

# “A chronological analysis of monetary policy and the financial system in South Africa”

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## A chronological analysis of monetary policy and the financial system in South Africa

### Abstract

This paper presents an overview of the financial system and monetary policy in South Africa. An outline of how financial development has progressed in South Africa – from the 1960s up to 2012 – and the underlying financial reforms are examined. A discussion of the environment existing during such development, and the various indicators of the bank-based side of the financial sector is also elucidated on. Inclinations show increased financial development, which can mainly be explained by increased personal credit, relatively decreasing share of sight deposits and increased financial depth. Financial liberalization managed to increase interbank competition though it did not lead to a higher savings rate despite the relatively high interest rates after financial liberalization.

**Keywords:** financial development, financial reforms, South Africa, monetary policy.

**JEL Classification:** E44, G18, E52, G21.

### Introduction

The importance of the financial sector to economic growth has been a topic of great contention and inquisitiveness among economists. A number of studies have been undertaken; and mixed results have been reported. Theoretically and empirically, there is some extensive evidence that financial development and economic growth are causatives<sup>1</sup>. However, the underlying postulation of financial development and depth being associated with economic growth tends to be explained by its presumed effect on investment. The attestations are that financial development leads to greater and more efficient investment accumulation.

The motivations for the role of the financial sector are explained by how financial system fosters capital accumulation and technological innovation. Capital accumulation is effected through steady-state growth: either by influencing the rate of capital formation/accumulation through altering the savings rate, or by re-allocating savings among different capital-producing technologies, or by monitoring the rate of technological innovation, or by all three of these (Levine, 1997).

The financial system not only provides services that pool funds from savers, and channels these savings to investors; but it also provides the payment system that facilitates trade and exchange. This was the argument by McKinnon (1973) and Shaw (1973) to move away from financial repressive policies so as to foster increased financial development, which would lead to increased economic growth. The

McKinnon-Shaw hypothesis advocates for the removal of interest rate ceilings and other government regulations (financial liberalization) that discourage competition in the financial sector. Competition supposedly leads to higher savings and investments (increased allocative efficiency of capital) that contribute to growth.

However, proponents for financial repression argue that government intervention in the financial sector may be necessary so as to place clear limits on the degree of competition allowed in financial markets, to avoid the weakening of the risk-return relationship, the loosening of credit limits, falling profits, and the incidence of increased speculative activity. Also, financial repression enables governments to require financial institutions to lend to specific activities and provide credit at subsidized rates and to borrow with ease to finance budget deficits (Graham, 1996).

Therefore, the purpose of this study is to analyze chronologically, the evolution of the South African financial system and its monetary policy stance. Furthermore, a variety of specific indicators of financial structure and development are discussed herein so as to measure financial depth and look at the performance of the financial sector before and after financial liberalization.

The rest of the paper is organized as follows: Section 1 gives a brief introduction to the evolution of the country's financial sector and outlines the monetary policy and financial reforms in South Africa for the periods of 1965-1980, 1981-1994 and 1995-2012, respectively. Sections 2 and 3 present the trends in financial sector development indicators and other indicators, respectively, in South Africa during the study period. Final section gives the conclusion.

### 1. The evolution of monetary policy and financial sector reforms in South Africa

A look at the history of the South African financial sector shows that it started to show evidence of di-

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<sup>1</sup> See studies by Odhiambo (2010) and Nazlioglu et al. (2009), Fowowe (2013), Badunenko and Romero-Avilla (2013), Barajas, Beck, Dabla-Norris and Yousefi (2013), Schiantarelli (1996), Love (2003), Love & Zicchino (2006), Schich and Pelgrin (2002), Baliaoune-Lutz (2007), Lynch (1995), Xu (2000), Benhabib and Spiegel (2000), Misati and Nyamongo (2011), Dutta and Roy (2009), Hermes (2005), Ndikumana (2000, 2005), Levine, Loazy and Beck (2000), Carlin and Mayer (2003), Rioja and Valev (2004).

versification in the 1950s. Up until this stage, the banking sector had been dominated by commercial banks; and these institutions had only a limited product range. Discount houses, merchant banks and other general banks increased the competition; and there was, subsequently, an expansion of the product range offered by the financial sector.

Currently, the financial intermediaries market in South Africa is made up of the Central Bank of the country, the South African Reserve Bank (SARB), depository corporations like commercial banks, and non-bank financial institutions. The SARB, like all other central banks, protects the value of the rand, controls inflation, regulates the money supply, and assists in the formulation and implementation of macro-economic policy. The Bank is governed by a fourteen-member Board of Directors, including one governor and two deputy governors, all of whom are responsible for the day-to-day affairs of the Bank, and are appointed to five-year terms by the President of South Africa. The stakeholders of the Bank elect eleven additional directors for three-year terms (Allen, Otchere & Senbet, 2011 p. 106). Depository corporations comprise commercial banks and any other financial institutions that are in the business of accepting transferable deposits. Non-bank financial institutions include those institutions that do not accept transferable deposits, but are involved in financial intermediation through issuing securities, accepting unique deposits, and dealing in different types of liabilities that are close substitutes for deposits.

Trends in sectoral contributions reveal that the South African financial sector is an important con-

tributor to gross domestic product and economic development. The largest industries in South Africa, as measured by their nominal value added in 2013, were finance, real estate, and business services (21.5%), general government (17.1%), the wholesale, retail and motor trade; catering and accommodation industry (16.6%); and the manufacturing industry (11.6%) (Statistics South Africa SA, 2014 p. 5).

A summary of the historical background of the South African financial sector and its legal reforms from 1964 onwards is given in sub-sections 1, 2 and 3. Sub-sections 1 and 2 give the process of financial development in South Africa before independence in 1994. However, there were two regimes that existed during the said period, that is, the monetary policy or financial-repression era (Sub-section 1), and the beginning of financial-liberalization era (Sub-section 2). Sub-section 3 summarizes the evolution of financial development after independence.

**1.1. Summary of monetary policy in South Africa (1965-1980).** Government-led-development was the ruling economic development paradigm in South Africa during this period. Given increased international pressure due to apartheid in South Africa, financial repressive policies were put in place so as to avert capital flight and to maintain stability in the economy. Monetary policy was the main driving instrument used to control the financial sector. The legislation, reforms and policies put in place during this period that had an effect (direct or indirect) on the financial sector are summarized in Table 1 below.

Table 1. Summary of monetary policy in South Africa (1965-1980)

1964	<p>Appointment of the Technical Committee on Banking and Building Society legislation in 1961. The Report of this Technical Committee was published in 1964, and most of the recommendations of this Committee were embodied in a new Banks Act in 1965. The Bank Rate was raised in July 1964, and again in December 1964.</p> <p>The Central Bank made use of direct measures to control overspending and inflation. Credit ceilings, high cash reserves, and varying liquid asset requirements, dual exchange rates, ceilings on advances, and consumer credit controls. A period of financial repression.</p>
1965	<p>The Banks Act was issued. This Act laid down one uniform set of legal requirements for all banking institutions, which included commercial banks and other "monetary" banking institutions, were differentiated only with respect to the banks' "short-term", "medium-term" and "long-term" liabilities. In this manner, the "near" banks were brought more closely into the ambit of the policy operations of the Reserve Bank.</p> <p>In terms of the Banks Act of 1965, monetary banks were obliged to keep 8% of their short-term liabilities in cash at the Reserve Bank. The Act also empowered the Reserve Bank to vary the percentage of liquid assets to be held by all classes of banking institutions, and not only commercial banks.</p> <p>In October 1965, a credit-ceiling was imposed on the so-called "monetary" banks, i.e. those banks with short-term liabilities of 8500 000 or more, which, according to the Banks Act, had to maintain a cash reserve at the Central Bank.</p> <p>Upper limits on deposit rates payable on banks and building societies were imposed and exchange controls were maintained.</p> <p>An increase in the Bank Rate to 5 per cent was announced on March 5, 1965.</p> <p>Commercial bank liquidity ratios in respect of short- and medium-term liabilities were raised to 34 and 24 per cent, respectively. These ratios were subsequently increased, in successive monthly stages of 2 per cent each, to the legal maxima of 40 and 30 per cent, respectively.</p> <p>In November 1965, credit control in terms of the new Banks Act was replaced by the credit-ceiling method. Banks were requested, first on a "voluntary", and later on a mandatory basis (1967), to limit the total of their discounts and advances, and later also their private sector investments, to the level of such credit as at a stipulated date.</p> <p>The Reserve Bank issued a proclamation, in virtue of the powers conferred upon it under the Currency and Exchanges Act of 1933, laying down maximum rates for deposits of varying maturities at banking institutions and building societies, effective from March 22 1965.</p>

Table 1 (cont.). Summary of monetary policy in South Africa (1965-1980)

1966	Minimum and prime overdraft lending rates were set by agreement with the Reserve Bank at 1.5% and 2% above the Bank rate; the fixed exchange rate remained in operation; and the credit ceiling was reduced to 92.5%. The Bank rate was increased to 6%, from 5%.
1967	Proclamation R184 of 1967 conferred powers upon the Reserve Bank to call for supplementary cash-reserve requirements. "Voluntary" control over credit extended by the banks was made mandatory in terms of a special proclamation issued under the Currency and Exchanges Act of 1933.
1968	A directive was issued (in March) requiring monetary institutions to invest 32% of any increase in their short-term liabilities; 12% was to be maintained with the Reserve Bank, and 20% with the NFC. The Bank rate was increased to 6.5%.
1969	Easing of the directive of March 1968 as part of efforts to relieve upward pressure on interest rates. Deposit rate control was withdrawn in July 1969, as part of a new multi-faceted attack on inflationary pressures, which also included the raising of the Bank rate. Liquid asset requirements increased. December – the Reserve Bank obtained an agreement from the commercial banks to limit their interest rate on 12 months' deposits to 7 per cent per annum. This arrangement was subsequently rescinded in August 1970.
1970	Government decides to subsidize certain interest rates and the maximum interest rate on deposits of 1969 were abolished. August –The Reserve Bank placed the so-called "non-monetary" banks under the credit and investment ceilings. By the end of 1970 then, all registered banking institutions, except discount houses, were subject to: (a) Ceilings on certain loans made by them, and on certain kinds of investments in the private sector; (b) Supplementary cash reserve requirements (over and above the statutory requirement of 8 per cent of their short-term liabilities to the general public) based on the increase in their short-term liabilities, after March, 1968; and (c) Additional liquid asset requirements against their short-term liabilities. Significantly, none of these control measures was provided for in the present Banks' Act.
1971	The rand devalued by 12.28%
1972	Financial Institutions Amendment Act introduced Amendments to the Banks Act empowered the Reserve Bank to increase the minimum cash reserve of 8% against short-term deposit liabilities, and to impose a cash reserve against medium-term bank liabilities. The Bank Rate decreased to 6%.
1973	Open market operations were introduced in September. The Bank rate decreased to 5.5% in March. In September, the use of the bank rate as a reference point for setting the rate of accommodation for discount houses was terminated.
1974	June – a managed-independent float of the rand was introduced
1975	February – abolishment of fixed pattern of interest rates for transactions in government securities. July – Agreement between Reserve Bank and clearing banks that the banks' prime rate would in future be the lowest overdraft rate charged to their best customers, and that it would maintain a fixed relationship with the Bank Rate (between 2-3% difference). The rand was devalued by 4,76 per cent on 27 June 1975, and 17,9 per cent on 22 September 1975.
1976	Rondalia and the Rand banks were forced into curatorship.
1977	Due to the small-bank crisis, the five largest banks then (Barclays, Standard, Nedbank, Volkskas and Trust) with the Reserve Bank opened a special Fund through the NFC called the 'lifeboat' to support banks being weakened by a run on their deposits. The fund dissolved by September.
1978	Rediscounting of bankers acceptances was introduced.
1979	August 1979 – Credit ceilings applicable to banking institutions' discounts and advances, and to their investments were raised by 4%. LADOFCA Amendments – important amendments were made to the Limitation and Disclosure of Finance Charges Act, 1968 (Ladofca). Henceforth, all money lending, credit and leasing transactions involving amounts in excess of R100 000 were exempted from the provisions of the Act; and finance charge rates prescribed in terms of the Act would be market-related.
1980	Beginning of free enterprise and market-oriented economic policies by moving towards deregulation and privatization. Deposit rate controls being abolished August 1980 – Credit Ceilings abolished

Source: Banda (2007), Franzsen (1983), Boreham (1971), De Kock Commission Report (1985), Gidlow (1995 a, b), SARB

**1.2. Summary of financial sector reforms in South Africa (1981-1993).** The period from 1981 to 1993 marked the beginning of financial liberalization. However, South Africa was still under colonial control and apartheid was still prevalent. The financial sector was still facing all the challenges associated with operating in a 'closed' economy.

The advent of financial liberalization was only realized after the de Kock Commission reports of 1978

and 1985, which recommended the opening up of the financial sector and also a more market-oriented monetary policy. Abolishment of repressive policies and procedures, starting with interest and credit controls, began in 1980. Financial sector reforms were mainly focused on making the domestic market more open to mostly local banks. A number of reforms that pointed to extended financial sector freedom were put in place. The summary of such reforms is given in Table 2 below.

Table 2. Pre-financial liberalisation reforms in South Africa (1981-1983)

1981	Abolishment of credit and interest rate ceilings, reduction in cash reserve and liquid asset requirements, Termination of the Registrar of Corporation in 1983, which led to increased entry into the financial intermediation sector. Increase in intra-financial institution competition
1982	A number of new banks entered the market. The rand was allowed to fall against the dollar by 36%. Prime rate limits were abolished; but all banks had to inform the Reserve Bank of any intended prime rate changes.
1983	The rand was allowed to float. Termination of the Registrar of Corporation in 1983, which led to increased entry into the financial intermediation sector.
1984	Reserve Bank Act amended and the Reserve Bank was authorized to pay interest on reserve balances. The Public Debt Commissioners (PDC) was renamed the Public Investment Commissioners. CPD (Corporation for Public Deposits) established as the NFC was dissolved. The CPD'S main purpose was to rationalize investments in short-term surplus funds belonging to the public sector, and to enable monetary authorities to control investment of these funds more efficiently. The 2% of medium-term liabilities held by the NFC was abolished.
1985	The Financial Institutions Amendment Act of 1985 was introduced – banks were permitted to include their holdings of bank notes, coins and gold coins in vaults, tills and automated teller machines in their holdings of cash reserves for meeting the cash-reserve requirements The power of the Reserve Bank to impose supplementary liquid asset requirements was revoked. The Bank rate was reintroduced. The country experienced a foreign debt crisis when a consortium of foreign banks led by Chase Manhattan withdrew credit facilities.
1986	Reduction of the cash-reserve requirement against banks' short-term liabilities to the public, from 8% to 5%. The Building Society Act was phased out.
1987	The responsibility for banking supervision was transferred from the Department of Finance to the Reserve Bank.
1988	Cash and liquid asset requirements were made the same for banks and building societies under amendments to banking and building society legislation enacted in 1988.
1989	A Financial Services Board was established. Bond markets (informal and formal) combined into the Bond Market Association. Bank mergers of Nedbank and the South African Permanent Building Society into NedPerm Bank.
1990	The deposit-taking institutions Act was passed. The Deposit Taking Institution Act of 1990 was issued.
1991	Building societies, commercial banks, discount houses, general banks and merchant banks were grouped together to form banking institutions. Bank merger of Untied, Volkskas and Allied to ABSA There were 51 banks
1992	Usury Act, 1992 passed ABSA took over Bankorp
1993	The reserve requirement lowered from 1.5% to 1.0% The Mutual Banks Act, 1993 (Act No. 124 of 1993) was passed. There were now 40 banks – due to realignments and mergers.

Source: Banda (2007), Franzsen (1983), Boreham (1971), Gidlow (1995a, b), SARB (1994-2014).

**1.3. Summary of financial sector reforms in South Africa (1994-2012).** In 1994, South Africa attained independence and with it came increased investor confidence both domestically and internationally. Financial sector reforms had to take cognizant of this increased attention and notable reforms led to financial liberalization in the economy. Even-

tually, with the passage of time, financial liberalization had a major impact on the debt-to-income ratio, as more once-excluded households (because of apartheid) were exposed to the growing credit-provision market (due to increased bank competition). A summary of financial sector reforms during this period is given in Table 3 below.

Table 3. Summary of financial sector reforms in South Africa (1994-2012)

1994	The SARB became an active contributor and effector of the Basel Bank Supervision standards, and a signatory to the Core Principles for Effective Banking Supervision of 1997. The financial sector became open to the world. The number of foreign banks authorized to establish offices rose from 31 to 46 by 2004.
1996	Tight requirements were established for foreign institutions that aimed to enter the banking sector, i.e. the Government Gazette, No. 17115 of 1996
1998	A third system of monetary accommodation was introduced from March 1998, with the repurchase (repo) interest rate being market-determined in daily tenders of liquidity through <i>repurchase transactions</i> . Twelve banking institutions were appointed as primary government bond dealers – six branches of foreign banks and six local banks existed. Islamic Bank Limited liquidation order given. The rand depreciated considerably (about 28% in nominal terms against the US dollar from April to August 1998), prompting a monetary policy response that resulted in short-term rates soaring 700 basis points.
1999	FBC Fidelity Bank Limited was put under curatorship.
2000	An Inflation-targeting framework was introduced. Government Gazette No. 21936 of 28 December 2000 issued.

Table 3 (cont.). Summary of financial sector reforms in South Africa (1994-2012)

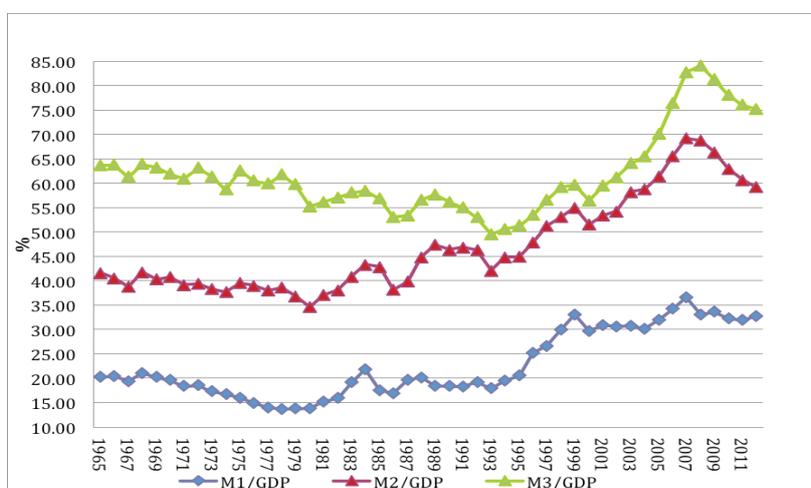
2001	The rand depreciated by 21% in nominal terms against the US dollar between September and December 2001.
2002	Inflation-targeting strategy introduced, in an endeavour to bring consumer prices under control.
2004	Regal Treasury Private Bank Limited liquidation order given
2007	Rennies Bank Limited changes name to Bidvest Bank Limited
2008	The Banks Act was last amended on 1 January 2008, mainly to comply with the requirements and principles of the Basel II framework
2009	2 Bank Registrations cancelled - Commerzbank Aktiengesellschaft and Meeg Bank Limited
2010	The South African Postbank Limited Act, 2010 (Act No. 9 of 2010) (the Postbank Act) issued to separate the Postbank from the South African Post Office to an entity registered in terms of the new Companies Act ABN AMRO Bank NV changes name to The Royal Bank of Scotland NV and Teba Bank Limited to UBank Limited. During the year, ABN AMRO Bank NV, Johannesburg Branch, was acquired by The Royal Bank of Scotland NV and its name was changed to The Royal Bank of Scotland NV South Africa Branch. Imperial Bank Limited's registration is cancelled
2011	The Royal Bank of Scotland NV registration cancelled
2012	South African Postbank Limited Act, 2010 (Act No. 9 of 2010) (Postbank Act) was passed by Parliament and the President assented to it on 1 December 2010, and it was published in Government Gazette No. 33835 on 3 December 2010, so as to cater for discrepancies between the Postbank Act and the Banks Act. November – Banks Amendment Bill published – so as to “amend the Banks Act, 1990, in order to define certain expressions, and to amend certain definitions; to bring certain provisions in line with their practical application; to update references to legislation and institutions; to extend the use of the name bank to representative offices; to provide that a contravention of the Financial Intelligence Centre Act, 2001, is a cause for suspension or cancellation of registration as a bank; to align the Banks Act, 1990, with the Companies Act, 2008; and to comply further with the requirements of the Basel Committee of Banking Supervision; and to provide for matters connected therewith”. Effective January 2013 Credit Agricole Corporate and Investment Bank – South Africa Branch registration cancelled.

Source: Hanival & Maia (2008), Bamber, Llewellyn & Store (2001), Falkena, Davel, Hawkins, Llewellyn, Luus, Masilela, Parr, Pienaar & Shaw (2004), Banda (2007), Aron & Muellbauer (2007), SARB (1994-2014).

## 2. Trends in financial sector development in South Africa

For the purpose of this study a number of specific financial development indicators are employed in this section so as to measure financial depth and look at the performance of the financial sector in South Africa. The measures of financial depth and performance employed in this study are the M1, M2, M3 to GDP ratios, credit and deposit to GDP ratios, the M1 to Deposits ratio, real interest rate and interest margin, and the savings to GDP ratio. These are all employed so as to briefly check if the Mckinnon-Shaw assertion of the removal of financial repressive policies led to increased financial development and savings.

**2.1. M1, M2 and M3.** Financial deepening is usually measured by relating monetary and financial aggregates, such as M1, M2 and M3 to the gross domestic product (Nzotta & Okereke, 2009). Generally, an increase in any of these ratios indicates that financial assets are growing. M3 represents the sum of currency and deposits in the central bank, plus transferable deposits and electronic currency (M1), plus time and savings deposits, foreign currency transferable deposits, certificates of deposit, and securities repurchase agreements (M2), plus travellers checks, foreign-currency time deposits, commercial paper, and shares of mutual funds or market funds held by residents.



Source: IMF – IFS statistics compact disc, October 2013.

Fig.1. Ratio of M1, M2 and M3 to GDP

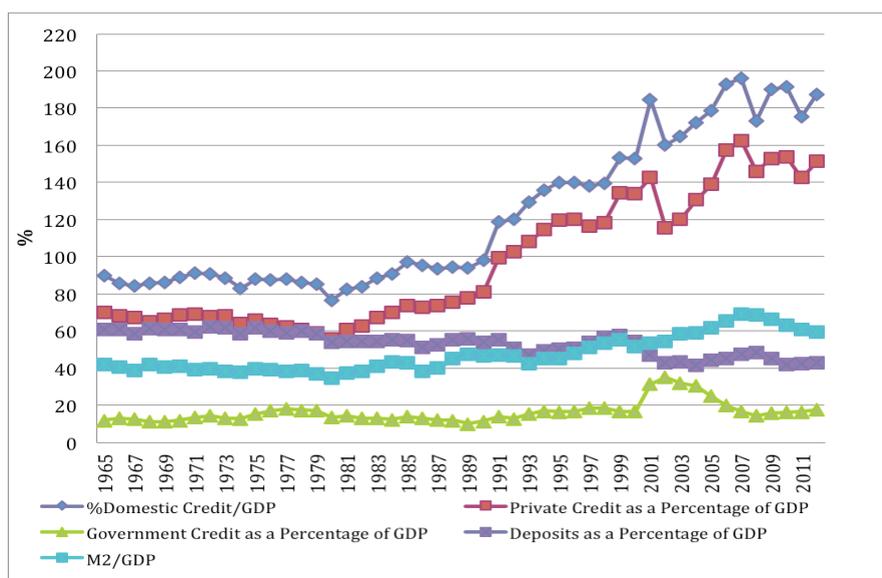
Figure 1 shows that the level of financial development in South Africa has been generally improving since the advent of the 1980s. All the ratios increased sharply during the period after 1994. The M1/GDP ratio increased from 19.61% in 1994 to 33% in 1999, to an all-time high of 37% in 2007, culminating in an average of above 30%.

The increased M1/GDP ratio, a measure of the degree of monetisation of the economy, shows that there was an increased confidence in the financial sector for payments; and the ratio was increasing with the increase in economic transactions. The M2/GDP ratio measures the size and depth of the financial sector and its development, and the ratio increased from below 40% levels before 1983 to above 50% levels after 1994.

The M2/GDP trend is closely mirrored by the M3/GDP trend, although at a slightly higher percentage level. However, the spread between the M3/GDP and the M2/GDP ratios has decreased in the post-independence years, compared to the pre-independence years, that is, from 25% in 1965 to an

average of 10% after 1994. The decrease was due to, firstly, the financial sector being opened up to international players; and the increase in investor confidence after independence had a positive effect on deposits. Secondly, there was relatively a trend of positive real interest rates (as compared to the pre-independence period). The spike in the year-on-year inflation rate in 2008 to 12% from 7% in 2007 and negative real interest rates seems to have had a negative effect on M1/GDP, M2/GDP and M3/GDP ratios.

**2.2. Credit, deposits and broad money.** Figure 2 shows that the level of financial development in South Africa has been improving since the early 1990s. However, not all financial indicators increased sharply during the period of 1990-2012. Only domestic credit and private credit increased sharply from below 100% levels to more than 120% levels. The government credit over GDP ratio increased from 11% in 1965 to 17% in 2012. However, the share of total deposits, as a percentage of GDP, decreased from 60% in 1965 to 43% in 2012.



Source: IMF – IFS Statistics compact disc, October 2013

**Fig. 2. Trends on credit, deposits and broad money**

**2.3. Domestic credit to the private sector.** The ratio of domestic credit to GDP is an indicator of financial depth and development. The ratio of domestic credit to GDP and the ratio of private credit to GDP appear to closely mirror each other implying that private credit forms a greater part of all domestic credit. From 1965 to 2012, the ratio of private credit to total domestic credit remained above 68%. It appears that government competes with the private sector in the debt market. The share of private credit in domestic credit took a slump in the periods of 1974 to 1982 (below 75% levels – lowest was 69% in 1979) and in 2001-2003. Inherently, during

these periods, the government credit share of domestic debt was relatively at its peak.

The period of 1965 to 1979 saw the private credit/domestic credit ratio gradually decreasing from 77.7% to 69.2%. In the same period, the government credit/domestic debt ratio increased from 12.8% to 19.9%. The same behavior can be deciphered for all the periods after that – leading to the conclusion that the government and the private sector appear to be competing for domestic credit.

From the above-illustrated trends, it is imperative to state that the main upshot of regime change and

financial liberalization (after 1994) has been the more-easily obtained credit; while under the apartheid system, rural and urban black households, the bulk of the population, had highly constrained access to formal saving-and-credit opportunities. (Aron & Muellbauer, 2000b). Instead of income-based deposits being used as a source for credit creation, debt-based deposits seem to be financing the extension of private-sector credit.

On the other hand, deposits in South Africa have decreased from 60% in 1965 to 43% in 2012. Deposits act as a proxy for the supply of loanable funds available to the banks for lending purposes (Dutta and Roy, 2009). A look at the deposits-to-domestic credit ratio shows an increase in the efficiency of financial intermediaries in credit-creation; and it shows evidence of financial development in the South African economy, especially in the period starting from 1990. Presumably, due to credit ceilings and tight monetary controls, efficiency in the financial sector appears to have been hampered, as the ratio of deposits to total domestic debt remained generally constant at around 1.5 in the period of 1965-1989.

After 1989, with increased bank competition, mergers and acquisitions, the change in the political environment and the advent of financial-liberalization, the deposit-to-credit ratio increased to more than 3.5 by 2001 and remained above 3.5 in the period of 2001-2012.

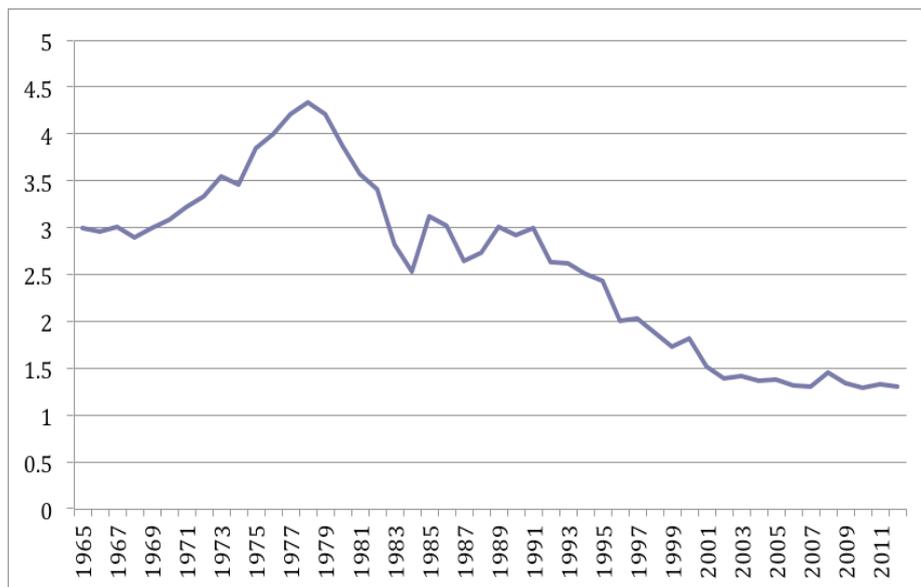
The notion of increased financial development in South Africa is supported by the ratio of M1 to deposits (see Figure 3). M1 is used here as a proxy for

the use of notes and coins, and also for short-term deposits. The ratio of M1 to deposits shows, to a particular extent, the ratio of all deposits that are short-term; and as this ratio decreases, it shows that more deposits are long-term deposits.

The contrary is also true, as the ratio of M1 to deposits increases over time that shows an increased preference for short-term deposits by economic agents. In other words, financial systems are valued mostly in the economy as better facilitators of exchange than mobilisers of savings, and allocators and channels of resources to resource-deficient economic agents. A look at the South African M1-to-deposits ratio shows that it has progressively decreased in the later years (1994 onwards), compared to the 1960s and the 1970s.

The high levels of the M1-to-deposits ratio before 1994 may be attributed to the financial repressive policies that existed then, the increasing inflation rate, and the political environment, which did not offer much security for savings. Nevertheless, after 1994 with the coming of the new government, decreasing inflation rates and progressive financial-sector liberalization, the share of short-term or sight deposits in total deposits continued to decrease. By 2012, it was 1.3, compared to 2.5 in 1994, and 3 in 1965.

In other words, by 2012, 57% of all deposits were sight deposits, as compared to 71% in 1994, and 75% in 1965. The decreased share of sight deposits is evidence of increased financial development and confidence in the money market.

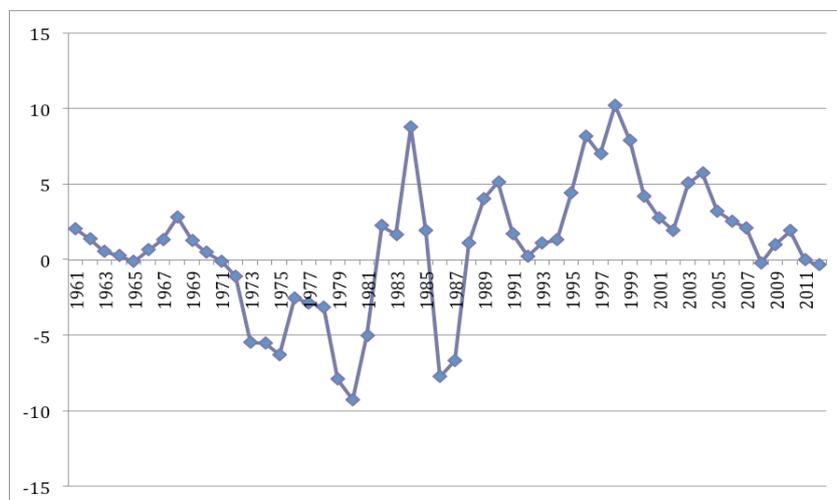


Source: IMF – IFS Statistics Compact Disc, October 2013.

Fig. 3. Ratio of M1-to-deposits

### 3. Trends of other financial sector indicators

**3.1. Real interest rate on short-term deposits.** Before the 1990s, the real interest rates – with the exception of 1984 – were generally below 3%.



Source: IMF – IFS statistics compact disc, October 2013.

**Fig. 4. Real interest rate on short-term deposits**

From 1981 to 1992, real interest rates were volatile: with many ups and downs, with no clear trend – as the trend changed every two years. However, after 1992, real interest rates tended to increase up until 1998, where they hit a plateau of 10%, and from then on started on a stepped decrease that ended at below 0% levels in 2012.

During the 1970s and the 1980s, South Africa was using a fixed-interest policy, as interest rates were heavily relied upon in the performance of monetary policy (Akinboade and Makina, 2006). The control of interest rates, a characteristic of financial repression, had a negative effect on the real interest rate in the period before 1994. Inflation was increasing; while interest rates were not reacting to market play; hence the below 3% levels (and a period of negative real interest).

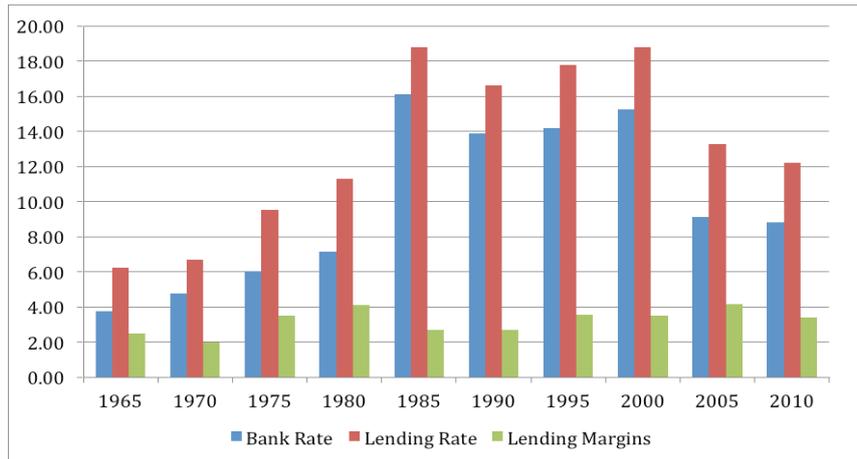
The trend after 1994 of increased real interest rates is best explained by the change in the political environment, increased financial liberalization, openness to international and local financial sector investment, low inflation rates, increased deposits, and increased private sector credit. However, real interest rates have relatively gone down after the year 2000 and much more after the 2008 financial crisis.

**3.2. Interest rate margins.** A look at the bank rate (central bank policy rate) and the lending rate

brings about an understanding of the accounting for transaction costs by the financial sector, and the interest rate policy of the nation as a whole. The anticipated expectation is for the lending rate to always be above the bank rate, because the former usually covers for the costs of borrowing money from the Central Bank (the bank rate), the cost of borrowing money from other banks or financial institutions, and the costs of all lending transactions in any financial institution.

As expected, trends on the bank rate and the lending rate show a situation, where both variables moved in unison throughout. However, there were years in which they were not different from each other, for example, during the decade from 1980. Also, from 1980, the bank rate was volatile and increasing, and eventually started to decrease from 1998 onwards. Abolishment of credit and interest rate ceilings, reduction in cash reserves and liquid asset requirements accounted in part for the trend after 1980.

Figure 5 gives the notion that some semi-formal link existed between the Reserve Bank's discount rate (Bank rate) and the prime rates of clearing banks for lending on overdraft, which ensured that changes in Bank rate would be passed on to the borrowing clients of banks, as this had been traditionally observed by the South African commercial banks.



Source: IMF – IFS statistics compact disc, October 2013.

Fig. 5. Lending margins

On average, despite the abolishment of credit and interest ceilings, it appears the lending margins were always between 2% and 4%. This was planned rather than circumstantial, because the monetary authorities had a hand in the determination of lending margins, especially before 1980. Examples of such repressive intrusions include the maintenance of the margins between the clearing banks’ ‘minimum’ and prime overdraft lending rates, and the bank rate at 1% and 2%, respectively, until 1966, and then setting them at 2% and 2.5% from 1967 to 1975.

**3.3. Savings.** Trends in savings show higher savings rates before 1990 that were higher than 20%, compared to the period after 1990. Relatively, as also confirmed by Odhiambo (2009), the savings rate in South Africa has dwindled significantly since the 1980s. In 1980, savings comprised 34% of GDP; and have gently declined, until in 2012, they were a mere 13% of GDP. The decrease in savings may be attributed to a rapid rise in credit-financed consumer spending, and a weakened corporate savings rate since 1995 (Aron & Muellbauer, 2000b).



Source: World Bank, WDI, 2014.

Fig. 6. Gross savings as a percentage of GDP

Returning to the personal sector, it is clear that despite the direct and indirect effects of positive real interest rates in the 1990s, net household saving has fallen to very low levels. The cause of these low savings might be attributed to the open hand that has been extended to all financial institutions through financial liberalization. The financial system instead of encouraging saving, due to

increased competition that came about through financial liberalization, ended up encouraging borrowing by households. On the monetary policy side, the high interest rates that can be used as a necessary tool to restrain and control consumer credit, could also have led to restrained investment and economic growth (Aron & Muellbauer, 2000b).

During 2006, government recorded its first contribution to overall saving since 1981, when it recorded a surplus on the fiscal account for the first time. The largest and most consistent saver in the economy remains the corporate sector – with its savings following the movements of the economy closely, with higher savings when the economy is performing well, and declining when the economy slows down (Aron & Muellbauer, 2000a).

The South African Reserve Bank has continuously made cautionary statements aimed at deterring consumers from borrowing excessively for consumption purposes, credit extension by banks to the household sector has been extremely high, perhaps irresponsibly so (Hanival and Maia, 2008).

## Conclusion

Monetary policy, financial reforms and financial sector development in South Africa during the period of 1965 to 2012 have been discussed and a number of financial indicators employed. Inclinations show increased financial development, mainly explained by increased personal credit, relatively decreasing share of sight deposits and increased financial depth. Financial liberalization, as advocated for by the McKinnon-Shaw hypothesis, managed to increase interbank competition though it did not lead to a

higher savings rate despite the relatively high interest rates after financial liberalization.

Nonetheless, the ever-increasing personal credit has to be checked, if the economy's savings rate thresholds are to be realized. The current stance followed by monetary authorities of only encouraging consumers to avoid financing consumption with debt, has to be complemented by particular methods or instruments that appeal to the providers of such credit facilities. For example, the SARB could appeal to the moral responsibility of all financial institutions in tackling the personal credit problem. However, in coming up with corrective measures, precautions must be taken to avoid steering the economy back towards financial sector repression. Furthermore, the effect of the stock exchange on savings and maybe on bank-based financial development need to be assessed to fully appreciate the impact of market-based financial development on the South African economy. The mixture of banks and markets changes, as the economy develops; then policy and institutional impediments to the evolution of the financial system could lead to significant costs for economic development; and therefore, negatively affect economic development (Cull, Demirgüç-Kunt & Lin, 2013).

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