THE FRANZSEN COMMISSION ON MONETARY POLICY

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THIS discussion of Fiscal and Monetary Policy in South Africa, the third Report of the Commission of Enquiry into Fiscal and Monetary Policy in South Africa, will focus mainly on the Commission's analyses of and recommendations for stabilization policy in South Africa. It will more particularly be concerned with the Commission's views on monetary policy.

The Commission clearly identifies the major problem that has undermined monetary policy and especially the control of the money supply in South Africa. This is the persistent tendency for public sector spending to rise in excess of the sector's ability to finance this expenditure in a non-inflationary way. In addition there has been the related problem of successfully offsetting the inflationary impact of inflows of foreign capital.

The Commission explains that the demands the central government makes on the financial system is reflected in the budget deficit. If the Revenue and loan amounts are amalgamated as the Commission recommends they should be as a regular practice in future budget statements[2] 'the difference between the total revenue and expenditure in any given year would be reflected in a net amount i.e. the budget deficit as surplus'. (161). The Commission states that the budget deficit was some R35m in the 1938/39 tax year, R46m in 1946/47 and 'grew considerably larger in the fifties and sixties' to R154m in 1960/61 and R461m in 1969/70

[1] R.P. 87/1970 Hereafter referred to as 'the Commission'. Numbers unless otherwise specified refer to the paragraphs of the Commission's report.

[2] See paras. 167-178.

priorities. This is a very different procedure from that of more or less independently determining the desirability of certain projects and only then attempting to find the funds to finance the expenditure. If not through sufficient taxation or genuine borrowing then, if necessary, by recourse to money creation. [5]

The Commission found the traditional budgetary system inadequate for the purposes of forward planning and the co-ordination and control of public expenditure.[6]

> 'Apart from the need for co-ordinating the three separate budgets of the Ministers of Finance, Transport and Posts and Telegraphs more closely, there is in practice a need for more continuous and centralised co-ordination between the various budget programmes in the present structure. The extra-budget-vote expenditures and the expenditure incurred by statutory boards are largely independent of budget-vote expenditure, and this, on the whole, does not promote financial control and co-ordination.' (95).

The Commission proposes that a Cabinet Committee under the chairmanship of the Minister of Finance and consisting of a limited number of ministers be formed to undertake the tasks of planning and control. The Committee would be served by the Department of Finance acting as a secretariat.

> 'All public expenditures, loan and other financial matters on which decisions are desired from the Cabinet Committee or from the Cabinet should be co-ordinated by the secretariat. Matters, including legislation, that have financial implications should therefore not be submitted direct to the full Cabinet but first to the Cabinet Committee. In this way the financial policy of the government will be co-ordinated more effectively and with greater continuity.'(132).

The Commission furthermore points out that the necessity for control is one of considerable urgency in the light of the revealed capital programmes of the public sector.[7]

> '. . . The Commission has heard of several capital programmes that may exert further upward pressure on the growth rate of public expenditure over the next few years unless the Treasury determines clear priorities in its forward planning of the budget.' (136).

[5] Genuine borrowing can be taken as that borrowing that does not require an increase in the cash base of the system.

[6] See para. 91.

[7] See page 35, note 12.

ary finance and/or to making government securities more naturally attractive to the financial market. In particular through the offer of higher interest rates. Since at least 1949 the monetary authorities in South Africa have in the main attempted to resist the tendencies of the financial market to lead the interest rate structure in the upward direction.[8]

In my opinion the Commission has failed to consider the full implications of the captive market. Requiring financial institutions of all kinds to hold a larger volume of government securities than they would prefer to do will tend to reduce the riskiness of their overall portfolios. While compulsory investments of all kinds reduce risks they also reduce the profitability of financial institutions and so probably their willingness to compete actively for borrowers and lenders. This must tend to reduce the flexibility and responsiveness of the financial system. There is clearly a 'trade-off' between a more secure financial system and a less flexible and competitive one.

The economy requires of financial institutions as it does of all producers of goods and services that they be prepared to take risks in response to their views of change and changing circumstances.

It should not be the task of the monetary authorities to attempt to protect lenders from their own folly other than to seek effective disclosure of a financial institution's activities and profitability. What should remain a vitally important task for the authorities is the prevention of the cumulative liquidity crises that have been so characteristic of financial developments in many countries. Liquidity crises result in the insolvency and liquidation of normally solvent financial institutions and their depositors. In a financial crisis illiquidity leads to more illiquidity and like so many falling dominoes the insolvency of one bank may lead to further rounds of insolvency and illiquidity with most unfortunate repercussions for income and employment. The central bank can prevent this by making cash available freely when only cash will do by exercising its classic function as lender of last resort and freely discounting a wide range of eligible financial securities. It may also be possible to prevent panic by small depositors and investors by way of a deposit insurance scheme on the lines of the scheme operated in the United States.

Nor is it by any means the moral responsibility of financial intermediaries, including insurance companies and pension funds, to lend to the public sector, as the Commission seems to believe they should,[9] if

[8] See Brian Kantor. The Evolution of Monetary Policy in South Africa, *South African Journal of Economics*, March 1971, especially pp. 63-68.

[9] See p. 57 note 6 where the Commission quote from Budget speeches of the Minister of Finance.

captive markets should be abandoned overnight what may become truly market rates would obviate the necessity for any captive market. Institutions and individuals would then hold government stock voluntarily on the basis of alternative risks, costs and yields. Furthermore, if interest rates were market rates the Reserve Bank would not, other than in exceptional circumstances, be required to act as a residual buyer. Indeed for the Reserve Bank to act in this way is to provide just the sort of inflationary finance the Commission is concerned with avoiding. When the Reserve Bank has acted as the residual buyer it has been to prevent interest rates rising to levels to which remnants of the free market would have taken them. The Reserve Bank exchanges its own liabilities which are the cash base of the system for the excess supply of securities on the market. Such debt management is and has proved to be inconsistent with control of the money supply.

Portfolio switching in the absence of a residual buyer implies that some institutions are selling while others are buying. Any tendency towards an excess supply of securities on the market, by pushing interest rates up and the prices of securities down, tends to make selling less attractive and buying more so. Higher interest rates may also encourage economic units to economise on their cash balances — a step which would increase the velocity of circulation of money. This is a point to which we will return below.[10]

The Commission is troubled by the prospect of high or higher interest rates that a free operation of market fences may bring. This despite the proposals the Commission makes for directly compensating householders and firms for the effects of higher rates. If there are politically influential groups of borrowers whom it is thought desirable not to offend with higher interest rates, direct subsidies that could be made available to these groups may be an alternative to attempting to keep down the entire interest rate structure. The availability of such subsidies should serve to reduce the concern the authorities may feel for high interest rates and so encourage stricter control of the money supply. The Commission's general attitude towards greater deposit and interest rate freedom is at best highly qualified.

> 'In view of such factors as the large number of financial enterprises in the Republic, the keen competition between deposit-receiving institutions as well as between these and non-deposit-receiving institutions, for the same savings total, the existing differences in the legislation governing the operations of banks,

[10] See below pp. 269/270.

The Commission goes so far as to recommend that no new banking institutions be allowed to register because of the likely effect of additional banking competition on deposit rates.

> 'On the matter of competition for deposits, the Commission is of the opinion that for the foreseeable future the Registrar of Financial Institutions ought only in exceptional circumstances to approve new registrations of banking institutions. Further recommendations in this regard are made in Chapter VIII and include an increase in the prescribed initial capital upon establishment and a restriction on the percentage of the shares in a banking institution that may be held by any one person. The Commission believes that a proliferation of banking institutions is not in the best interests of either financial stability or growth because a continual increase in the number would impose undue pressure on deposit rates.' (675).

Economic growth is concomitant with increased specialisation. For example by producers and factors of production, by savers and investors and by financial institutions themselves. Financial development is the process by which, as the economy's stock of savings and wealth grows with economic development, financial institutions become more specialised to cater for the more specialised requirements of lenders and borrowers. Financial institutions act as intermediaries between the ultimate savers and investors of the economy. If additional financial specialisation is to succeed the innovating institution must either increase the real return from lending and/or reduce the real cost of borrowing. It must offer lenders a superior real rate of return to that previously available to encourage them to switch portfolios and it must offer to reduce costs to the ultimate borrowers otherwise they would not seek facilities. By so doing the influence must tend to promote economic growth through increased saving and investment. It could not be doubted that the great variety of financial services provided today in South Africa by comparison with twenty or even ten years ago has reduced the real cost of borrowing: that is, it has widened the range of purposes and borrowers for whom funds will be made available. Innovation in lending and borrowing like innovation everywhere in the economy needs to be encouraged to stimulate increased productivity and economic growth. Any attempts to reduce the competitive pressure in the banking sector, that may tend to ossify the banking structure, could be serious for the prospects of high rates of economic growth in South Africa.

As alternatives to calls on the local capital market and therefore the possibility of higher interest rates the Commission recommends that the public sector make use of (1) more self-financing by public authorities,

> 'Because the tax concession applicable to South African Treasury bonds has not succeeded in arousing the interest of the general public, the Commission recommends that consideration should be given to the possibility of redeeming future bond issues at a premium and to enhancing the attractiveness of the interest rate paid. The Commission is of the opinion that the tax exemption in respect of interest receipts on present issues of Treasury bonds should be replaced by the concession recommended in paragraph 88 of the Commission's Second Report, viz. the exemption from normal taxation of interest receipts on certain defined investments up to a given maximum.' (223).

The effect of these concessions must tend to distort and complicate the tax structure as well as the financial markets. Any justification for this must turn on regarding lending to the public sector as somehow more sociably desirable than other forms of lending. As was implied earlier this is not acceptable. The public sector should compete fairly for resources and the taxpayer should be faced with the full cost of such expenditure.

It would appear that the Commission is inclined to view interest rates as essentially a 'monetary' phenomena. It considers that the monetary authority is able to control the level of interest rates in the economy and should consider such control as one of the important objectives of stabilisation policy. It has been argued above that such control of interest rates may prove inconsistent with control of the money supply. If interest rates are tending to rise and the monetary authorities sought to prevent such an increase they would then have to expand the money supply in order to take up surplus securities. On the other hand when interest rates would otherwise fall, perhaps because of a relative unwillingness to borrow, and the authorities sought to prevent such a fall they would have to sell additional securities in exchange for money. The money supply would accordingly contract while interest rates would remain stable. Nevertheless, even such control of interest rates at the expense of control of the money supply may only prove to be possible in the short run.

The Keynesian view of the determination of interest rates is similarly monetary. In this analysis reductions in the supply of money, assuming the demand for money to remain as it were, will have the effect of increasing the rate of interest. Similarly increases in the money supply will cause interest rates to fall, except in the case of the so-called liquidity trap where the demand for money is perfectly interest rate elastic. That is when interest rates are considered low and unlikely to fall any further additional money balances are held as such and not thought to be worth while exchanging for interest earning securities.

or reductions in the money supply would reduce increased market interest rates temporarily below/above their natural level. The consequent increase/decrease in the price level would by increasing or reducing the demand for loanable funds restore market rates to their natural level.

In the pure theory if changes in money balances were exactly proportional to initial money balances, i.e. the money supply were increased or reduced without effect on the distribution of wealth or income, then changes in the money supply would have no long-term effects on the rate of interest or relative prices in general. The absolute price level would change in the same direction as changes in the supply of money.

It would be comparatively easy to build into the analysis of interest rates the influence on borrowers and lenders of their expectations of the future level of prices. The payment or receipt of interest is naturally made in money. The real value of these money payments depends on the purchasing power of money. Increases in the price level reduce the real value of interest receipts and also reduce the real cost of interest payments. Both lenders and borrowers will therefore make allowances for expected price increases in deciding on the rates of interest they would be prepared to accept or pay. Interest rates established in the capital and money markets would still clear these markets. In other words in free markets interest rates will adjust to eliminate any excess demand or supply of funds. However, all other influences remaining the same, including the expected real profitability of investment and the real propensity to save, nominal interest rates will be higher in an economy that anticipates inflation than the same economy where inflation is not expected. Real interest rates would be the difference between the nominal rates of interest and the increase in the general level of prices over the period for which the funds were loaned and borrowed.

If in turn the supply of money were increased at a faster rate than would be required to maintain the expected rate of inflation, money and interest rates would also appear temporarily below their natural level. Again, spending would be encouraged and the market rates through the effects of faster price increases would tend to return to their natural level.

While the Commission is well aware of the effect of anticipated inflation on interest rates its general view of interest rate determination could be described as Keynesian, especially to the extent that the Commission associates tight money with high interest rates. In my opinion what could be called the Classical Theory as it has been outlined above is more revealing of interest rate determination in South Africa

alternative measures by which the portfolio of government securities held by the Reserve Bank could be enlarged.[15]

Use of Open Market operations or the stabilisation account is required should the authorities in South Africa wish to control the domestic money supply independently of the balance of payments. Open market sales are required when the balance of payments surplus is increasing the money supply too rapidly and open market purchases if the unfavourable balance of payments would otherwise cause a deflationary decrease in the money supply. Such open market policy, to successfully achieve its objectives for the money supply, would have to be exercised without concern for its effects on the interest rate structure.

Commercial Banks and their control

The Commission justifies the use of credit ceilings as a necessary and temporary measure in exceptional circumstances:

> 'From its investigations the Commission is quite convinced that the use of credit ceilings as a monetary policy measure in South Africa and elsewhere should be attributed to the fact that in the exceptional monetary circumstances experienced during recent years the traditional indirect measures have not been effective enough. The inflationary financing of large expenditures by the Government or an exceptionally large inflow of capital from abroad not only creates large quantities of liquidity in the form of money and quasi-money in the possession of the private non-bank sector, but also supplies the banking system with considerable excess liquidity. Under these circumstances a restrictive policy based on liquidity or cash requirements for banking institutions might be ineffective. It then becomes necessary to employ as a temporary measure direct control over the credit granted by banks until such time as the liquidity of the banking system becomes more normal.' (592).

The Commission explains that the credit ceiling applied in South Africa to banks with short-term liabilities of R500 000 or more until 1965 and later in 1970 to all banks has not been a very rigorously applied measure.[16] Nevertheless one may wonder after what period such control measures cease to be regarded as temporary by the banks affected and begin to have important effects on their lending and borrowing policies. The credit ceiling must tend to restrain their search for additional

[15] See para. 682.

[16] See para. 593.

native to variable 'cash ratio' requirements. The Banks Act required that a fixed 8 per cent of the bank's short-term liabilities be kept in cash. The banks have since, in terms of another statute, been subject to supplementary cash reserve and additional liquid assets requirements.[19] The Commission has confirmed that the liquid asset ratios have not been an effective control measure. The authorities have not enjoyed control of the supply of liquid assets as they have been defined.

As we have seen the Commission has not seen fit to recommend that the use of liquid asset ratios as measures to control the supply of deposits be abandoned. Instead the Commission proposes to re-define those liquid assets eligible for the liquid asset ratios more narrowly in the attempt to bring them under the control of the authorities.

> 'Although the definition of liquid assets should be left to the Technical Committee, the Commission is of the opinion that, for purposes of an effective monetary policy, the above definition of liquid assets is too broad. It should not be possible for banks to comply with higher liquid asset requirements by extending their credit granting to the private sector — in fact this is something that increases in the liquid asset requirements should try to prevent . . .' (615).

Nevertheless the sale of liquid assets is one of the means by which credit is extended to the public sector. Spending financed by the issue of liquid assets is as expansionary as any kind of private or public sector spending. Therefore holding liquid assets, however narrowly defined, is not equivalent to the requirement to hold cash when those cash deposits are sterilised by the central bank. At best the liquid asset requirement can set an unrealistic upper limit to the deposit multiplier. And then only if the authorities control the supply of liquid assets and the banking sector is not able to increase its share of the total stock available by bidding up their prices in order to satisfy the liquid asset requirement.

If the cash-using habits of the economy are stable, control over the supply of cash can be sufficient for controlling the supply of bank deposits. Liquid assets requirements are superfluous for control purposes. Cash is always the most liquid asset. Liquid assets are equivalent to cash only when the central bank is prepared to freely exchange cash for liquid assets to prevent their prices from falling and short-term interest rates from rising. In these circumstances liquid assets are naturally as good as cash and the volume of cash has become a passive element that responds to the demands of the banks and the private sector. In other

[19] See paras. 586-587.

> desire to spend money on goods and services at the ruling prices is larger than the community's ability and willingness to supply those goods and services at the prevailing remuneration of factors of production. The phenomena of inflation can assume many forms. A situation of continuously excessive demand for goods and services is called demand-pull inflation. Wage-push inflation occurs when employees strengthen their bargaining position so much that wage costs rise without a corresponding increase in productivity. Another form of inflation is imported inflation, i.e. when the increase in the domestic price and wage level and the expansion of the money supply during a particular period is caused mainly by foreign developments. Should the authorities shut their eyes to harmful methods of finance that rapidly increase the money supply, monetary inflation occurs' (5)[21]

The Commission's interpretation of money as an accommodating rather than a causal factor in inflation is perhaps understandable since recent monetary policy in South Africa has not succeeded in preventing the money supply from expanding to provide such accommodation. The Commission also recognises as was mentioned earlier that such accommodation needs to be avoided if inflation is to be controlled. To give emphasis to the monetary nature of inflation it may be argued that prices are rising because the nominal money supply is growing at a faster rate than economic units are willing to absorb into their money holdings. The excess supply of money therefore spills over into the commodity and financial markets. If the economy is already in a state of full employment the consequent additional demand must result in rising prices. Interest rates may temporarily fall but will later tend to follow the rising prices upwards.[22]

The Commission gives the following interpretation of why control over the money supply is important — 'money' being defined as ' . . . the total of the domestic, generally acceptable means of exchange of payment, i.e. notes and coins in circulation outside the banking system and the deposits of the general public at the banking system withdrawable on demand by means of cheques'. (note 3 p. 143).

> 'Control over the money supply is necessary because what is required ultimately in all expenditure is disposal over 'money' as a means of exchange or a means of payment. The implementing of expenditure plans by a prospective spender necessarily

[21] See especially paras. 3-28.

[22] See above pp. 14-17.

> quasi-money. This indeed was the point of departure of those who drafted the present Banking Act' (581).

Alternatively increases in 'money' and 'quasi-money' could be analysed as the effects of increases in the velocity of circulation of a more narrowly defined supply of money.

While one would agree with the Commission on the importance of money one would do so for somewhat different reasons. The significant feature of money or rather the money or cash base of the economy, is that it is a monetary quantity that can be directly controlled by the monetary authority. Furthermore such control has long been politically acceptable and is more consistent with the general nature of a market economy than are possible alternative controls. Some of these alternatives are direct controls of certain specified kinds of lending and spending. Two such measures in South Africa are credit ceilings and building controls.[23] Other alternatives could be direct controls on security issues on the Stock Exchange, rationing and so on. As we discussed previously the captive market is also a direct control on lending by financial institutions and intermediaries. One need not have to justify here the usefulness of free and competitive markets as a mechanism for the efficient allocation of scarce resources and loanable funds.

Of prime importance for the stabilising role of changes in the supply of money is that the aggregate demand for money should be stable. By stable it is meant that the demand for money responds predictably to changes in the variables that are known to influence that demand. If the demand for money is not stable then changes in the rate of turnover of money balances (i.e. the velocity of circulation of money) may react unpredictably to changes in the money supply. In which case changes in the supply of money become unreliable as a stabilising measure, and even possibly destabilising.

If the demand for money is stable the activities of all financial intermediaries will become dependent in part on the supply of money. Control of the supply of money would then give the monetary authority leverage everywhere in the financial system. When the cash base of the system is reduced the financial institutions competing for deposits and funds may be able to reduce the demand for money and serve to increase the supply of loanable funds. They will not be able to eliminate such demands. This they could achieve if the owners of commercial bank deposits could be encouraged through the offer of higher interest rates to exchange these deposits for deposits with other financial institutions or

[23] See para. 419.

sort of pattern that the so-called 'monetarists', notably Milton Friedman, believe they have discovered for the United States.[24]

Perhaps this argument will help to explain why I have not been able to agree with the Commission on the necessarily destabilising role of competition for deposits.

Fiscal Policy:

The Commission sees fiscal policy as the major instrument of discretionary stabilisation policy and the major target of such fiscal policy as private consumption expenditure:

> 'It is evident from these statistics (in the components of aggregate demand cited in para. 12) that by far the largest component of gross domestic expenditure, i.e. approximately 62 per cent, consists of private consumption expenditure. The curbing of excessive consumption expenditure so as to bring about stability is one of the most difficult directives for any government to carry out. In this respect the authorities have to rely largely on certain general fiscal measures because in its influence on spending, monetary policy is less effective.' (13).

One would be inclined to view this assertion about the relative strengths of fiscal and monetary policy as over-confident in the light of recent developments in monetary theory and the so-called 'monetarist counter-revolution'.

The Commission would rely on a variety of discretionary fiscal policy instruments[25] including the variations of tax rules between budgets[26]. It particularly approves of the usefulness of variations in indirect taxation for stabilisation purposes:

> 'Adjustments to the rate at which indirect taxes, such as the newly instituted sales duty, are levied provide the government with a means by which the amount of consumer spending can be influenced. In 1969, private consumption expenditure amounted to about R7 200 million or 62 per cent of the gross domestic product. As was argued in the Commission's First Report, if what is spent by the less well-to-do section of the population on essential goods and services were excluded, a potential amount of more than R2 000 million that could serve as a basis for fiscal action would be left. A change of 5 per-

[24] See inter alia Milton Friedman, *The Optimum Quantity of Money.* Macmillan (London).

[25] See paras. 319-358.

[26] See paras. 353-354.

Conclusion:

By way of conclusion one could summarise the major issues raised in this discussion of the Commission's report as follows. There is agreement with and approval of the Commission's proposals for eliminating the public sector's dependence on inflationary finance. Nevertheless the permanent need for the public sector to rely on a captive market for its borrowing was not considered desirable. It is argued that the Commission prefers to maintain such controls because, amongst other reasons, of its fears of otherwise higher interest rates. This concern for the level of interest rates was not shared. First because the existence of a captive market and the consequent necessity of the public sector to pay less than true market interest rates was considered inequitable, and secondly because of a different view of interest rates and their determination. It was argued that sensitivity by the authorities for the level of interest rates could undermine their ability to control the supply of money, the control of the supply of money being considered essential for controlling inflation. The argument was also made that effective control of the cash base and thus the supply of money in the system could obviate the necessity to apply a variety of cash, liquid and other asset ratios. It was considered that liquid asset ratios are superfluous to cash ratio requirements.

It was felt that the Commission's proposals for fiscal policy would need to be corroborated by further statistical evidence, particularly on the predictable relationships between changes in indirect and direct tax rates on savings and work effort and also by evidence of the successful application in South Africa of economic forecasting techniques to stabilisation policy.