2 CHAPTER 2: BACKGROUND INFORMATION

2.1 Synopsis of the political, institutional and economic environment at the time of the S A Reserve Bank's assistance to Bankorp

2.1.1 Introduction

Any attempt to look back from the perspective of 2001 to a period some decades before and evaluate decisions taken during that period is challenging, as such a lapse of time creates an opportunity for the benefit of perfect hindsight.

In South Africa's instance any such reconsideration of events and decisions is even more challenging, as a completely new political, social, institutional and economic order has developed during the last decade. Since democratic elections in 1994, the general environment has improved to such an extent that many people will experience difficulty remembering the previous dispensation. In achieving the objective of pronouncing on the S A Reserve Bank's assistance to Bankorp in the 1980s and early 1990s, it is, therefore, necessary to review the political, institutional and economic environment at the time.

The S A Reserve Bank assisted Bankorp (or one or more of the subsidiaries in the Bankorp Group) over a number of years. The period 1985 to 1992 is of importance for purposes of this Report, as the assistance under consideration was granted, renewed and/or revised on a number of occasions during this period. This synopsis of the prevailing political, institutional and economic environment is, therefore, broadly limited to this period.

2.1.2 Political environment

The assistance to Bankorp in 1985 took place within a particular political context. In 1983 the government of State President P W Botha introduced constitutional reform in the guise of a tricameral parliamentary system. Its racist structure fuelled deep-seated political grievances that, in turn, provided the political impetus for the formation of the United Democratic Front (UDF). The UDF successfully mobilised intense political protest against all forms of apartheid.

Between 1984 (after the implementation of the tricameral constitution) and 1988, more than 3 500 people (the vast majority of them township residents) were killed in political conflict, approximately 45 000 people were detained without trial and work stoppages and strikes increased from 469 in 1984 to 1 148 in 1987 (Political conflict in South Africa - Data trends 1984 to 1988, 1988: various pages). By June 1986 a country-wide state of emergency was declared, press censorship became progressively stricter and the powers of the security forces were extended.

The entire management of government during this period was carried out by means of the National Security Management System (NSMS) headed by the State Security Council in which cabinet members participated and in which regional and local management centres were established. The entire design was to implement a so-called "total strategy", which had as its aim the curbing of what the government at the time referred to as a "total onslaught" launched against the state by the ANC and communist forces. As Seegers states, *every government institution in South Africa is required to participate in the NSMS and this compulsory participation takes place on regional, sub-regional, mini-regional and municipal levels* (Seegers, 1990: 110).

The deep-seated acceptance of this "total onslaught" thesis and the need for a "total strategy" to resist the onslaught, was reflected, for example, in the following introduction to a judgement of The Hon Mr Justice M T Steyn: *South Africa is in the mid 1980s a society in travail … Much of that resistance is violent and is directed not merely at the authorities of government and administration, but also at other individuals and also indiscriminately at the general public* (<u>Bloem v State President</u> 1986(4)SA 1064(O) at 1067).

The revised constitutional structure did not improve South Africa's international acceptability and failed to halt the increasingly strong steps to isolate the country internationally. Following the violent events after the introduction of the tricameral Parliament, the UN Security Council imposed a number of economic sanctions and restrictions on sport and cultural relations. This was followed by the imposition (over a period of time) of economic sanctions on the country by the USA, the European Community (then the EC, now the EU) and Nordic countries. This culminated, *inter alia*, in trade and financial sanctions against South Africa. In the latter instance the sanctions led to massive capital withdrawals and disinvestment. The refusal of key international banks to renew credit lines forced the authorities to announce on 28 August 1985 the temporary closure of the foreign-exchange market and on

1 September 1985 the declaration of a standstill on South Africa's foreign debt repayments. This forced the country to negotiate the rescheduling and orderly repayment of its foreign debt over a prolonged period of time through a series of "standstill arrangements".

In the four years between 1985, when State President PW Botha turned his back on meaningful political reform in his *Rubicon Speech,* and 1989, South Africa experienced a capital outflow of some R 27 000 million (Natrass et. al., 1990: 18).

During this period *a* siege mentality prevailed in South African government and business circles which had a wide influence on the conduct of economic policy. Particularly notable in the present context were the existence of fragility in the financial system and a secretive approach to the conduct of business.

On 8 May 1989 Dr Gerhard de Kock, then Governor of the S A Reserve Bank, warned that *if adequate progress is not made in the field of political and constitutional reform, South Africa's relationships with the rest of the world are unlikely to improve to any significant extent … In that event, South Africa will probably remain a capital-exporting and debt repaying country for years … In such circumstances, the average standard of living in South Africa will at best rise only slowly* (De Kock, 1989b: 7).

Political struggle at home, international pressure and economic difficulty contributed to the announcement on 2 February 1990 of the legalisation of liberation movements, the release of political prisoners and the removal of certain emergency regulations. This paved the way for political change, but the process was not a smooth one and financial markets remained fragile.

A multi-party conference on South Africa's future constitution was proposed in January 1991, but a resumption of violent political conflict in April of that year threatened to derail the process. Formal negotiations did not commence until December 1991 (Codesa 1).

In February 1992 it was announced that the level of support for the negotiation of a democratic constitution would be tested by means of a referendum of South Africa's white population. The referendum was held in March 1992 and confirmed an overwhelming mandate for the continuation of the process of reform.

Codesa 1 was derailed in May 1992 because of an impasse reached about certain constitutional guarantees and by August 1992 an unprecedented level of mass action occurred. The UN intervened by sending a special envoy to the country to re-establish contact between the parties who had participated in Codesa 1.

An internal peace summit was arranged for September 1992, and by April 1993 Codesa 2 was constituted. In June 1993 it was agreed that democratic elections would be held on 27 April 1994.

The announcements of 2 February 1990 and subsequent developments gave rise to a general reappraisal by the international community of its relations with South Africa. During 1991 South Africa was readmitted to international sporting competitions. In July of that year the US administration officially lifted federal sanctions against the country, although a number of states and cities in the USA did not lift their prohibition on investing in South Africa. In October 1991 Japan lifted sanctions, while the Commonwealth lifted its cultural sanctions, but retained sanctions on finance, arms, trade and investment.

In 1992 the EC partially lifted its sanctions, and following the adoption of legislation in September 1993 providing for a transitional administration, the international community lifted the remaining economic sanctions against South Africa. In May 1994 the UN Security Council ended its mandatory arms embargo against the country.

This improvement in international relations was accompanied by the progressive resumption of normal foreign financial relations following the foreign debt standstill of August 1985. South Africa renegotiated the rescheduling and orderly repayment of its foreign debt over a prolonged period of time in terms of a series of standstill arrangements. The first of these rescheduling arrangements (First Interim Arrangements) ended on 30 June 1987. This was followed by the second arrangements (1 July 1987 to 30 June 1990) and the third arrangements (1 July 1990 to 31 December 1993). The final arrangements for the rescheduling of foreign debt in the standstill of August 1985 came into effect on 1 January 1994 and were terminated on 15 August 2001, when the rescheduling of the country’s foreign debt came to an end.

2.1.3 Economic environment

2.1.3.1 Economic growth

Despite the international pressure on the domestic economy in the 1980s, periods of surprisingly rapid economic growth were recorded. However, by the early 1990s strain was clearly showing, as is evidenced by three consecutive years of negative economic growth (1990 to 1992). Table 1 depicts real growth in Gross Domestic Product and Gross Domestic Expenditure for the period 1985 to 1992.

Table 1: Economic growth in South Africa

Year	% Change in GDP	% Change in GDE
1985	-1,2	-7,8
1986	0,0	0,7
1987	2,1	3,8
1988	4,2	6,3
1989	2,4	1,2
1990	-0,3	-2,0
1991	-1,0	-0,6
1992	-2,1	-1,9

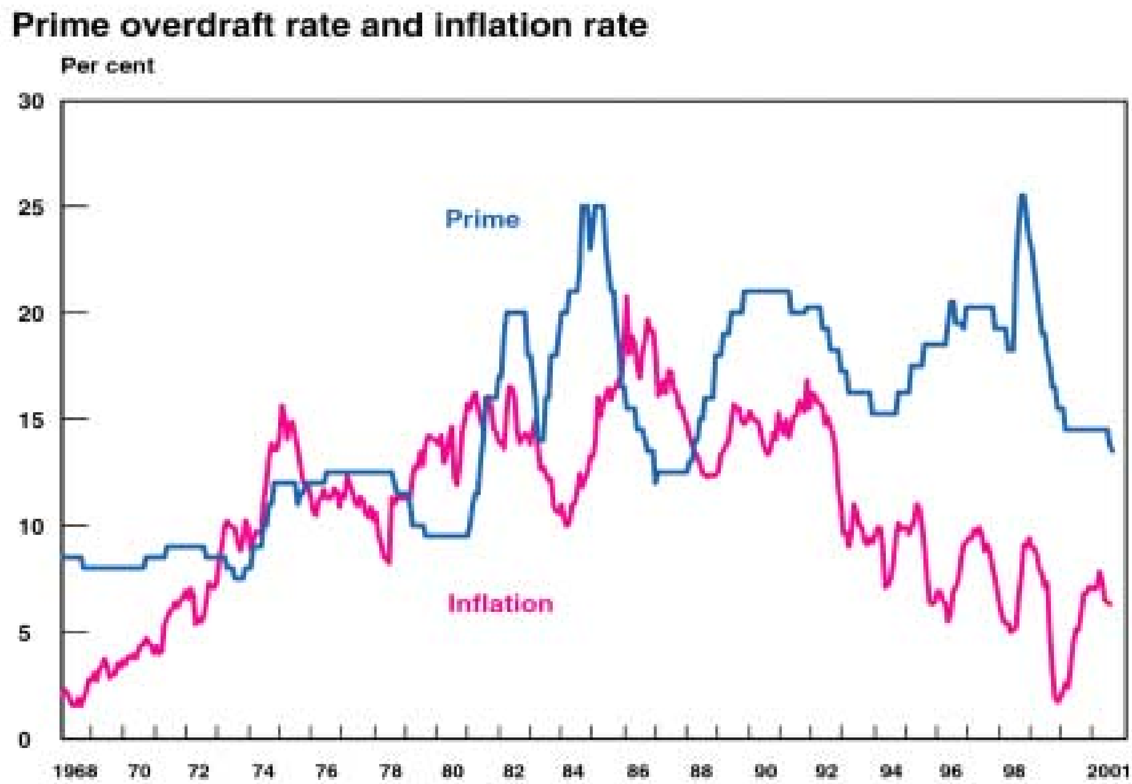
Source: S A Reserve Bank *Quarterly Bulletin* (various issues)

An important reason for the improvement in the level of economic activity in the period 1987 to 1989 was a rise in the extension of bank credit to individuals. This implied that households used credit to protect their standards of living. This practice was clearly not sustainable, and was one of the factors contributing to the introduction of stricter monetary policy in that period.

2.1.3.2 Monetary policy, inflation and interest rates

Graph 1 depicts the prime overdraft rate and the inflation rate over the period 1967 to 2001. However, not obvious from this graph is the important change in the approach to monetary policy that occurred in 1981. Up to 1980 one of the cornerstones of monetary policy was credit ceilings; implying that until 1981 the prime rate was not at the actual market clearing level. Thereafter monetary policy relied more on an active interest rate policy. Moreover, the regime of credit ceilings imposed limitations on the capacity of banks to extend credit and, therefore, might have prevented banks from undertaking risky loans, but it could also have had the opposite effect. Thereafter monetary policy relied more on an active interest rate policy.

Graph 1



Source: S A Reserve Bank

The change in the monetary policy approach in 1981 also introduced a new competitive environment for banks. This culminated in the cancellation of the cartel agreement between banks with effect from 28 February 1983, when the ROCO (Register of Co-operation) agreement was cancelled.

The introduction of competition between banks in the early 1980s can be one of the explanations why some of the major South African banks ran into serious difficulty by the middle of the 1980s: as in many other countries, not all banking institutions had the same ability to adapt to the new environment, and a competitive environment encouraged reckless lending by some banks.

A further secondary effect of the replacement of direct controls (credit ceilings) with market-oriented monetary policy was that interest rates became much more volatile than before. Not all banks had at that time the necessary internal systems in place to deal with such increased interest rate volatility.

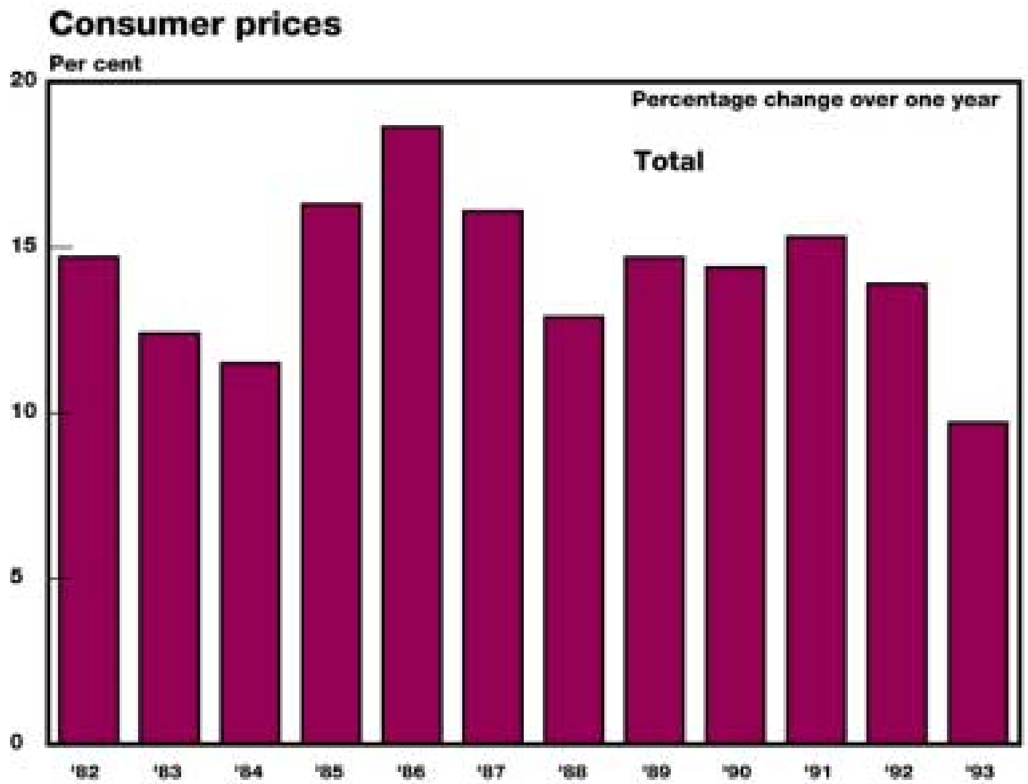
From a lower turning point in 1986/87, interest rates were increased in a number of steps over the ensuing period until 1989. As a result of these increases, Bank rate and the prime lending rate were respectively 7,5 and 8 percentage points higher by August 1989 than at the beginning of 1987, and these rates increased even further by another percentage point on 11 October 1989. Increasing interest rates were the result of a deliberate tightening in monetary policy. This was a reaction to, *inter alia*, rapid credit extension growth. It was necessary to dampen domestic demand to contain inflation and achieve a surplus on the current account of the balance of payments large enough to finance the repayment of foreign debt.

During the period 1985 to 1987 inflation, albeit at a high level, was not regarded as South Africa's main economic problem. An acceleration in the domestic inflation rate during that period was mainly the result of a depreciation in the exchange rate of the rand, which was in turn caused by an outflow of capital from South Africa (see section 2.1.3.3) below. The rate of increase in domestic prices, depicted in graph 2, decelerated from 18,6 per cent in 1986 to 12,9 per cent in 1988, but renewed inflationary pressures emerged towards the end of 1988 and early in 1989. This re-emergence of inflationary pressures contributed to a tightening of monetary policy.

Given the new policy focus, interest rates also stayed at higher levels for longer periods than before, while banks and businesses in general had previously become accustomed only to short periods of high nominal interest rates.

This change in policy introduced to South Africa for the first time in many years the principle of sustained real positive interest rates. However, the downside was that borrowers of funds were not accustomed to paying a real price for funds and a number of households and businesses ran into financial difficulty and defaulted. This permanent change in the prevailing pattern of interest rates was accompanied during the period 1990 to 1992 by a severe recession (three years of negative growth). This combination of a lack of growth and real positive interest rates necessitated difficult adjustments by households, non-financial businesses and banks. They might have exacerbated the problems of Bankorp in the late 1980s, but the bank's difficulties began before that and resulted from its poor management, strategy, and lending policies as outlined in Chapter 3.

Graph 2



Source: S A Reserve Bank

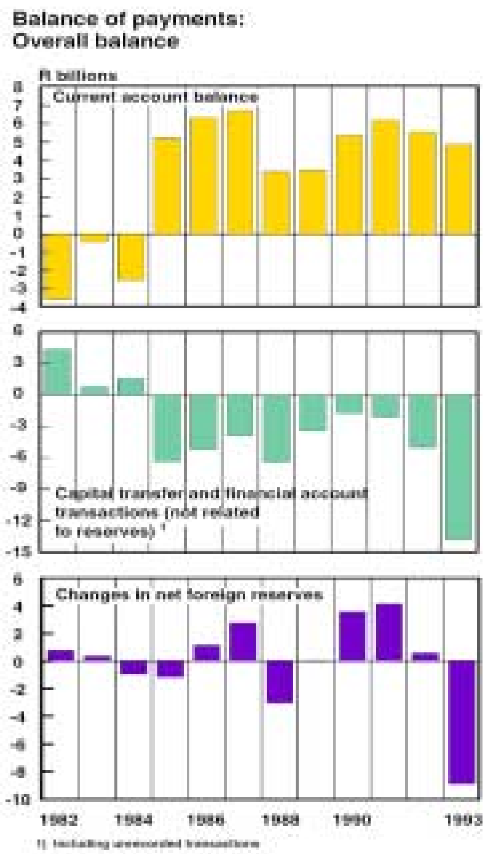
The change in the focus of monetary policy introduced in 1988/89 has remained in place since then, and positive real interest rates, which, as graph 1 shows in *ex post* terms, have existed since 1988/89, are today an accepted feature of South Africa's financial and economic environment.

2.1.3.3 Balance of payments and the exchange rate

A major feature of the period 1985 to 1989/90 was the overriding objective of maintaining a sufficiently large surplus on the current account of the balance of payments. Such a surplus was necessary for ensuring an inflow of foreign exchange large enough to meet the country's foreign debt repayment obligations, arranged by 1990 in terms of the *First* and *Second Interim Debt Arrangements*.

The large outflow of capital from South Africa is depicted in graph 3. Capital became more expensive as a result of this outflow. This contributed to a general pattern of higher domestic interest rates.

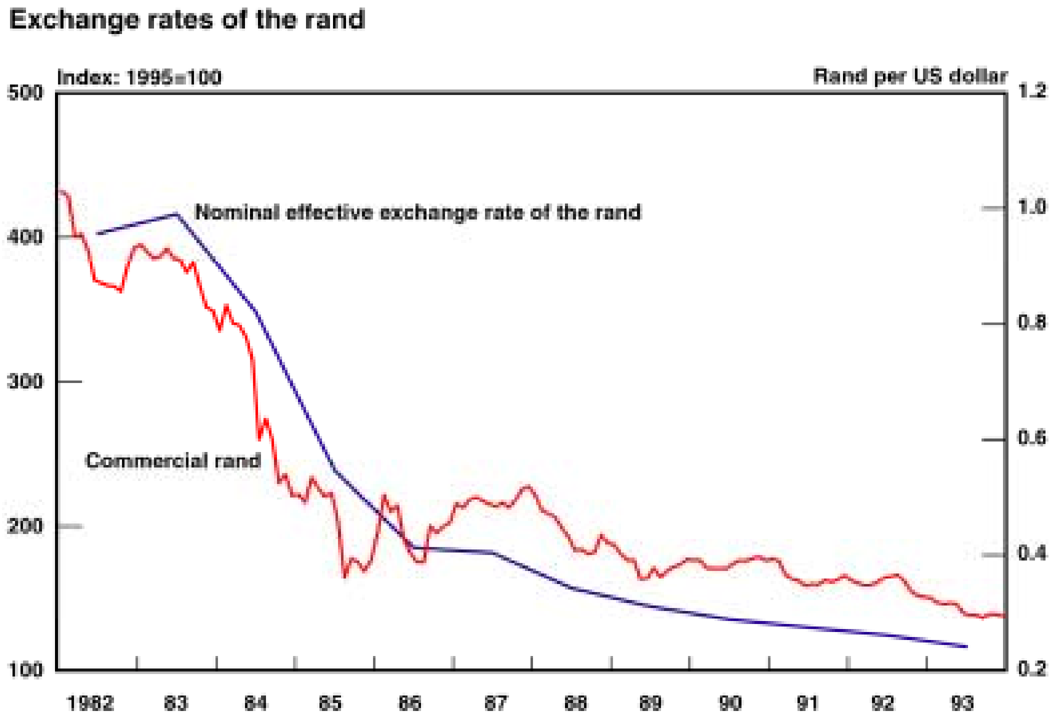
Graph 3



Source: S A Reserve Bank

In an effort to ease the adjustment to the debt standstill and the outflow of capital, the authorities permitted the exchange rate to depreciate. Moreover, exchange control over non-residents was tightened at the time of the announcement of the debt standstill in August/September 1985, as the *financial rand* system was reintroduced: a dual exchange rate system designed to cater for investment flows of non-residents. This system had previously been abolished (in February 1983), but its reintroduction was forced by the events at the time. Graph 4 depicts exchange rate movements.

Graph 4



Source: S A Reserve Bank

The dual exchange rate system, which was one of a number of market impediments that created distortions in the allocation of capital, was finally abolished in March 1995 owing to the considerable improvement in South Africa's international financial relations.

2.1.4 Institutional environment

During the 1980s and early 1990s institutions in South Africa became accustomed to operating under conditions of siege and within an environment of strict exchange control. Moreover, with mounting external pressure, domestic institutions had to adapt to internal policies aimed at structurally adjusting the economy.

In the latter part of the 1980s the S A Reserve Bank voiced concern about the growth in credit, and banks were urged to practise restraint in their financing of consumer goods and the provision of mortgage financing for luxury homes in particular.

An overview of the number of South African banks (known as deposit-taking institutions in 1991) during the late 1980s and early 1990s is given in Table 2.

Table 2: Number of banks and building societies in selected years

Year	Banks(1)	Building societies(2)
1987	52	16
1988	59	16
1989	60	16
1990	54	13
1991	48	8
1992	45	8

(1) Includes 4 discount houses until 1990

(2) Includes equity, permanent, mutual and terminating building societies

Source: Bank Supervision Department, S A Reserve Bank

The figures in table 2 can be put in perspective if the dominating position of the (then) five major banking groups, ABSA, Bankorp, FNB, Nedperm (currently Nedcor) and Standard (in each instance including all subsidiaries and associated banking companies), relative to total assets in the banking industry is highlighted as in table 3 (below). While the five largest banks together accounted for approximately 83 per cent of the banking sector's assets in 1991, Bankorp alone accounted for some 10 per cent.

Table 3: Total assets of banks (deposit-taking institutions) as at 31 December 1991, R million

Total assets	R 257 696	
Five major banks	R 214 624	(83,3%)
Bankorp	R 26 089	(10,1%)

Source: Bank Supervision Department, S A Reserve Bank

At the end of the 1980s there was a change in the S A Reserve Bank's focus on banking supervision. The Governor of the S A Reserve Bank in his annual address to shareholders had made regular references over a number of years to the importance of a stable and sound banking and financial system. The address of 1989, for instance, mentions that the S A Reserve Bank would pay attention to an improvement of the internal management, control and reporting systems of banks.

The address of 1991 mentions that the S A Reserve Bank had taken steps to protect the interests of depositors at three institutions (although it seems that this reference did not include the assistance given to Bankorp that year), and two banks were placed under curatorship and a third one liquidated. It was explained that this action of the S A Reserve Bank was not an unqualified guarantee that the Bank would always protect depositors, countering a perception at the time that the Reserve Bank would automatically help all depositors of banks in distress (a perception that could have induced moral hazard). The policy of the S A Reserve Bank was (and still remains) that depositors would only be helped to the extent necessary to maintain confidence in the banking system and the stability of the banking and financial systems.

2.1.5 Conclusion

As mentioned in the introduction to this review chapter, it is difficult to consider events after the lapse of a decade or more. Domestic conditions and international relations have changed considerably and the South Africa of today is a completely different country from the one of the 1980s and early 1990s.

A number of general conclusions can, however, be drawn:

- it is doubtful whether all domestic banks had the necessary controls and systems in place to deal with increased competition after the change in monetary policy introduced in 1981;
- certain banks experienced difficulty adapting to the declining exchange rate of the rand and increased interest rate volatility in the 1980s;
- capital outflows during the 1980s and early 1990s and the debt standstill forced painful structural adjustments onto the domestic economy; and
- the reintroduction of sustained real positive interest rates since 1988 put many borrowers of funds in distress.