

Monetary policy and the balance of payments*

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This address deals with monetary policy and the balance of payments in South Africa in 1988/89. It does so under three headings: the good news, the bad news and the policy.

THE GOOD NEWS

Upswing more vigorous than expected

The main good news is that from the third quarter of 1987 onwards the upswing in the South African economy gained much more momentum than had been anticipated. Total spending, output and income increased at higher than expected rates. A previously sluggish economic recovery became a quite vigorous upsurge.

Good recovery in real growth rate

The greater strength shown by the upswing contributed to a further improvement in the rate of real economic growth. Since 1984 real gross *domestic* product has grown as follows:

	%
1984	5
1985	-1
1986	1
1987	2½
1988	2½ - 3 (estimated)

Taking into account all the circumstances – including the large net outflow of capital, the trade and financial sanctions, and the droughts and floods of this period – the increase in the growth rate since 1986 represented a commendable performance.

In terms of real gross *national* product, the expansion was even more impressive. Between the second quarter of 1986 and the second quarter of 1988 real gross *national* product increased at a rate of about 5 per cent per year. This means that *per head of the population* it increased over this period by nearly 3 per cent per year.

The main reasons why gross *national* product showed a higher growth rate than gross *domestic* product during this period were an improvement in the terms of trade and a reduction in interest payments to foreigners.

Substantial increase in gross domestic spending

The main driving force behind the forward surge in the economy was a marked rise in consumer and investment spending. In recent years gross domestic spending has increased as follows:

	Nominal %	Real %
1984	20	8
1985	4½	-8½
1986	15½	1
1987	21	5
1988	22 (estimated)	7 (estimated)

In the first half of 1988 real gross domestic spending was no less than 10 per cent higher than in the first half of 1987. Its main component, real private consumption, was 4 per cent higher in the second quarter of 1988 than in the second quarter of 1987, and 8 per cent higher than in the second quarter of 1986.

Preliminary estimates suggest that while a decline in inventories produced a decline in total real gross domestic expenditure during the third quarter of 1988, real *consumer* spending showed a further annualised rate of increase during that period of between 5 and 6 per cent. In addition, real *fixed investment* appears to have risen at an annual rate of around 13 per cent during the third quarter.

Levelling-off tendency in economic activity

In recent months the upswing appears to have levelled off. The business cycle in South Africa has either already reached an upper turning point or is about to do so. The indications are that the economy will now move into a gradual downward phase of the business cycle. For the present, however, the level of economic activity remains high.

Decline in inflation rate

The good growth performance of the South African economy in 1987 and 1988 was all the more gratifying because it was accompanied, at least until the second quarter of 1988, by a marked further decline in the rate of inflation. The annualised quarter-to-quarter increase in the consumer price index declined from a peak of 24,9 per cent in the first quarter of 1986 to 9,2 per cent in the first quarter of 1988.

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Excellent debt-servicing performance

Further good news is that South Africa's already sound foreign debt ratios have all improved further during the past year. Present indications are that, in addition to continuing to meet all foreign interest and dividend payments, the South African economy will by the end of 1988 have made net repayments of roughly US\$6,0 billion (about R12,6 billion) of foreign debt, valued at constant US dollar exchange rates, over a period of only four years.

South Africa's ratio of foreign interest payments to exports of goods and services, which amounted to only 10,7 per cent in 1985, compared with an average of 30,2 per cent for Western Hemisphere developing countries, declined to a mere 7,1 per cent in 1987. It is still falling and will probably amount to only about 6½ per cent for 1988 as a whole.

Similarly, South Africa's ratio of foreign debt to total exports of goods and services declined from a peak level of 171 per cent in 1984 to 93 per cent in 1987. In contrast, the comparable ratio for Western Hemisphere developing countries deteriorated from an average of 273 per cent in 1984 to 332 per cent in 1987.

Given these extremely sound debt ratios, an economist from Mars would have some difficulty in understanding why South Africa ever required any kind of "debt standstill" or "interim debt arrangements" with foreign creditors. The answer, of course, lies outside the sphere of pure economics and international finance.

In any event, the way in which the South African economy – confronted as it was by a unique and quite daunting set of challenges – managed to combine massive debt repayment and balance of payments adjustment with real economic growth and declining inflation during the period 1985 to 1988, constituted a sterling performance that has not gone unnoticed in overseas financial and business circles.

THE BAD NEWS

(Partly the result of the good news)

Excessive rise in total spending

First and foremost among the items of bad news is the excessive and unsustainable rate of increase of total consumption and investment spending during the past year. As indicated earlier, gross domestic expenditure increased during 1987 by 21 per cent in nominal terms and by 5 per cent in real terms, i.e. after correcting for inflation.

Up to a point this increase was highly desirable, since it provided the main driving force behind the upswing in output, real income and employment that the economy not only required but could afford at that time. But as the months passed, the spending reached excessive proportions and became too much of a good thing. Coming on top of the increase in 1987, the (estimated)

further rise in gross domestic expenditure in 1988 of 22 per cent in nominal terms and 7 per cent in real terms, was simply too high. It resulted in new demand inflation in the domestic economy and helped to place the overall balance of payments under pressure.

Overshooting of the money supply targets

The excessive increase in total investment and consumption during the past year was made possible and facilitated by an inordinate rise in the broad money supply, M3. Compared with its official 1988 target range of 12 to 16 per cent, M3 showed the following quarter-to-quarter increases, at a seasonally adjusted annual rate:

	%
First quarter 1987	5,0
Fourth quarter 1987	26,1
Second quarter 1988	25,0
Third quarter 1988	29,4

Account must, of course, be taken of the fact that the velocity of circulation (V) of M3 declined during the first three quarters of 1988. This was largely the result of "reintermediation", i.e. the return to bank and building society balance sheets of credit previously extended directly by primary lenders to ultimate borrowers without the intermediation of a bank or building society. This means that the *effective* broad money supply or MV, i.e. M3 *adjusted for changes in its velocity of circulation*, increased by considerably *less* than M3 during the first three quarters of 1988. Even with this qualification, however, the rate of increase in M3 was still unduly high, and contributed to the excess demand in the economy.

Excessive rise in M3 caused by undue increase in bank and building society credit

The accelerated rise in M3 largely reflected an increase in credit extended by banks and building societies to the private sector. At seasonally adjusted annual rates the quarter-to-quarter rate of increase in such credit increased from 11,7 per cent in the first quarter of 1987 to 22,1 per cent in the fourth quarter of that year, 26,1 per cent in the first quarter of 1988, 24,1 per cent in the second quarter and 31,5 per cent in the third quarter.

Excessive rise in bank and building society credit made possible by undue increase in Reserve Bank credit

In the circumstances of the past year the banks and building societies could not have expanded their credit so excessively if the Reserve Bank had not provided

them with the necessary cash reserves by extending accommodation to them in one way or another – a point to which I shall return.

Reduction in current account surplus

As a direct result of the excessive spending in the economy, imports increased faster than exports, and the current account of the balance of payments, at a seasonally adjusted annual rate, showed a small deficit of R410 million during the first quarter of 1988 and a surplus of only R960 million during the second quarter.

During the third quarter of 1988, however, the surplus on the current account increased to an annualised rate of R4,5 billion. For the calendar year 1988 it is now estimated that the current surplus will amount to around R2 billion.

By itself the current account of the balance of payments therefore does not pose a problem. Indeed, for a developing country to achieve sizeable current account surpluses for five consecutive years, which now appears to be the likely outcome for the period 1985 to 1989, represents a major achievement.

Accelerated net capital outflow

The weakness in the overall balance of payments remains the capital account, despite the existence of not only the tightest exchange control over capital movements in South Africa's history but also special interim debt arrangements with foreign creditors. Since 1985 the net outflow of capital (not related to reserves) amounted to the following:

	<i>Rand billion</i>
1985	9,2
1986	6,1
1987	3,1
1988 – first quarter	0,7
– second quarter	2,1
– third quarter	2,4

It is particularly worrying that, after amounting to only R0,7 billion in the first quarter of 1988, the net outflow of capital increased to R2,1 billion in the second quarter and to R2,4 billion in the third quarter. This outflow included much more than planned debt repayments. A substantial part of it consisted of unfavourable leads and lags in foreign payments and receipts, including a shift of trade financing from foreign to domestic sources of funds.

A major reason for this large outflow was the increased real interest rate differentials between South Africa and the major financial centres following the substantial increases in interest rates in the main industrial countries since early June 1988. In the United Kingdom, for example, the nominal prime lending rate of most banks increased from 8,5 to 13 per cent between early

June and August 1988 – a rise of 53 per cent. On a *pro rata* basis this represented a much greater increase than the rise from 12½ to 16 per cent in the prime overdraft rate of South African banks between January and August 1988 – an increase of 28 per cent. After correcting for inflation this meant a substantial widening of the gap between real interest rates in South Africa and in the United Kingdom. This, in turn, strengthened expectations that the rand would depreciate further in terms of the main currencies.

Decline in gold and foreign exchange reserves

Against this background the Reserve Bank's gold and foreign exchange reserves, which had increased from R3,2 billion (US\$1,6 billion) in April 1986 to a peak of R7,0 billion (US\$3,4 billion) in August 1987, declined to R4,6 billion (US\$1,9 billion) in October 1988.

Depreciation of the rand

In addition, the effective exchange rate of the commercial rand, which had appreciated by 27,7 per cent between 12 June 1986 and the end of 1987, depreciated by 10,3 per cent in the first half of 1988, by a further 4,9 per cent in the third quarter, and by another 2,2 per cent in October.

New increase in inflation rate

Further bad news is that the rate of inflation has also begun to rise again. The annualised quarter-to-quarter increase in the consumer price index moved up from 9,2 per cent in the first quarter of 1988 to 13,9 per cent in the third quarter. It is likely to rise further before a new downward movement can be induced again. The main reasons for this unfortunate development are not hard to find: excessive increases in the money supply and total spending, and the depreciation of the rand.

THE POLICY

Monetary and fiscal policy too expansionary

The combination of good and bad news I have outlined has obviously had implications for economic policy. In retrospect it must be concluded that the "mix" of fiscal and monetary policy as applied during the first half of 1988 was too expansionary. But even if the policy had been near perfect until May 1988, it should in subsequent months have been tightened sooner and to a greater extent to cope with the unexpected events that followed.

These events included (in addition to the continued vigour shown by the South African upswing):

- the marked appreciation of the U.S. dollar in terms of the other main currencies following the publication of better-than-expected trade figures for the United States in June 1988;

- the subsequent tightening of monetary policy and the substantial rise in interest rates in the industrial countries;
- the decline in the price of gold to below US\$390 per ounce at one stage; and
- additions to government spending in South Africa, including the announcement of a 15 per cent general increase of salaries in the public service from January 1989.

The Reserve Bank did see the need to tighten monetary policy as far back as December 1987 and, in fact, at that stage already informed the banks and building societies that it was adopting a less accommodative monetary policy stance. The Bank also realised that the key to success in its endeavour to control the growth of the money supply was effective restraint over its own domestic credit creation. It therefore took steps to curb its own credit extension and, as both a logical consequence and an integral part of this more restrictive policy, raised its Bank rate in stages from 9½ per cent in March 1988 to 14½ per cent in early November. On each occasion these increases were accompanied by comparable increases in the prime overdraft rates of commercial banks, which accordingly moved up over this period from 13 to 18 per cent. Most other short and medium-term lending in deposit rates, as well as mortgage rates, also increased, either leading or following the Bank rate adjustments.

From early May onwards the Reserve Bank also ceased to relieve shortages in the money market by means of repurchase agreements or the provision of tender funds from the Corporation for Public Deposits. In addition it announced that it would in future provide accommodation against the security of non-liquid assets only in exceptional circumstances, and then only at severe penalty rates. This greatly reduced this kind of accommodation.

The Reserve Bank continued, however, to moderate the upward movement in interest rates by expanding its own domestic credit in two main ways. The first was by rediscounting liquid assets or extending overnight loans against the security of such assets. The second way was by continuing to perform its function of providing forward exchange cover, for the account of the Treasury, to authorised exchange dealers for periods up to twelve months. During the course of 1988, and particularly after the first week of June, the marked appreciation of the dollar against the rand resulted in substantial losses on this account, and therefore in an increase in the Reserve Bank's claims against the Treasury. The Bank in effect bought dollars spot at a high rate in rand and supplied dollars at the lower rate for which it had contracted forward. This represented an involuntary increase in central bank credit creation, which served to augment the cash reserves of the banks and therefore to moderate the upward pressure on interest rates.

All things considered, there can be little doubt that monetary policy should have been tightened earlier and that interest rates should have been allowed to rise sooner. In its attempts to moderate the rise in interest rates in order to promote economic growth and to assist drought-stricken farmers, small businesses and home-owners, the Reserve Bank initially created too much central bank credit and in this way facilitated the excessive increases in bank credit, the money supply and total spending.

On more than one occasion during the past year the Reserve Bank reproached the banks and building societies for their part in the overspending process, and formally requested them to slow down their credit extension. As I have stated before, however, it would be wrong to hold the banks principally responsible for either the excessive increase in the money supply or the rise in interest rates. Of course, bank credit expanded too much. But it did so in response to the strong upswing in economic activity and the accompanying rise in the *demand* for loanable funds of all kinds. And it was the Reserve Bank that supplied the cash reserves necessary to underpin the increase in credit. In the final analysis the Reserve Bank must therefore accept the responsibility for the excessive rise in the money supply.

Implications for monetary and fiscal policy in period ahead

Against this background it is imperative to ensure that the "mix" of monetary and fiscal policy in the period ahead is tight enough, firstly, to reduce the downward pressure on the rand and the gold and foreign exchange reserves, and secondly, to limit the new upward tendency of the rate of inflation and, in due course, to reverse it. This implies the following:

- (1) Assuming an expenditure "deflator" (the relevant rate of price increases) of about 16 per cent in 1989, the aim should be to reduce the rate of increase of nominal gross domestic expenditure from an estimated 22 per cent in 1988 (7 per cent in real terms) to around 16 per cent in 1989. In other words, there should be little if any increase in real spending in 1989. Such an outcome would still leave scope for a growth rate of real gross domestic product in 1989 of around 2 per cent if total exports rise more than imports.
- (2) To this end the rate of increase of the broad money supply must be drastically reduced below the quarter-to-quarter annualised rates of 25 to 29 per cent registered in recent quarters. At this stage a target range of 12 to 16 per cent between the fourth quarter of 1988 and the fourth quarter of 1989 would seem appropriate.
- (3) This, in turn, means that the rate of increase of bank and building society credit will have to be severely curtailed.

(4) The essential prerequisite for any such outcome is clearly the curbing of net Reserve Bank credit. If the cash reserves spouting from the Reserve Bank's credit "tap" cannot be adequately regulated, nothing else will succeed in controlling the money supply and total spending in the economy.

(5) The curbing of Reserve Bank credit at a time of high credit demand and declining foreign reserves, inevitably implies a rise in nominal and real interest rates. This is why the Reserve Bank has during the course of 1988 progressively accepted increases in bank and building society lending rates, as well as in its own Bank rate and related refinancing rates, as both a consequence and an integral part of its less accommodative monetary policy. In particular, that is why Bank rate was increased from 12½ to 14½ per cent last week and why most prime overdraft rates moved from 16 to 18 per cent.

Note: Against this background it should be stressed once again that the Reserve Bank's policy is *not* one of "raising interest rates as the sole instrument of monetary policy in order to curb consumer spending". The Reserve Bank has no interest rate target; it has a money supply target. To curb the money supply, it must curb bank and building society credit. And to do that, it must curb its own creation of cash reserves for the banks. And when it does that at a time when economic activity is high and the demand for credit strong, normal market forces will raise short-term interest rates. If something is made scarcer, it is only logical that its price should rise. The rise in interest rates is therefore essentially a consequence of the decision to curb the creation of Reserve Bank credit as an absolute prerequisite for controlling the money supply and total spending.

Furthermore, the "rate of interest" is not an "administered" price to be determined by either the Government or the Reserve Bank like the price of maize or railway tariffs. There is not one interest rate but dozens of interest rates or yields. They normally fluctuate daily in response to changes in demand and supply in the relevant financial markets. Of course, for the reasons mentioned earlier, the Reserve Bank can and does *influence* the level of interest rates when it affects the cash reserves of the banks and the money supply by means of its discount policy, open-market operations, etc. But neither the Government nor the Reserve Bank sets either the level or the structure of interest rates in the manner in which "administered prices" are determined.

It follows that it is not the policy of the monetary authorities to "peg" the level of interest rates. In South Africa's sophisticated financial system, with its enormous potential for "disintermediation", there can be no question of effective control over the money supply and total spending if interest rates are not free to move to realistic levels.

(6) Whether the present stance of monetary policy is restrictive enough will depend in large measure on the nature of fiscal policy in the months ahead. In his March 1989 Budget the Minister of Finance provided for an increase in expenditure of only 12,6 per cent in the 1988/89 fiscal year, and a "deficit before borrowing" equal to 4,9 per cent of the anticipated gross domestic product, compared with 5,8 per cent in the previous year. At the time this appeared to be adequate for the task at hand. In addition, the actual Budget "turnout" during the first half of the fiscal year, i.e. April to September, was more than satisfactory. In the light of the subsequent economic developments, however, the 4,9 per cent deficit now appears to have been on the high side.

Moreover, there have recently been warning signals that government spending might rise faster during the second half of the fiscal year than during the first, and that, notwithstanding a larger than expected increase in tax revenue, the Budget "deficit before borrowing" might turn out to be even larger than 4,9 per cent of gross domestic product. If this proves to be the case, fiscal policy will in all probability have been too expansionary. The "mix" of monetary and fiscal policy as presently constituted might then prove inadequate to achieve the desired policy objectives.

To prevent the deficit before borrowing from exceeding the Budget estimate and to maintain an adequate "mix" of fiscal and monetary policy, is easier said than done. But the matter is receiving attention at the highest level.

Likely consequences of policy

Monetary and fiscal policies always work with a time lag of many months. In the months immediately ahead the money supply will therefore remain above the target range, the gold and foreign exchange reserves and the exchange rate of the rand will probably remain under some pressure, and the rate of inflation is bound to rise to some extent. But if a "mix" of monetary and fiscal policies is applied along the lines I have indicated, there is every prospect that the following desirable results will be achieved in the course of 1989:

(1) The current account of the balance of payments will show a comfortable surplus in 1989 of around R4 billion.

(2) South Africa will continue to demonstrate its ability to meet all its commitments under the interim debt arrangements.

(3) The gold and foreign exchange reserves will level off and then begin a new upward movement.

(4) The effective depreciation of the rand in terms of other currencies will be arrested and, at times, reversed – depending, of course, on "imponderables" such as the behaviour of the US dollar and the dollar price of gold.

(5) The new acceleration of the rate of price increases will in due course prove to have been only a temporary reversal of the downward trend in the rate of inflation that was evident from the first quarter of 1986 to the first quarter of 1988. The official objective of gradually reducing the rate of inflation by about 2½ percentage points per year will then become attainable again.

(6) The economy is likely to experience a moderate cyclical downturn in the period immediately ahead. But a rate of growth of real gross domestic product of the order of 2 per cent in 1989 should still prove attainable. More importantly, however, the removal of excess demand and the strengthening of the balance of payments and reserves will lay the foundation for more rapid growth in the medium and long term.

Concluding observation

It is common knowledge that the South African economy has for some years now had to face up to unique challenges as a result of sanctions, disinvestment and other socio-political developments. No one should underestimate the harmful effects of these constraints. And the need for *long-term structural* adjustment in the economy cannot be stressed enough. But the *short-term* economic stabilisation problem confronting South Africa at present is no "mystery disease". It is a fairly common ailment that is relatively easy to diagnose, namely excessive money creation and spending. It is fortunately also an ailment that can be cured, with a certain time lag, by appropriately restrictive monetary and fiscal policies. The monetary and fiscal authorities accept that it is now up to them to ensure that such policies are effectively implemented in the period ahead.