Mr. Stals discusses the importance of credit extension for macroeconomic financial stability Address by the Governor of the South African Reserve Bank, Dr. Chris Stals, at a Breakfast Meeting of the Institute of Credit Management in Johannesburg on 29/10/98.

1. A "credit" economy

Modern economies are often described as "credit-based" economies. This is a true reflection of the functioning of modern, sophisticated economies in which money plays the important part as a means of exchange, as an instrument of payments and as a store of value.

The availability and the use of credit facilitates the exchange of goods and services, the production processes and the growing importance in all modern economies of financial services. One can hardly visualize a modern economy that works without credit.

The normal characteristic of credit is that one participant in the economy, be it an individual, a corporate body or a governmental institution, denies himself the immediate use of purchasing power already in his possession, and makes this purchasing power on a temporary basis available to another participant in the economy who has an immediate need for the use of the purchasing power. This kind of transfer of purchasing power from savers (the lenders) to users (borrowers) will never create macroeconomic distortions in the economy. On the contrary, as already mentioned, it supports maximum economic growth and development in the country.

This basic form of credit extension encouraged the development over many years of financial savings institutions, financial intermediaries, institutional investors, fund managers, etc. that serve as useful conduits for transferring purchasing power from savers to users, either for consumption or for real or financial investment purposes. The financial authorities in all countries have a responsibility to oversee these financial institutions, mainly with the intention of protecting the general public, be they lenders or borrowers, against exploitation that may lead to an unreasonably low remuneration for savers, exorbitantly high costs for borrowers and/or financial losses for both.

Together with the development of these specialised financial intermediaries financial markets emerged where the transfer of savings from lenders to borrowers can take place in a more competitive environment with greater transparency and more general participation. These markets, such as the stock exchanges, bond markets, markets for derivatives and short-term money markets play a very important part in the optimum allocation of scarce resources in modern economies. Financial authorities also have a vested interest in overseeing these financial markets to ensure orderly conditions, the effective and efficient transfer of funds from borrowers to lenders and the maintenance of orderly and stable conditions in the markets.

A further development in this process of the transfer of purchasing power from savers to users of funds, took place with the development of cross-border or international transfers of purchasing power. Savers in the more mature economies of the world where the demand for purchasing power is relatively low, found it increasingly attractive to make loans to the less-developed economies where they could earn much higher interest rates. These cross-border movement of funds introduced a new dimension in the credit extension process, in the form of exchange rates for foreign currency transfers. The financial authorities of individual countries now obtained more than just an overseeing function in the credit extension process. Rightly or wrongly, governments were in the past seen to be responsible for the fixing of the exchange rate, and for ensuring that convertibility of national currencies into other currencies will at all times be possible.

There is one further form of credit extension that has become of vital importance for macroeconomic financial management, and that is the extension of bank credit that simultaneously also creates money. Banks are not normal financial intermediaries that accept funds from savers and then make loans out of these funds to borrowers. Banks can create money to make loans, and in the process can increase the total purchasing power in the economy.

In summary, therefore, the presence of credit facilities, financed out of normal savings, is an essential and necessary element of all modern economies. The financial authorities should have no more than an overseeing function in the management, organisation and internal administration of the whole process of credit extension. As far as both financial intermediaries and financial markets are concerned, the authorities should restrict their intervention to the creation of a protective and transparent legal and accounting framework within which institutions and markets can function effectively.

However, the financial authorities have more than just an overseeing function when it comes to international credit extension activities, and to the creation of money by banking institutions.

2. Bank credit extension

Excessive bank credit extension lay behind many of the global financial problems of recent times. In a number of the East Asian countries, controls on banking institutions were rather lax and enabled them to increase their total credit to governments and private sector borrowers by substantial amounts over a protracted period of time. In the process, interest rates were kept artificially low and banks on an increasing scale relied on foreign borrowings to supplement their liquidity base for the continuing expansion of total credit.

In the end, when foreign investors became reluctant to continue to provide the liquidity base for the credit extension by the banks, the financial systems crumbled. In summary, the final collapse was forced by:

- A withdrawal of foreign deposits from banks and of foreign portfolio investments from the capital markets of the affected countries.
- Foreign credit previously extended to the East Asian countries was therefore withdrawn.
- A reduction in the amount of liquidity available within banking institutions as they lost foreign deposits and had to fund the withdrawal of other investments from the capital markets.
- Forced reductions in the amount of credit banking institutions could make available to their clients, many of whom were overborrowed and could not meet the demand for the repayment of loans.
- An unavoidable depreciation of exchange rates and sharp rises in interest rates which forced losses on borrowers of foreign and domestic funds. Overborrowed institutions were forced into liquidation, and in the process transferred their losses to their lenders.

The consequences of this credit crunch are now well-known. In many of the East Asian countries, negative real economic growth rates are now experienced as painful consolidations and reforms of banking and financial structures are taking place.

The East Asian financial crisis, which quickly spread to other emerging markets, to the smaller more stable developed economies of the world and recently also to major financial centres such as New York provided a stark reminder of how important sound credit management is for the protection of macroeconomic financial stability in individual countries, and in the world at large.

No country can procure permanent and sustainable economic growth at a high level if this growth is dependent on the creation of an increasing amount of credit, extended by banking institutions. Not only lenders (banking institutions) and borrowers (private sector institutions and individuals) can be destroyed in the process, but also total financial systems and even total economies can break down under the burden of too much credit.

Central banks have the unenviable task of judging at all times what amount of additional bank credit will in prevailing circumstances be reconcilable with the objective of maintaining overall financial stability. Economies normally provide early warning signals of excessive credit extension, such as rising inflation or unaffordable increases in imports, or the withdrawal of foreign funds from the country. It is important not to ignore such signals.

3. Other lessons from the global financial crisis

The recent turmoil in world financial markets provided important lessons, not only for central bankers, but also for credit managers in private sector financial institutions. The following three lessons must have come to the notice of many a private sector financial institution:

(i) Risk management models based on past experience or on rigid computer programmes do not necessarily provide adequate protection against potential losses in the new environment of financial globalisation. Experience and discretion cannot be replaced by models and machines.

(ii) The value of collateral against credit extension can disappear overnight (vide the Russian example).

(iii) Excessive leveraging must be avoided at all times, and particularly in the present environment of volatile global changes (vide the example of the Long-Term Capital Management Fund).

Governments, central banks, market managers, private sector institutions and private individuals all have learned once again from this experience that the excessive use of credit sooner or later leads to disaster. At this juncture, the world economy is paying a high price in the form of depressed growth for being reminded of these basic truths.

4. Credit extension and the South African economy

Although the South African economy was also severely affected by the current world financial crisis, a sound banking system, well-managed financial institutions and effective financial markets protected the country against the almost total collapse of the economy, as happened in a few other countries.

The Reserve Bank has some concern, nevertheless, for the increasing use of bank credit to maintain expenditure levels. The recent financial crisis forced exorbitantly high interest rates on the South African economy and borrowers of funds could not avoid sharp rises in the cost of servicing existing debts. The world financial crisis therefore hopefully also served as a grim warning to all South African borrowers and lenders that excessive debt positions should be avoided. Neither the Reserve Bank nor the Government can guarantee low interest rates or overall financial protection in the new environment of a worldwide integration of financial markets.

It will also be foolish for South Africa now to try to revive the domestic economy by creating an excessive amount of additional credit extended by banking institutions in a fragile global financial environment. Such a policy could easily lead South Africa also on the path of overall economic disaster, as more than one country in the rest of the world experienced over the past year.

5. Conclusion

I believe that members of this Institute of Credit Management are aware of the potent danger of excessive debt positions, be it for countries, governments or private sector borrowers. The discipline of controlling this dangerous element of modern, sophisticated market economies, is not a responsibility only of the central bank. It is not only a problem of macroeconomic policy, but also one for institutions operating at the micro-level. We can all make a contribution towards protecting our country from falling in the debt trap of excessive borrowing by applying sound principles in the management of our debt positions.