What should government do to protect South Africa's economy? Monetary policy options and recommendations

Our economy is in crisis

COVID-19 has prompted an economic crisis in South Africa. Our economy was already in bad shape before the pandemic. Now, along with most countries in the world, our economy has been hit badly by the lockdown which has stopped most economic activities, and by a loss of international trade.

Here we set out what some the monetary risks are, what monetary policy options government has to set our economy on a better path, and specific recommendations for what monetary policy interventions government must make in the coming weeks and months to help our economy to survive and recover. These are restricted to monetary policy proposals. These are presented for discussion and debate in the C19 People's Coalition.

Risks

Four main macroeconomic risks to South Africa's economy are:

1. A fall in aggregate demand: people have less money and are buying less, which means the economy is slowing down

2. A rise in borrowing costs: it is becoming more expensive for government to borrow money in order to keep spending

3. Exchange rate depreciation: the Rand is losing value against other countries' currencies like the US dollar and the Euro

4. Potential lack of access to dollar liquidity: as our Rand weakens, we may not have enough US dollars and other major currencies available to buy goods and services we need from outside South Africa.

If our government fails to respond adequately to these risks, then…….?

Macroeconomic measures must be taken to counteract these risks. Monetary policy has a strong role to play.

What is monetary policy?

"Monetary policy" refers to policies that manage the flow of money into and out of a country, and the cost of borrowing it. Governments make choices about monetary policy to influence: interest rates, lending practices, inflation management, financial integration (or not) with the rest of the world, and central bank operations. Monetary policy is the mandate of both the central bank – our South African Reserve Bank (SARB) – and the government – our National Treasury.

The main problem underlying all these problems is capital outflows: investors are taking their money out of South Africa. Since the COVID-19 pandemic started, the rand has depreciated against the US dollar, falling from R14 at the start of 2020 to R19 on 5 April 2020. This pushes up prices in South Africa, and can threaten some jobs and sectors. The rand has been one of the hardest hit of all the currencies in 'emerging markets' (middle-income countries).

Borrowing costs have risen although they have not yet hit unprecedented levels. Low commodity prices will further deplete foreign exchange earnings and create a weaker rand (which in turn feeds into higher US$-denominated borrowing costs). The choices government makes in the coming weeks and months will determine whether South Africa gets into a further debt trap, which could limit the money available in the national budgets for years, or even decades, to come.

Mandate

The Reserve Bank has "operational independence" to achieve various objectives set for it by the Constitution, but also has to follow the government's instructions which the Minister of Finance issues periodically.. Government can – in line with the constitutional mandate – instruct the Reserve Bank to achieve pro-poor or developmental objectives. The Government also controls other aspects of monetary policy.

There is no reason why the Reserve Bank should not be instructed to act in a manner that benefits the majority of South Africans including during this crisis, and beyond.

Recommendation 1: Government must instruct the Reserve Bank to take all necessary measures to ensure that 1. the livelihoods of individuals are preserved, 2. the sustainability of businesses is secured, and 3. the exchange rate is stabilised and government borrowing reduced.

Bond buying

The Reserve Bank has started buying government debt (bonds) in the "secondary market" –that is, buying existing debt off other holders of debt. This helps to contain the cost of borrowing – and it led to the fall in bond yields (their "price") at the end of March 2020 after the Reserve Bank began to buy bonds. It will also inject liquidity into the market. This means there will be more money available for investment to grow our economy.

Recommendation 2: The Reserve Bank must continue to buy government debt in the secondary market in order to contain borrowing costs.

Capital management measures

Managing the way in which money flows in and out of South Africa, and the way that Rands are traded is important for stabilising the exchange rate, ensuring we have access to US dollars, and limiting the cost of government borrowing. A major problem facing our eonomy now is "capital outflows" – that is, investors (businesses and individuals) taking their money out of South Africa, and putting it into other countries, which benefits those countries and not ours.

Recommendation 3: Put in place targeted capital flow management measures to limit and manage capital outflows.

Our government has not yet taken such steps. Even the IMF agrees that governments can and should limit capital flows during crisis conditions: this can 'prevent the free fall of the exchange rate and the depletion of international reserves.' It is essential to limit capital flows when countries face domestic or external shocks (like the current pandemic) that cannot be handled by ordinary macroeconomic adjustment or financial sector policies alone (or when the size or duration of the shocks are highly uncertain).' Clearly the current situation meets these requirements.

While our government hesitates to take these steps, we point out that many countries have done precisely this when faced with economic crisis – and it has helped them to stabilise their economies and recover from shocks.

Government can and should:

Limit investments and transfers abroad (as Iceland did following the 2008 global financial crisis);

Repatriate rands offshore (as Malaysia did following the 1998 East Asian crisis). To an extent this is already happening because of the requirement that institutional investors only invest a limited share of assets abroad. This means they must repatriate some of those assets when the rand depreciates in order to stay within the limit.

Restrict the sale and repatriation of non-residents' investments in the country in foreign currency, such as waiting periods for non-residents to transfer their profits from investments in our economy (as Ukraine did after the 2008 financial crisis), minimum holding periods (as Chile did), and taxes or time restrictions on the transfer of proceeds from selling rand assets (as Malaysia did after the 1998 East Asian crisis).

Require investors to settle international operation obligations in rands (as Malaysia did after the 1998 East Asian crisis).

Ban the early repayment of foreign exchange loans (asUkraine did after the 2008 financial crisis).

Measures to reduce the offshore trading of rands is also essential as approximately 80% of rand foreign exchange transactions take place outside of South Africa. This means that the government has less room for managing the exchange rate.

Interest rates

Interest rates set by the Reserve Bank influence the cost of borrowing throughout the economy – by individuals and by businesses. These rates need to be reduced, as was done on 14 April 2020, when interest rates were reduced by 1% (or "100 basis points"). Interest rates should be below the rate of inflation, so that people find it cheap to borrow money. This will take the real interest rate to below 0%. The extent to which South African can lower the interest rate into significant negative territory is uncertain – experience from developing countries doing this must be drawn upon to understand how they have managed the impact over this period. The difficulty in further rate cuts is that this could spark a large sell-off of rands and further depreciation in the value of our currency, unless there are stringent capital controls, or a further fall in inflation. Given these trade-offs, further consideration should be given to the benefits to our economy that can be gained from negative real interest rates.

Recommendation 4: National Treasury and the Reserve Bank should take steps to reduce the cost of borrowing, by reducing interest rates – including into negative real interest rates – and limit the interest rates that banks charge.

Measures must be put in place to limit the "spread" charged by commercial banks – the amount commercial banks charge above the Reserve Bank rate.

Credit

The Reserve Bank has an important role to play in providing credit to the economy. It should be providing credit at very low rates to businesses during COVID-19 in order to ensure they can pay their workers. This can be channeled through the commercial banks as they have very large networks.

The SARB can also provide credit to development banks, which are tasked with lending in developmental ways – the Land Bank, DBSA and others, for instance, are meant to prioritise disadvatanged individuals, including black South Africans, women, and the disabled.

Finally, the Reserve Bank can simple "give" the government money. This is a very contested area of economic theory. By printing more money, the Reserve Bank can help government to have the resources to spend on things we urgently need, though there is a risk that this can lead to inflation.

Recommendation 5: The Reserve Bank should provide subsidised credit to businesses and households via commercial and development banks and ensure this is passed on to end users. It should also "give" the government money in the short-term.

Access to dollars

US dollars are used as a global currency. Crises can lead to a reduction in availability of dollars, and a depletion of dollars that countries hold in reserve, in particular if our exports (which earn dollars) fall. One way to handle this is to secure access to "dollar swap lines" with the Federal Reserve, which allows our Reserve Bank to access dollars through the US Treasury (its equivalent to our Reserve Bank). The current temporary facility that is available allows the Reserve Bank to exchange some US Treasury securities for dollars, but this will not be sufficient for South Africa given the size of the reserve holdings. Establishing such a dollar swop line will make available more US dollars to the South African economy. It is also likely to reduce offshore currency markets, as it could encourage domestic banks to trade with the Reserve Bank, which has direct access to the US Federal Reserve. This could reduce exchange rate volatility.

Recommendation 6: Government should join with all other developing countries to put pressure on the US Federal Reserve to provide dollar swop lines to all our countries, so that we do not run out of US dollars in the current crisis.

Government must act!

Our government in South Africa has been very cautious in dealing with the economic crisis that has hit us. This is despite the evidence that our economy was in serious trouble even before the COVID-19 pandemic and the national lockdown. We call on government to take proactive steps to secure our economy, by using these monetary policy tools at its disposal.

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