MONETARY POLICY WITHIN MACROECONOMIC POLICY: AN APPRAISAL IN THE CONTEXT OF RECONSTRUCTION AND DEVELOPMENT

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Introduction

Monetary policy is an important part of macroeconomic policy, as the real and financial sectors of the economy are integrally linked. In conjunction with the South African government's commitment to reduce the fiscal deficit, the South African Reserve Bank's interest and exchange rate policies effectively set the macroeconomic framework and constitute a particular choice about the broad economic strategy to be followed. After three years of the new government, and in light of the macroeconomic strategy released in June 1996, it is timely to critically appraise the monetary policy framework.

The conduct of monetary policy must be evaluated in the context of recent macroeconomic performance, much of which has been poor. This paper will assess the linkages between macroeconomic variables and argue that the Reserve Bank's policy stance is inconsistent with an economic strategy for broad-based growth and employment generation and jeopardises long-run development goals, as embodied in the Reconstruction and Development Programme (1994). The paper will conclude by drawing some implications for economic transformation based on a discussion of the role of the financial sector in economic development, and the need to create industrial capacity.

The Macroeconomic Context: inflation and unemployment

The view that the reduction of inflation in South Africa during 1995 was a great economic success confuses means with ends. Lower inflation is not an end in itself but only a means, among many others, in the pursuit of economic development. While the recent record on inflation may be good, it must be evaluated in the context of the performance of other macroeconomic variables. Economic performance in terms of other indicators, most notably employment, has been poor, lending support to the observation from diverse positions (for

example, *Financial Mail*, Oct 6, 1995)[1] that the monetary policy outcomes during 1994 and 1995 were in fact largely due to the failure of the RDP as a strategy for economic development to redress the imbalances of the past. In this interpretation, lower inflation and the stable nominal exchange rate during 1995 were not elements of a successful and coherent economic strategy for transformation, but evidence of the South African Reserve Bank successfully exercising its independence. In effect, this has been acknowledged by the government's altered emphasis on growth in the macroeconomic strategy (Growth, Employment and Redistribution)[2], with the RDP now reduced to a social expenditure plan challenged with making the best use of the available resources. Increases in these resources are made contingent on economic growth, in a reformulation of the 'trickle-down' model.

During the first thirty months of South Africa's first democratically elected government, and in the middle of what is predicted to be the strongest upturn in economic growth for 15 years, unemployment increased significantly. With an unemployment rate of 29 per cent of the economically active population in 1995 (CSS, 1996b), employment status is the single most important determinant of economic welfare, and the poor record with respect to employment seriously threatens the government's attempt to reduce the existing high levels of poverty and inequality.

The increase in unemployment is due to job-creation falling far short of the number of entrants to the workforce. The Reserve Bank (Quarterly Bulletin, June 1996) reports that in 1995 there was no increase in non-agricultural private sector employment, while there were an estimated 350 000 new entrants to the labour market. Meanwhile total employment in the public sector increased slightly, but will decline as public service reform continues. The poor job-creation record should also be viewed in the context of the net loss of 420 000 jobs in the recession of 1989-93. While it is usual for employment to lag output, employment actually declined in the manufacturing, wholesale trade, private road transportation, mining and electricity generation sectors over 1994 and 1995. Although disputed by the Department of Trade and Industry, according to the South African Clothing and Textile Workers Union 17 700 jobs were lost in the textile, clothing and footwear sectors alone from September 1995 to February 1996.[3]

This economic record has provoked heated debate that has centred on alternative growth strategies, however, the focus of macroeconomic (and in particular monetary) policy on fighting inflation has not come under rigorous scrutiny. This is despite the determinants of inflation and issues of causality in monetary policy being highly contested, both theoretically and empirically. For

example, in the UK, money supply targeting and exchange-rate management in the mid-1980s broke down in the context of unstable money demand and foreign capital flows (Artis, 1995). The effectiveness of the South African Reserve Bank's monetary policy stance and its impact on other areas of the economy are therefore not clear, a priori. The specification of monetary policy objectives and instruments relies on assumptions about the functioning of the economy and involves an implicit prioritisation of objectives. At a time when many European governments have conquered inflation only to realise that high levels of unemployment persist, South Africa appears set to follow the misguided policies and priorities which these governments themselves are revisiting.

Theoretical Foundations of Monetary Policy

The focus of monetary policy on inflation is based on the Reserve Bank's 'mission' to protect the value of the Rand (Stals, 1993), and has in turn been used to justify directing interest rates at money-supply growth and support for the nominal Rand exchange rate.[4] The economic rationale underpinning the Reserve Bank approach to monetary policy is market oriented, and monetary policy has been accompanied by progressive liberalisation of foreign exchange controls. It is premised on the belief that growth will be private sector driven with minimal government intervention. In this framework, there is therefore an associated belief in the need to nurture business confidence in order to stimulate growth (see, for example, Nattrass, 1994; Fine, 1994).

The Reserve Bank's monetary policy stance, as set out in statements justifying changes in the bank rate, is consistent with orthodox neo-classical theory and financial liberalisation literature (McKinnon, 1973). For example, the 'Statement on monetary policy' issued on 29 June 1995 referred to 'underlying inflationary pressures undoubtedly increasing again in the South African economy' and 'the untenable large increases in bank credit extension'.[5] Similarly the statement issued on 29 April 1996 argued that '[growth of] both bank credit extension and the money supply ... are still on relatively high levels'.[6] According to this approach, raising the real interest rate will reduce demand for credit and hence inflationary pressures in the economy. Moreover positive real interest rates are also considered central to improving the quantity and quality of investment and so are viewed as an important foundation for long-term growth. There are therefore two closely related elements to the Reserve Bank's monetary policy position: the impact of higher real interest rates; and the prioritisation of inflation as the central macroeconomic variable.

Financial Liberalisation and Interest Rates

The logic of the financial liberalisation framework underlying the Reserve Bank's stance is that higher real interest rates induce people to postpone consumption and save a greater proportion of their income, as well as to hold their assets in financial form (McKinnon, 1973 and World Bank, 1989). Higher savings increase the resources available for investment, in what is commonly termed the 'prior-savings' approach. Moreover, higher interest rates also improve the quality of investment by ensuring that only those projects with positive net returns in real terms will be financed. Positive interest rates are also an integral part of financial deepening, whereby different financial instruments of a longer maturity and sophistication are developed to better suit the requirements of both savers and borrowers.

The process and effects of financial liberalisation have been studied extensively. While it is generally agreed that positive real interest rates are on the whole important to prevent borrowing for unproductive investments, higher real interest rates do not necessarily yield the desirable effects proposed by the financial liberalisation school (Weiss, 1995). There is little evidence that increasing interest rates in itself mobilises savings (and therefore increases investment), instead the stability of real interest rates is a much stronger determinant of savings (Dornbusch and Reynoso, 1989). For example, in South Korea, increased investment and capital deepening occurred after real interest rates were reduced, and the relative cost of capital had fallen (Harris, 1988). Moreover, the South Korean financial reforms were part of a package of measures increasing the state's role in the economy and its influence in the allocation of financial resources through the financial system. South Korean economic development was driven primarily by increased investment, which preceded strong export growth (Rodrik, 1995), and in which directed and subsidised credit played an important part (Harris, 1988; Amsden, 1989; Wade, 1996).

Inflation

The targeting of monetary policy at inflation is based on the belief that inflation inhibits the effective workings of markets. Reducing inflation enables relative prices to be more clearly perceived in the market place and lengthens agents' time horizons. It also reduces menu costs (the costs of changing and advertising prices) and search costs (incurred in gathering information on market prices). While these effects undoubtedly exist, there is an important distinction between an inflation rate which is high and/or unstable and one which is relatively low

and stable. There is little clear evidence that there are significant positive effects in reducing an inflation rate which is already relatively low and stable. Ever lower inflation is therefore not necessarily the path to growth and development, and the costs of reducing a moderate inflation rate, in terms of production and employment, may far outweigh any benefits from the lower inflation rate attained.

In addition, moderate inflation may actually facilitate adjustments in relative prices. To the extent that prices tend to be relatively inflexible downwards, relative prices will adjust more readily through differential (although not necessarily high) rates of increase. In an economy undergoing structural change relative prices would be expected to adjust significantly, and therefore moderate inflation may increase the speed of this adjustment.

Finally, the Friedmanite direct link between increasing prices and the money supply ('too much money chasing too few goods') which forms the basis of monetarism, assumes a stable money demand function, such that an increased money supply must mean that money loses value, in other words that prices rise. There is little reason to believe that money demand is stable: changing banking technology and the rapid spread of Automated Teller Machines and charge and credit cards, clearly impacts on the use of money and the velocity of its circulation.

Market Failures in the Allocation of Credit

Both financial liberalisation and the focus on inflation rely on assumptions as to the efficient workings of financial markets in allocating resources. The financial system is the means by which resources flow from surplus to deficit sectors, and has a crucial role in shaping the real economy. Financial markets are, however, intrinsically subject to market failures which render the concept of 'market-clearing' interest rates inapplicable.

Interest rates are a key price in many of the decisions taken over resource flows: they are the price of credit, the reward to postponing spending, and the return to holding wealth in financial as opposed to real assets. Borrowing to invest in a project (such as a manufacturing concern) means weighing the value of the return over time against the financial cost of the investment. As long as the value of the real return over time exceeds the cost of the loan, then it is rational to make the investment. A higher real interest rate implies that fewer projects will be profitable and investment will fall. However, other factors also have to be considered. If one becomes more confident, and believes that real earnings will rise in the future, it is rational to attempt to raise consumption today through

borrowing, as may have been the case with borrowing for consumer spending in the past two years.

Most importantly, the return to the lender does not only depend on the interest rate, it also depends on the probability of repayment, on which information is generally incomplete and asymmetric. By the nature of the transaction, the borrower knows more about the probability of their own default than the lender. This means that the rate of interest may influence who borrows and the borrower's behaviour. These two effects, known as adverse selection and moral hazard, mean that the probability of default is not independent of the rate of interest and imply that a higher rate of interest may lead to a lower return to the lender due to an increased probability of default (Stiglitz and Weiss, 1981).[7]

These effects mean that banks will ration credit on the basis of the quality of their information on prospective borrowers. Higher interest rates make information more important and increase the importance of risk in the decision. The higher the interest rate, the higher the cost of default to the lender and, if information is poor, credit rationing will increase.

These realities of the credit market therefore increase biases in lending: banks are more likely to lend where there is clear collateral, such as mortgage lending or instalment sale credit where the item can be repossessed. Conversely, credit rationing is strongest where information is poor and costly to gather. These include lending for projects with a high level of uncertainty about their return, such as those developing new products, or in new or relatively undeveloped sectors. Furthermore, these factors influencing lending tend to be stronger for sectors of the market which have historically been under-provided, and for small and medium-scale enterprises on which banks typically have poor information, and which do not normally have significant collateral or a long established reputation.

In addition, these considerations imply a tendency to short- term lending, as the shorter the period of repayment the less significant the interest costs. In the presence of pervasive market failures, high interest rates therefore induce commercial banks to increase short-term and low-risk loans, at the expense of lending for investment in industrial capacity. Higher interest rates particularly harm small-scale enterprises which are more subject to credit rationing under imperfect information. Nugent and Nabli (1992) found in a cross-sectional study of 54 countries that the less developed the credit market, and the greater the extent of market failures associated with information imperfections, the weaker the small-scale enterprise sector.

Credit allocation by financial institutions is therefore inefficient even on the narrow measure of static allocative efficiency, as financial resources do not flow

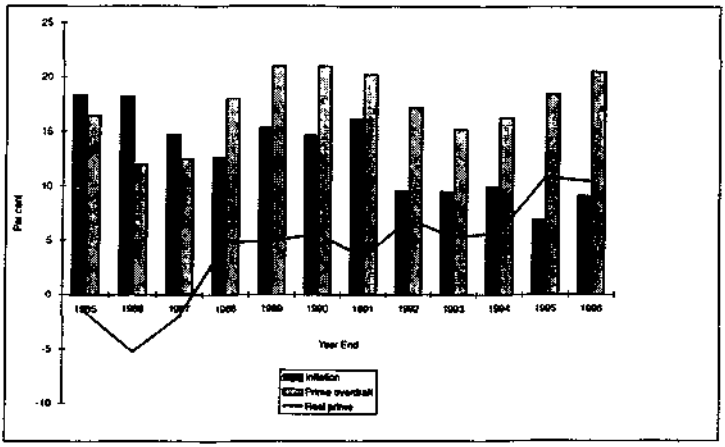
to where they may yield the highest return. Instead large established firms and those with access to foreign capital are favoured, while many firms may be constrained by retained earnings for their development. Quantity constraints are therefore important, for which there is considerable evidence (Harris, 1995).

The above discussion establishes that the straightforward relationship between the financial and real sectors of the economy which underlies the neo-classical framework of monetary policy is theoretically weak. Instead of higher interest rates reducing inflation while increasing savings and investment, they may reduce investment, inhibit industrial development, entrench short-termism and risk averse behaviour by financial institutions, as well as redistributing wealth from net debtors to net creditors (thereby increasing inequality).

Assessment of Macroeconomic Performance

The outlook for long-term growth in South Africa is clouded by the recent macroeconomic performance. While other factors such as the international environment are important, monetary policy must be held responsible for much of this macroeconomic record. In particular, the exceptionally high real interest rates resulting from a combination of increased nominal rates and lower inflation (Figure 1) have had a significant impact on the performance of major macroeconomic variables.

Figure 1: Inflation, and real and nominal interest rates



Source: South African Reserve Bank
Note: 1996 data is as of November

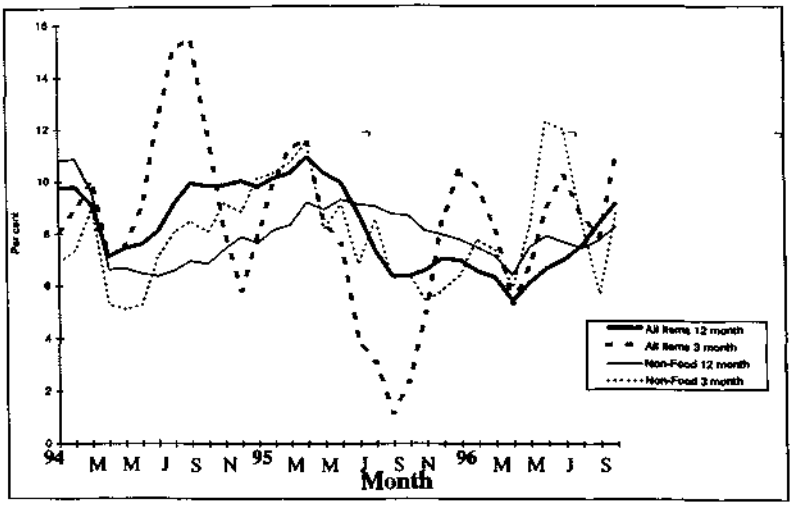
The fall in the inflation rate in 1995 was widely hailed as a success for Reserve Bank monetary policy (for example, 'Victory for Stals in war on inflation', *Business Day*, Oct 27, 1995). However, the success of monetary policy in 1995 in reducing inflation is significantly less than has been claimed, and the recent South African experience does not support the neo-classical model on which the formulation of monetary policy has been based. More careful analysis reveals that the underlying (non-food) inflation rate did not rise as high in the first half of 1995 as the headline rate nor did it reduce to the level of the headline rate in the second half of 1995 (Figure 2).

A significant proportion of the fall in the rate of inflation over 1995 was therefore due to food prices, whose movements have little to do with monetary policy. As illustrated by the 3 month annualised rate, inflation fell sharply from April 1995, before the Bank rate rise to 15 per cent on 30 June 1995 took effect.

Money supply and credit growth rates remained strong as the rate of inflation fell.

As discussed below, the rate of increase of producer prices fell sharply, under pressure from the imported goods component, suggesting supply-side rather than demand-side factors were significant.

Figure 2: 3 month (annualised) and 12 month rates of inflation

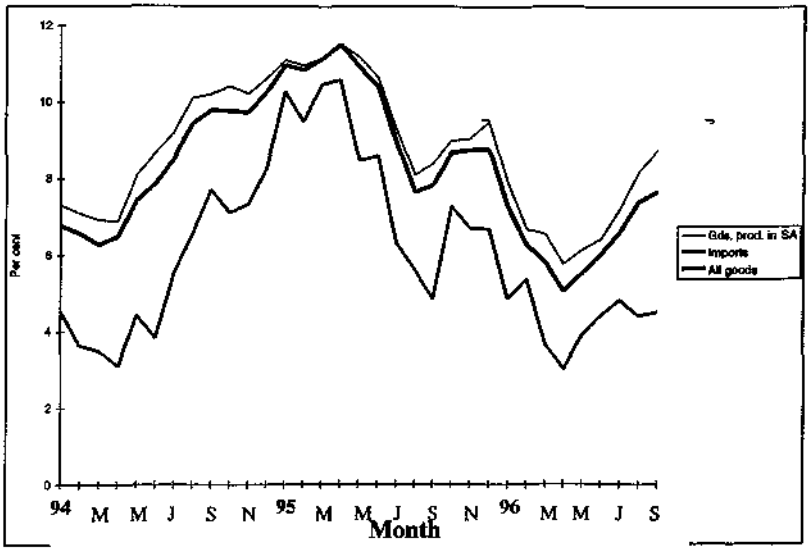


Source: South African Reserve Bank
Note: Calculated from the seasonally adjusted Consumer Price Index.

Key factors, including the strong nominal value of the Rand and tariff reductions, further stimulated consumption spending. This is the opposite effect from the demand restraint sought by the tightening of monetary policy.

Trade liberalisation and the relatively strong Rand in 1995 contributed to a rate of increase of imported goods prices significantly below that of domestically produced goods (Figure 3). While imports form a relatively small proportion (19.3 per cent) of the basket used to calculate the Producer Price Index (PPI), they have a wider impact through the pressure they exert on the prices of locally-produced, import-competing, goods, and therefore affect the prices of tradeable goods more generally.[8]

Figure 3: Annual rates of increase of producer prices



Source: South African Reserve Bank

The fall in the inflation rate was therefore due largely to food prices and tradeable goods. While high real interest rates may have contributed to the strong Rand and therefore to lower inflation during 1995, this was unsustainable and was in any case not the demand-side mechanism through which monetary policy was expected by the Reserve Bank to reduce pressure on prices.

Although the increased interest rates were only an indirect reason for the decline in the rate of inflation, they did contribute to continued capital inflows over 1995, much of which were of a short-term nature (Table 1).[9] These flows in turn increased liquidity in the economy and fuelled growth in credit and the money supply. The strength of the Rand supported by capital inflows, coupled with tariff reductions and the increase in domestic liquidity, contributed to rapid growth in imports outstripping exports and a dramatic worsening of the current account of the balance of payments.

Table 1: Balance of Payments, Rand millions

	1991	1992	1993	1994	1995	Q1-Q3 '96
Balance on current account of which:	6 187	3 940	5 829	-2 231	-12 656	-10 511
Merchandise exports[1]	44 709	49 010	56 512	64 952	80 991	70 650
Merchandise imports	47 385	51 883	59 869	76 251	98 443	85 642
Long-term capital flows	-1 730	-1 511	-272	3503	12 517	6 112
Short-term capital flows[2]	-424	-2 162	-14 749	1 849	9 216	-3 445
Change in net forex reserves[3]	4 033	267	-9 192	3 121	9 077	-7 844

Source:South African Reserve Bank
Notes: 1 Excluding gold
2 Not related to reserves
3 Owing to balance of payments transactions

The short-term capital inflows in 1995 were almost entirely to the monetary sector, and largely reflected foreign borrowing by South African banks to onlend at high domestic interest rates. In particular, consumer credit expanded through a financial system which remained oriented towards short-term lending for consumption and property. High real interest rates, rather than acting as a constraint on money supply growth and credit, instead therefore fuelled increases in credit in excess of the Reserve Bank's target ranges. The increased liquidity led the Reserve Bank to engage in open market operations, reportedly absorbing R2.8 billion in liquidity in August and September, 1995, through the sale of bonds on which the Reserve Bank paid interest (*Business Day*, Oct 25, 1995). The short-term foreign capital inflows were not sustainable, as the stability of the nominal value of the Rand (and its appreciation in real terms) over 1995 did

Figure 4: Effective exchange rates of the Rand

Source: South African Reserve Bank
Note: Index, average for 1990 = 100

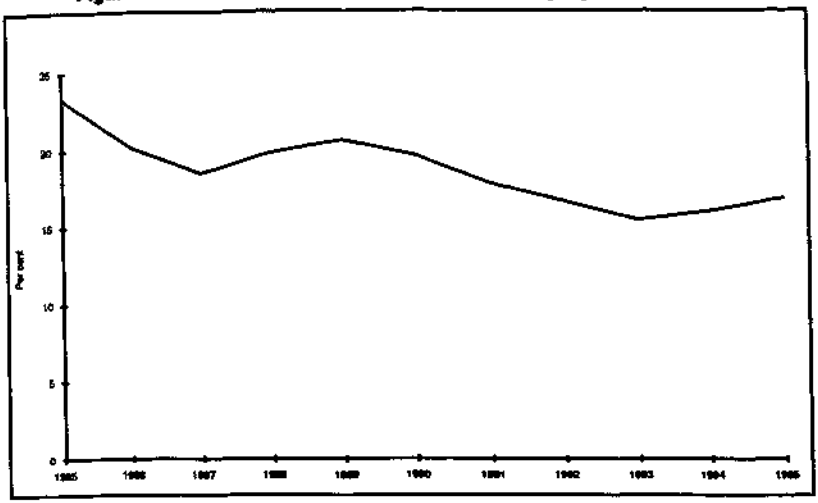
not reflect the underlying weakness of the economy, and the deterioration of the current account in particular.[10] As is to be expected when speculative bubbles burst, the correction was sharp, with a tendency to overshooting of the exchange rate, as reflected in the dramatic reversal of short-term capital flows in 1996 (Table 1) and the corresponding depreciation of the Rand (Figure 4).

While improved investment levels have been referred to as evidence of the success of monetary policy, they remain low in comparison with historical levels in South Africa (Figure 5), and are far below those necessary for the long-term growth rates required for significant employment creation. The ratio of manufacturing Gross Domestic Fixed Investment to manufacturing output reveals a steeper rise, from 17.9 per cent in 1993 to 20.9 per cent in 1995, although according to Fine and Rustomjee (1996) the Alusaf and Columbus projects accounted for almost half of all manufacturing investment over this period.

The increase in investment does not, however, derive from increased personal savings. Savings rates have fallen significantly, and the growth in investment is based largely on corporate profits, reflected in retained earnings and corporate

savings' levels. Even the exceptionally high real interest rates which now prevail (Figure 5) have not stemmed the decline in the ratio of personal savings to personal disposable income which fell to 0.9 per cent in the second quarter of 1996, and has been falling almost continuously from a high of 5.3 per cent in the first half of 1993.

Figure 5: Gross Domestic Fixed Investment, as a proportion of GDP



Source:South Africa Reserve Bank

While deposits of individuals at commercial banks increased by only 7.6 per cent during 1995, deposits of companies (excluding insurance and pension funds) increased by 25.8 per cent. This does not suggest a strong correlation between the level of interest rates and personal decisions between savings and consumption, much of the increase in deposits instead appears to reflect increased company profit levels. This further implies that established and profitable large-scale firms will be favoured in investment, and that financial resources for investment are not being channelled to where there is the most potential. The slight increase in investment levels does not therefore represent a success for the Reserve Bank's monetary policy.

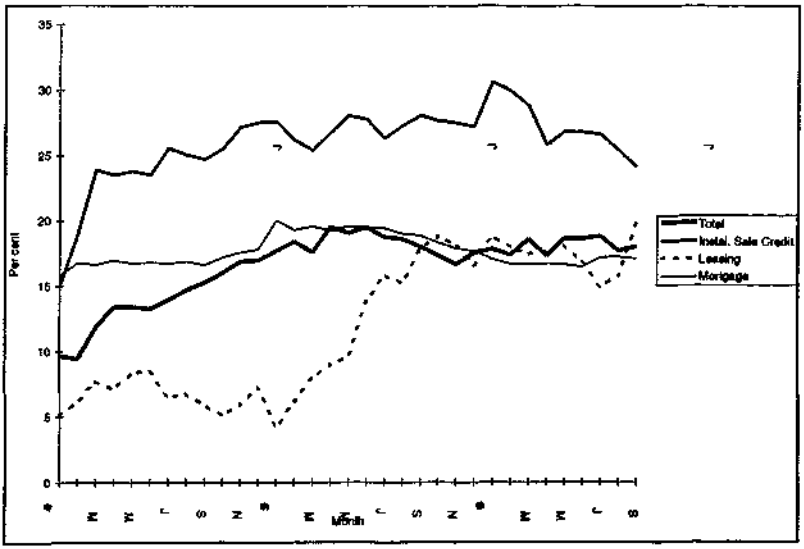
The Reserve Bank's mission to protect the domestic and external value of the Rand therefore focused on maintaining nominal stability in the short run, at the expense of the medium term. The use of interest rates as the major tool in an

anti-inflationary monetary policy attracted unsustainable capital inflows, and had a negative impact on the real economy, the strength of which is a key determinant of long-term direct foreign investment. As the recent experience of Mexico illustrates, a nominal exchange rate policy as part of an anti-inflation strategy is risky and potentially damaging in both the short and long-term (Krugman, 1995). If the exchange rate does not reflect the underlying competitiveness of the economy, then adjustment is only a matter of time.

The Effect of Interest Rates on the Economy in South Africa

In making investment more expensive but attracting foreign capital, higher real interest rates further skewed the allocation of credit. In addition, domestic industry and employment were damaged both by the strong Rand over 1995, and the rise in interest rates in response to the Rand's depreciation from February 1996.

Figure 6: Growth in credit extended to the private sector by monetary institutions, annual rates of increase of selected sectors



Source:South African Reserve Bank
Note:As of September 1996 the selected sectors collectively accounted for greater than 60 per cent of the total, with the bulk of the remainder due to other loans and advances.

While, as discussed above, investment increased only slightly relative to GDP, total credit to the private sector has continued to increase at relatively high rates (Figure 6). The highest rates of increase have been in instalment sale credit, the majority for the purchase of cars. As with mortgage and leasing finance, there is a clear collateral in the form of the durable good being purchased, mitigating the increased risk associated with higher interest rates.

This is consistent with the analysis of the financial markets undertaken earlier. Demand for consumer credit depends on expectations of future income, while credit for investment must balance the projected rate of return against the cost of borrowing. South African industry has also faced a changing trade environment and instability in real macroeconomic variables, implying greater uncertainty over the return to long-term investments. Concentration on interest rates as the main tool of macroeconomic policy therefore served to entrench the historical pattern of lending for property and consumption, with mortgages continuing to account for over 40 per cent of total credit.

Several factors also suggest that continued high rates of increase of consumer credit do not in any case reflect sustained inflationary pressures: the expansion of technologies in credit extension, in particular the introduction of retail charge cards, accompanied by aggressive advertising, has significantly contributed to increases in credit. The period of change involves an adjustment of an essentially one-off nature to the new purchase (and borrowing) mechanisms.

There have also been reports that the continued increase in this area of credit may represent distress borrowing as borrowers are unable to meet their interest payments and loans are rescheduled.

Despite ongoing technical change, the ratio of M3:M1 has been decreasing over all but one of the last six years, from 3.2 at the end of 1989 to 2.3 in September 1996. This suggests that the rate of increase in broad money has in fact been relatively low given the increase in liquidity, and that considering the other factors such as the short-term capital inflows during 1994 and 1995, high real interest rates have been exerting significant downward pressure on the demand for credit.

It is clear from this analysis that the interest rate policy pursued by the Reserve Bank has very significant implications for the structure and flexibility of the real economy. The sharply increased cost of investment inhibits the process of industrial restructuring as higher interest rates increase the likelihood of businesses not being able to adapt to the changing economic environment, instead collapsing, losing jobs and skills, such that South Africa partially de-industrialises before it re-industrialises. In particular, the ability of industry

to respond to the economic challenges of reduced protection, and to expand and create jobs, has been compromised.

In South Africa, the legacy of apartheid means that the economic effects of the high interest rate policy have racial implications in addition to the gender and rural-urban factors that commonly affect the extension of credit under imperfect and asymmetric information. Historically, commercial bank facilities in black areas (notably the 'townships') are extremely sparse and, as with business in general, management positions are predominantly held by white people. These factors compound information weaknesses. Banks' information base on black borrowers is much weaker, and their knowledge of businesses in predominantly black areas is also poor. The reality of credit extension means that, on average, black borrowers are at a disadvantage in access to credit, by the nature of the market and the existing institutions. Higher real interest rates compound these factors and impede black economic advancement.

The Conduct of Monetary Policy: how the Reserve Bank has influenced the macroeconomic policy framework

The Reserve Bank Governor stated that the rises in the Bank rate to yield unprecedented levels of real interest rates were justified on the basis of underlying inflationary pressures (Stals, 1995b and 1996a). It has been argued that higher interest rates were not the main reason for the fall in the rate of inflation over 1995, and that monetary policy has had other significant implications for macroeconomic variables. The assessment of macroeconomic performance since 1994 further revealed contradictions in macroeconomic policy between stabilisation objectives and growth and development.

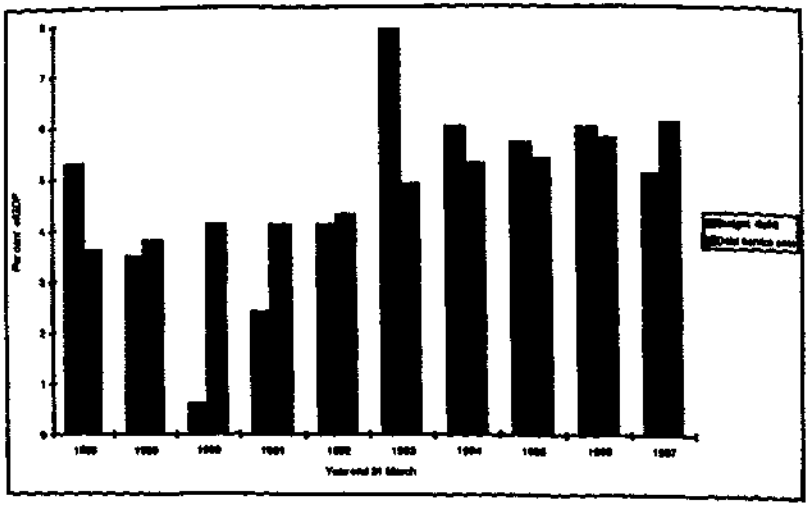
Within the constraints set by the previous government's legacy of a high and rising public debt, the macroeconomic framework has largely been determined by the logic and conduct of monetary policy. As part of this framework, objectives are prioritised and policy tools identified. In particular, inflation targets and the use of interest rates as the key policy instrument have been elevated above employment creation and the role of government in stimulating investment and growth. This market-oriented approach implies that the yardsticks of market reaction (for example, in the foreign exchange market) and notions of business confidence are implicitly and explicitly used to assess government's performance. A successful government thereby becomes one that attracts foreign exchange and stimulates interest in the Johannesburg Stock Exchange.

There have been three important elements to the influence of monetary policy over the macroeconomic framework. Firstly, the Reserve Bank Governor's position (Stals, 1996b) that interest rates are high because of government debt. Secondly, the use of money supply and credit targets as indicators of underlying inflationary pressures. Thirdly, the Reserve Bank practice of following the money and capital markets in setting interest rates (see Reserve Bank Governor's statements on monetary policy), while its ability to intervene in foreign exchange markets is constrained by foreign exchange reserves.

In each of these areas, the Reserve Bank has itself made important decisions which establish the range of possible options to which it, and the government, then find themselves constrained. In other words, reference to 'market forces' and 'globalisation' as restrictions on the policy agenda (Stals, 1995a, 1996b) fail to take into account the extent to which the agenda has been determined by the conduct of monetary policy.

The high level of public debt, now at 57 per cent of GDP, has corresponding implications for interest expenditure and for government's ability to reduce the budget deficit. While in the 1996/97 budget, the primary budget (of current

Figure 7: Budget deficit and debt service costs



Source: Department of Finance, Budget Review, 1996, Tables 6 and 7b
Notes: 1 Budget deficit excludes transfer payments
2 Data for 1996 and 1997 are estimates

revenue and expenditure) is projected to be in surplus, interest expenditure is increasing both as a proportion of total government expenditure and relative to GDP (Figure 7). High interest rates further increase interest expenditure and therefore the government's borrowing requirement, in a vicious circle. To attribute high interest rates to the size of government debt is to overlook this causality, and further ignores the role of government spending in generating economic growth, although economic growth is ultimately the desired route through which the debt burden should be reduced.

The Reserve Bank's position in this regard is therefore essentially based on short-term stabilisation, and an assumption that government expenditure crowds out rather than crowds in investment. By maintaining extremely high interest rates it ensures that this is the case. As such, this position is founded on an assumption that the market cannot be led, and that government is constrained to follow the market's interpretations of economic fundamentals. Actual market movements cast extreme doubt on this, and it also ignores the Reserve Bank's active involvement in managing money market liquidity.

The attribution of high real interest rates to the level of government debt also does not bear examination against recent South African or international experience. The deficit has been reduced yet real interest rates are at historically high levels. South Africa's government debt is not high by international standards, but real interest rates are among the highest in the world. Either this means that most other countries have an inflationary approach to funding government deficits, or that the South African deficit does not in fact require such excessive real interest rates.

The reliance on the interest rate as almost the sole instrument of monetary policy also meant that (through attracting foreign capital) high interest rates paradoxically supported credit and consumption in the short run, rather than reducing credit and aggregate demand. At the same time investment, production and employment suffered. The capital inflows, encouraged by high real interest rates, increased liquidity and money supply meaning that the Reserve Bank's targets were overshot throughout 1994 and 1995, seemingly indicating that monetary policy was not in fact overly restrictive on the economy. However, while there has been increased use of advanced technology in banking, a boom in consumer credit with almost all major retailers launching charge cards, and a greater incentive to save in longer-term deposits and earn higher interest rates, the ratio of M3:M1 declined, suggesting that disintermediation occurred and financial deepening was reversed.

Quantitative targets for money supply growth have very limited use in this context, and yield little understanding of the processes at work. Experience with

money supply targets in other countries (such as the UK) also points to their bluntness as policy instruments, especially in a financial system undergoing technological change. In addition, by stating the logic driving monetary policy and by setting money supply targets, the Reserve Bank conditions the market to expect increases in the bank rate if targets are not met and if, for example, the exchange rate falls. The market therefore discounts expected moves in the bank rate, such that private sector decisions incorporate expectations of government policy rather than the opposite claimed by the Reserve Bank. The claimed necessity of following market rates (and the apparent impotence of government) obscures the role of the Reserve Bank in influencing the perceptions of money-market agents through the stated logic of monetary policy which ensures that the policy has a self-fulfilling rationale. In other words, breached money supply targets lead to increased money market rates because an increase in the bank rate is expected by private sector agents, which in turn provides the Reserve Bank with the rationale for a higher Bank rate.

Exchange rate policy has also been governed by the preoccupation with inflation. While the nominal exchange rate remained stable over much of 1994 and 1995 (putting downward pressure on inflation through import prices), the real exchange rate appreciated, with a negative impact on the trade balance. The impact of this relative price effect was compounded by the effect of domestic liquidity on demand for imports and continued foreign capital inflows thus became necessary for the balance of payments. While foreign exchange reserves did accumulate, a cessation in capital inflows or worse, a reversal could not be supported and would precipitate a rapid and destabilising adjustment of the Rand, as was triggered in February, 1996, when the Union Bank of Switzerland released a report which assessed the Rand as being overvalued by approximately 20 per cent. The Reserve Bank Governor concurred with this assessment; however the flawed logic of monetary policy had meant maintaining high real interest rates, as outlined above, and waiting for the markets to make the adjustment and the bubble to burst.

The exchange rate should instead reflect the underlying economic fundamentals, and form an integral part of overall economic strategy. Trade liberalisation further strengthens this imperative. Moreover, and of particular relevance for South Africa in this context, it is evident that significant mineral exports tend to result in an overvalued exchange rate relative to underlying determinants of the economy's strength (commonly termed the 'Dutch disease effect').[11] To avoid these effects the Reserve Bank may 'sterilise' foreign exchange earned from mineral exports. Reducing the supply of foreign exchange in this manner puts pressure on the exchange rate to depreciate. In the past (from

1985, with the debt standstill and sanctions) capital outflows have effectively played this role in South Africa, forcing the economy to run a current account surplus. This surplus was largely achieved through tariffs and state investment in strategic areas such as heavy chemicals, rather than the development of a diversified manufacturing sector. The reversal of capital flows means that an appropriate exchange rate for manufacturing growth must take into account Dutch disease considerations.

Taken together, the objectives and conduct of monetary policy have therefore been paramount in determining the basis of the macroeconomic framework, and have led to the logic of deflation being accepted by government (in both the impact of interest rates on investment and more rapid reductions in the budget deficit). The Reserve Bank stance claims to accept the 'discipline' of the markets on government policy. But, as has been demonstrated, monetary policy was partly responsible for sizeable and unstable foreign capital inflows, a current account deficit and the resultant sharp depreciation of the Rand. Under these conditions, the only remaining explanatory factor in the neo-classical model underlying policy is government debt, so to maintain the macroeconomic framework enforced by monetary policy, the government has to cut the budget deficit, rather than evaluate spending against possible returns. This is combined with continued high real interest rates (exacerbating the debt burden) and accelerated liberalisation. As in many countries undergoing these policies as core elements of enforced Structural Adjustment Programmes, the sought after macroeconomic stability can only ultimately be achieved under this approach through deflation of the economy. The signs of this are already evident in the South African economy with the downturn of growth and employment creation.

Monetary Policy and the Financial Sector

Monetary policy cannot be properly evaluated in abstract from the workings of the financial system: the effect of policy choices depends on their impact on financial flows. These flows in turn depend on the structure and institutions of the financial system.

The financial sector in any economy plays a crucial role. The structural constraints that characterise the South African economy, and the economic restructuring underway, make its role particularly important at this time for the fundamental shifts in resource allocations required.

The nature of the development of the financial system is determined by common factors which underlie both the real and financial sectors of a country's economic structure. These include the banking tradition inherited from colonial powers, the concentration of ownership, and the history of government

intervention. The South African financial system is a product of the British colonial legacy and mineral-driven industrialisation under apartheid governments. In what is commonly termed a 'market-based' system[12], the commercial banks have an arms-length relationship with their clients and as a result, have little in-depth knowledge of the business of their clients and are not in a strong position to judge good from bad risks. They typically lend mainly for the short-term, and for the purchase of housing and consumer durables, rather than for long-term investment projects. Customers can however, move relatively easily and costlessly between banks. At the same time, the relatively developed capital market allows large established firms to raise equity finance, rather than borrowing.

The South African financial system differs from the British 'market-based' model in an important respect. Financial institutions are integral parts of the large conglomerates founded initially on mining. These conglomerates are characterised by cross-holdings and pyramid ownership structures, and close relationships do exist between commercial banks and firms within the same conglomerate, as well as between banks and other financial institutions, such as life assurance and pension funds. Past government policy supported this trend, for example, by providing capital for large-scale mineral-related projects through the Industrial Development Corporation. The South African financial sector is therefore integrally related to the existence of what may be termed a 'Minerals-Energy Complex' in South Africa (Fine and Rustomjee, 1996). As a result, access to finance is skewed towards firms within this group, such as in the heavy chemicals and plastics sectors.

Access to financial services also reflects the dynamic of the apartheid economy. Banking facilities are well developed in the historically white cities which have better infrastructure than many European cities.[13] A low level of outreach in historically black areas means that the banks have little information or experience in lending to the black population. These information factors combine with high, racially-based, income inequalities to reinforce the orientation of the financial sector to lending to the wealthy white population for consumer durables and housing.

While the financial system as a whole reflects the existing economic structure, it must also play a central role in its transformation, but the privately-owned institutions comprising the financial sector do not have objectives related to economic development.[14] Macroeconomic policies based on influencing the flows of resources through the financial system must take this into account, along with the effects of the pervasive market failures analysed above. Thus, if policies are formulated on the premise of an efficient and leading private sector without

significant government intervention, they must rest on an assertion that the damage from government introduced distortions will outweigh the effect of intervention in achieving development goals. Moreover, the legacy of apartheid has left the South African economy with structural weaknesses and extreme disparities, so that the market failures of the South African financial system must be evaluated in the context of its ability to serve the needs of all of South Africa's people. In light of this, adoption of a market-oriented approach implies very little faith in the ability of government, or a reluctance to directly address the economic position of the historically disadvantaged.

Macroeconomic and monetary policy cannot play an important role in broad-based development and employment creation unless these fundamental issues are addressed As has been demonstrated, the monetary policy pursued by the South African Reserve Bank from 1994 has focused on short-run stabilisation which provides a base for commercial banks' ongoing profitability, but is inconsistent with the development of manufacturing and employment creation. For broad-based development to be achieved, monetary policy and macroeconomic policy must be developed as part of a coherent economic strategy based on an evaluation of the existing structure of the economy and the financial sector in particular, as originally envisaged in the RDP.

Conclusions: monetary policy, development and employment

Monetary policy in the first two years of the new government has been little changed despite the supposed reorientation of economic policy towards reconstruction and development. Interest rates have been targeted at inflation almost to the complete exclusion of other factors, based on the assumption that inflation results from excess demand, rather than structural problems related to supply. The Reserve Bank has continued to target money supply and credit under the assumptions that they are good indicators of aggregate demand, and that the interest rate can be used to control money supply growth.

Under this approach, interest rates have been raised while inflation has fallen. The case made for the extremely high real interest rates is that the short-term costs involved must be borne if the economy is to have a non-inflationary platform for sustained growth in the future. In so doing, it assumes both that the costs of such a policy do not place South Africa on a lower growth path, and that market failures and rigidities in the economy are insignificant.

The performance of monetary policy has been evaluated both against its own objectives of reducing inflation through restraining the money supply, and against the requirements of growth and development. Monetary policy has not achieved its objectives, and its underlying rationale has not been supported by

the recent experience. It has further been argued that the conduct of monetary policy has ignored the characteristics of the South African economy

Although inflation has fallen during the past two years, it had started declining before the contraction in monetary policy, due to a range of factors including cheaper imports and declines in food prices. High interest rates themselves contributed to lower relative import prices as they attracted short-term capital inflows which supported the nominal value of the Rand. While this reduced inflation in the short run, its impact on the current account of the balance of payments meant it was unsustainable, and led to the sharp depreciation of the Rand, placing upward pressure on prices.

The focus on financial variables and disregard for the real economy meant that a myopic monetary policy followed myopic markets. Despite the economy being in the boom phase of the business cycle, there has been negligible net employment creation and, while investment rates have risen slightly, they remain far below those of the early-1980s. Structural economic change requires greatly increased investment if economic restructuring is to occur in an expansionary environment, rather than be a step towards contraction and deindustrialisation. In turn, this requires framing monetary policy in the context of reform of the financial sector to address the existing orientation of credit for consumption and housing, and for large-scale industry.

Instead, the balance of payments and exchange rate instability, exacerbated if not created by monetary policy, has been used to support a more rapid programme to reduce the fiscal deficit in an attempt to attract foreign capital, as outlined in the government's macroeconomic strategy. However, without a programme of government investment to provide the basis for broad-based economic growth and employment creation, capital inflows will again only be attracted by high interest rates and will be short- term in nature.

An alternative approach is to pursue growth, reconstruction and development through increasing industrial capacity. This relaxes supply constraints, and therefore relieves the heavy weight on interest rates for containing inflation through restraining demand. In the context of a financial sector which retains apartheid biases and is subject to market failures, this requires significant government intervention in the financing of investment, both through capital expenditure on infrastructure and through institutions such as the Industrial Development Corporation. Government support for restructuring and employment creation as part of this strategy would also provide a stronger basis for negotiating a social accord, to further reduce inflationary pressures in the economy.

NOTES

1. The Financial Mail argued of the RDP that 'Modesty is its virtue' (07.04.95), and on 19 May, 1995 that the RDP 'is a programme of unproductive public works.., fortunately still largely inert', while it linked perceived economic development with the RDP's failure on 6 October 1995, arguing that 'there is a real prospect of breaking out of a no or low-growth cycle and matching the sustained eight percent or so of the sixties', but 'that if the spending envisaged by the Reconstruction and Development Programme gets underway, it could destroy the fiscal discipline underpinning the current private investment boom.'
2. Growth, Employment and Redistribution: A Macro-Economic Strategy was released by the government in June, 1996. The impact cannot as yet be evaluated, but the document confirms the monetary policy stance adopted by the Reserve Bank without an assessment of its effect over recent years.
3. While the SACTWU figures are retrenchment numbers, there has also been job creation, such that the net result is not as large a negative figure.
4. The Reserve Bank Act states 'The primary objective of the South African Reserve Bank is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic' (Section 224.(1)). The value of a currency over time is determined by a range of factors reflecting the underlying strength or weakness of the economy. Interest and inflation rates impact directly on the currency in the short-term, but in the long run their effect depends on their influence on sustainable economic growth. For growth to be sustainable it must be founded on broad-based investment and employment generation.
5. This Statement was issued when the bank rate was raised to 15 per cent.
6. This Statement was issued when the bank rate was raised to 16 per cent.
7. The case of adverse selection is where a higher interest rate may cause safer borrowers to stop borrowing as their expected return is no longer sufficient to cover the cost of credit, this leaves the higher-risk borrowers, on whom the bank has a lower expected return. The case of moral hazard is where a higher rate of interest encourages the borrower to attempt more risky projects which, if successful, will yield a rate of return greater than the interest rate. But, the higher probability of default lowers the return to the lender.
8. Weights in the PPI based on 1985 statistics were applied to data up to May 1995, new weights based on 1989/90 statistics were applied to data as from June 1995. As imports have been increasing as a proportion of Gross Domestic Expenditure, these weights understate the impact of imported goods prices on South African inflation.
9. Capital flows dramatically reversed in the third quarter of 1994, clearly largely due to increased confidence following the first democratic elections. It is unlikely that interest rates account for this dramatic change, however it is probable that they were significant in the continued inflow of short-term foreign capital during 1995, much of which was borrowing by South African banks for lending domestically at prevailing interest rates. This interpretation is supported by the reaction of South African banks following the collapse of the Rand in raising their prime rate (led by Standard Chartered) without a lead from the Reserve Bank.
10. Even though, as calculated by the Reserve Bank, the real exchange rate only reflects prices as measured by the PPI, and not the underlying determinants of competitiveness such as labour costs and employment, it is also important to note that indexing of the real exchange rate can implicitly suggest that the aim should be to return the exchange rate to the base year value,

but this is in no way an 'equilibrium' level. If rates of productivity improvement, investment and skills development are below international levels, then the real exchange rate should be depreciating, in response to underlying determinants of the competitive strength of the economy.

11. The impact of significant exports of natural resources on the economy is named the 'Dutch disease' after the experience of the Netherlands following the discovery of natural gas. Exports of natural gas led to significant appreciation of the real exchange rate which negatively impacted on other sectors of the economy, in particular manufacturing, resulting in unemployment.
12. In contrast, in a 'bank-based' system such as in Germany or Japan, the close relationships which banks have with their borrowers enable them to make decisions on lending for risky investments and for longer periods. In this system, it is not uncommon for banks to have representatives on companies' boards, and to play a financial advisory role. Through these relationships, the reduction of information asymmetries increases the availability of finance for investment by small and medium- scale companies who could not raise funds from the capital market.
13. According to the World Bank Urban Sector Reconnaissance Programme (1993), in the formerly white cities in South Africa, per capita spending levels on infrastructure have been equivalent to those in the top four or five countries in the world.
14. For example, in a 1994 record of understanding, commercial banks agreed to a target of 50 000 low-cost home loans in the 12 months to June 1996. It has been reported (Business Day, 05.07.96) that none of the banks reached their individual targets, and by the end of April 1996 fewer than 17 000 mortgages had been granted to this sector.

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