Mr. Stals discusses "The many facets of interest rates" Address by Governor of the South African Reserve Bank, Dr. Chris Stals, at a Breakfast Meeting of the Insurance Brokers Council of South Africa, on 2/9/98.

1. Introduction

Nobody will deny it that South Africa has extremely high interest rates at this stage. In the context of South Africa's own historical record and measured against a current rate of inflation of about 6½ per cent, nominal interest rates are extremely high. In the context of the world environment, and particularly within the group of emerging market economies, the level of South African interest rates lies in the upper quartile, but is still beaten by a number of other comparable countries. Six of the 24 emerging markets listed in the weekly publication of the Economist, for example, have higher short-term interest rates than South Africa at this stage.

Nobody will deny it that the high level of interest rates is bad for the South African economy, particularly at the current stage of the business cycle and a rather depressed domestic economic situation. It is only the few savers we still have in the country, and the old-aged people who live off their interest income, who may benefit from these high interest rates. On the other hand, the high interest rates will most probably reduce consumption financed with borrowed funds, and also investment in fixed capital, equipment and inventories. The future production capacity of the economy is therefore constrained by the present adverse financial conditions. In terms of domestic needs, South Africa now requires a stimulation of the economy, and would prefer lower interest rates to encourage economic development.

There is also a fairly general consensus of opinion that the present high interest rates were recently forced on South Africa by the international financial situation. The so-called East Asian crisis that started to surface in Thailand more than a year ago spilled over into the economies of many other countries. Even countries with more stable economies such as Australia, New Zealand and Canada were adversely affected by these developments. Emerging countries far away from the East Asian epicentre such as Mexico, Colombia, Brazil and Venezuela have been infected by the problem. Countries with economies in transformation such as the Czech Republic and Poland also suffered and the recent catastrophic developments in Russia cannot be completely divorced from the East Asian crisis. In the end, South Africa also could not escape from the turmoil.

There are major differences of opinion among economists inside and outside of South Africa on what the reaction of the official macroeconomic policymakers in South Africa should be to soften the blows for the economy. At the one extreme there is the International Monetary Fund that believes that much more restrictive monetary and fiscal policies should have been applied in South Africa in recent months to fend off the attacks of international speculators and short-term profiteers.

At the other extreme we find economists in South Africa with major private sector interests who believe that the Reserve Bank should have kept interest rates artificially low with a complete disregard of the consequences this would have had for the exchange rate of the rand and subsequent inflation. There are those who believe that the Reserve Bank should have done more to keep the exchange rate stable, even if it should have required the reintroduction or tightening of exchange controls.

There are many naive critics in South Africa who believe that the Reserve Bank is fully responsible for the high interest rates and that the Reserve Bank indeed used its mythical powers to force interest rates to these destructively high levels. In their ignorance they believe that the Reserve Bank can even at this stage pull the rabbit from the hat and instantaneously bring interest rates down again. Unfortunately, in the real world such miracles are just not possible.

2. What caused interest rates to go up

To avoid confusion in this debate, the real causes for the recent sharp rise in interest rates should be revisited. It will be recalled that in the first quarter of this year there was wide-spread optimism that interest rates in South Africa could decline further during the course of 1998. The Reserve Bank had already reduced its Bank rate from 17 to 16 per cent in October 1997, and to 15 per cent on 9 March 1998. Inflation was declining, foreign portfolio investments flowed into the country, the foreign reserves were rising and the exchange rate of the rand was under pressure to appreciate.

However, the situation changed dramatically in May 1998 when non-residents reviewed their investment strategy and started to withdraw some of the funds they had previously invested in South African bonds. During the four months January to April 1998, non-resident investors increased their holdings of South African bonds by approximately R16 billion. Over the next four months, that is from May to August 1998, they reduced their holdings of South African bonds by about R19 billion.

This dramatic change of strategy had an almost immediate negative effect on the overall demand and supply conditions in the South African financial markets. The yield on long-term government bonds rose from just below 13 per cent at the beginning of May to a peak of over 21 per cent last week. Other interest rates followed the upward trend and established the extremely high levels we now have for the Reserve Bank's rate for repurchase transactions, the prime overdraft rate, and the mortgage lending rate of banking institutions.

In this process, triggered by a decline of investors confidence in the emerging markets of the world, little concern was shown for the depressed conditions in the South African economy. No consideration was given to the needs, desires or expectations of the people of South Africa. Neither the Minister of Finance nor the Governor of the Reserve Bank was consulted by the markets before interest rates were forced to higher levels. The whole process was driven by external factors that swept across many of the smaller economies of the world like a huge tidal wave. The switch from a R16 billion inflow of capital for investment in South African bonds in the first four months of 1998 to an outflow of an almost similar amount in the next four months dramatically changed the demand versus supply conditions in the South African financial markets. In the situation, it would have required a massive creation of money by the Reserve Bank to prevent interest rates from rising to the extent they did. Such a creation of money in turn would have added fuel to the inflationary pressures that were already stimulated by the depreciation of the rand.

3. What can now be done to bring interest rates down?

It is amazing to read in the financial press in South Africa almost every day the accusation that the high interest rates in South Africa at this stage are a reflection of the Reserve

Bank's deliberate "high-interest-rate-policy". The present level of interest rates is often described as being "artificially" high because of Reserve Bank intervention in the market. These critics overlook the fact that the Reserve Bank indeed raised the amount of accommodation made available to banking institutions at the daily repurchase tender for central bank funds from R4.1 billion early in May to R9.8 billion at this stage. This action by the Reserve Bank obviously prevented interest rates from rising even further and, if anything, created an artificially low level of interest rates in the country. Perhaps with some justification, this policy of the Bank was recently criticised by the International Monetary Fund.

The Reserve Bank also made a huge amount of forward cover available to South African residents with outstanding commitments in foreign currency, and to non-resident investors with open rand positions in South Africa with the objective of discouraging them from sending more funds out of the country. This policy undoubtedly contributed towards maintaining interest rates at a lower level as the IMF quite correctly pointed out. In South Africa, the Bank is widely criticised for having provided this forward cover, but at the same time also blamed for the "high" interest rates.

After four months of heavy pummelling by the markets, South Africa now finds itself in a situation where:

- the exchange rate of the rand has depreciated by about 25 per cent;
- the banking sector has lost a lot of liquidity;
- interest rates have risen to a level where borrowing from the banking sector for the financing of additional economic activity has become almost prohibitive.

There is therefore an understandable pressure on the Reserve Bank to do something that will bring interest rates down immediately and effectively for all borrowers in the South African market. Can the Reserve bank do anything to salvage this situation?

A simplistic view is that the Bank should reduce the rate for its repurchase transactions and therefore provide accommodation to banking institutions at a lower cost. This view overlooks the fact that the repo rate of the Reserve Bank is determined on a daily basis through a tender system, and is no longer fixed by the Bank. Should the Reserve Bank therefore want to reduce the repo rate, it will have to offer more central bank funds ("high-powered" money) to the banking institutions.

In deciding on its policy, the Reserve Bank must, however, take into account:

- the recent large outflows of funds through the Bond Exchange. An expansion of domestic liquidity in this situation could facilitate the outflow of funds;
- existing relationships between interest rate margins, spot exchange rates and forward rates. A disruption of these relationships can easily lead to new speculative transactions against the rand;
- the continuing high rates of growth in bank credit extension and in the money supply; and
- the need to keep inflation in check in the aftermath of a depreciation of the rand of more than 20 per cent since May this year.

In this situation, it will be irresponsible for the Bank to create more money in an effort to force interest rates down. Advantages, if any, to be gained from such a policy will be very short-lived.

A solution in the short-term for the South African dilemma can only come from the original source of the problem, that is, from the international financial markets. Confidence must return to the many international fund managers who have decided in recent months to withdraw substantial amounts of portfolio investments from the bond markets of the smaller economies around the world. These fund withdrawals not only forced interest rates to higher levels, but also created turmoil in the foreign exchange markets. A return of stability to these markets will pave the way for lower interest rates in South Africa, and in many other affected countries of the world. For any individual country such as South Africa to try to break out of these shackles at this stage will be almost impossible, unless impenetrable brick walls will be constructed around the South African economy to isolate it from the rest of the world.

4. Can South Africa survive with these high interest rates?

As already mentioned, the high level of interest rates at this stage is not consistent with the current needs of the South African economy. There is, however, very little we can do to get ourselves out of the dilemma in the very short-term.

The present unsatisfactory situation emphasises the long identified need for South Africans to save a greater percentage of our income or, to put it in more sensible economic language, to consume less. We must remember that, in terms of the macro-economy, consumption financed with borrowed funds counts as negative saving. By borrowing from banks to finance current expenditure, we actually use up tomorrow’s income today.

The situation also emphasises once again that the South African total production machinery must become more competitive. We must make ourselves not only more self-sufficient in the provision of finance for our own economic development, but also in the production of the goods and services we need for domestic consumption and real investment. In other words, we must reduce our dependence on the rest of the world and eliminate our vulnerability for recurrent balance of payments crises.

As long as these high interest rates are forced on us by the international situation over which we have no control, a slow-down in total economic activity will be unavoidable. Sensible adjustment to the realities of the situation will, however, avoid a major recession that is already predicted in some quarters, and feared by many. To delay a spending decision today, does not mean a permanent abolition of a justifiable need, but realistic deference to the economic disciplines and constraints of an adverse global situation, until international conditions improve again.

In the meantime, we should not lose confidence in the resilience of the South African economy, and in its ability to weather the current storm. Looking around the world today, we still have, even in the present adverse climate, many reasons for remaining optimistic about the medium and longer-term prospects for the South African economy. Our banking system remains sound, our financial markets operate with great efficiency, and a huge pent-up demand for goods and services needs but little encouragement to re-stimulate the economy.