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SARB Monetary Policy and South African Financialization

Introduction

The monetarist-based central bank reforms that have spread to many of the world's developed and emerging economies since the early 1990s have become some of the most entrenched elements of neoliberal policy, and yet are rarely the topic of serious academic analysis. Particularly deserving of attention are the connections between the entrenchment of restrictive monetary regimes and the global spread of financialization, the growth in economic and political dominance of the financial sector and rentier interests. These trends are particularly interesting in the case of South Africa, an emerging market with a progressive-minded government that seemingly adopted neoliberal central bank policies enthusiastically and of its own accord.

This paper uses the experience of South Africa as a case study in which to explore the spread of neoliberal monetary policies and their impact on the financialization of a developing economy. The first section of the paper discusses the adoption of neoliberal policies for the South African Reserve Bank. The second half then turns to consider how the reformed central bank has permitted and encouraged the expansion of a parasitic financial sector in the South African economy. I argue that the SARB reforms were initiated as a result of direct and indirect pressure on the government by the domestic financial sector and international agents, most notably the international financial institutions. The lowered inflation rate and high real interest rate provided by the reformed SARB has, in turn, supported the expansion of the financial sector and its speculative investments in the pursuit of short-term gains.

This paper begins with a general introduction to the concept of financialization before discussing the defining traits of the neoliberal central bank and the recent transformation of the SARB, including an analysis of the roles of actors outside of government. The paper then turns to look at how the SARB has promoted the interests of rentiers by fuelling the expansion of the financial sector, to the detriment of the real economy. A brief mention is also made of how central bank policy has allowed financial interests to pursue dangerous speculative behaviour. The conclusion draws on suggestions for an employment-centred monetary policy to illustrate what an alternative regime might include.

The Neoliberal Central Bank

The package of neoliberal recommendations concerning monetary policy has been applied gradually in most countries. It is most commonly understood to be composed of central bank independence, a sustained focus on creating an environment of low and stable inflation (possibly through the formal adoption of inflation targeting), and the use of only indirect methods of monetary policy (such as short-term interest rates as opposed to more interventionist measures) (Epstein, 2006 p.1). Some authors also include the commitment to floating exchange rates under this approach (e.g. Filho, 2005 p.1). As with other neoliberal austerity measures, this set of policies has been recommended by the advocates of neoliberalism as a universally-applicable approach. As Epstein notes, this current orthodoxy is historically unique, in that the earlier central banks of today's developed economies were closely tied to the government and were actively involved in the economy by "financing governments, managing exchange rates, and supporting economic sectors by using 'direct methods' of intervention," among other interventionist activities (Epstein, 2006 p.1).

The international movement to this monetarist ideal began gradually in the late 1970s as the Keynesian era drew to a close (Filho, 2005 p.8). While the introduction of flexible exchange rates and a reduced role for government in guiding monetary policy

were central to the immediate stabilization measures pushed by the IMF following financial crises, central bank independence and formal inflation targeting were only prescribed where there was already a more "mature phase of neoliberalism" in which inflation had already been reduced (Filho, 2005 p.12).

Inflation targeting was pioneered by New Zealand in 1990 and has since been adopted by twenty-three countries, including a few transition and middle-income economies such as South Africa, Chile, and Brazil (Epstein, 2002 p.3). Where it is a formal policy, inflation targeting involves establishing a commitment to an acceptable range of inflation rates that provide price stability. These institutional commitments to restrictive monetary policies and high real interest rates have had the most dramatic effects for the interclass income redistribution discussed here.

These reforms have been quite successful at reducing inflation. As Harvey writes, "the reduction and control of inflation is the only systematic success neoliberalization can claim" (Harvey, 2005 p.156). It is noteworthy here that although many central banks, including the SARB, track asset prices, no inflation targeting program has included the targeting of asset price inflation, which is important to rentiers (Epstein & Yeldan, 2008).

Before continuing to look at how the neoliberal central bank in South Africa has been recreated to promote the interests of rentiers over those of capital and labour, it is critical to first separate the present discussion from that which is carried out between orthodox economists and Keynesians. Briefly stated, the *prior savings* understanding of monetary policy employed by neoliberals states that savings lead to investment, which increases output. They recommend high real interest rates to encourage greater saving to begin this process. Structuralists and Keynesians disagree with this analysis, and claim that savings are a function of income and that high interest rates actually discourage investment (Edwards, 1998 p.59). Wilkins' econometric study of South Africa concludes that there was little evidence that savings were determined by interest rates, and instead suggests that the Keynesian model better explains levels of savings and investment (Wilkins, 1993).

The structuralists and Keynesians argue that a commitment to tight monetary policies involves the sacrifice of a valuable policy tool, and limits the ability of the central bank to respond to exogenous shocks (Maxfield, 1997 pp.7-9). Other criticisms of inflation-focused central bank policies note that, in addition to preventing the use of monetary policy to pursue full employment, the bank is unable to support industrial policy or allocate credit to sectors where the social need is highest, such as housing. The use of only a limited set of indirect policy tools, such as short-term interest rates, also prevents the strategic use of direct strategic credit allocation through subsidized interest rates, credit ceilings, and capital controls (Epstein 2006 pp.11-13). Even the World Bank has admitted that the direct targeting of credit at low interest rates played a role in the successful development of the East Asian economies, particularly in Japan, Taiwan, and South Korea (World Bank, 1993 pp.235-239).

There has been no shortage of empirical studies examining the effects of monetary policy in South Africa and elsewhere on these terms. While the present study certainly belongs among the Keynesian approaches in its assumptions, it is primarily concerned with how high tight monetary policies have fed South Africa's financialization and what indirect structural effects that this has had on the country's real economy. The high real interest rates that are required to maintain price stability in South Africa have slowed short-run real economic growth, as is expected. Because they have benefited the financial sector, however, and a redistribution of resources to the owners of financial assets has begun.

Introducing Financialization

As defined by Epstein, financialization "refers to the increasing importance of financial markets, financial motives, financial institutions, and financial elites in the operations of the economy and its governing institutions, both at the national and international levels"

(Epstein, 2002 p.2). Financial markets and the financial services sector play very important economic roles in any economy by efficiently allocating resources between firms and individuals and across various time preferences. They reduce production and transaction costs and collect and distribute market information.

What is troubling about recent financialization is that oversized financial sectors have started to slow real investment and economic growth, focus on short-term speculative gains, and contribute to the development of inequalities by excluding large sections of the population from access to the income it creates.

Harvey notes that financialization in the neoliberal era has been "marked by its speculative and predatory style" and a dramatic increase in the total daily turnover of financial transactions in international markets, from $2.3 billion in 1983 to $130 billion in 2001 (Harvey, 2005 p.161). He also argues that the expansion and rise in the influence of finance and financial services has created sharp inequalities through largely speculative gains and the creation of "fictitious wealth" (Harvey, 2005 p.157). In many economies around the world, financial services have claimed increasing shares of private debts and larger proportions of GDP (Palley, 2008 p.7). Interestingly, this growth in the financial sector has not included a large increase in its share of total employment (Palley, 2008 p.9).

Financialization is also dangerous because it is an unsustainable growth model. According to Bernanke and Gertler's financial accelerator theory, asset prices increase until firms become reluctant to continue debt-financed investment, initiating an economic downturn that leads to a fall in asset prices and a credit crunch (Bernanke & Gertler, 1996). This would suggest that financialization will ultimately lead to longer, more volatile business cycles that become increasing unstable. There is little empirical evidence that growth through the expansion of the financial sector, particularly when based in stock markets, leads to faster economic growth or more development in transition economies with underdeveloped industrial sectors (Zhu et al. 2002). Labourers and capitalists do earn rentier income through their own financial assets as well. As groups, their roles are less influential and their gains are smaller, however, as is illustrated at various points below.

Of course, central bank policy is far from the only factor behind the international rise in importance of financial interests. In addition to the move to more restrictive monetary policies and inflation targeting, Epstein and Jayadev claim that financialization in the OECD countries has been fed by financial sector liberalization; the increased emphasis on fiscal austerity, to the extent that they also reduce inflationary pressures; and the redistribution of political and economic power away from labour (and in some cases, industry) to the rentier class, which has been both an effect and further cause of continued financialization (Epstein & Jayadev, 2004 p.9-10). Although these factors have been very relevant in South Africa and other cases, the activities of the central bank have had important, distinct, and ongoing effects in support of finance.

While the focus here is on monetary policy, the liberalization of South Africa's capital account since March 1995 has meant that interest rate fluctuations are now tied to exchange rate policies. This is a result of the "open-economy trilemma," which illustrates that it is only possible for policymakers to select two of open capital markets, fixed exchange rates, and control over domestic interest rates (Obstfeld & Taylor, 1998).

The Transformation of the SARB

In their history of South African monetary policy, Aron and Muelbauer identify three general periods of policy pursued since the 1960s. The first shift was away from a liquid asset ratio-based system with quantitative controls on interest rates and credit and towards a toward a cash reserves-based system, which began full operation by mid-1985 and included pre-announced money targets by 1986. The third period, which began in 1990, brought in a number of additional targets for the newly independent central bank to track (including the exchange rate, output gap, balance of payments,

wage settlements, credit growth, and the fiscal stance) and has also seen the adoption of formal inflation targeting (Aron & Muelbauer, 2007).

As should be expected as part of the transition to a lower rate of inflation through these central bank reforms, nominal interest rates fell slightly and real interest rates rose as the SARB tightened the money supply. Nominal rates fell from an average of 17.1 percent during de Kock's governorship (1981-1989) to an average of 14.2 percent in the first five years of Mboweni's tenure as governor (1999-2004). Over the same period, real interest rates increased from 3.3 percent to 7.7 percent, and reached a high of 11.5 percent during the second half of Stals' governorship that overlapped with the beginning of the post-apartheid period (1994-1999) (Aron & Muellbauer, 2007 p.707). Within this larger period, real rates declined until the sudden depreciation of the rand in late 2001 forced nominal rates up, with real rates increasing again after the currency shock subsided (Gleb, 2003 p.48). Both nominal and real interest rates generally became less volatile since the 1980s, and inflation, as measured by both CPI and CPD, has steadily declined (Aron & Muellbauer, 2007 p.707).

What explains the shift to increasingly restrictive monetary policies internationally and in South Africa? Mainstream neoclassical economists support the adoption of monetary reforms, and inflation targeting in particular, by claiming that it will reduce inflation without affecting real variables in the long run, that it will increase the credibility of the central bank (and thus reduce the sacrifice ratio in inflation reduction), and that macroeconomic growth and stability will be improved (Epstein, 2002 pp.3-4).The questionable growth record of these policies in practice has led political economists to provide a number of alternative explanations for their adoption based on competing interests.

Political explanations suggest that governments limit their control over central bank policy in order to avoid blame for economic downturns (Semler, 1994), to resolve and prevent disputes over policy (Bernhard, 2002), or that these reforms are brought in by conservative governments attempting to limit the influence of expected leftist successors (Boylan, 1998). Other explanations focus on the role of groups and forces outside of government, and suggest that hegemonic ideas may develop a "taken-for-granted quality" (Marcussen, 2000), or that governments are open to the influence of domestic (Goodman, 1991) and international financial interests (Bowles & White, 1994) that push for an independent central bank directed by monetarist guidelines.

In the case of South Africa, it would appear that the adoption of monetarist regulations for central bank operations was part of a larger shift to neoliberal ideals under the ANC government influenced by domestic financial interests and the international investors, institutions, and governments that promoted neoliberal ideas from outside of the country. This confluence of local and global pressures has closely approximated what Epstein and Gintis term the "International Credit Regime" (Epstein & Gintis, 1992). This regime includes domestic rentier interests that have directly advocated inflation targeting and central bank independence to limit the influence of labour over central bank policy and the additional pressures from larger international forces, as the elimination or reduction of capital controls and financial liberalization have increased opportunities for capital flight. Peet refers to the soft-power influences of the international and domestic components of this system as examples of hegemony and subhegemony, respectively (Peet, 2002).

Generally, neoliberal central banks arose in this context after governments became convinced that they were necessary to maintain access to foreign credit. Maxfield argues that holders of financial assets push for these institutional reforms and will be more willing to invest in countries with independent central banks not only because they help create a more stable and predictable investment climate, but also because "investors may believe that their ability to influence policy is greater the more independent the central bank is from the executive branch" (Maxfield, 1997 p.6).

In the early 1990s, the African National Congress based its economic policies on a firm commitment to growth through redistribution (see MERG, 1993). By 1996 and the publishing of the *Growth, Employment, and Redistribution* (GEAR) report, the ANC had stated its intention to follow a largely neoliberal development approach (Peet, 2002 p.74). In the time between, financial interests and their allies had convinced the new democratic leaders to abandon the use of monetary policy as a macroeconomic tool.

Business groups, such as the South African Foundation (now known as Business Leadership South Africa), whose members are predominantly providers financial services and international corporations based outside of South Africa, had called for fiscal and monetary austerity by the democratic government (SAF 1996). Specifically regarding monetary policy, Salam, an insurance conglomerate, laid out a "Platform for Investment" in 1990 that warned against the dangers of "macroeconomic populism" and called for restraint in central bank policy (Peet, 2002 p.72). Following these calls by South African rentiers, the GEAR report would explicitly commit the government to a "consistent monetary policy to prevent a resurgence of inflation," a nominal "exchange rate policy to keep the real effective rate stable at a competitive level," and "a further step in the gradual relaxation of exchange controls" (Department of Finance, South Africa, 1996).

From an early point, the ANC leadership was exposed to the dangers of even discussing radical reforms and threatening the freedom of financial markets. Following his release from prison in 1990, Nelson Mandela said, "the nationalization of the mines, banks, and monopolies is the policy of the ANC and a change or modification of our views in this regard is inconceivable." Within hours of hearing this, traders at the Johannesburg Stock Exchange launched a selling spree (Marais, 1998 p.146). Mandela would officially abandon the idea of nationalization while attending the World Economic Forum in February 1992 (Peet, 2002 p.71).

Compared to the experiences of other developing economies during the neoliberal era, the international financial institutions provided smaller assistance packages to South Africa, and did not have the same conditionality leverages as they did over other economies. Similarly, although increased flows of aid accompanied the economic reforms, the government never depended on them and donors were unable to attach conditionalities (Handley, 2005 pp.222-223). The IFIs instead influenced South African economic policy through a "trust-building process" that convinced policymakers of the benefits of committing themselves to pursuing neoliberal austerity measures. The World Bank was also involved in developing the GEAR report which has guided the country's macroeconomic policy through most of the democratic period. (Peet, 2002 p.73).

The SARB's Promotion of Financial Interests

This second component of this study, which considers the consequences of SARB policy, is based on an interpretation of the ideas of Gerald Epstein, who has argued that the primary effect of the adoption of restrictive monetary regimes such as inflation targeting has been "to reduce inflation and increase the share of income going to rentiers in many parts of the world" (Epstein, 2002 p.5). The idea that price stability predominantly affects financial interests is not new however, and was at the root of the criticisms that Keynes made about the neoclassical concern with inflation in *The General Theory*. Keynes argued that reniters, or "functionless investors" are the strongest advocates for, and primary beneficiaries of, inflation-fighting policies. His definition of rentier is that of one who generates income through their ownership of financial assets, rather than through ownership of real assets such as productive capital or real estate. Rentier income can therefore be thought of as the income received by owners of financial firms such as banks, stock brokers, insurance companies and the return to individual holders of financial assets (Kalecki, 1990 p.202).

Generally, the financial sector benefits from neoliberal monetary policies because they offer high real interest rates, and because inflation erodes the value of financial assets. The restrictive monetary policies that have become entrenched elements of SARB policy through the series of institutional reforms that were outlined above have promoted the redistribution of resources and investment to the domestic and international financial interests that operate in South Africa and away from the real economy. Working from the predatory and speculative traits that Harvey associates with the expansion of the economic and political power of the financial class in the neoliberal era, two points of further interest emerge. It is first considered how financial markets have expanded at the expense of the real economy. Second, it is also discussed how the SARB's maintenance of high real interest rates has encouraged a focus on short-term gains and speculative investments.

The Growth of the Financial Sector

The South African financial services sector has grown over the past decade to become significantly larger than those found elsewhere in southern Africa. It contributes 22.6 percent of the country's GDP, while Namibia, which is home to the next largest financial industry in the region, owes only 14.4 percent of its GDP to the sector. The South African financial markets are also very significant for an economy of its size; the total market capitalization of the Johannesburg Stock Exchange, which totalled US$267.7 billion in 2003, ranked South African markets 19th in the world in size, and 4th as a percentage of GDP, at 161.84 percent. South Africa's present credit regime is seen as being one of the most liberal in the world, and has led to consumption fuelled through easy access to debt (Muellbauer, 2005 p.19).

More important have been the involvement of external investors in the economy. South Africa has not seen the large inflows of foreign direct investment that were expected to follow its democratization, but has become a major destination for portfolio inflows. A comparison between South Africa and 16 other emerging economies with similar credit ratings between 1994 and 2004 reveals that FDI flows (as a percentage of GDP) were less than half of the group average, but portfolio investments were about three times as large (IMF, 2004). South Africa received 22 percent of the net total portfolio equity flows to developing countries between 1995 and 2005 (World Bank, 2003). Obviously, these financial investments do relatively little to boost real output in the economy, when compared to greenfield investments in productive capital.

It would appear that greenfield investment in South Africa has become quite expensive, or that it at least provides less lucrative returns in comparison to those available in financial activities. An increasing share of FDI inflows are confined to mergers and acquisitions of existing productive capacity, which, although it may facilitate some technology transfers and productivity improvements, does not expand the economy's capital stock (Nordas, 2001).

Overall inequality increased in South Africa as financialization has accellerated; the Gini coefficient increased from 0.608 to 0.669 between 1995 and 2000, and poverty worsened over the same period (Simkins, 2004 p.9). There are three general ways in which an overactive financial sector excludes poorer groups and encourages the development of increased inequalities. First, the poor in South Africa and elsewhere are less likely to hold financial assets and will see smaller gains from the expansion of financial markets (Klasen, 2004 p.81). Second, as noted above, the financial sector provides few employment opportunities as it grows, and even fewer suitable for unskilled workers (BER, 2004 p.16). Finally, the mobility of financial capital and global perspective of investors will accentuate international inequalities (Armijo & Echeverri-Gent, 2005 p.36). Other indirect causes of increased inequalities exist, such as those that result from financial crises.

It is important to note at this point the distinction between rentier and industrial capitalist interests in South Africa, as industry has not benefited from the economy's

financialization to the degree that it has elsewhere. Epstein's study of financialization in the developed economies notes that a recent development has been the merging of financial and industrial interests in the United States and some European economies, as non-financial firms have increasingly been driven by rentier motives. Most notably, this has included the increased share of industrial wealth generated through portfolio capital gains, rather than through traditional profit-making (Esptein, 2002 p.18).

Epstein's model suggests that at low output levels, industry is less concerned about inflation than financial interests are, since parallel increases in output and price level will increase profits, but will erode the value of most assets. Industrial capitalists would therefore set a lower optimal interest rate than would rentiers. This arrangement changes with increased employment and the financialization of the activities of non-financial firms, as both tighter labour markets and the concern over asset appreciation make capitalists more worried about inflation. Conflict over monetary between these two groups also declines near this point of convergence (Epstein, 2002).

As Kalecki would argue, this merging of industrial and financial class interests is largely confined to growing economies operating near or past capacity (Kalecki, 1990 p.355); persistent excess capacity (largely due to the high unemployment that has persisted since the apartheid era) has prevented this merging of interests in South Africa. Econometric estimates placed capacity utilization in the manufacturing sector around 80 percent in the 1990s (Weeks, 1999 p.805). Broadly defined as those wanting formal work, but unable to acquire full-time positions, the involuntary unemployment rate in South Africa was at 38.8 percent in 2005, and at 26.7 percent when defined as those actively seeking work (Kingdon, 2005). Roughly 11 percent of those listed as unemployed work in low-productivity positions in the informal sector (Edwards, 1998 p.49).

Further evidence against this merging of class interests in South Africa comes from the complaints made by industry, both export- and domestic-oriented, against the actions of the central bank, even though most elements have accepted flexible exchange rates and capital account liberalization (Gleb, 2004 p.397). Complaints about high interest rates have come from various industrial leaders, including the construction industry (Cockayne, 2007), South Africa's large auto sector (Mutikani, 2003), and commercial agriculture and food processing (Nicanor, Roberts, & Walker, 2006 p.43). It is unclear if industry's exclusion from financialization in South Africa will slow the progression of financial dominance or only prevent the broader distribution of its gains.

Speculative Investment Behaviour

High short-term real interest rates can also encourage large inflows of speculative investment for as long as the country maintains the confidence of investors that assets will continue to increase in value and that the exchange rate will at least remain stable (Edwards, 1998 p.63). High and increasing interest rates, as well as years of international isolation, meant that South African assets were relatively undervalued in the mid-1990s, which made them more attractive to outside investors (Mohamed, 2003 p.10). The developed financial markets discussed in the previous section have also been important in initiating investor interest. These flows are not supportive of sustained economic growth and are highly volatile, as was demonstrated in 2001, when the rand dropped more than 35 percent against the US dollar after investors lost confidence in the country and quickly withdrew their funds (Mohamed, 2003 p.19). In an earlier period, high interest rates may have also encouraged the speculative investments that preceded the 1985 financial crisis (Edwards, 1998 p.63).

The most commonly cited proximate explanations for the run on the rand, which began in mid-February 2001, were rumours about President Mandela's health and a Union Bank of Switzerland report that it was overvalued (Carmody, 2002 p.258). Turning to look at deeper factors, it appears that the Union Bank was correct, and that a speculative bubble in the South Africa market had resulted from the large inflows of

speculative portfolio investments that were encouraged by tight monetary policy. Net portfolio investment inflows increased from relatively modest levels in the early 1990s to approximately $8.5 billion by 1999, though these sharply turned negative at the beginning of the crisis and remained so for some time afterwards (Mohamed, 2003 p.10).

Although the 2001 exchange rate collapse was relatively mild in a global perspective, it left its mark on the South African economy and caused a temporary, but serious, decline in growth (Aron & Muelbauer, 2007 p.727). The situation was only made worse after the SARB raised interest rates by 4 percent in 2002 in order to slow the inflation that accompanied the devaluation. The rentier class was best able to minimize its losses after the initial period, and much of the burden of these problems was borne by those with lower incomes, for whom fewer alternatives were available (Mohamed, 2006 p.4).

Beyond risking financial crises, short-term capital inflows may also be damaging insofar as they help to support a higher real exchange rate, which can damage primary and manufactured export industries (Edwards, 1998 p.63). This was certainly the case prior to the 2001 collapse, and in the time since as the rand has recovered, the country's international competitiveness has been eroded again and many factories have been forced to close (Botha, 2005 p.5).

Conclusion

The South African Reserve Bank gradually adopted and institutionalized monetarist policies in a process that included the active participation of the internationally-hegemonic neoliberal discourse and the sub-hegemonic domestic financial interests, who saw the largest opportunities for gain. Once these policies were in place, the SARB was able to support the expansion of the financial sector over the interests of South African labour and industry. This has damaged the present and potential growth of the real economy, created short- and long-term instabilities, and increased inequalities in an already seriously divided country.

An alternative arrangement for the central bank may exist under a set of policies that seek to maximize employment rather than minimize inflation rates, though this is by no means the sole option in confronting and challenging rentier interests. An interesting proposal by Demir suggests that developing countries avoid the capture of their financial systems and economies by rentier interests by regulating international capital flows to prevent sharp fluctuations and rapid build-ups of speculative activity in financial markets, reducing real interest rates, improving access to long-term investment financing for non-financial firms, and reducing public sector borrowing requirements (Demir, 2007 pp.356-358). Lower interest rates may be an effective guard against speculative inflows of "hot money" by themselves, even if they are not accompanied by exchange or capital controls, which may be difficult to rigidly enforce (Edwards, 1998 p.63).

Further research is needed to asses how proposals such as this could be used to redirect investment towards the real economy and employment creation. Comparative studies beyond the South African case would also highlight the common features of its experience and inform predictions on what future developments may include, whether or not alternative reforms are pursued.

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