolonged recession.

There will be considerable pressures on a new government to spend more. If this is done without adequate matching tax increases, the monetary system may not be able to cope, however developed are financial markets. Moreover, if the deficit is not reduced, any impetus for vigorous economic growth may be stifled as the private sector competes for limited domestic savings. Although some inflows of foreign capital may be expected, it would be unwise to increase debt service substantially by new foreign borrowing on commercial terms.

4.2 On financial structure

The experience of other African governments suggests that trying to use credit to improve the distribution of income and wealth is inappropriate. The effects of policies can be perverse, and, even if some of those previously excluded manage to borrow successfully, the majority of would-be borrowers will remain uncreditworthy and without access to formal sector borrowing.

It is better to increase the creditworthiness of borrowers by improving education and providing infrastructure than to thrust cheap credit at them, which they may not use successfully, ruining the lender in the process. While it is easy to wreck even sound institutions, it is a long and costly process rehabilitating unsound ones.

South Africa does have some experience with sound development financial institutions, and credit has been made available to creditworthy small-scale borrowers. Nevertheless, there will be sustained demands to intervene in favour of those who have been excluded (rightly or wrongly) from even these institutions. Something will have to be done to satisfy the political pressures. If the new government wishes to change the lending behaviour of private and public institutions, it will need to do so with tough supervision, with caution and with no illusions as to the risks of such reforms and the high cost of correcting mistakes.

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