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ECONOMICS

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This set of lectures contains:

LECTURE 1 : The Meaning and Functions of Money.

LECTURE 2 : The Creation of Bank Credit.

LECTURE 3 : Further Aspects of Money.

LECTURE 4 : The Banking System.

LECTURE 5 : The South African Money Market.

LECTURE 6 : The General Level of Prices.

LECTURE 7 : The Economic Responsibility of the State.

LECTURE 8 : Public Finance & Taxation.

TEST LD2

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NOTE: The test on this set of lectures is bound in at the end of the book.

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THE MEANING AND FUNCTIONS OF MONEY

A. THE ORIGIN OF MONEY

At a very early stage man learnt the advantages of exchange. As soon as he produced a surplus, he found it beneficial to exchange this surplus for some other article of which he stood in need. Thus the hunter might exchange his surplus of skins for the wool of the shepherd, and so on.

Direct exchange in this manner is known as barter. In none but the most primitive societies, however, is barter possible. The chief difficulties encountered with this system are: -

1. COINCIDENCE OF WANTS

It involves what is called a double coincidence of wants. Thus the farmer who had a surplus of corn and who needed, say, wool, would have to find someone who needed corn but had a surplus of wool, before an exchange could be effected. Such a coincidence is rare and that is why barter is impracticable as a method of exchange in modern times despite our vastly improved communications.

2. DETERMINATION OF VALUE

There is no satisfactory determinant of value. It would be very difficult to measure corn in terms of wool or wool in terms of corn. The value of money is equal to that of its purchasing power.

3. DIFFICULTY OF SUBDIVISION

A third difficulty is the exchanging of articles of widely divergent values and natures. It is hardly possible, for example, to exchange an ox for a fish.

4. PORTABILITY

A fourth difficulty is that things such as oxen and wool are not readily carried about with one.

As life became more complex and less primitive, methods of exchange of goods and services became increasingly important. Man tried to fix upon some intermediate commodity to exchange for goods and services. Cattle, skins, shells and cloth have all been used but with obvious disadvantages.

While we in the twentieth century deal in cheques, Bills of Exchange, Credit cards and so on, it is interesting for us to be reminded of the simple currencies of bygone centuries.

Many thousands of years ago, bearskin-clad traders bartered stone axes for fresh meat and bone daggers for a cooking pot, but these traders were laying out the foundations for twentieth century economics.

Their descendants took the process one step further. The cowrie shell, the claw of a tiger and other scarce items gained a trading value because of their scarcity. Cowries were most certainly used as a medium of currency in China in about 2000 B.C. and in Ancient Egypt.

Tobacco, tea, ammunition and bottles of alcohol have all acted as a medium of currency at some stage in history. In the previous century English miners received a portion of their wages in beer, and even today, despite widespread criticism, employees on some Cape vineyards continue to be plied with wine in part return for work.

Alexander the Great of Macedonia, was perhaps unwittingly responsible for the first serious bout of inflation. From his conquered territories he confiscated vast quantities of gold and silver which he turned into coinage. The increase in the quantity of coinage in circulation, without a matching growth in production, caused prices to soar. Nevertheless, Alexander was the first ruler to have his bust on a coin - albeit only after his demise in 323 B.C.

Banknotes (paper money) were first used in China. Surviving woodblocks attest to the use of some form of paper money, if only briefly, well before 900 A.D.

Before we proceed, let's re-state what we know: -

EXCHANGE, then, may take place in two ways: -

1. DIRECTLY, by barter
2. INDIRECTLY, through the use of an intermediate commodity, money.

Thus bartering gives place to

BUYING AND SELLING

and value expressed in terms of money is known as price.

B. DEFINITION OF MONEY (FUNCTIONS OF MONEY)

1. A MEDIUM OF EXCHANGE

The prime and chief requisite is that it shall be universally accepted in exchange for goods and services - an obvious essential in our present society.

2. A MEASURE OR STANDARD OF VALUE

It is clear that if all articles are quoted in terms of one commodity (money) exchange is facilitated and value easily calculated. Money thus provides a means of comparing the relative values of different commodities and provides a measure of value without which it would be impossible to express or compare the wealth of individuals or nations.

It is also clear that the function of money as a standard of value is closely connected with its function as a medium of exchange. It is not necessary, however, that the actual medium should itself be the standard. It may be represented by a token. A token suffices where it is related as a multiple or a sub-multiple to a basic coin or note and is thus capable of exact interpretation. In South Africa, for instance, the Rand is the standard unit of value. All

values are measured in Rand or in portions or multiples of a Rand. The actual medium of exchange consists of various alloys and paper money but only relatively small commercial transactions are settled in notes and coin. Other media such as cheques, drafts, mail and telegraphic transfers and, latterly, credit cards are widely used.

3. A STANDARD OF DEFERRED PAYMENTS

As commerce becomes more complex, borrowing and lending become very important features of the economic structure. It is usual to measure debts in terms of money, and upon this foundation the whole of the credit system of a country is based. Therefore it is essential that the commodity borrowed or lent should not vary too much in value. Money should possess this quality so that a borrower, lender, purchaser or seller knows what he is getting and what he has to pay or repay in terms of money or value.

4. A LIQUID ASSET AND A STORE OF VALUE

Because money is a recognised medium of exchange, most people keep a reserve of it either in their pockets or in their homes, to make their day-to-day purchases. In the same way, firms keep a certain amount of money in petty cash. Further reserves are often kept in the form of a current account at a bank.

Money which will not be required in the near future is usually invested in securities. If an unexpected need for ready money arises, the investment will be sold, possibly at a slight loss. Assets, which can readily be converted into money without undue loss, are said be be liquid assets; the less the possibility of loss resulting from the urgent conversion, the more liquid the asset.

Money itself is, therefore, the most liquid of all assets and because of its comparative stability of value, it is considered to be a good store of value.

5. IT FACILITATES UNILATERAL TRANSACTIONS

It allows people to make gifts in the form of a commodity which can be easily exchanged for other goods and services. It also makes possible the payment of taxes.

D. THE QUALITIES OF A GOOD MONEY MATERIAL

These qualities are easily remembered by adopting the mnemonic "DISHCUP":

1. DIVISIBILITY
2. INDESTRUCTIBILITY
3. STABILITY
4. HOMOGENEITY
5. COGNISABILITY
6. UTILITY
7. PORTABILITY

1. DIVISIBILITY

Money must be capable of being divided into smaller denominations and re-united without loss. Virtually no commodities except the precious metals have these qualities.

2. INDESTRUCTIBILITY

It is necessary for the money material to be indestructible and not subject to rust. Gold and silver do not deteriorate in storage and they, therefore, possess the needed durability or indestructibility.

3. STABILITY

Its value should remain fairly stable in comparison with other commodities. If it were not stable it would be useless as a store of value. This is connected with durability. Stability cannot exist unless the supply is relatively small but constant - not subject to sudden fluctuations.

4. HOMOGENEITY

Units of the same denomination must be uniform in size, weight and quality and legally acceptable. Same-sized units of many other commodities vary considerably in weight and quality and are thus unsuitable. Gold and silver, however, can be refined to a uniform quality.

5. COGNISABILITY

The money material must be readily recognisable and distinguishable from other substances. Uniform die stamping and milling in minting makes counterfeiting difficult.

6. UTILITY

The basic material used, e.g., gold, must have value and utility apart from its use as money. It must be an economic good in that it possesses all the attributes of wealth. Both gold and silver are extensively used commercially and industrially and, in fact, most of the free world's current supplies of these metals finish up in private hoards or in commercial and industrial use rather than in "money".

7. PORTABILITY

It must be conveniently portable and must have large value compared to its bulk and weight. People should be able to carry large quantities, in need, but it should also be easy to transport long distances at little cost.

It is easy to show by reference on the one side to the functions of money and on the other to the qualities of the various metals that gold and silver, although not ideal, are very suitable as money. They are prized on their own account and they possess in a high degree the qualities of portability, durability, homogeneity and divisibility. As regards indestructibility and cognisability, gold possesses these qualities in a large measure, but silver to a less extent. Their official value has remained comparatively steady over short periods though over centuries great changes have taken place in the value of both metals.

Before you continue with the lecture test yourself by answering the following questions.

1. Give two examples of the difficulties encountered with the barter-exchange system.

2. How would you define 'money'?

3. List two qualities of a good money material - elaborate on each example.

E. FORMS OF MONEY IN GENERAL USE

In early times media of exchange consisted of ingots of metal, usually gold or silver which had to be weighed and tested each time as exchange was effected.

The disadvantages of this system led to the minting of coins, i.e., shaped pieces of metal, the weight and fineness of which are certified by a mark or stamp. In modern times intricate designs are stamped on coins to minimise the possibility of counterfeiting.

Nowadays, of course, there is little temptation to the coin counterfeiter because coins made of precious metals do not circulate. For convenience and to avoid the loss through wear and tear which necessarily result from the constant handling of precious metals, gold and silver coins have been replaced by token money - coins for small values and paper notes for larger values.

Token coins are made of cheap but hardwearing metals and alloys, and they are called "token" because the value given to them by Government decree (and embossed on them) exceeds their intrinsic value, i.e., the value of the metal contained in them.

Minting of Coins is a monopoly of the state. Coins are minted from metal of a certain standard of fineness as laid down by the Government. The standard of fineness of Standard Gold in South Africa is 22 carats, i.e., eleven-twelfths pure Gold.

Mintage or Brassage is the charge levied by the State to cover cost of minting.

Paper money, sometimes called representative money, came into use in Europe in about the fifteenth century, when gold circulated as money, it became the custom for wealthy people to deposit their savings with goldsmiths for safe keeping. The goldsmith handed the depositor a receipt, of course, and when the deposit was withdrawn, he took the receipt back. Eventually, people found that there was no need to withdraw their deposits every time they required gold to pay a creditor; all they needed to do was to arrange for the goldsmith to alter their receipt and

issue another receipt to the creditor. In fact, it soon became a practice for these receipts to circulate from debtor to creditor without any intervention by the goldsmith. In other words, they began to fulfil a function of money.

This method of discharging obligations was found to be very convenient, and goldsmiths' receipts circulated fairly freely as paper money. Soon, the goldsmiths realised that they could make a profit by lending out such receipts as interest, even though no gold had been deposited against them; as long as they had enough gold on hand at all times to meet the relatively infrequent demands for withdrawals there was no danger. At this stage, the business of goldsmithing began to take one the aspect of banking and many goldsmiths found it so profitable that they gave up goldsmithing completely. They concentrated on banking and became private banks.

Nowadays, the business of note issuing is usually under Government supervision and in most countries paper money is issued only by the central bank, or by the Government itself, and the notes are not usually convertible on demand into gold, or some other precious metal, as they were when they were issued by private banks. Most paper money is now inconvertible.

The advantage of maintaining convertibility of notes is the confidence which traders both at home and abroad have in the currency. If the national standard of value is based on gold, these traders know that they can take a note of the issuing authority at any time and convert it into gold, and this is a valuable feature from the point of view of the foreign trader because gold is virtually the only universally acceptable standard of value. In fact, as long as confidence in the issuing authority remains unimpaired, convertible notes are "as good as gold". In other words, the currency is just as good as gold, but there is no loss of metal from abrasion or damage. Moreover, the greater the confidence in the issuing authority, the smaller the reserves of gold which this authority need keep, because if the notes are highly acceptable, demands for conversion will be few. People will want gold only if they have to make payments abroad, or if they are doubtful about the stability of the notes. By experience,

bankers and other note-issuing authorities discovered the proportion of their note issues which they needed to keep covered by gold; in most countries the minimum legal ratio of gold reserves to total note issues was about 35% when the gold standard was in operation. It was found that if the reserves fell below this ratio, people tended to lose confidence in the notes.

This leads us to another advantage attached to the use of paper money. If the volume of currency in circulation were to vary every time stocks of gold bullion changed, price fluctations would be frequent, because the prices of goods are closely associated with the volume of currency in circulation. If, on the other hand, changes in gold stocks merely cause a temporary change in the ratio of gold reserves to note issues, the price level tends to remain more stable. In other words, paper money can be regulated to prevent sudden changes in the price level when the supply of bullion changes.

In most countries, currency notes have been declared at some time or other to be inconvertible. This may be because the gold reserve has fallen to an unduly low level and the authorities wish to conserve what is left, as was the case in Great Britain in 1931. Or it may be because expenses are high (e.g., in time of war) and the Government wishes to print notes in order to pay its debts. Clearly this procedure lowers the ratio of the gold reserve to note issues, and if the notes remained convertible people would rush to convert them into the more stable medium - gold.

F. LEGAL TENDER

Legal tender is that form of currency which the law compels a creditor to accept in settlement of the debt due to him. This concept does not apply, of course, to precious metals like gold, because anybody is willing to accept these in unlimited quantities, but when token coins or incovertible notes are issued, the Government must give them legal backing, particularly if they circulate side by side with gold or convertible notes. For instance, you could not compel a shopkeeper to accept

R20 in silver (meaning here, "loose change") in payment for a coat you have bought; but you could compel him to accept R4 in silver and R16 in Reserve Bank notes. It would, of course, be foolish for the shopkeeper to refuse the R20 silver, and such a step might damage his goodwill, but if the notes were convertible into gold, as they used to be, the necessity for a regulation on what is and what is not legal tender would be obvious. So no creditor may be made to accept more than 10 cents in bronze and more than 400c in silver. (Note, however, that cheques drawn against deposits are not legal tender and hence creditors are not legally obliged to accept payment in this form, although they do so by custom or by arrangement. In recent years, the use of credit cards has spread rapidly. In effect, this is merely an alternative method of utilising existing bank deposits. It is more convenient and safer than having actual cash).

A country cannot, of course, make laws governing legal tender outside its boundaries. Thus if I, in Durban, owe R10 to a man in the U.S.A., I cannot force him to accept a Reserve Bank note in settlement of his debt. Unless he has purchases to make in South Africa he may not be able to use a South African note; if Reserve Bank notes were freely convertible into gold, however, he would no doubt accept one in payment of his debt, because he could then spend it anywhere in the world, for it would be "as good as gold" and gold is an international medium of exchange and measure of value.

People in South Africa do not, however, accept inconvertible notes only because the Government compels them to do so. They accept them because they are confident that they will be able to use them to buy the things they need; they accept them because they realise that they are generally acceptable. People cannot easily be forced to use a money they distrust. If they suspect that paper money is about to undergo a marked change in value they will use something else as a measure of value, such as boots or pins (provided there is no penalty against this step) even though these commodities have not been declared to be legal tender.

Money is no longer backed by gold or any other direct asset. It's general acceptability lies in the fact that it is backed by law.

1. OTHER FORMS OF MONEY

(a) Bank deposits (subject to checking on demand)

Definition

Bank deposits constitute the principal source of funds to individual commercial banks. Typically, they contribute over 90 percent of all the funds a bank has at its disposal. Deposits may be demand deposits (or current accounts) subject to withdrawal by cheque; or time deposits (often called savings or deposit accounts), withdrawable at specified future dates, after the lapse of a specified time, or upon 30 days' notice.

In almost all the countries today, the money supply consists of notes and coins issued by the government and the central bank, and deposit money. Notes and coins need no further discussion. However, it is of paramount importance to place sufficient emphasis on bank deposits (current accounts). These money deposits are created by the commercial banking system. It has already been mentioned how bank notes promising to pay gold on demand circulated as money and how, because most people did not require the actual gold, the banks were able to create money by printing and putting into circulation many more notes than they could redeem in gold at any one time. But note that when the banks lost the right to issue notes of their own, the form of money creation changed but the substance did not. Customers of the banks often deposit paper money with the banks for safe-keeping just as, in former times, they deposited gold. The bank receiving the money gives the customer a promise to pay it back on demand. Instead of taking the form of a printed bank note, as in the past, this promise to pay is recorded as an entry on the customer's account. If the customer wishes to settle an account, he may claim his money in rand notes, and pay it over to another person. This method is, however, cumbersome, particularly for large payments, and it would, therefore, be much more convenient if the bank's promise to pay cash could merely be

transferred from one person to another. This is done by means of a cheque. If individual A deposits R50 in a bank, the entry, a R50 credit in his account, is the bank's promise to pay R50 cash on demand. If A pays B R50 by giving him a cheque that B then deposits in the same bank, the bank merely reduces A's deposit by R50 and increases B's by the same amount. Thus the bank still promises to pay out on demand the R50 originally deposited, but it now promises to pay it to B rather than to A. If B now pays C R50 by cheque and C deposits the cheque, then the promise to pay (i.e. the credit entry in someone's account at the bank) will be transferred from B to C.

Richard G. Lipsey concludes as follows:

"The modern deposit is the equivalent to the old bank note: a promise on the bank's behalf to pay out on demand the money of the time. The passing of the bank's note from hand to hand transferred ownership of the claim against the bank; this is now done by means of a cheque; which is merely an order to the bank telling it to transfer from one individual to another its onligation to pay cash. It is true today, just as it was in the past, that most of the bank's customers are content to pay their bills by passing among themselves the bank's promises to pay cash; only a small proportion of the bank's customers want cash at any one time. Thus, just as in the past, the bank can create money by issuing more promises to pay than it actually has cash to pay out. The bank can grant a loan by giving the customer a credit on his account equal to the amount of the loan. If the borrower uses the loan to pay bills by cheque, then the deposit is transferred from person to person. In most circumstances, the bank can have liabilities greatly in excess of the amount of cash that it has in reserve. These deposits can be used to buy goods and services through the medium of cheques. Since they are a generally accepted means of exchange, they are money.

The great proportions of transactions (by value) take place by cheque and only a small proportion by notes and coin. Thus, in the modern world, the greater proportion of the money supply is the deposit money that is created by commercial banks. The banks can, if they wish, contract the money supply by not creating deposits, or they can expand it by creating deposits up to the limit of prudence or law (so that there is just enough cash to meet the normal demands of customers who do not wish to pay by cheque). It is, of course, in the bank's interest to expand the supply up to the safety limit because every pound (rand) created can be used to grant a loan to purchase a bond, or to acquire some other asset that pays a return to the bank."

To sum up, bank deposits can be acquired in one of four ways:

(i) A person paying notes and coins into a bank to the credit of his account acquires a deposit or enlarges his existing deposit. Provided this is not a savings or fixed deposit, the the definition of money as the medium of exchange in private, non-bank circulation means that the stock of money remains unchanged because one type of money has been converted into another.

(ii) By paying a cheque into the bank, the payee acquires a bank deposit. But because the drawer has lost a deposit equivalent to the amount of the cheque, the money stock is unchanged.

(iii) The bank purchases assets from someone, and credits the seller in its books. The assets can be fixed property, loan stock, or bills. The money stock increases, since the seller acquires a deposit and no-one loses a deposit. The bank is said to have <u>monetized on asset or claim</u>.

(iv) The bank grants a loan against the borrower's promise to repay it. Bank loans are normally in the form of overdrafts, which means that the borrower is allowed to overdraw his account up to an agreed amount, for which collateral security is lodged with the bank. When the borrower makes use of his overdraft facilities by drawing cheques, and the recipients pay these into their respective banks, the newly created deposits enlarge the stock of money. If the payees encash their cheques we see the same result, for notes and coins then enter private, non-bank circulation.

In (iii) and (iv) banks create money. They grant loans and make investments against payment in their own debt - or deposit liability - which serves the community as money.

(b) Demand deposits and time deposits.

Lipsey explains, inter alia, as follows: "If a customer has a deposit in a bank, he can keep it in one of two forms: in a demand deposit (current account) or a time deposit (deposit account). The distinction between these two types of deposit is commonly made throughout much of the world, although the terms applied to them vary.

The two main characteristics of a demand deposit are that the owner can withdraw his money on demand, and that the bank agrees to transfer demand deposits from one person to another when ordered to do so by the writing of a cheque. The first characteristic makes the demand deposit as satisfactory a store of value as is currency, since the holder of a demand deposit can withdraw cash from his account without having to give any prior notice. The second characteristic helps to make the demand deposit a medium of exchange. The holder of a demand deposit may make a payment by writing a cheque on his account. The cheque instructs the writer's bank to pay without delay a stated sum to the person in whose favour the cheque is drawn.

Time fixed deposits differ in both of these essential features. The owner of a time deposit must legally give notice (possibly 30 or 60 days) of his intention to withdraw his money. Furthermore, the holder of a deposit account cannot pay his bills by writing a cheque ordering his bank to pay someone out of his deposit".

(c) Near money (interest-bearing time deposits, often called savings or deposit accounts).

The term "near money" has been introduced to describe short and medium term deposits not subject to withdrawal by cheque. These funds earn interest and therefore, according to the IBSA, cannot be included in the concept of money. In addition they are tied up for short periods and are thus not perfectly liquid.

The two most important functions of money are, first, to act as a medium of exchange and, second, to be a temporary store of value to bridge the gap between receiving and making payments. The problem of deciding what is money stems from the fact that anything that can fulfil the first function can also fulfil the second one, but many things that can fulfil the second do not fulfil the first.

To illustrate what is involved, consider an example. If A has a donkey and wants some chickens, A wants, in effect, to barter the former for the latter. In a monetary society, however, A sells his donkey and accepts money, which he may keep until he finds the chickens that he requires. As long as all sales and purchases do not occur at the same moment, everyone needs such a temporary store of value between the act of selling and the act of buying. Whatever serves the function of a medium of exchange can be held and thus can also serve the function of a temporary store of value.

It is the case that other assets can also be used for this store-of-value function. If there is another asset in the economy - for instance, time

deposits - that is not a medium of exchange, but has a completely secure capital value, and on which interest can be earned, it may well pay A to use this asset as his temporary store of value. Thus A accepts rand notes when he sells his donkey for R50, but he does not hold this money. Rather, A deposits it in his savings account and earns interest on it, secure in the knowledge that when he finds the chickens he desires he has R50 available. Whether A does this or holds the money, depends on the transaction costs (which includes inconvenience) of turning his money into a safe, interest-earning asset and then back into money again, and on the interest that he can earn over the short time that he is holding the purchasing power. If we concentrate only on the medium-of-exchange function of money, there is little doubt about what money today is. Money consists of notes and coins and demand deposits; no other asset constitutes a generally accepted medium of exchange. Whereas problems arise with the temporary-store-of-value function, time deposits are perfectly satisfactory for this. Lipsey elaborates as follows: "If you have a time deposit at a bank you know exactly how much purchasing power you hold (at today's prices) and, given modern banking practices, you can turn your deposit into a medium of exchange - cash or a chequing deposit at a moment's notice. Additionally, your time deposit will earn you some interest during the period that you hold it. Neither currency nor the typical demand deposit will do so. Thus, time deposits fulfil, at least as well as the things traditionally regarded as money, the function of a temporary abode of purchasing power.

There is a whole spectrum of assets in the economy that yield an interest return and also serve as reasonably satisfactory temporary stores of value. The difference between these other assets and savings deposits is that their capital values are not quite as certain as are those of savings deposits. If I elect to store my purchasing power in the form

of a government bond that matures in 30 days, its price on the market may change between the time I buy it and the time I want to sell it - say 10 days later. If the price changes, I will suffer or enjoy a change in the purchasing power available to me. But because of the short horizon to maturity, the price will not change very much. (After all, the government will pay its face value in a few weeks). Such a security is, thus, a reasonably satisfactory short-run store of purchasing power. Indeed, any readily saleable capital asset whose value does not fluctuate signigicantly will satisfactorily fulfil this short-term, store-of-value function. If it also earns an interest rate, it will have an actual advantage over any medium of exchange on which interest cannot be earned, provided that the purchasing power is to be held long enough for the interest to exceed the transactions costs (commissions etc.) of buying and selling the security, plus an evaluation of the time and trouble involved.

Whether time deposits and short-run government securities are to be regarded as money is still a matter of debate and may depend partly on the problem being studied. Two things are, however, clear: (1) there is a definite distinction between those assets that serve as media of exchange and those that do not; (2) there is a whole range of assets whose capital values vary from being completely insensitive to interest-rate changes to being highly sensitive, and those in the low-sensitivity range constitute acceptable short-term stores of purchasing power between the time of a sale and the time of a purchase. These latter assets, which adequately fulfil the temporary-store-of-value function but do not themselves fulfil the medium-of-exchange function, are called near money".

G. SOUTH AFRICAN CURRENCY

Before 1914 gold coins circulated in South Africa, but during the First World War, South Africa, as did most other countries, restricted the full operation of the gold standard.

After the war, South Africa reconverted her currency.

In 1931 at the time of the Great Depression, Britian was forced to abandon the gold standard but South Africa maintained the convertibility of her currency.

South Africa was generally expected to follow suit sooner or later, and as a result there was an outflow of money from the country. This drained her reserves and caused a disruption of her foreign trade to such an extent that she too was forced to leave the gold standard in December 1932.

Today South Africa uses inconvertible currency in the form or bank notes issued by the South African Reserve Bank. However, gold coins are still legal tender but are not in fact used as the circulating medium.

H. REGULATING THE CURRENCY

In most countries, the benefits of a centralised currency issue, controlled by the authority which holds the monetary reserves of the country, have been realised and the central bank as previously mentioned has the monopoly of the note-issuing rights.

1. This (a) ensures uniformity in the note circulation;
   (b) gives the state some supervision over the legal tender currency without making it directly subject to the jurisdiction of a government department;
   (c) gives the notes a prestige which they would not have if they were issued by a variety of commercial banks; and
   (d) enables the Government to participate in any profits accuring from the note-issuing right. The assets acquired by government through note-issue are income earning assets.

2. As you will now realise, it is extremely important that confidence be maintained in a paper currency by some form of control, and in most cases, adequate control has in fact been ensured by government supervision or legislation.

3. This was a subject on which there was considerable controversy in Britain prior to the passing of the Bank Charter Act of 1844, which for nearly a century regulated the issue of notes by the Bank of England, and their convertibility into gold.

   The controversy raged on such matters as the granting of legal tender rights to bank notes; whether bank notes should be issued by the commercial banks only, the regulation of issues etc.

4. About 1840, after a series of business crises which had disturbed trade in England during the preceding twenty years and caused gold out-flows, currency and banking theorist began to group themselves into two schools of thought.

   (a) <u>The Currency School</u>.

   The members of this school based their ideas upon the report of the "Bullion Committee" which had been appointed after an enforced suspension of conversion of Bank of England notes into gold in 1797. They believed that in the case of a currency consisting partly of metallic money and partly of paper money, the notes would not continue to circulate unless they were fully backed by gold. They maintained that price fluctuations could be avoided only be the separation of the Banking and Issue Departments of the Bank of England. Notes must be regarded purely as a substitute for coin.

   Two points overlooked were:-

   (i) The outflow of gold was caused, not so much by the fact that the British banks had expanded credit, as to the fact that they had done so while the countries with which England traded had not; and

   (ii) Ordinary bank cheque-drawing accounts were just as expansionary as unbacked notes. The cheques were substitutes for currency which was not fully backed.

   (b) <u>The Banking School</u>

   This school of thought contented that 100% gold backing was not necessary: provided a fall in the gold reserve was accompanied by a reduced circulation, the currency

would remain stable. Its members believed that if price fluctuations were to be controlled, deposits as well as not issues would have to be taken into account. The volume of notes in circulation should be determined only by the needs of commerce. Any excess over this amount, they thought, would be presented for conversion into gold.

The Bank Charter Act of 1844 accepted the principles of the Currency School

5. Here are six different statutory methods which have since evolved to regulate note issues.

(a) Fixed Fiduciary Issue.

In England, currency note issues were controlled by the fixing of a definite maximum issue which could be made without a gold backing. This is known as the Fiduciary Issue. This method is subject to the defect of inelasticity, however, for at times when there is a drain of gold from the country, an undue contraction of the amount of a currency in circulation may result: in times of prosperity, however, the fact that each additional £ issued must be fully backed by bullion, serves to prevent the undue expansion of currency and credit which might otherwise result from the general optimism.

The Currency and Banknotes Act of 1928 provided for the temporary suspension of the fiduciary issue regulations and in fact this allowed for more elasticity.

Recent chages in British banking legislation have in fact allowed the Government to set the amount of the of the note issue and it is a simple matter for it to be altered when the Government considers it necessary. Very little of it is in fact backed by gold.

(b) Fixed Legal Minimum issue.

By this method, no expansion of the currency is allowed even if there is an increase in the gold reserve. This system was at one time used in France, but was abandoned on account of its excessive rigidity.

(c) Note issues to be covered by certain defined government bonds subject to a maximum fixed with reference to the paid-up capital of the issuing banks. This is another rigid system. It was at one time used in the U.S.A.

(d) Proportionate metallic reserves.

This method provides for a "ratio fiduciary issue" and has been used by the Federal Bank in America since 1914 and also by a number of other countries.

(e) A legal gold reserve minimum against notes and deposits with currency notes ranking as a first charge on the assets of the central bank.

This is the system in use in South Africa.

(f) No reserve requirements.

The justification for this policy is the idea that in a modern community it is more important to control the "credit base, which consists of the commercial bank deposits with the central bank, rather than the note issue, which is only a reflection of note policy".

6. The state has, in many cases, claimed a share in the profits accuring from the note-issuing monoploy. In South Africa and the U.S.A. there are regulations limiting the amount distributed as dividends by the Reserve Banks, and providing for excess profits to accrue to the State.

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SUMMARY

Money, which originated from a desire to avoid barter, functions as a :

1. Medium of Exchange.
2. Measure of Value.

3. Standard for Deferred Payments.
4. Liquid Asset and Store of Value.

Money may be defined as - anything which is universally accepted in discharge of business obligations because it acts as a measure of value of all other commodities and a medium of exchange between all other commodities.

QUALITIES OF GOOD MONEY MATERIAL:

1. Divisible.
2. Indestructible.
3. Stable in Value.
4. Homogeneous.
5. Cognisable.
6. Useful
7. Portable.

Note that the initial letters of thes qualities make the word DISHCUP.

FORMS OF MONEY

1. Standard Coins.
2. Token Coins.
3. Convertible Paper Money.

Legal Tender - those forms of currency which the law compels a creditor to accept in final discharge of his debt.

Other forms of money are:

1. Banks deposits.
2. Demand deposits and time deposits.
3. Near money.

REGULATING THE CURRENCY

There are various methods of regulating the currency. These include:

(a) Fixed Fiduciary issue.
(b) Fixed Legal Minimum issue.
(c) Note issues which have to be covered by certain defined government bonds.
(d) Proportionate metallic reserves.
(e) A legal gold reserve minimum against notes and deposits.
(f) No reserve requirements.

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PROGRESS QUESTIONS

1. What is a 'Token Coin'?

2. Describe the services rendered by standard money in a modern commercial society.

3. What are the advantages of paper money?

4. Why are gold and silver relatively suitable materials for money?

5. Define legal tender.

6. Distinguish between demand deposits and near money.

7. What are the chief reasons for entrusting the issue of bank notes to the central bank in most countries.

8. Under modern social and economic conditions discuss what you consider to be the essential qualities of good money.

9. In what aspects does our present day money fall short of these criteria?

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THE CREATION OF BANK CREDIT.

A. INTRODUCTION

Money, as we saw, has been described in various ways, but generally, it has been agreed that the functions of money are: -

1. A medium of exchange,
2. A unit of account,
3. A store of value.

In practice, however, it is often difficult to distinguish between what is money and what is not. There are a number of financial assets which perform the above three functions to some degree and the borderline between what might be termed money assets and non-monetary assets is never really clear.

Bank deposits are a case in point. Most people would not disagree that bank deposits should be regarded as money. But when describing bank deposits as money they are referring to demand deposits (i.e., those deposits which are repayable or transferable on demand). The inclusion of time deposits in the definition of money is by no means agreed upon by all monetarists. Then there is the question of which deposits should be called money. In other words, should the deposits of other financial institutions as well as banks be included, say building societies, since they too may be effectively repayable on demand?

In Britain, for example, money stock has been officially defined as net domestic deposits of the U.K. banking sector plus currency in circulation. Similarly, in South Africa the stock of money is the total of coins, banknotes and bank deposits withdrawable by cheque. Currency in circulation forms a small part of the total supply of money, usually about twenty percent, thus the rôle played by bank deposits in the supply of money is very important.

Although we all use paper money and coins daily, by far the largest quantity of modern money does not exist in any visible form at all. It takes the form of bank credit. Huge sums are paid simply by transferring credit from one customer's account to another's within the banking system. These accounts exist

as entries in computer memories or in the form of book entries. The extensive use of credit cards and automatic teller machines has enabled us to transfer credit very easily.

Money in this form is said to be "abstract" and, as long as it is acceptable, it fulfils all the requirements that have been listed for money. It can, of course, be withdrawn from the bank in the form of visible paper and coin, but normally it is much more convenient to handle just as a "transferable credit".

B. BANK ASSETS

1. Bank deposits can clearly be regarded as money. If a customer has a deposit with a bank it can be held in the form of a current account (demand deposit) or a deposit/savings account (time deposit). The holder of this demand deposit may obtain cash for his deposit without giving notice of his intention and he may issue cheques against his deposit. The holder of a deposit account must give between 30 and 60 days notice of his intention to withdraw money. However this law is not often enforced by banks.

2. Banks must always have enough cash available to be able to -

   (a) meet customers' demands for cash, and
   (b) carry out customers' instructions to transfer funds, by the passing of cheques, to other banks without delay.

3. They do this both by -

   (a) holding cash, and other highly liquid assets from which cash can be replenished, and
   (b) by borrowing.

4. A bank expects to earn nothing on its cash holdings and little on its more liquid assets, but high earnings are needed to make a profit and to attract business by providing good services and paying interest. Banks must therefore balance the need for liquidity against the desire for higher earnings.

In South Africa legislation ensures that the banks maintain sufficient cash and liquid assets in their portfolios.

C. THE VOLUME OF BANK DEPOSITS - CREDIT MULTIPLIER

1. In this lecture we are concerned with the rôle of the commercial banks in the supply of money and credit.
Banks can create money by making loans to their customers. Usually they do not lend cash but credit to the customer's account with the sum advanced to him.

(a) The Early Bankers

The operation of this system can be seen by reference to the work of the original bankers. These were merchants who accepted gold for safe-keeping and issued notes in exchange. After a time these notes became acceptable as a means of payment. The recipient had confidence in them because he could return to the merchant and exchange them for the equivalent amount of gold.

In practice, the merchants found that a large proportion of the notes they issued were never presented to them for conversion back into gold. Therefore they did not need to hold enough gold to back all their notes. If experience showed them that less than half the notes they issued would be presented for conversion at any one time, they could operate safely with a 50% ratio of assets (gold) to liabilities (notes issued). The additional notes could be issued in the form of advances to customers and they represented an increase in the supply of money. The balance sheet of the bank might have looked like this: -

Liabilities	R	Assets	R
Notes Issued	500 000	Gold	250 000
		Advances	250 000

The requirement to hold 50% of the assets in gold creates a deposit multiplier of 2, i.e. the bank can create money to the extent of twice its gold holding.

2. The Contemporary System

Exactly the same reasoning applies to the present day except that bank deposits rather than notes are the main liability. The controls, for example on liquid assets and reserve assetes etc, are more stringent - as laid down in the Banks Act of 1965. To illustrate the point, let's simplify and assume that the most important limit to making a loan is a 12,5% reserve asset ratio rather than gold. Suppose a bank balance sheet as follows:

Liabilities	R	Assets	R
Deposits	10 000	Liquid Reserve Assets	1 250
		Advances	8 750
			10 000

If the bank gains R100 cash which it is able to include as part of its reserve assets, the reserve ratio will rise above 12,5%. The bank is now in a position to extend credit. A customer may ask for a loan and a deposit will be created in his favour. Thus, the supply of money in the hands of the public has increased. In return the bank has an additional asset in the form of an advance backed by the customer's promise to repay or, if necessary, by a collateral security such as property or an insurance policy owned by the customer.

The balance sheet will read as follows once the reserve asset ratio has been restored: -

Liabilities	R	Assets	R
Deposits	10 800	Liquid Reserve Assets	1 350
		Advances	9 450
			10 800

It will be seen that although the reserve assets increased by only R100, total assets have increased by R800. Thus a reserve asset ratio of 12,5% leads to a deposit multiplier of 8. The banks are able to expand their deposits in this way because they are confident that customers will transfer only part of their deposit by withdrawing cash and that the rest will be transferred by cheque payments involving bank credit.

The system would work in the opposite direction if there was a reduction in reserve assets. The banks would have to reduce their liabilities by calling in loans or not renewing them as they mature.

It should be noted that this reasoning applies to the banking system as a whole. An individual bank could not respond in this way immediately because its customers will transfer some deposits to other banks during the course of a day's business. Assuming that the increase in cash assets is a permanent gain to the banking system, and working on a reserve asset ratio of 12,5%, the banks collectively can make loans which result in total deposits rising by a multiple of 8. Which particular banks increase their cash and therefore the loans, and which do not, will depend upon their size, skill in attracting customers and their customers' need for loans.

3. The Credit Multiplier Formula

According to Goedhuys the mechanism of deposit expansion by bank lending and investing, and its theoretical limits, may be summarised in the formula of the credit multiplier in which the following symbols are used: -

$\triangle$ RB, the cash inflow into the banks, which constitutes additional cash reserves.

r, the conventional cash reserve maintained by the banks, expressed as a percentage of deposit liabilities.

$\triangle$ D, the increase in bank deposits resulting from bank lending and investing. It is assumed that the investment in liquid assets other than cash is fully spent by the sellers of these assets.

q, the percentage of any deposit increase ($\triangle$ D) which persons and firms draw in cash in order to maintain their customary proportion of cash to deposits in their total money holding.

The amount paid out in cash, q$\triangle$ D, in step with the rise in deposits, reduces the amount of the cash reserve and therefore acts as a brake on lending and investing as they progress. The sum q $\triangle$ D and the amount retained r $\triangle$ D must equal the original cash inflow $\triangle$ Rb, so that we can write:

$$\triangle Rb = (r + q) \triangle D$$

From this, we find the credit multiplier:

$$\frac{\triangle D}{\triangle Rb} = \frac{1}{r + q}$$

As an example, assume these values:

r = 10%; q = 25%

Then the value of the credit multiplier is:

$$\frac{\triangle D}{\triangle Rb} = \frac{1}{\frac{10}{100} + \frac{25}{100}} = 2,9 \text{ (approximately)}$$

A cash inflow of R100 would then, under the reasonably realistic assumptions made, lead to a deposit expansion of R290, and a balance sheet positions as follows:

Complete balance sheet of all banks

Liabilities		Assets	
Primary deposit	100	Cash reserve	29
Created deposits	190	Loan and investments	261
	290		290

The cash reserve, which originally stood at R100 (the full amount of the inflow) gradually declined to R29 owing to cash withdrawals totalling R71, or one-quarter of the deposit expansion of R290 (approximately one-quarter, due to rounding off the credit multiplier). The cash withdrawals also account for the difference between the loans and investments of R261 and the eventual deposit creation of R190.

A cash outflow puts the credit multiplier into reverse, when it becomes the credit contraction multiplier, with opposite but symmetrical results.

(d) How well have you understood this lecture so far? Test yourself by answering the following questions.

(1) What is the approximate percentage of the money supply - that is in circulation in the form of notes and coins.

(2) What is the credit multiplier?

D. HOW DOES THIS WORK IN PRACTICE?

Here are further examples involving a number of banks, of the credit multiplier process.

Remember: - Bankers contend that they can lend out only the deposits they receive. They will say that if a bank attracts an extra R100 it can only lend an extra R100. Economists, however, say that banks create money, because lending itself creates deposits. However, deposits are also created by discounting bills, buying securities and through the selling of foreign exchange accruing to customers to the central bank.

The economists' statement rests upon the theoretical model in terms of process:

Let us assume that there are 5 banks: A, B, C, D, and E.

(i) A Borrower goes to Bank A for a loan. Bank A, satisfied that the borrower has sufficient security to be able eventually to repay the loan and of course the interest, credits Borrower's account with R100.

(ii) Borrower uses this money to buy goods and services and therefore makes payments, (probably by cheque from his account).

(iii) Let us assume that R80 of this loan finds its way to the deposits of Banks B, C, D, and E (R20 apiece) - because the people to whom the Borrower makes his payments hold deposits at these banks.

(iv) Now Bank A will have claims against it worth R80 but Banks B, C, D, and E have increased their cash holdings by R20 each.

(v) The economists say that those banks will now be able to start "creating" money by making loans up to about 12 times this amount, i.e., R240 each. (Let's say they need to keep a cash ratio of only about 8%).

To take another example, let us suppose there are 2 banks, A and B, and (a) and (b) are their respective customers.

TRANSACTION 1. (a) deposits R100 cash with A.

Bank A's balance sheet:

	R		R
Deposits	100	Cash	100

TRANSACTION 2. (c) borrows R50 cash from bank A. (c) now owes bank A R50 and the bank has R50 less cash.

Bank A's balance sheet:

	R		R
Deposits	100	Cash	50
		Advances	50
	100		100

TRANSACTION 3. (c) pays his money to (b) who pays it into his bank B.

Bank B's balance sheet:

	R		R
Deposits	50	Cash	50

After transaction 3, the combined balance sheets of Banks A and B are: -

Bank A and B's balance sheets combined:

	R		R
Deposits	150	Cash	100
		Advances	50
	150		150

The banks owe R150 (R100 to (a) and R50 to (b)). There is R150 of money; the banks have only R100 cash. Thus although each bank has only lent the money it possesses, the banking

system as a whole has created money to a greater extent than its holdings of cash.

Now consider this example: -

(i) Suppose that banks have only 2 types of assets, cash which is non-interest earning and loans which do earn interest. Banks satisfy their need for liquidity by holding a fixed minimum of cash to their deposit liabilities of 10 percent, and to make things simpler let us assume that there is only 1 bank. Initially deposit liabilities of R100 are matched by R10 in cash and R90 in loans, giving a cash ratio of 10%. If the public now acquire an extra R10 of cash and demand is fixed, they will deposit it with the bank.

(ii) The bank now has R20 cash and R110 deposits. This will increase its cash ratio to 18,2% which is higher than its minimum requirement of 10%. If it leaves things like this it will not be making maximum profit because loans yield interest and cash does not, so the bank will now increase its loans by R9 to give it a cash holding of R11 (10% of its R110 deposits).

(iii) Now the extra loans will be used to make payments and these will find their way back to the bank as extra R9 deposits. The bank's cash ratio is now 16,8%, which is higher than its requirement of 10%, and so loans will go on being made by the bank until deposits are R200 and loans are R180.

(iv) If a banking system works to a minimum ratio of reserves then banks will create money by a multiple of the size of its cash holding, in this example by 9 times its cash holding. It makes no difference to the theory if we allow the banking system to consist of many banks.

NOTE: The theory does, however, assume that the public are willing to hold additional bank deposits,

and if this assumption is removed the theory needs modifying. So too is the case if we take into account the fact that banking systems normally hold liquid reserves as well as cash. We shall come back to these points later in the lecture

Against this background, lets' re-assess the banker's contention that he lends only the deposits that he receives.

(a) A successfully managed bank always has <u>assets equal</u> to its <u>liabilities</u>.

(i) The bank deposits (i.e., the debts of the bank to the public) are always covered by assets people have offered to the bank in exchange for deposit claims against the bank.

(ii) When a bank lends to a borrower, an exchange of claims takes place. The borrower offers a claim of some sort, money, a government bond or perhaps a mere promise backed up by some redeemable security, against a book debt, a bank deposit (i.e., a claim against the bank).

(iii) Very few of the loans granted by the bank to lenders will actually be drawn out in cash. Thus the loan in most cases is only a book entry as the money passes from the borrower's account to the account of the individual whom he pays.

(b) This is why the banker will say that he does not create money.

<u>BUT</u>:

(c) The economic significance of this exchange of claims is the fact that the claims against the bank, i.e., a debt which did not previously exist, can increase general purcahsing power because it is <u>money</u>, whereas the debt against which it was exchanged <u>is not</u> money.

(d) The whole operation therefore has the effect of adding to the total supply of money.

E. LIMITATIONS TO THE CREATION OF CREDIT

1. The cash ratio is the obvious first limitation to the creation of credit. Since cash must be paid on demand to any customer requiring it, a bank must have some of its assets in the form of cash. The greater the amount of deposits, i.e., liabilities to the public, the greater the amount of cash required to meet this demand.

2. The total amount of cash in the country. The total amount of cash can only be altered by the monetary authorities, i.e., the Government in conjunction with the central bank. If the total amount of cash is decreased, the banks will be forced to restrict credit; if it is increased, the banks can create further credit.

3. The amount of cash the public wishes to hold is another obvious limitation on the power of the banks to create unlimited credit.

4. The availability of security acceptable to banks will be another limitation upon banks in their creation of credit.

In conclusion it can be stated that the bank's ability to create credit depends upon the liquidity ratio, the availability of reserve assets and the number of customers requiring loans.

It is by increasing or decreasing the amount of liquid assets held by the banks that the Reserve Bank attempts to control the money supply.

F. INADEQUACIES OF THE CREDIT MULTIPLIER THEORY

1. The theory of the way in which bank deposits, i.e., money, can be created by the banking sector can be said to amount to nothing more than a statement that if an economy has certain specified characteristics and if the banks work to particular rules, then bank deposits will have a given relationship to bank reserves and a change in the amount of those reserves will lead to a multiple change in bank deposits or money.

2. The trouble is that when the theory is applied to actual conditions the presupposition upon which the theory rests does not apply in its entirety and has to be modified.

3. First of all banks do not hold their reserves in the form of cash only. Most countries, in particular South Africa, require their banking systems to hold a fraction of their reserves in the form of liquid assets. Although the theory can work when the necessary reserve needed is a fixed ratio of some group of assets, if the supply of reserves is determined by the level of bank deposits, instead of the other way round, then it is no good looking at the level of reserves to offer explanations of changes in deposits.

4. Also the assumption that the public's demand for cash is fixed, is an important element in the model theory; when this assumption is removed the analysis needs modifying.

   Since the public use both cash and bank deposits as a means for payment of debts, it seems reasonable to suppose that the public's demand for cash will rise with the demand for bank deposits. This means that the banks will lose some of their cash in the course of a deposit expansion - called the internal cash drain. This will reduce the multiple expansion of deposits.

5. Therefore, given actual conditions in a real environment, before the theory can be used to explain the behaviour of bank deposits it is necessary to take into account the deviations from the specified conditions of the theory. In particular it is important to study the factors which determine the supply of reserves.

G. GOVERNMENT POLICY AND CONTROLS

1. NATIONAL ECONOMIC POLICY

The four main objectives of national economic policy may be said to be:

(a) To maintain full employment in the sense that, making allowance for chronic, seasonal and frictional unemployment, the labour force is utilise to the greatest advantage.

(b) To maintain stability in the domestic purchasing-power of the monetary unit, i.e in the general price level.

(c) To achieve a healthy balance of payments on both current and capital accounts and thus to maintain the external value of the national currency.

(d) To stimulate economic growth in those areas in which it is most likely to promote rising standards of living for the population.

It must be realised that these four objectives are not necessarily mutually compatible. Many decades ago, for example, Maynard Keynes argued that a country must choose between maintaining internal or external monetary equilibrium; it cannot achieve both stimultaneously. For example, a policy aimed at maximum growth is likely to cause inflation, especially when it produces a substantial and prolonged balance of payments surplus and is accompanied by serious shortages of certain types of skilled and semi-skilled labour.

2. FINANCIAL POLICY

Whilst a sound financial system is necessary to achieve any or all of the above objectives, the monetary authorities (i.e. the Treasury assisted by the central bank) are more directly concerned with the second and third, i.e. in maintaining a stable currency. The central government's chief contribution lies in its fiscal policy, i.e. the financing of state expenditure through various forms of direct and indirect taxation and through capital loans. The central bank, though independent of direct state control, carries out the task of implementing the decisions of the Treasury. Its advice, coupled with that tendered by expert economic advisors, assists the Minister of Finance in making such decisions.

As we have already seen, bank loans and advances create deposits, i.e. they increase the supply of money. Consequently the monetary authorities have developed various methods of controlling the volume of bank credit. These are:

(a) The control of interest rates through Bank rate and open market operations. (See below).

(b) The control of bank credit through:

(i) Prescribing minimum cash reserves against public liabilities, i.e. against various classes of deposits.

(ii) Prescribing minimum ratios of specified 'liquid assets' to public liabilities.

(iii) Engaging in open market operations, i.e. the purchase and sale of various types of government securities.

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SUMMARY

A. INTRODUCTION

Bank deposits can be regarded as money. Most money is said to be 'abstract' as it takes the form of 'bank credit'. Approximately 20% of the money supply is in the form of notes and coins.

B. BANK ASSETS

Banks must always keep a liquid position, this requirement is stipulated in the Banks Act of 1965, plus the bank must also have enough cash to meet demands by customers. Banks must therefore balance the need for liquidity against the desire for higher earnings.

C. THE VOLUME OF BANK DEPOSITS - CREDIT MULTIPLIER

Banks can create money by making loans to their customers. Usually they do not lend cash but credit the customers' account with the sum advanced to him.

The mechanism of deposit expansion by bank lending and investing may be summarised in the formula of the 'credit multiplier'.

D. HOW DOES THIS WORK IN PRACTICE?

Bankers contend they only lend out the deposits they receive. Economists say banks 'create' money. The economists argument rests on the theory of the multiplier process. An example involving five banks is provided in the lecture. The banker will always argue that he does not create money because all the bank loans/credit are guaranteed by some form of redeemble security.

E. LIMITATIONS TO THE CREATION OF CREDIT

There are a number of limitations to the creation of credit for example; cash ratio held by banks, cash held by the public, the total amount of cash controlled by the Reserve Bank and the availability of security acceptable to banks.

F. INADEQUACIES OF THE CREDIT MULTIPLIER THEORY

Inadequacies of the credit multiplier theory. There are a number of deviations in reality from the specified conditions of the theory.

G. GOVERNMENT POLICY AND CONTROLS

The government adopts a national economic policy and a financial policy in order to create a balance between growth and stability in the economy.

In order to control the supply of money, the monetary authorities regulate the supply of bank credit in a number of different ways.

PROGRESS QUESTIONS

1. Discuss the mechanism of the credit multiplier, i.e. how does the bank create deposits (additional credit).

2. What exactly do you think the bankers mean when they say the banks do not create money?

3. What features of the credit multiplier theory do you regard as the most inadequate?

4. Why do you think a surplus supply of money is disadvantageous to an economy? How does government control this?

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FURTHER ASPECTS OF MONEY

A. INTRODUCTION

In this lecture we shall study some further aspects of money, building upon what we already know about the subject. In particular, we need to have a further look at the meaning of "stock of money" which will introduce us to the concept of "near money". We shall also look at the Quantity Theory of Money and inflation as well as some related topics.

To revise, let's restate what we already know about money: -

1. Money, in the most general sense, is anything (cattle, shells, precious metal, banknotes) widely accepted in payment for goods and in settlement of debts.

2. Money is a medium of exchange. By using money as a go-between in the exchange of goods and services, the difficulties of barter are avoided.

3. Money is a unit of account.

4. Money is store of value.

5. Money can be created by commercial banks by means of the credit multiplier. The ability of banks to create money has an important influence on investment and consumer spending and consequently on general economic activity and prices.

6. In every money-using economy, there is at any given time, a given volume or stock of money in existence. This quanitity is not constant but changes over time. It is this stock of money which needs further attention.

B. THE STOCK OF MONEY

The stock of money in existence at any given time can be measured --- but we need to decide what to include. This will depend upon whether we are attempting to describe: -

1. Money as the circulating medium of exchange (let's call this M1); or

2. Money as the spending potential in the economy (let's call this M2); or

3. All bank liabilities in the form of currency and deposits (let's call this M3).

Let's now define these various concepts:

M1 = Notes and coins (in circulation outside the banks) and chequable deposits held at the banks by the private non-bank sector.

This is called the narrowly-defined monetary aggregate. Notice that the definition included chequable deposits, i.e. demand deposits with banks which are withdrawable by cheque, on anything under one months notice.

Furthermore, notice that the definition excluded government holdings of money since government spending is less closely tied to its money holding and receipts than is private sector spending. Foreign deposits are also excluded from the definition.

M2 = M1 plus:

All deposits not withdrawable by cheque held by the private non-bank sector.

This is broadly - defined aggregate. As we see, it is M1 plus medium-term deposits. Again, it excluded government and the bankers themselves, as well as foreign deposits. Medium-term deposits are those that have fixed maturities or notice periods of between one and six months and include savings.

The store-of-value function of money is often performed by money-like assets which are not means of payment,

strictly so called. These are assets which are very close to money and termed "NEAR MONEY".

Examples of near money are:

(a) Demand deposits not withdrawable by cheque but transferable by other means;

(b) Savings deposits which may be drawn in cash on demand;

(c) Time deposits.

(Note these important points about near money:
These funds earn interest and cannot really be included in the concept of money. Moreover they are tied up for short periods and are thus not perfectly liquid.
Nonetheless, they can be speedily converted into money).

M2 is a more complete measure than M1 of the spending potential in the economy.

M3 = M1 plus

M2 plus

All currency and deposits held by the government sector, including deposits longer than 6 months held by the private sector.

This is not really a measure of the money stock as such but it is used in analyses of the banking sector. It measures all bank liabilities in the form of currency and deposits.

C. MONEY AND THE ECONOMIC PROCESS

As we know, money is essentially a labour-saving device in the exchange of goods and services. Without money, all the problems

of the barter system would hamper the production, efficiency and growth of an economy. With money to lubricate the wheels of trade, greater production and a more efficient and wide-ranging system of exchange provide a greater satisfaction of economic wants than is possible without money.

However, the use of money is not always <u>beneficial</u> because variations in the SUPPLY of and DEMAND for money may cause disruptions - and disruption always means (even if only temporarily) lower or misdirected production, faulty distribution and therefore <u>less</u> satisfaction of wants. Variations in the supply of or demand for money could bring about unemployment; or spiralling wages; or prices could be unevenly altered; or the whole level and pattern of trade could be disrupted.

There is therefore, a need for a country to work out a <u>monetary policy</u> which can usually prevent distortions of the monetary mechanism and can channel the "influence" of money towards improving the performance of the economy. There are various ways of doing this, for example, stimulating flagging confidence or restraining speculation or by striking a balance between capital formation and consumption. These considerations constitute monetary theory which merges into macro-economics which is beyond the scope of this course.

D. THE SUPPLY OF MONEY AND THE GENERAL LEVEL OF PRICES

It is concern for the general level of prices which demands control of the expansion and contraction of the supply of money. Money is by definition of its function always acceptable and thus any money created will always find willing holders. However, people are not concerned with the nominal quantity of money they may be holding (i.e, the number of Rands) but with its <u>real</u> value in purchasing-power terms. If, therefore, people find themselves with an excess quantity of (nominal) money, they will dispose of their surplus holdings in exchange for other financial or physical assets.

If excess supplies of money are general to the economy, it will lead to an overall excess demand for goods (both directly and

indirectly) as a result of a fall in the costs of financing spending. In this respect money is different from other assets. Any excess supply of money is reflected in the demand for, and prices of, all goods - financial and physical. Conditions of excess supplies for other financial assets will immediately influence the price of those assets, while further repercussions are most unlikely to be as significant or widespread. If, therefore, the authorities wish to restrain changes in the general level of prices, they must control the supply of money. There are many ways in which the money supply can be controlled but they need not detain us here.

E. OPEN MARKET OPERATIONS

This refers to action taken by the S.A. Reserve Bank to <u>expand</u> or <u>contract</u> the money supply.

"Open market" refers to the buying or selling by the Reserve Bank of any assets, for example, Government stock or Treasury Bills. In general the principle is to exchange "paper assets" for "cash".

If there is too much "liquidity" in the economy then The Reserve Bank, to avoid inflationary pressures must remove the excess cash or money. To do this it will SELL "government paper", e.g. Treasury Bills. Holders of these bills, i.e. financial institutions in the money market will then exchange "cash" for "paper". Thus a liquid asset (money) is exchanged for a paper asset. As the Reserve Bank is now the holder of the "cash asset", money is effectively out of circulation in the economy. The economy is thereby deflated.

It should not be difficult to see that the reverse action by The Reserve Bank "BUYING" paper would increase the money supply and thereby INFLATE the economy, e.g. increase the means of payment and therefore potential spending. The effectiveness of open market operations depends largely on the volume of central bank securities which it can place on the market without seriously affecting either its own investment portfolio or the market price. Where the central bank has extensive investments, spread over a wide range of maturities, it can obviously either buy or sell without serious consequences.

In South Africa, the market in long-dated government stocks is narrow and is largely dominated by the Public Debt Commissioners, Pension Funds and Insurance Companies. Consequently, the monetary authorities have had to concentrate on the short-term market in treasury bills. Obviously, however, the purchase of large amounts of such bills, except in times of severe shortage of money, may be impracticable, whereas the issue of large amounts might not be considered sound finance from the point of view of the Treasury. As a support for other control measures, however, open market operations have at times been valuable.

Let us see how well you understand the lecture so far.

1. What do you understand by the term 'near money'?

2. In what ways (list two) can a substantial variation in the money supply have an adverse influence on the economy?

3. What action can be taken by the S.A. Reserve Bank to <u>contract</u> the money supply?

4. Define M1, M2 and M3.

F. THE QUANTITY THEORY OF MONEY

We must now consider why the value of money alters and what the economic effects of changes in its value are. Economists frequently disagree as to why the value of money alters. Many different explanations have been offered, but we shall restrict ourselves to the most important ones.

The quantity Theory of Money was known already to eighteenth century economists although not under its present name. Essentially, the theory states that the value of money depends on the quantity of it that is in circulation. In this form, however, the theory, although manifestly true, does not help to clarify the aims of monetary policy.

1. FISHER'S QUANTITY EQUATION

An Amercian economist, the late Professor Irving Fisher, first stated the theory in the form of a Quantity Equation. You should remember, however, that Fisher's Quantity Equation is merely one way of stating the Quantity Theory of Money. The theory is something much wider than the Equation.

In its original form, Fisher's equation stated that $PT = MV$, where M represented the quantity of money in existence in the country, P stood for the general price level measured by some index number of prices, V stood for the velocity of circulation of money and T for the number of transactions effected with the help of money during a year.

Some explanation may be needed at this point. The velocity of circulation represents the number of times each unit of money is "turned round" on the average in the course of a year. It is evident that money affects prices when it is used in the purchase of goods and services, since without the possession of money the demand of the individual for goods is not "effective". Money may perform its services either by a given quantity working slowly or by a smaller quantity moving faster from hand to hand. The effect of R50 on prices is the same whether fifty rand notes are used once in a year only or whether ten rand notes are used five times. MV, the product of the quantity of money in existence and its average velocity of circulation, represents therefore the total money expenditure in a year, or the total effective demand for goods and services.

Using Fisher's equation we get the following statement: -

$P = \frac{MV}{T}$. This means that the price level will rise if MV (i.e. either the quantity of money, or its velocity of circulation, or both) increases, and it will fall if with given effective demand the number of transactions undertaken with the help of money increases.

Fisher assumed throughout that $\frac{V}{T}$ was unlikely to alter, since this fraction was based on the money-using habits of the

community which were not expected to change in the short run, so that changes in P could be explained solely by changes in M.

An increase in the general price level is the same thing as a fall in the value of money. The value of money is then bound to fall if more money is brought into circulation; it is bound to rise if some money is taken out of circulation. Using this approach Fisher showed that the phenomenal falls in the value of money which took place in America during the Civil War and in Germany between 1922 and 1923 were the result of the monetary policies of the respective governments when they tried to pay for their current expenditures by adding to the supply of money.

We have already seen that under modern conditions only a small proportion of the total supply of money consists of legal tender money; the bulk of money in use today is bank money consisting of the deposits which the public holds with the banks. Fisher later reformulated his equation as follows: - $PT = MV + M'V'$ where M' represents the total volume of bank money and V' stands for its velocity of circulation, while M and V respresent the quantity of legal tender money and its velocity of circulation. The results of this later version of the Quantity Equation are basically no different from those of its earlier formulation, but account is taken of the existence of bank money which represents such an important proportion of the total supply of money.

You will appreciate that the Quantity Equation does not help us in measuring the value of money as such. We have seen already that this is a conceptual impossibility. What the equation does or attempts to do is to account for changes in the value of money. The reason for Fisher's basic point, namely that rising prices are the direct result of more money being brought to bear on a limited supply of goods, is his belief that all money available will actually be spent on goods and services. More money will therefore mean additional demand and that, given supply, will mean higher prices.

2. OBJECTIONS

(a) Extra Money not Necessarily Spent

The Quantity Equation is rather too plausible. It over-simplifies the explanation of changes in the price level by assuming that whenever there is more money in circulation, that money will actually be spent. This is not necessarily true. People do not spend all their money. Varying sums of money may be retained as reserves for future expenditure and if the increase in the quantity of money were to be absorbed in an increase in private hoards, the effect of it on the price level would turn out to be negligible.

(b) Demand Factors Overlooked

The Quantity Equation is also an explanation which stresses supply factors to the total exclusion of demand factors. Everything is made dependent on the supply of money and it is too readily assumed that the demand for money is a demand for money to spend. In fact, the demand for money is really a demand for money to hold, as Keynes showed in his theory of liquidity preference. The more money people are prepared to hold rather than spend, the lower will be the price level.

(c) Production Effects Overlooked

One important factor which Fisher overlooked is the effect of an increased supply of money on production. as we have shown, that $\frac{V}{T}$ was constant. If, however the country is suffering from serious unemployment of its productive services, an increase in the quantity of money leads to an increase in expenditure, or indeed any increase in expenditure which calls for more money to serve it, will not lead to higher prices but rather to increased production at given prices. More goods will become available at existing prices. Fisher, like so many other classical economists, based his theory on the disproved assumption that full employment was the normal state of affairs and that unemployment

was a mere aberration from the normal which could therefore be disregarded.

(d) Psychological Factors Under-Rated

Lastly, the Quantity Theory of Money tends to under-rate the importance of psychological factors. The purchasing power of money is affected not only by the relationship of the present supply of money to present transactions, but also by expectations as to the position which will prevail in the future. If it is generally expected that the value of money will fall, which means that prices will rise, people will try to get rid of money as quickly as possible so as not to be caught with it in their possession when its value has declined, and the increase in expenditure which will follow will bring about the fall in value of money earlier than had been expected.

3. THE MODERN THEORY

(a) The Stream of Expenditure

It is generally agreed now that the Quantity Equation by itself proves little; it is merely a convenient method of pinpointing the main factors which influence the value of money. Modern writers, particularly those influenced by Lord Keynes, prefer to study changes in the value of money from the point of view of a stream of expenditure meeting a stream of goods and services available for consumption. If expenditure rises at a faster rate than the volume of output, prices will rise and the value of money will fall.

Now, an increase in the stream of expenditure is not the same thing as an increase in the quantity of money. It is the decision of the public to spend more which matters and that is not directly dependent on the amount of money in existence. In fact, for reasons which will be discussed later, the supply of money will adjust itself to the demand for it. If the public want more money, the general machinery of our financial and banking system will provide it.

(b) Maintenance of the Value of Money

Money is thus merely a passive and not an active cause of price changes. If the value of money is to be maintained it must be done by influencing either the volume of expenditure (curbing it where there is a danger of the value of money falling, or stimulating it if the value of money tends to increase) or the volume of output or both. To achieve this we may use one or more of three possible weapons: monetary policy, which works through a manipulation of interest rates and control of credit; fiscal policy, which takes its effect through a control over government revenue and expenditure; and direct controls, such as building licences, which directly restrict the ability of the public to spend money on certain purposes.

(c) Dangers of Monetary Instability

Frequent changes in the value of money are dangerous for the following reasons: -

(i) Changes in the value of money are not of equal importance to all sections of the community. Some people are likely to gain and others will lose. Any change in the value of money represents therefore a form of redistribution of income and this redistribution does not necessarily take place in a socially desirable direction.

(ii) Business contracts are expressed in terms of money, and if the value of money changes, the very foundations on which business rests are in danger of being undermined.

(iii) Not all prices will rise or fall in the same proportion and the working of the price system may thus be disturbed. At some time, for instance, wages may rise faster than the rewards of other factors, with the result that entrepreneurs will choose to alter the combination of factors of production without a change in real costs having taken place.

G. THE PROBLEM OF INFLATION

Inflation refers to the sustained increase in the general price level in an economy or in other words, a decline in the purchasing power of a nation's currency. Deflation, on the other hand, refers to a persistent rise in the value of money represented by a continuing fall in the general price level.

In order to understand the meaning of inflation it is necessary to explain causes thereof and possible remedies.

The problem is not so much the general price level, but the rate of increase in the general price level. A rate of increase of 3% is not a serious problem. However, "double digit" inflation, i.e. $\pm$ 10% is. Prices need to change in particular markets in order to allocate resources, i.e. price rises in some, price falls in others. However, when all markets show a rapid rate of increase in prices, leading to a high rate of increase in the general price level in the economy, serious economic problems arise.

Causes of inflation can be either "costpush" or "demand pull".

1. "COST PUSH"

"Cost Push" refers to rises in prices due to increases in the costs of production. For example, increase in wages or a rise in the oil price, or an increase in the prices of steel or railway tariffs or even in import duties. All these increases in prices increase the cost of production and consequently the general price level in the economy. A serious problem occurs when the rate of increase in these prices is high or accellerates over time.

2. "DEMAND PULL"

"Demand pull" inflation refers to the pressure of spending via increased means of payment, i.e. money increases on the current ability of the economy to supply the goods demanded. For example, in RSA (1980). The gold price rise and consequent excessive earnings, (money income)

plus other real income rises (increased salaries and wages and reduced direct taxes) placed pressures in the economy's ability to meet damands. In the property market, for example, shortages occurred, e.g. insufficient bricks hence prices rose. In the labour market shortages of skilled workers developed. Consequently prices in these markets must rise.

How do we measure changes in purchasing power? We begin by restating some of what we already know. Money is used to purchase a very wide range of goods and services. It is used for the purchase of consumption goods and capital goods, as well as for transaction in financial securities representing the latter. It buys goods in organised commodity markets, as well as in wholesale and retail distribution establishments. In the field of services, it is used for the payment of labour as well as such consumption services as city transport or domestic heating and lighting. The first problem, therefore, is to decide which goods and services should be selected in order to measure changes in purchasing power.

It is now generally agreed that the most appropriate index is that which refers to consumption goods and services.

Some doubt exists with regard to the definition of a consumption good or service. Durable consumption goods such as motor vehicles or television sets may be regarded as a form of investment because they yield a stream of satisfaction over a period of several years. Strictly, only the costs of operation, including wear and tear and depreciation, should be included in a consumption price index. This, however, would pose almost insoluble statistical problems so that no distinction is made between food and drink and durable assets. Even though consumers maintain stocks of consumable goods, and clothing which may last for several months or years, the act of purchase is considered as an act of consumption. From the monetary point of view this is defensible, even where the purcahse price is paid in instalments under a hire-purchase contract.

There is, however, a second problem. With such a great variety of consumption goods and services, it would be impracticable to compile an index to include them all. Prices are therefore collected in various categories such as food, fuel & light, clothing and footwear, etc., and combined in a composite index. These prices are expressed as percentages of the prices ruling at a carefully selected base date and after 'weighting' in accordance with their relative importance in a representative consumers' budget. The final process of averaging gives a composite figure known as the Consumer Price Index (CPI). When this index rises it means that money is capable of purchasing fewer goods; prices have escalated and inflation has risen.

H. REMEDIES

It is frequently suggested that the chief remedy for inflation is an increase in production. This is not entirely true. Everything depends on whether the increased production can be obtained without the generation of additional incomes. If higher production means higher incomes as well, then while there are more goods to be bought there is also more income to buy them with and the position is not improved. What we really want is increased productivity; which means that more is produced at a falling cost per unit. This can be achieved not only by harder work (which is in any case difficult to achieve in many occupations) but also by better organisation of the productive effort and particularly by the use of more roundabout methods of production, i.e. the employment of more capital in connection with a given quantity of labour.

In modern market economies the responsibility of combating inflation rests with the economic policy makers, i.e. the central government and the Reserve Bank (the fiscal and monetary authorities respectively) together with the private sector. In principle, it is the co-operation of the government and the private sector that combats the problem. However, it is the government that provides the general direction and lead together with the actions of the Reserve Bank which is the monetary authority.

If there is too much spending in an economy, the policy makers can use fiscal instruments to check the excessive spending;

for example, raise the rate of taxes, as well as monetary instruments, e.g. raise the Bank rate. Usually it is a combination of a variety of instruments that can control excessive spending in the economy.

I. THE CHARACTERISTICS OF FINANCIAL ASSETS

Finally, let's look briefly at the characteristics which determine attractive financial assets (from the point of view of the investor). Generally, an individual asset will be made attractive on the basis of its

1. transaction costs
2. marketability
3. money-value certainty.
4. real-income certainty.

Let's study each of these separately:

1. TRANSACTION COSTS

One of the factors which determines the attractiveness of a financial asset is the transaction costs involved in their buying and selling, for example, taxes, stamp duties, brokerage charges, commissions, ledger fees, etc. plus the cost of acquiring information --- to ascertain the alternative assets available.

Any well-developed market will organise itself to reduce the costs of keeping buyers and sellers properly infomed. A good example of this is the trading floor of a stock or commodity exchange where traders are able to hear all offers to buy or sell and can see the prices at which transactions are concluded.

2. MARKETABILITY

The question here is "Is there a good market for this asset on which it can be easily bought and sold?" Any good market should have many buyers and sellers who, individually, will be unable to influence the trend of market prices.

3. MONEY-VALUE CERTAINTY

By this is meant the certainty with which one is able to predict the future money value of the asset. The highest money-value certainty among assets is normally that of money itself. Other assets may be more or less like money in this respect. Some financial assets, for example, savings accounts, may be instantly convertible into money. Other assets may have a specific maturity date and the money value of the asset will consequently vary inversely with fluctuations in market rates of interest.

Degrees of money-value certainty will also depend on confidence in the value of money itself. If the value of money fluctuates in an unpredictable way, this clearly reduces money-value certainty.

4. REAL-INCOME CERTAINTY

This refers to the yield generated by the asset and the certainty with which that yield may be expected. Income is, of course, paid and earned in money, but lenders will be concerned with the expected real value earned on any particular asset. Lenders, therefore, will make due allowance for any expected change when comparing alternative assets.

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SUMMARY

A. INTRODUCTION

B. THE STOCK OF MONEY

MI = Notes, coins and all chequable deposits held by private non-bank sector.

MII = MI plus all deposits not withdrawable by cheque held by private non-bank sector.

MIII = MI + MII plus all currency and deposits held by the government sector.

C. MONEY AND THE ECONOMIC PROCESS

Money can be regarded as a labour saving device which facilitate the exchange of goods and services. It is not always beneficial, however, price supply and demand can disrupt the economy. A monetary policy is needed.

D. THE MONEY SUPPLY

Variations in the supply and demand for money may cause disruptions in the Economy for example;

unemployment
spiralling wages
unevenly altered prices
disruption of trade

E. OPEN MARKET OPERATIONS

This refers to the action taken by the South African Reserve Bank to expand or contract the money supply.

F. THE QUANTITY THEORY OF MONEY

Why does the value of money alter?

1. Fisher's Quantity Equation states that PT = MV. Fisher argued that the value of money is bound to fall if more money is brought into circulation. An increase in general price level was equal to a fall in the value of money.

2. However there are a number of objections to Fisher's theory - these are:

   (a) Extra money not necessarily spent.

   (b) Demand factors overlooked.

   (c) Production effects overlooked.

   (d) Psychological factors under-rated.

3. MODERN THEORY

   Economists influenced by Keynes - study changes in the value of money from the point of view of a stream of expenditure meeting a stream of goods and services available for consumption. If expenditure rises at a faster rate than the volume of output, prices will rise and the value of money will fall. This school contends that an increase in expenditure is not the same thing as an increase in the quanity of money.

G. INFLATION

Inflation means a persistent fall in the value of money represented by a continuous increase in the general level of prices. There are two main causes of inflation viz. 'costpush' or 'demand pull'.

H. REMEDIES

How may problems of inflation be solved?

(a) Improve and expand productivity

(b) The implementation of stricter fiscal and monetary controls by the authorities.

I. CHARACTERISTICS OF FINANCIAL ASSETS

These may be defined as:

(a) transaction costs

(b) marketability

(c) money-value certainty

(d) real-income certainty

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PROGRESS QUESTIONS

1. The Quantity Theory of Money does not prove anything. Do you agree?

2. Explain what is meant by 'demand pull' inflation?

3. List two features which would make a financial asset attractive? Give reasons for your answer.

4. The value of money must be stable if it is to fulfil its functions adequately. Comment.

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USE THIS PAGE FOR MAKING NOTES

THE BANKING SYSTEM

A. INTRODUCTION

The banking system of almost every country is built up around a central bank. In South Africa the central bank is the South African Reserve Bank.

A central bank is distinct from the ordinary commercial banks, and its policy is primarily directed not to the making of profits, but to the maintenance of financial stability throughout the whole banking system. For this reason, central banks are usually subject to close government supervision, and in some cases are owned by the State.

Let us now consider the functions of a central bank, and the maintenance of financial stability.

B. THE PURPOSE OF THE CENTRAL BANK

1. BANKER'S BANK

As with most other central banks, the S.A. Reserve Bank is the source of further credit for the commercial banks. As we have seen, there are times when these financial institutions, having advanced as much of their own money as they safely can, require further resources. They then go to the Reserve Bank for accommodation, just as their own customers come to them for overdrafts and discounts.

2. BANKER TO THE GOVERNMENT

In most countries where there is a central bank, this bank acts as banker to the government. This entails running a current account, and managing extra-budgetary funds, i.e., the balances of such government undertakings as Post Office Savings Bank, Unemployment Insurance and Workmen's Compensation.

Since government expenditure frequently takes place before the revenue from taxation begins to come in, the central bank is often called upon to make advances to the government.

The function of acting as banker to the government is of great assistance to a central bank in maintaining financial stability. Government finance involves large sums of money and can exert an important influence on the monetary system of a country. For example, if everybody pays income tax at more or less the same time, there will be a marked decrease in the aggregate of deposits with the commercial banks, the basis of credit. On the other hand, at times when interest on government stocks is paid to the stockholders and by them into their current accounts, there will be a marked expansion in the credit base. The central bank knows when to expect these disturbing influences and can mitigate their effect by means of the credit-control weapons described below.

3. CONTROLLING CREDIT

(a) One of the functions of a central bank is to hold the reserves of the other banks; it is the banker's bank, often known as the lender of last resort. Changes in the amount of commercial bank deposits with the central bank will tend to cause changes in the volume of credit in the country. Let us see why this is so.

Suppose the central bank has private deposits (i.e., deposits made by individuals and not by banks) of R75, and against this cash it advances R25 to another customer. The customer to whom this R25 is advanced will eventually pay it over to somebody else, most probably in the form of a cheque. The recipient of this cheque will pay it in to his banker for the credit of his account, and his banker will ultimately present it to the central bank for payment. Now the banker holding the cheque has an account with the central bank, so that all that is required will be a transfer from the customer's account to the credit of the banker's account in the central bank's books. This is quite a simple transaction but it has important repercussions.

Balances with the central bank are regarded by the commercial banks as equivalent to cash. If the banker

referred to above have advanced R9 000 against a reserve of R1 000 with the central bank, now that this reserve is increased to R1 025 he will be able to increase the amount of deposits to R10 250 without changing the proportion of reserves to liabilities (i.e., the cash ratio). In other words, he can increase his advances to R9 225.

Lending action by the central bank, therefore, is likely to produce nine times the effect on the total volume of bank credit in the country where such proportions of reserves to liabilities are generally accepted. Similarly, if the central bank pays out cash, either by discounting bills or purchasing stocks and shares, the sums paid out become "bank cash" because the balances of other banks are increased. The basis of bank credit is then correspondingly increased. If, on the other hand, the central bank sells securities, both bank cash and the volume of credit are contracted.

This method of regulating the amount of credit is known as "open market" operations. It consists of varying the quantity or form of the investments held by a central bank with a view to changing the size of the cash base.

The most usual method is the buying and selling of government securities on the open-market, therby increasing or decreasing the reserves of the commercial banking sector.

(b) The Reserve Bank must also be able to exercise some influence on the credit given by the commercial banks by way of facilities to their customers. The Bank does so by controlling interest rates, particularly the discount rate, which is the rate at which the Bank will discount "first class" bills. Other short-term interest rates, including the bank's prime rate, tend to follow the movements of the discount rate. By raising or lowering its rate, the Bank should be able to make money dearer or cheaper, thus discouraging or encouraging borrowing as it sees fit.

(c) As one of the duties of the Reserve Bank is to safeguard the stability of our banking system, the commercial banks are obliged to maintain certain minimum cash reserves with the Bank as well as a minimum liquid assets requirement as against their liabilities to the public. These minimum requirements may be varied by the Reserve Bank.

(d) Another method of credit control which may be used on special occasions is "moral suasion". In this case, the central bank does not take any direct action. It asks for the co-operation of the commercial banks in curtailing credit, and discourages public borrowing by propaganda. This method is particularly useful where the central authority is desirous of checking certain types of credit creation - e.g., credit created for the purpose of carrying out highly speculative transactions.

4. REGULATING NOTE ISSUE

The Bank, as you know, issues all our banknotes and has the sole right to do so. Previously in South Africa each commercial bank has its own note-issue but this proved undesirable, as often notes were issued in excess of the country's real requirements. So now the issuing of notes in South Africa is confined to the Reserve Bank. The actual production of the notes is done by a non-profit organisation which is wholly-owned by the Reserve Bank, called the South African Bank Note Company (SABNC). This is an important aspect of maintaining financial stability.

5. The Bank has, therefore, a good deal of control over the internal monetary affairs of the country. But South Africa is far from being independent of the outside world, and we have considerable dealings with other countries. So the Reserve Bank has been entrusted with the supervision of foreign exchange reserves as well. In conjunction with its exchange business must be mentioned another important section of the Bank's business. It finances the huge gold export of this country, buying the gold from the Mines and selling it again on the Gold Markets in Zurich, and elsewhere in Europe. The sale of the gold provides the Bank with much of its foreign exchange,

as it receives payment in London and thus accumulates large sums of British Sterling, and other European currencies and U.S. dollars. These can be utilised whenever the South African commercial banks require exchange in London, Europe or the United States of America.

NOTE: From 5 September 1983 the Reserve Bank agreed to pay USA dollars to gold mines for their gold supplies to the Bank. This, together with the abolition of currency controls over non-citizens in February 1983, will probably see a reduction in the control-over-foreign-reserves function of the Bank.

To summarise, we may say that as with central banks generally, the Reserve Bank provides banking, financial and related services in that it is the:

(a) custodian of other banks' cash reserves;

(b) bank of central clearing and settlement;

(c) supervisor of foreign reserves;

(d) issuer (sole!) of banknotes;

(e) government's banker;

(f) clearing centre for economic and financial statistics and intelligence;

(g) bank of rediscount and lender of last resort.

What does not lie within the control of the Reserve Bank are tax (i.e. fiscal) policies. Those are the responsibility of the Minister of Finance and the Treasury.

C. COMMERCIAL BANKS

The work of the commercial banks covers an enormous range of services, and it is easy to lose one's sense of perspective. For this reason, we divide the services of the banks into two main categories, to stress the importance of the single first item --- short term loans --- compared with the multiplicity of items under the second heading.

1. THE BANKS PROVIDE SHORT-TERM LOAN CAPITAL

From the vast sums of money deposited daily into the commercial banking system, the banks lend (to individuals, but chiefly to trading institutions) great amounts on overdraft. This means simply that by arrangement with the bank, a customer is authorised to overdraw his account up to a specified sum, on which he will pay interest to the bank.

The bank usually requires security of some form as a guarantee that, when required, the overdraft will be refunded; and the security may take many forms which we need not detail here. It is enough to know that the bank is not simply rashly lending out depositors' funds.

Overdrafts are the main source of short-term "working capital" in commerce and industry, which often works on the basis of borrowing money at, say, 9% on overdraft to buy stocks or raw materials, on which it can make, say, 15% profit.

2. THE BANKS PROVIDE A WIDE RANGE OF SERVICES

In addition to his chief function in linking up borrowers and lenders of money, the modern banker performs a great number of other services which are of great value to his customer and to the community in general.

These consist chiefly of:

(a) Collection and payment of money

(i) In addition to paying cheques drawn on them by their customers, bankers also collect for

their customers cheques drawn on other banks in all parts of the country. In the same way, bankers pay and collect bills.

(ii) When dividends are paid on shares, they can be sent to the registered holder's banker for credit to his account. This procedure is often adopted, too, with interest warrants on debentures.

(iii) Banks also undertake to make periodical payments on behalf of customers with current accounts, i.e. stop orders.

(iv) When subscriptions for shares are offered by a company, it can be arranged for the applications to be administered by a bank.

(b) Transferring of money

The facility with which banks transfer sums of money from one town to another has been made possible by the extensive network of branches established by the commercial banks throughout the country. In many cases, of course, all the customer with a banking account need do is to issue a cheque, which he can send to any part of the country. However, the banks will transfer money by various other means as well:

(i) By letter mail (mail transfers).

(ii) By telegram, to avoid delay. (Telegraphic transfers - T.T.) As in the case of mail transfers, no money is actually remitted.

(iii) By bank draft.

(iv) By letter of credit. A traveller's, or circular, letter of credit is issued to persons wishing to obtain funds at different places.

(v) Travellers' cheques.

(c) Purchase, sale and safe custody of securities, valuables and precious metals

(i) Bankers will buy and sell securities at the request of their customers.

(ii) They will also undertake to accept valuables for safe custody.

(iii) South African banks usually have an assay department, to which metals may be sent for analysis.

(d) Undertaking financial responsibility on behalf of customers

(i) It is the practice of bankers to guarantee payment of certain cheques in favour of such payees as the Receiver of Revenue, the Postmaster, the Collector of Excise, etc. These are vouched for by the endorsement of authorised bank signing officials and are called marked cheques, oor "Cheques marked for Payment".

(ii) Provided they are supplied with adequate security, bankers guarantee fulfilment of obligations assured by their customers. They will also arrange property guarantees, letters of credit and commercial credit. Another form of guarantee issued by banks in connection with overseas trade is the shipping guarantee.

(iii) Because of their known trustworthiness, banks are frequently appointed as executors or trustees in deceased estates.

(iv) Banks can undertake to make payments in various parts of the world, and also act as agents for other banks in this country.

(e) Credit card services

These services are of two kinds:

(i) Courtesy cards, which support another document, e.g. a cheque card or a travel card, which presented by its holder at the same time as

his cheque, guarantees his credit with the bank up to the amount shown on the card.

(ii) Credit cards (shopping cards) are independent of any other document and enable their holders to draw money or to make purchases up to an agreed limit.

(f) Miscellaneous services

(i) For the benefit of the business community, banks issue regular reports on trade conditions and on the state of trade generally in various parts of the world.

(ii) To facilitate business dealings, banks are frequently requested to give references concerning the financial standing (credit-worthiness) of their customers.

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SUMMARY

The banking system of almost every country is built up around a central bank. In South Africa the central bank is the South African Reserve Bank.

PURPOSE

1. Banker's bank.
2. Banker to the government.
3. Controlling credit:

(a) Open market operations

(b) Fixing a rate for discounts

(c) Minimum cash reserve and liquid asset requirements

(d) Moral suasion

4. Regulating note issue.
5. Supervision of foreign exchange reserver.

COMMERCIAL BANKS provide a wide number of services.

1. Provide short-term loan capital.

2. Collection and payment of money.

3. Tranferring of money.

4. Purchase, sale and safe custody of securities, valuables, and precious metals.

5. Undertaking financial responsibility on behalf of customers.

6. Credit card services.

7. Miscellaneous services.

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P R O G R E S S Q U E S T I O N S

1. Describe the methods which may be adopted by a central bank to control the creation of credit.

2. What role does the Reserve Bank play in South Africa?

3. What other services does a commercial bank provide apart from providing short-term loans?

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THE SOUTH AFRICAN MONEY MARKET

I. MONEY MARKETS GENERALLY

A. INTRODUCTION

The primary function of a money market is to bring those who desire to borrow into contact with those who are prepared and able to lend. The market deals mainly in short-term loans, and most of these are based on bills of exchange. (Long period loans and investments of all property within the capital market e.g. shares, debentures, mortgage bonds and loan stock issues). The principal source of the loanable money on the market is the surplus funds which the numerous large commercial banks (as distinct from the central bank) wish to keep relatively liquid.

A money market has no definite situation. When we refer to the Money Market, we include all the institutions that contribute funds to the Market and all those that borrow these funds. Thus, for example, the London Market includes the Bank of England (which is the hub of the Market), the British joint stock banks, the Commonwealth and foreign banks; the accepting houses whose business is to accept bills of exchange on behalf of customers and float long-term loans; the discount houses and bill brokers; and to a certain extent the Stock Exchange, the Insurance Companies and all those engaged in industry, commerce and shipping. The Market is made up of lenders and borrowers, and can thus be said to comprise every potential lender and borrower of Market funds.

A number of different rates of interest or discount are normally quoted on money markets: -

Bank rate is the rate at which the central bank itself will discount first-class bills.

Market rate is the rate charged by the joint stock banks and bill brokers for discounting first-class bills. Higher rates

will be quoted for bills which are not such good class, or which have long periods to run.

Short-term rates are quoted for loans repcyable on demand, or for terms of up to seven days.

Deposit rates are the rates paid for bank deposits. Unless market rates reach an above-average level, the commercail banks do not normally pay interest on deposits, unless special arrangements are made for large amounts or long-terms. Building societies pay on day-to-day deposits (savings accounts) and higher rates for long term (1 - 2 years) fixed deposits. These rates are varied by agreement from time to time in accordance with money market conditions, but they are not changed frequently.

B. THE CONDITIONS NECESSARY FOR A MONEY MARKET

1. An adequate and regular supply of short-term, negotiable, interest-bearing and widely acceptable securities. The short-term would generally be less than a year, and never more than five years. In most money markets the securities consist largely of Treasury Bills, Short-term government bond and bills of exchange, particularly bills bearing a bank signature. The New York Money Market is exceptional in that stock exchange securities are predominant.

2. A substantial fund of liquid resources seeking short-term investment.

3. The concentration of surplus financial resources in the hands of a few financial institutions from which they can be obtained by bill brokers and discount houses without undue fuss or administrative cost.

4. A number of firms specialising in the purchase and sale of, and investment in short-term securities. If the size of the market permits, this specialisation should be in a particular branch or section of the business.

5. A central institution which will act as a lender of last resort. This institution, which will generally be a central bank, must be prepared in a time of pressure to lend to the full extent necessary to enable bill dealers to honour their obligations. Only if there is confidence that this support will be forthcoming in time of need can there be a fully flexible money market, for only then will bill brokers respond effectively to the changing needs of trade.

6. A suitable legislative framework. This must be such that financial institutions are able to make their short-term surpluses available to the market, and that depositors in the market are protected against undue speculation by bill dealers and discount houses which, in any event, operate largely on borrowed capital.

7. A banking system which is prepared to use the facilities provided by a money market.

8. Encouragement and assistance from the government and monetary authorities, particularly in the early stages of development.

C. THE ADVANTAGES OF AN ACTIVE MONEY MARKET

1. Funds which would otherwise lie idle, or which might be invested for short-term abroad, are mobilised for domestic use.

2. It enables the general credit system to operate more efficiently in that the requirements of lenders and borrowers are met more expeditiously and at less cost, and because interest rates are a more sensitive and accurate reflection of general business trends.

3. The ease of acquiring or disposing of short-term securities when there is an active money market widens the market for them, and governments are able to make greater use of short-term bonds and Treasury Bills in their debt operations.

4. The cash holdings of banks become more stabilised because temporary surplus funds can generally be placed at call in the money market, and the possibility of calling in these funds in times of pressure provides a cheaper first line of defence than recourse to the central bank.

5. The wider environment in which the central bank is able to operate, and the greater availability of credit instruments both in number and variety, make its operations more effective. Moreover, both bill dealers and the commercial banks become very responsive to changes in monetary policy, the former because they work with borrowed capital on fine margins of profit, and the latter because their cash reserves are at the minimum.

D. DISTINCTION BETWEEN THE MONEY AND CAPITAL MARKETS

The Capital Market consists of a Primary Market and a Secondary Market. The Primary market operates when the borrower and saver (investor) first get together. This happens when for example, Escom has a new stock issue and invites subscribers to purchase its stock. Similarly when companies have a share issue there is a direct offer and acceptance to subscribe for its shares between the company (the borrower) and the investor (saver). The Secondary Market exists where these securities or shares or stocks are traded between investors, i.e. this market does not effect the company or original borrower directly. Equities, i.e. shares are traded in the secondary market on the Johannesburg Stock Exchange.

The term capital market is usually applied to the market for medium-term and long-term loans as distinct from the market for short-term loans or working capital which is usually referred to as the money (or discount) market.

The capital market, in a strict sense, is concerned only with issues of new securities (i.e., long-term securities, both debt and equity) whereas the money market concerns itself, as we have seen, with short-term arrangements. It should be noted that the two markets are closely interrelated, because both lenders and borrowers may, within limits, move from one to the other.

The capital market, therefore, brings together those with savings to invest and those who want to use such savings to increase their productivity.

It consists of:

1. Savers and borrowers. These may be individuals, companies or the Government and quasi-government bodies.
2. Institutions that bring savers and borrowers together.

LET'S REVISE

1. List the conditions necessary for a money market to exist.

2. As briefly as possible list the advantages of an active money market.

3. Distinguish between

(a) Money and capital markets.

(b) Primary and secondary markets.

II. THE SOUTH AFRICAN MONEY MARKET

A. PERIOD BEFORE 1949

Before 1949 there was no money market operating in South Africa. Most of South Africa's trade was financed by open account or bank drafts. Short-term loans could only be effected through direct contract between lender and borrower. Banking institutions conducted most their money-market operations through the London market. Although the Government issued Treasury Bills from time to time these were usually held by the purchasers until maturity. In the 1920's there were several attempts to improve the position in South Africa:

1. The Kemmerer - Vissering Commission in 1925 reported that one of the biggest handicaps under which the Reserve Bank of South Africa operated was the difficulty of its carrying out open market operations.

2. In the mid 1920's the Reserve Bank opened branches in Johannesburg, Cape Town, Port Elizabeth, Durban and East London with the object of expanding its bill-discounting business.

3. In 1927 an agreement was entered into by the Reserve Bank and the Government, in terms of which the Government would issue 3 months Treasury Bills to persons with surplus funds and the bank would then, after 14 days, discount them at $\frac{1}{8}$% above the rate of issue. Before this the Bank had done little discounting except for the commercial banks or for the Treasury itself. Later in the same year the commercial banks announced that they would pay interest on deposits of R20 000 or more which were subject to not less than 31 days' notice of withdrawal, showing that they too realised the possibility of using short-term funds profitably. But neither scheme succeeded. The treasury bill scheme was withdrawn after 6 months and the commercial banks payment of interest on deposits in 1933.

The 1944 Bank Act gave the Reserve Bank greater freedom of action in lending and discounting. It did away with the need for "two or more good signatures" before discounting of commercial and agricultural bills and it allowed the bank to discount all government, including foreign government bonds. In 1948 the Bank began to buy and sell Government stocks in its operations.

B. THE PERIOD SINCE 1949

1. In 1948 the Social and Economic Planning Council, in its report on Central and Commercial Banking in South Africa commented on the absence of an organised bill market in South Africa. There were no specialist discount houses, nor was there an organised outlet for temporarily surplus funds.

   The only significant step which had been taken towards the establishment of a domestic money market had been the issue of short-term Treasury Bills by the Treasury.

   There was legislation which restricted the manner in which banks, building societies, and insurance companies could use their surplus funds.

   Because of their large cash reserves the commercial banks were not obliged to follow the lead indicated by the Reserve Bank in credit policy. Nor did the interest rate structure necessarily respond to changes in credit conditions, or to a lead given by the central bank. Thus the prevailing credit policy was enforced largely through persuasion.

2. THE SETTING UP OF THE NATIONAL FINANCE CORPORATION. (NFC)

   In 1949 the National Finance Corporation was set up to develop an active money market. About the same time the legislation governing the use of surplus funds by financial institutions was amended, thereby giving greater scope for money-market operations.

The NFC has been replaced by the Corporation for Public Deposits from 1984 (dealt with below).

The National Finance Corporation was a corporate body with a capital of R2 million subscribed by financial houses and mining concerns.

It was designed to: -

(a) Utilise idle capital in the national economic interest.

(b) Establish a short-term money-market in South Africa.

(c) Attract foreign capital.

The National Finance Corporation, proved to be a success in that it achieved its objectives during the first few years of its existence.

(a) It succeeded in mobilising idle balances from all centres of South Africa, the main sources were from the diamond and gold mining houses, insurance companies and building societies, as well as from the commercial banks.

(b) A fairly active money-market, with developments taking place freely in 6 months Treasury Bills, was developed and extensive use made of the facility of depositing call money with the corporation and earning interst on it.

It became clear, however, that not only was there room for other specialist institutions to follow the lead of the National Finance Corporation, but also that without these additional institutions, the money-market structure could not be complete.

(a) Its investments were almost entirely government securities and Treasury Bills, and

(b) On its own, the National Finance Corporation could not create a competitive market for surplus funds.

C. THE CORPORATION FOR PUBLIC DEPOSITS ACT 46 OF 1984

In 1984 the National Finance Corporation was dissolved, and replaced by the Corporation for Public Deposits.

The Public Investment Commissioners Act 45 of 1984 and the Corporation for Public Deposits Act 46 of 1984, are the result of the recommendations of the Franzen Committee and the De Kock Commission which had investigated the investments of the Public Debt Commission (PDC) and the Fiscal and Monetary Policy in South Africa respectively. The Franzen Committee found that the short-term investment activities of the PDC were to a large extent a banktype function, which required a specific expertise which did not accord with the purpose of the PDC, namely to invest public sector money in long-term stock. The Committee recommended that the short-term funds of the Commissioners to be transferred to the National Finance Corporation of South Africa (NFC). The De Kock Commission however recommended that the NFC should disappear altogether. A decision was then taken to dissolve the NFC and to establish a new institution namely the Corporation for Public Deposits (CPD), and to transfer the short-term deposits from the PDC to the CPD.

The Public Investment Commissioners Act gives effect to the abovementioned decision. The former Public Debt Commissioners will now operate under the new name of Public Investment Commissioners and will in terms of the Act concentrate on the investments of long-term deposits. The Corporation for Public Deposits Act establishes the CPD, and it is provided that this institution be a wholly-owned subsidiary of the Reserve Bank. The latter Act also dissolves the National Finance Corporation.

The Corporation for Public Deposits Act (No 46 of 1984) was promulgated for the following purposes:

1. To establish the Corporation for Public Deposits.

2. To provide for the investment of certain moneys received or held by, for or on behalf of the Government of the Republic and certain bodies, councils, funds and accounts; and

3. To provide for the dissolution of the National Finance Corporation of South Africa.

It is important for you to understand what is meant by a public deposit, so let's see what the Act says about it.

"Public deposit" means an amount of money other than revenue as defined in the Exchequer and Audit Act.

(a) which is received or held by, for or on behalf of -

    (i) the Government of the Republic, including the South African Transport Services, the Department of Posts and Telecommunications and the provincial administrations; or

    (ii) any body, council, fund or account established under any law which may invest, such amount of money with the corporation; and

(b) which is not required for immediate use or as a reasonable working balance; and

(c) which is not invested or otherwise utilized, in terms of a provision of any law, otherwise than in terms of this Act.

The corporation may accept all public deposits, repay those deposits on demand and pay interest on them. It also has the power to do the following:

1. It may invest public deposits and other moneys at its disposal in:

   (a) stock, bonds or treasury bills

   (b) bills or promissory notes issued by the Industrial Development Corporation and the Land Bank

   (c) stocks or bonds issued by the Department of Posts and Telecommunications

   (d) stock or bills issued by the Rand Water Board

   (e) debentures, bills and stock issued by the National Housing Commission

   (f) securities issued by the South African Transport Services, the Electricity Supply Commission and other government bodies.

   (g) any other debentures, bills, promissory notes or securities or bankers' acceptances issued within or outside the Republic.

   (h) deposits with any financial institutions as defined in the Financial Institutions (Investment of Funds) Act.

2. It may hold, buy, subscribe for, acquire a sell, deal in or underwrite stock, bonds, bills, promissory notes debentures, securities or bankers acceptances (which collectively can be called financial instruments) it may invest public deposits and other money;

3. It may pay to its shareholders, from its net profits, an annual dividend on the paid up capital of the corporation;

4. It may open accounts at the Reserve Bank or at any Banking institution outside the Republic;

5. In order to repay public deposits or other liabilities the corporation may

   (a) discount treasury bills with the Reserve Bank;

   (b) sell to the Reserve Bank at market value, or at a mutually agreed price, any of the financial instruments in which it has invested public deposits and other money

   (c) borrow money from the Reserve Bank against security of these financial instruments.

The Reserve Bank has an obligation under the Act to enable the corporation to repay public deposits accepted by it or to pay its other liabilities, in the manner just described.

It may also, at the request of the corporation, resell, on mutually agreed terms, to the corporation, stock on bonds sold to the bank.

The corporation has to establish a reserve fund into which a certain amount of money as determined by the board of the corporation must be paid. This amount will come out of annual net profits after payment of a dividend. The balance of the net profits must be paid annually into the State Revenue Fund.

A VERY IMPORTANT POINT:

No provision of the Banks Act of 1965 will apply to the Corporation.

NOW ANSWER THE FOLLOWING QUESTIONS

1. How did the NFC achieve its aims?

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2. What is a public deposit?

3. Please revise carefully the powers of the Corporation for Public Deposits.

4. What is the Reserve Bank's relationship with the Corporation for Public Deposits?

D. THE ESTABLISHMENT OF A DISCOUNT MARKET IN SOUTH AFRICA:

There are now 3 institutions registered as discount houses in South Africa. The first one was established in 1957 and the last one only in 1971.

The Discount House of South Africa was established in 1957. It deals mainly in short-term assets, borrowing surplus cash "at call" from banks, building societies and finance houses and using these funds to discount short-term bank acceptances, such as trade bills and Treasury Bills and to buy short-term Government stocks.

In June, 1961 the National Discount House of South Africa Limited, was sponsored by three merchant banks which had previously acted as discount houses.

In 1971 the Interbank Discount House was established. The activities of the discount houses are controlled by the Reserve Bank of South Africa and they have re-discount facilities with the bank.

A security for their borrowings from the banks and the finance houses, the discount institutions pledge their investments plus a safety margin which they finance out of their own resources.

They are very sensitive to changes in the supply of and demand for money.

E. MERCHANT BANKS OF SOUTH AFRICA:

The first of these was established in 1955 and there are now 9 such institutions in South Africa. They are all based on the British mode.

Union Acceptances Ltd. was the first South African acceptance house. As part of its merchant banking operations it was prepared to accept Bills of Exchange for South African financial institutions. With the signature of Union Acceptance Ltd., on them, the bills became classed as bank bills.

The Accepting Bank for Industry was the second merchant bank. It later amalgamated with another merchant bank to form the Central Accepting Bank (Senab). Senab later amalgamated with the City Merchant Bank to form Sentak.

Acceptance business is only one of the many functions performed by the merchant banks in South Africa, as indeed it is in London.

An accepting house may be defined as a merchant bank which undertakes to accept bills of exchange, drawn by firms in the country in which the accepting house is situated, on foreign importers. Thus the accepting house, and not the seller of goods, takes the risk of the importer failing to pay. The importer pays a commission to the accepting house.

Accepting houses also perform activities which have originated incidentally to their major activities. They act as trustees for trust funds of various kinds; they act as investment advisors and have influence upon the management of private investments amounting to hundreds of millions of rands.

Many merchant banks act as issuing houses. They assist companies by raising finance through the issue of shares. The backing and reputation of a merchant bank is of considerable importance in the disposal of new issues. Furthermore, they are willing to underwrite an issue which they regard as a worthwhile enterprise by guaranteeing to take the shortfall if the funds are not fully subscribed by the institutions and/or general investing public. Merchant Banks often have the responsibility of fixing the pace for an issue. They will advise as to the best type of issue.

Merchant Banks are thus concerned more with large transactions than the small day to day transactions for any private individual that a Commercial Bank deals in.

F. CONFIRMING HOUSES

1. FUNCTIONS

Confirming houses are credit institutions that specialis in financing the purchase of international merchanaise. They can also provide a buying service in exporting countries. The financial facility has become the more important of these two functions. The confirming house however still makes available its buying and credit facilities to consumers who purchase their consumer goods and raw materials from local manufacturers.

The credit facilities supplied by South African confirming houses are normally over and above those first provided and secured by banking institutions. Therefore the credit risk to the confirming house is somewhat greater. Yet this higher credit risk is acceptable to the confirming house because of its close ties with its clients.

There are three main benefits from the financial facility provided by confirming houses:

(a) By using a confirming house to give an undoubted guarantee of payment for mechandise required the the importer is able to ensure that he buys such merchandise at the lowest price, takes delivery at the time required, and has a company that is geared to monitor his orders, both from a delivery and a forwarding point of view, thereby saving himself considerable expense in his own business. These factors are particularly important when a world "boom" creates a seller's market.

(b) Very often the purchases require long-term manufacture, and orders may have to be placed six months or more before delivery. The international financial strength of the confirming houses is such that the manufacturer/supplier is prepared to go ahead with such manufacture without calling upon

the importer to put up cash deposits or letters of credit, which inhibit the importer's cash flow for long periods.

(c) As most of the clients of confirming houses are aiming at increasing their market share, they usually experience the familiar problems that accompany such expansion, e.g. with staff, premises, administration, and finance. The clients often appreciate being able to use their confirming house as a sounding board before making decisions on matters that will have a fundamental effect on the future development of their businesses.

2. DEVELOPMENT OF CONFIRMING HOUSES

Confirming houses were first operated in the 18th century as a means of providing buying and financial facilities to companies that were formed in the world's new territories, to enable those companies to deal with the major industrialised countries of Europe, especially Great Britain. The confirming and shipping house is in the main, connected with Britain and, in particular, with countries like Australia, New Zealand, South Africa, other African States, and the West Indies.

In the days before jet travel importers from these countries were rarely able to visit factories in Great Britain to select their own merchandise, and it was essential, therefore, that they had someone in Britain with knowledge of their particular types of merchandise who could buy for them and who was up to date with the latest trends in their particular types of business. Thus the confirming houses based mainly in London had staff who were termed "buyers". In addition to this buying facility, it became essential for the importer to receive a degree of credit as - even today - it can take six weeks from the time that merchandise is shipped in London until it is received in, say, Johannesburg.

The confirming houses found it necessary to set up offices in the countries to which they were exporting and for those offices to be staffed by people who were able to monitor the creditworthiness of their clients. Before the Second World War the confirming houses controlled a large percentage of the importations brought in by the countries that were involved in this process. At that time there was relatively little industrial activity in the importing countries, and most of their consumer products were imported.

The industrialisation of countries such as Australia and South Africa had a major effect on the shipping and confirming business. Jet travel also has become part of everyday life, and it is normal practice for directors and buyers of companies in South Africa to go to Europe, America, and the Far East on buying trips where they sample and choose the merchandise they require.

As a result of these two major changes the function of the confirming house has changed dramatically. Confirming houses still employ buyers in their London offices, but their main duty is no longer that of buying. British confirming houses have had to face the fact that the South African companies which previously imported the majority of their consumer goods are now purchasing a significant part of their consumer goods and raw materials from local manufacturers and, although they still require the financial facility, such facility is required in rand currency. Confirming houses have therefore tended to become <u>fewer</u> in number and <u>larger</u> in size, and several South African-based companies have entered the confirming business.

3. LEGISLATION GOVERNING CONFIRMING HOUSES

As confirming houses are not deposit-receiving institutions, there is no direct statutory control over their business. As credit institutions however they are subject to the Credit Agreements Act, No. 75 of 1980, and the Limitation and Disclosure of Finance Charges Act, No. 73 of 1968.

4. The sources of finance available to a confirming house, after its own equity, come almost wholly from the banking sector. Confirming houses are not deposit-receiving institutions and therefore look to the commercial banks and merchant banks for facilities by way of over-draft, bill negotiation, acceptance credit, and sight/ usance letter of credit facilities.

   Because imports are highly cyclical it is essential that shippers have flexible facilities with their bankers to cope with peak periods of turnover. In essence the financing of international trade is a short-term lending operation. Bills of exchange are normally drawn at 120 days after sight, letters of credit are drawn at sight or have a tenor of not more than six months. As a result, confirming houses are involved mainly in money market activities.

G. THE BENEFITS OF A DOMESTIC MONEY MARKET IN SOUTH AFRICA

1. The commercial banks are provided with an outlet for their short-term funds.

2. It provides and avenue through which business houses may borrow funds for a short term.

3. The government can raise short-term loans at current market rates. Before the Treasury Bill tender system was introduced, the Government normally turned to the Reserve Bank for its current requirements and was charged at a rate which may have been too high or too low at current market rates. Now the Government's requirements are part of the general supply and demand for short-term funds, and can be said to play their natural rôle in the market.

4. The Reserve Bank Can:-

   (a) Carry out its maney and credit functions more efficiently (i.e., money policy).

   (b) Lead the "state of the economy" more easily. The supply of and demand for short-term funds acts as a barometer.

   (c) Rely on the maximum use being made of available money and credit.

5. The community as a whole benefits from the greater use which is made of available funds, and to businessmen, the market provided an indication of interest-rate trends.

Before we go on to the present money market situation in South Africa, revise your knowledge of the foregoing paragraphs.

1. Name the three discount houses operating in South Africa.

2. Define an accepting house.

3. Briefly list the benefits of a domestic money market in South Africa.

G. THE S.A. MONEY MARKET TODAY

1. LENDERS ON THE MONEY MARKET

The principal source of the loanable money, is as we have said, the surplus funds which numerous large commercial banks wish to keep relatively liquid.

Banks invest a portion of their funds in Government and other securities; a further proportion is used in granting loans and advances; then a part is retained in cash to meet everyday demands; and a large amount is left on current account at the Reserve Bank. But beyond this, the banks usually have a floating surplus of money described in their balance sheets as "Money at Call, or Short Notice". This is the loanable funds which they lend out to the Money Market at low interest for short periods, i.e., "overnight", day to day, or for seven days. Most of the money is repayable at call (or demand) or at some specified short notice. It is, therefore, quickly available to meet sudden emergencies if they arise.

Considerable sums are also lent on the market by finance companies, insurance companies and underwriters.

2. BORROWERS ON THE MONEY MARKET:

(a) Discount Houses: These institutions specialise in the discounting of bills of exchange. They came into being because the banks were not ready purchasers of bills accepted by firms of which they knew very little or nothing. The Discount Houses made it their business to keep themselves informed on the credit-worthiness of numerous trading concerns, often specialising in particular types of trade. They accept money on deposit from the general public at a slightly higher rate of interest than the ordinary banks pay, but add to these resources by borrowing at short term

on the money market. The funds borrowed by the Discount Houses on a day to day basis at "fine" interest rates, and these make a "turn" by investing their deposits in short-term securities such as: -

(i) Bank Bills, i.e. bills accepted (and not merely endorsed) by a bank. The bank is usually a merchant bank because commercial banks do not as a rule practise this type of lending. Such "bank" bills are eligible for discount by the Reserve Bank.

(ii) Treasury Bills.

(iii) Government Stock with not more than three years to maturity.

In the background, holding a sort of watching brief and acting as lender of last resort is the Reserve Bank. It may come to the assistance of the dealers by re-discounting Treasury Bills or Bank Bills, or by making day-to-day loans against the pledge of acceptable assets. The Discount Houses, however, avoid "going into the Bank" if they can, because for any assistance they get they are charged Bank-rate, and this is more than they earn on their short-term investments.

It is not only as lender of last resort, however, that the Reserve Bank may intervene in the market. It may do so to make its monetary policy effective. For example, it may do this by buying and selling Government Stock and Treasury Bills in the market, i.e., open market operations. Thus, it will buy in the market when it wishes to bring down interest rates by increasing the amount of money in the market.

The general day-to-day procedure is for the discount houses to check up each morning the bills they hold which are maturing, and the bills they are committed

to buy. Then banks, mining houses, etc., are telephoned to ascertain how much they wish to lend or withdraw. If the position does not balance and the discount houses require more funds, they will then ring around again and, by offering a higher rate, try to squeeze out of the market the additional cash with the Reserve Bank to borrow the shortfall. This procedure will generally have to be finished by midday.

(b) Bill Brokers: A bill broker is an intermediary between those who have bills to sell and those who wish to buy bills for investment, in just the same way as a produce broker is an intermediary between importers of foreign produce and manufacturers who need the produce as raw material. By specialising in this highly technical business, they acquire an intimate knowledge of the financial standing and "creditworthiness" of the drawers, acceptors and endorsers of bills offered for discount.

They work mainly on capital borrowed from the banks, and their profits consist of the commission (or "brokerage") they charge to one or both of the principals, allowed for in the quoted rate of discount, but they also make a profit out of the difference between the rate at which they can buy and sell bills (i.e., the difference between their borrowing and lending rates). They run the risk, of course, of having to repay the money they have borrowed before the maturity of the bills they have purchased with it, and hence having to re-borrow at a higher rate than they charged on the bills discounted. They must be expert, therefore, in forecasting the probable state of funds in the market, and be able to adjust their rates accordingly.

(c) Governments are large borrowers of temporary funds. This borrowing has a considerable influence on the state of the market.

3. MONEY BROKERS

The branching out by the discount houses and other financial institutions into money broking, and the entry of new firms specialising in it, constitutes, conceptually, a separate category of money market, parallel to the banking system. It is characterised by a type of financial intermediary which is not a deposit-receiving institution but a person or firm who intermediates in inter-company lending in a variety of forms. Finance houses, trust companies and general banks have added money broking to the range of financial services they offer.

Money brokers place funds on behalf of, and channel them to industrial and commercial companies and semi-government institutions, in maturities from call to medium-term. Their income is the raising fee, charged as a percentage of the sums raised for their borrowing customers. The borrower also pays the interst negotiated with the lender. The intermediation by the money brokers also takes form of broking in commercial and banking evidences of debt, such as those dealt in by the discount houses, as well as 'commercial paper' which means basically the promissory notes of the borrowing firms. The acceptability of commercial paper to the lenders depends on the reputation of the broker, who may have endorsed the paper, and that of the issuer.

The money brokers provide a new source of credit because they, like the discount houses, mobilize temporarily idle funds, but they do not create either money or near-money since in their capacity as brokers they have no liabilities that could serve as such. They are instrumental in accelerating the turnover of existing demand deposits. The monetary authorities view the parallel market with some concern because it falls outside the scope of credit ceilings, liquid-asset requirements, and cash ratios, except in so far

as these control instruments curb the creation of money by the banking system and so leave less money availabe for broking.

Let's revise once again.

1. Who are the lenders on the money market?

2. What function does a discount house serve?

3. Why does a discount house need to borrow money?

4. How does a discount house invest its deposits?

5. What is the Reserve Banks relationship with the discount houses of South Africa?

6. Briefly describe the function of a bill broker.

7. Discuss money broking as a financial service.

H. BILLS ON THE MONEY MARKET

On the money market, dealings revolve around various types of bills, the chief types being:

1. BANK BILLS:

These include all those bills drawn on, and accepted by the Banks and Finance Houses. Sometimes the term is employed in respect of any bill bearing the name of a bank as drawer, acceptor or endorser.

In the market, bank bills are referred to as "First Class Bills" or "Best Paper", because of the financial guarantee behind them. They are always discounted at the finest rates.

2. TRADE BILLS:

These comprise all commercial bills drawn on and accepted by merchants and traders. They are sometimes described

as "Ordinary Bills", "Trade Paper", or "Commercial Paper". Usually they are quite secure, but discount rates for these are always higher than for "Bank Paper" and depend largely on the standing of the parties behind them, and market haggling. Commercial bills which arise from international trade sometimes have shipping documents attached, and are then known as documentary bills. Usually, the bank in the foreign centre which act as agent for the drawer of the bill, has instructions not to hand over these documents (which enable the importer to obtain possession of the goods shipped) until the bill of exchange relating to them has been either accepted or paid.

3. ACCOMMODATION BILLS:

Accommodation bills of exchange are not drawn in connection with the purchase or sale of goods; they are merely a means by which one person, by "lending" his name to another, enables the second person to raise credit. The person who is short of funds draws a bill, by arrangement, on his friend. The friend then accepts the bill for the "accommodation" of the drawer, who can then discount the bill with his bank. The accommodation party does not expect, however, to have the bill presented to him for payment on due date. It is understood that the drawer of the bill will buy it back from his bank before it falls due for payment.

Banks do not favour this form of bill of exchange, because if the drawer finds that he cannot repay the bank before the bill matures the bank will have to look to the accommodation party to meet the bill, and he may not be in a position to do so and may also be somewhat resentful.

4. TREASURY BILLS:

Up to June, 1958, Treasury Bills were issued for terms of 3, 6 or 12 months at rates of discount fixed by the Treasury, after discussions with the Reserve Bank and the National Finance Corporation, to persons who applied for them usually

in amounts of not less than R100 000. They were generally issued in the name of the applicant "or order" though occasionally "bearer" Treasury Bills were issued.

In 1958 the "tender" system was introduced. Under this system, the Treasury gives notice each Friday of the amount of Bills it proposes to issue the following Thursday. The Bills are all for 91 days, and are issued in blank "to order" in multiples of R10 000 to the most acceptable tenderers whose tenders are for at least R100 000. The Reserve Bank, in its capacity as agent of the Government, may accept any tender in whole or in part, and applicants are advised each Friday of the amounts allotted to them

They must be taken up by the following Thursday, and for the Discount House this is a delicate procedure. Treasury Bills tie up the money invested in them for a full thirteen weeks, but the yield on the money invested in them is very little more than the interest which has to be paid by the discount houses to borrow it. If the discount houses over-estimate their liquidity during the three months following the purchase of Treasury Bills by them, they will find themselves involved in loss through having to discount Treasury Bills with the Reserve Bank; if they underestimate their liquidity, they lose interest which they could otherwise have earned on Treasury Bills.

This Treasury Bills tender system constitutes, however, an accurate reflection of the supply of and the demand for short-term funds in the money market, and on the South African money market it is the rates paid for Treasury Bills rather than Bank-rate which tends to establish market rates generally.

Although they are a form of accommodation bill, Treasury Bills are recognised to be a first class security, because the accommodation party is none other than the Government. They are a means by which the Government borrows on short

terms, and are made payable at the Central Bank at a fixed future date. The commercial banks "discount" them for the Government as a short-term investment --- one which is backed by the best possible security.

5. NEGOTIABLE CERTIFICATES OF DEPOSIT (N. C. D.)

This is a receipt given by a bank for the deposit of funds. The bank promises to return the amount deposited plus interest, to the holder of the certificate of deposit on the date specified on the certificate. The fact that the bank agrees to pay the amount of the deposit plus the interest to the holder of the certificate of deposit, allows the certificate to be negotiable and to be traded prior to actual maturity date.

These certificates are a new money market instrument adopted by the large commercial banks to attract the short-term funds from local authorities, municipalities and large industrial and commercial companies. This money would otherwise be invested in Treasury Bills, short-term Govt. stocks, bankers acceptances, and other short-term money market instruments.

Unlike other short-term investments, N.C.D.'s are offered at an interest add-on basis rather than on a discount basis. Bankers Acceptances for instance, do not carry a coupon rate of interest; the yield on such investment is determined by the purchase price which is based on its discounted value, and at maturity the holder receives the par value. N.C.D's however, carry a coupon rate of interest so that at maturity the holder receives par value plus interest at the stated rate.

N.C.D.'s permit investors to place large sums of money in a short-term investment with a tailored maturity date, and companies are therefore able to obtain N.C.D.'s that mature on or before the provisional tax payment or dividend dates, i.e. before large liquid cash resources are required.

The N.C.D. has become popular because it offers:

- Liquidity in the form of a negotiable certificate issued for a specific deposit and which can be sold in the money market.

- Opportunity to choose the desired date of issue and more important, the desired date of maturity, and

- a relatively high rate of return.

N.C.D.'s are normally issued in units of R5000 or R10 000 subject to a minimum investment ranging from R10 000 to R50 000. Most banks issue N.C.D.'s with maturity dates of 3-12 months. N.C.D.'s can also be brought from the discount houses at ruling money market rates.

The interest rate averages slightly higher than the 91 day Treasury Bill and less than the rate on 4-6 month prime commercial paper.

As a last exercise on this lecture define the following:

1. Trade bills.

2. Accommodation bills

3. Treasury bills

4. N.C.D.'s

SUMMARY

I. MONEY MARKETS GENERALLY

A. INTRODUCTION

The primary function of a money market is to bring borrowers and lenders together.

A number of different rates of interest on discount are normally quoted as money markets:

1. Bank rate - the central bank rate for discounting first class bills.

2. Market rate - the joint stock banks and bill brokers rate for discounting first class bills.

3. Short-term rates - for loans repayable on demand or 7 days.

4. Deposit rates - paid for bank deposits.

B. CONDITIONS NECESSARY FOR MONEY MARKET

1. An adequate and regular of short-term, negotiable, interest bearing, widely acceptable securities.

2. The concentration of surplus financial resources in the hands of a few financial institutions.

3. A number of firms specialising in the purchase and sale of, and investment in short-term securities.

4. A central institution which will act as a lender of last resort.

5. A suitable legislative framework.

6. A banking system which is prepared to use the facilities.

7. Encouragement and assistance from the government.

C. THE ADVANTAGES OF AN ACTIVE MONEY MARKET

1. Mobilisation of idle funds.

2. Efficient operation of the general credit system.

3. Ease of acquiring or disposing of short-term securities.

4. Stabilisation of cash holdings of banks.

5. Effective operations by the central bank.

D. DISTINCTION BETWEEN THE MONEY AND CAPITAL MARKETS

The capital market consists of a primary market and a secondary market. The primary market operates when an initial investment is made, and the secondary market when securities are traded between investors on the Stock Exchange.

The term capital market applies to the market for medium and long-term loans, and is mainly concerned with issues of new securities.

The money market is concerned with short-term loans on working capital.

II. THE SOUTH AFRICAN MONEY MARKET

A. PERIOD BEFORE 1949

Before 1949 there was no money market operating in South Africa. Several attempts were made to improve this position, e.g.

1. The Kemmerer - Vissering Commission of 1925 which commented on the difficulty of open market operations

2. Expansion of the Reserve Bank which opened other branches in major centres.

3. The issue of treasury bills and short term loans by the commercial banks.

None of these schemes was very successful.

B. THE PERIOD SINCE 1949

1. In 1948 the Social and Economic Planning Council commented on the absence of an organised bill market in South Africa, and the restrictions placed on banking institutions as far as cash reserves and surpluses were concerned.

2. THE SETTING UP OF THE NATIONAL FINANCE CORPORATION.

The NFC was set up in 1949 to develop an active money market, and was designed to

(a) use idle capital

(b) establish a short-term money market

(c) attract foreign capital

It achieved these objectives during the first few years of its existence.

Nonetheless, there was a need for other specialist institutions to complete the money market structure.

In 1984 the Corporation for Public Deposits was established and took over many of the functions of the NFC.

3. THE ESTABLISHMENT OF A DISCOUNT MARKET IN SOUTH AFRICA.

There are at present 3 Discount Houses.

(a) The Discount House of South Africa (1957)

(b) The National Discount House of S.A. Ltd (1961)

(c) The Interbank Discount House (1971)

The activities of the discount houses are controlled by the Reserve Bank and they have re-discount facilities with the bank.

They are very sensitive to changes in the supply of and demand for money.

4. MERCHANT BANKS OF S.A.

There are 9 such institutions in the Republic, and most may be classified as acceptance houses. They undertake to accept bills of exchange, drawn by firms in the country in which the accepting house is situated, on foreign importers. The accepting house thus takes the risk of importers failing to pay.

They also act as trustees for funds, and as investment advisors.

Many act as issuing houses, assisting companies in issuing shares.

They are more involved with large transactions than the small day-to-day investments.

5. CONFIRMING HOUSES

Confirming houses are credit institutions which specialise in financing imports. They are subject to the Credit Agreements Act and the Limitation and Disclosure of Finance Charges Act. Since they are credit institutions, and not deposit-receiving, their main sources of finance are the commercial and merchant banks.

Confirming houses operate mainly in the money market.

C. THE BENEFITS OF A DOMESTIC MONEY MARKET IN SOUTH AFRICA

1. An outlet for bankers short term funds.

2. An avenue through which business houses may borrow funds.

3. The government can raise short term loans at market prices.

4. The Reserve Bank can function more efficiently

5. The community as a whole benefits from the greater use which is made of available funds.

D. THE S.A. MONEY MARKET TODAY

1. LENDERS OF THE MONEY MARKET

The principal source of loanable funds is the surplus funds of commercial banks which they wish to keep fairly liquid.

Other institutions providing short term money are finance companies, insurance companies, and underwriters.

2. BORROWERS ON THE MONEY MARKET

(a) Discount houses which specialise in the discounting of bills of exchange.

They make a profit by investing deposits from the public in

(i) Bank bills, notably negotiable certificates of deposit (N.C.D.'s) a new money market instrument adopted by the commercial banks to attract short term funds. They are offered at an interest add-on basis, rather than a discount basis, and permit investors to place large sums of money in a short term investment with a tailored maturity date.

N.C.D.'s are popular because they offer

- liquidity
- opportunity to choose date of issue and maturity and
- a relatively high rate of return.

(ii) Treasury bills

(iii) Government stock with not more than 3 years to maturit

The Reserve Bank acts as a lender of last resort to the discount houses, or it may intervene in the money market to make its monetary policy effective.

(b) Bill brokers who act as intermediaries between those who have bills to sell and those who have bills to buy. They work mainly on capital borrowed from the banks and their profits consist mainly of commission they charge to one or both of the principals.

(c) Government

(d) The Stock Exchange

E. BILLS ON THE MONEY MARKET

1. BANK BILLS

These include all those bills drawn on, and accepted by the banks and finance houses - they are known as "first class bills".

2. TRADE BILLS.

These comprise all commercial bills drawn on and accepted by merchants and traders. Commercial bills arising from international trade sometimes have shipping documents attached, and are known as documentary bills.

3. ACCOMMODATION BILLS

These are a means by which one person, by "lending" his name to another enables the second person to raise credit. These bills are not favourably regarded by banks since repayment problems can easily arise.

4. TREASURY BILLS

Treasury bills are all for 91 days and are issued in blank "to order" and are put to tender each Friday, and must be taken up the following Thursday.

Discount Houses must be especially careful in estimating their liquidity levels if they invest in Treasury Bills.

The Treasury Bill system provides an accurate reflection of the supply of and demand for short-term funds in the money market. Treasury Bills are recognised as a first class security because they are Government backed.

PROGRESS QUESTIONS

1. Describe the development of a Money Market in South Africa.

2. Describe the functions of a discount house and an acceptance house.

3. Why is a money market an essential ingredient to the efficient working of an economy?

   What disadvantages did South Africa suffer as a result of being without such a market until fairly recently?

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NOTES ON PROGRESS QUESTIONS

Question 1 : can be answered from the lecture.

Question 2 : Briefly the functions of discount houses are short-term borrowing and lending, the borrowing being generally on shorter-terms than the lending: -

(a) Acquiring Treasury Bills at the weekly tender.
(b) Discounting commercial bills.
(c) Purchasing government bonds.
(d) Borrowing on call and short notice from the commercial banks (and other institutions).
(e) Using the Central Bank as a lender of last resort.

Accepting houses are merchant banks (or commercial banks) which make the acceptance of bills of exchange part of their business. They use, apart from their capital, funds placed with them on deposit account.

Question 3 : This question calls for a discussion of the functions of a money market and such information can be obtained from the lecture. It then requires an account of the principal disadvantages of not having such functions at the convenience of the major financial institutes of a country and more particularly the handicap that this produces for the Government and its central bank in the implementation of its monetary policy.

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USE THIS PAGE FOR MAKING NOTES

THE GENERAL LEVEL OF PRICES.

A. THE VALUE OF MONEY AND THE PRICE LEVEL

The Quantity Theory of Money holds that the value of money is determined by the total quantity of money, and that changes in the total will cause changes in the value. Or, more simply: "The value of money is determined by the quantity of money, the velocity of circulation and the number of transactions involved".

We can see the truth of the conclusion which follows from the argument embodied in the Quantity Theory of Money on the subject of the value of money, namely, that if the general level of prices is doubled, then the value of money is halved. The doubled level of prices is represented by P x 2, and the reciprocal of this (i.e., the value of money) is $\frac{1}{P \times 2}$. In other words, the value of money is halved because:

$$\frac{1}{P} \times \frac{1}{2} = \frac{1}{P \times 2}$$

In practice, it can be seen whether the amount of money and quasi-money in circulation has increased more or less rapidly than the economy has expanded, by comparing the ratio of money (i.e. coin and notes) and quasi-money with the gross domestic product in one year with that in another. Any appreciable increase in this ratio indicates that the amount of money in circulation has increased. (This may, of course, have been counteracted by a reduced velocity of circulation).

B. MEASURING CHANGES IN THE VALUE OF MONEY

Money is valued not for itself, but for the things which its possession will command. If a unit of money will purchase more today than it did a year ago, we can say that the value of money has risen. If we wish to express this in terms of prices, we say that the prices are lower this year than they were last year. (It will, of course, be obvious that, if

more can be purchased, the price must be lower). Obviously then, if we wish to compare the value of money at two different dates, what we have to do is to compare prices ruling at the two dates.

In order to do this, economists have evolved the method of index numbers, whereby prices ruling at a certain date are represented by 100. If, subsequently, the general price level rises by 15% as compared with the standard year, the index number is quoted as 115; if it falls by 15%, the index number is quoted as 85.

Here are some difficulties which prevent the calculation of exact index numbers:

1. All prices do not rise or fall simultaneously. Some rise while others are falling. The index number must, therefore, be based on the prices of a large number of representative articles.

2. All commodities do not enter into consumption in the same proportion, and an ill-balanced choice of representative commodities may produce an index number which does not faithfully reflect the purchasing power of money.

3. Goods included in the "base" figures may go out of consumption, and new commodities not included in the original data may find an important place in the circle of exchange at a later date. Thus, motor cars, radios, television sets and electrical apparatus are hardly likely to be included in a price index number which is based on 1914 prices.

4. Seasonal products, which may be largely consumed, must be excluded when short-term fluctuations in the purchasing power of money are being studied, e.g., fruit and vegetables.

5. Changing tastes, and changes in the age or sex composition of the population, may alter the relative importance of various commodities in the family budget.

Despite these limitations, however, index numbers are of con-

siderable service in both economic study and business management. They show that, in ordinary times, the general price level moves up or down in a fairly regular motion. From price statistics based on index numbers, businessmen are able to forecast future price movements more accurately than was possible when they had to rely on guesswork. Index numbers, too, are utilised in some industries to adjust wages to changes in the cost of living and have doubtless been instrumental on several occasions in preventing disputes. As far as possible they should be specially constructed to meet the requirements of the particular problem to be dealt with.

Index numbers give us a reasonably accurate basis for comparing changes in the value of money over a period of years, but they give no indication of the cause of those fluctuations. We shall now study likely causes and effects of changes in the value of money, or, what amounts to the same thing, changes in the general level of prices.

By referring to the general level of prices we exclude the uncertain factors such as fashion, changes in taste and changes in output, which cause fluctuations in the prices of individual commodities.

C. INFLATION

1. NEW TERMS TO BE NOTED

(a) Inflation

When there is a state of disequilibrium between purchasing power which is increasing and the output of commodities and services which is not increasing correspondingly, the result is inflation - a "blowing-up" of prices. The term can be used to indicate an increase in the amount of money circulating (which does not necessarily mean a rise in prices), or it can be used simply to refer to the price-rise itself. It is in this latter context that the consumer currently uses

the word.

(b) Hyper-inflation

This term indicates that prices are rising faster and faster, and the value of money is falling so rapidly that people are no longer prepared to accept money in exchange for goods. (Reference has been made to this state of affairs in earlier lectures.)

(c) Creeping inflation

This indicates a price-rise of about 2% per annum. It is more or less acceptable on the premise that such a rise acts as an incentive to investment.

(d) Inflation and employment

In this context, note the following terms:

(i) Inflation occurs if action is taken which has the effect of raising prices above the level of those in full employment - a term which you have met before.

(ii) Deflation means either a decrease in the amount of money available OR a fall in prices. It occurs if action is taken which lowers prices and output below the equilibrium level of full employment.

(iii) Reflation occurs if action is taken to raise prices and output to a level of full employment.

(iv) Disinflation occurs if action is taken to counteract a state of inflation by lowering prices to an equilibrium level.

2. WORLD CONDITIONS

In the world itself there has been a continuous inflationary trend since World War II.

Up to the commencement of the war the position was that most of the countries of the world were still trying to overcome the devastating effects of the Great Depression, which lasted from 1929 to 1934 and which was started by the Wall Street crash in America in October, 1929. Why the depression was so severe and why it dragged on so long was also due to various reasons. After the Wall Street crash, new investment had dropped by 1933 to a level of 34% below what investment had been in 1929. Prices of agricultural products and finished goods in America fell to almost nothing and thousands of banks collapsed and had to close their doors. This depression was "exported" to Europe and other countries throughout the world, causing a collapse of the existing international monetary mechanism.

The monetary mechanism collapses when currency becomes useless as a standard measure of value. The currency rapidly depreciates as a result of price changes. Inflation appears in the economy in various forms, stemming from different sources, but all have certain features which warrant their common name.

The popular description of inflation is a situation in which too much money chases too few goods, i.e. people in a country are demanding more than they are producing. There is essentially an excessive demand for its total production.

The business cycle of a country varies between prosperity and a slump. Prosperity is usually associated with a boom period. This boom period is in turn associated with inflation and sometimes with devaluation. At the other extreme we have what is called a slump. This denotes a low level of business activity, low prices, low wages and incomes, a minimum flow of investments, thousands of unemployed workers, a great amount of indebtedness, loss of confidence and a high degree of uncertainty.

The reasons behind such a state of affairs may be numerous and will differ from one economic situation to another.

3. THE SOUTH AFRICAN ECONOMY

It is clear that any changes in the economic structure of the Western world will have an effect on the economy of South Africa.

In Europe itself during World War II there was a great destruction of capital goods and international investments in the form of factories, buildings etc. which made necessary the reconstruction work and programmes which had to be instituted to overcome this destruction. During this period, an upsurge in the inflationary spiral occurred as the cost of consumer and capital goods increased greatly. South Africa buys much mining equipment and other capital equipment from overseas and the rise in costs had an effect on its economy.

D. MONETARY CAUSES OF PRICE CHANGES

1. INFLATION

As was said earlier in this lecture, inflation is said to exist when "there is too much money chasing too few goods". In other words, because of -

(a) a restriction in the volume of goods coming forward for sale (e.g., in famine or war);

(b) an increase in the quantity of money or credit in circulation; or

(c) an increase in the rate of circulation - the flow of consumers' expenditure increases in relation to the flow of goods for sale, and prices rise. Trade increases with an increasing population, and also with invention and improvements in organisation, and if prices are not to fall, the volume of currency must be correspondingly increased. However, any increase beyond this volume raises prices, and it is this excessive increase which constitutes inflation. A characteristic feature of inflation is its tendency to have cumulative and accelerating effects. These are emphasised in the example which follows.

2. AN EXAMPLE OF PROGRESSIVE INFLATION

The continued and deliberate inflation of a currency of government issues of additional legal tender, in the form of either government notes or notes issued through a central bank under government control, would take the following sequence:

(a) The government uses the new currency to make its own purchases. The increase in total demand sends up the prices of those goods immediately affected, and the rise gradually spreads to other commodities and throughout industry.

(b) The rise in the general price level leads to a period of trade activity. Increased profits induce more entrepreneurs to enter industry and their demands for raw materials drive up the prices of raw materials still more; in the majority of industries a rise in wages and salaries follows. Prices are, in effect, pushed up by the increasing costs which producers have to meet as a result of the increased demand for production goods, and pulled higher by the consumers who have more purchasing power in terms of money. The pulls increase entrepreneurs' profits, who bid still more strongly for materials and send their costs higher still. This is the cumulative effect which is inherent in a serious inflation.

(c) This is only an apparent prosperity. There is no rise in real wages because the supply of goods available for private consumption has not increased. In spite of "overtime" and other devices for increasing output, it is very probable that the supply will be less, because the energy of many people will have been devoted to making goods for the government.

(d) If the cause of abnormal expenditure continues, further government expenditure will be at a higher rate due to the general increase in prices and wages. Budgetary deficits will necessitate further

inflation, and at a more rapid rate.

(e) This continuous fall in the value of the currency renders it unsuitable as a store of value, and people begin to look for new methods of keeping their savings. Some purchase as much as they can of a foreign currency which is tied to gold or, for some other reason, is more stable than their own; others purchase durable goods such as land or diamonds, the value of which is likely to remain firm relative tc that of commodities in general. Business firms invest their profits immediately in new machinery and plant, new office premises and any other form of expenditure which is likely to strengthen their economic position. At the same time the thriftless get through their easy profits in an orgy of extravagance. Hence it follows that everybody, except the increasing hordes of the unemployed, is busily employed so long as the process of inflation continues.

(f) The essential feature of the next stage is that people do not know what prices to charge, with the result that:

(i) prices fluctuate violently from day to day;

(ii) prices vary from place to place;

(iii) in most places people have become accustomed to the effects of inflation and the probability of its continuance and always try to anticipate it by charging "tomorrow's price". Today's currency is not sufficient for tomorrow's prices, which are the prices appropriate to tomorrow's currency, and consequently, in spite of its abundance, currency is always scarce.

At this stage the government is able to excuse itself for the continued inflation with the plea that it is only increasing the currency in response to the needs of industry and commerce.

(g) At this stage the currency becomes useless as a standard measure of value. No one will enter into a contract defined in terms of a currency which is rapidly depreciating.

(h) The currency collapses. People refuse to sell goods in exchange for the currency. Although it remains legal tender and people must accept it in settlement of debts, they cannot be made to sell. In fact they will sell only under conditions similar to barter: when the buyer contracts voluntarily to pay in gold or its equivalent.

When the currency has become almost useless as a measure of current value and entirely useless as a store of value, inflation cannot be profitably continued. The usual procedure at this stage is the discarding of the old currency and the introduction of a new one.

3. EXPANSION OF CREDIT

Inflation may also be the result of banking and financial policy leading to an over-creation of credit, induced, for example, by speculation. In these cases the consequences will not be so serious.

4. CONTROLLING INFLATION

The commonest methods of controlling an inflationary trend are:

(a) restricting the creation of credit by the banks. Bank credit constitutes part of the money in circulation in a country. The methods of influencing credit creation are dealt with later on;

(b) rationing the supply of goods which are in short supply. The object is to let everyone have a fair share in the available supply of goods at a price lower than that which would prevail in a free market. Rationing is not normally applied

to goods other than necessities such as food and clothing;

(c) price control. Producers have to supply goods at prices laid down by government edict, even if this leaves a portion of the demand (at the price) unsatisfied.

These controls do not, of course, eliminate the inflation; they merely suppress it. The inflationary conditions are still present, but their cumulative effects are watered down.

5. DEMAND INFLATION

Although we have emphasized here the importance of inflationary trends resulting from monetary causes (since we are at present dealing mainly with banking and money matters), you should note that all inflations are not necessarily the result of monetary factors. A distinction is sometimes made between a cost inflation and a demand inflation. Demand inflation results in circumstances when, following an upsurge in economic activity (induced by an increase in demand, possibly through increased employment), the factors of production become more difficult to obtain. Possibly they have to be enticed away from other uses, or possibly less efficient units of factor have to be used. In either event the cost of the factor per unit of output is likely to rise, with the result that the price level to consumers of the articles produced will also rise. The term "cost inflation" is applied to a situation where a rise in prices has followed a rise in costs which is not associated in any way with an increase in demand or an increase in output. Through trade union action, for example, a large group of employees may obtain an increase in wages, even though there has been no increase in their output or efficiency. This means that there is a larger volume of earnings engaged in "chasing" the same volume of goods, with the result that inflationary trends are likely to be set up.

For the relative significance of demand inflation and cost inflation it should be noted what adverse effects they have on the balance of payments of the country, on the quality of labour, on the value of money and on savings and the tendency to save.

E. INFLATION IN SOUTH AFRICA

Rising prices and easy credit are characteristics of inflation. Easy credit is not itself the danger. The real trouble only starts when the production of goods and services fails to match the demand. The production of goods depends on the labour position at the particular time, and whether there is full employment. Full employment does not mean that every man, woman and child works throughout the day. It does however mean that trained workers, who are willing to work at current rates of wages, will not be unemployed because there is an insufficient demand for their services. Those who are not working in the period of full employment will do so of their own choice and not because there are insufficient jobs to go round.

The key to any inflationary process is provided by determining whether it is cost-push or demand-pull inflation. Once this has been diagnosed the appropriate remedies can be applied.

1. COST-PUSH INFLATION (WAGES PUSH INFLATION)

In this case, signs of inflation become increasingly apparent and manifest themselves in rapidly rising prices and wages, without a corresponding increase in productivity. The dominant factor causing this is usually non-economic in nature. For example, trade unions may be powerful enough to demand and obtain wage increases for their members without a corresponding increase in productivity.

This causes a general rise in the price of consumer goods so that the group which originally came with its wage claims, now finds that the original increase in wages has been eliminated by a general rise in the price of consumer goods and that the cost of living has increased.

2. DEMAND-PULL INFLATION

Another typical form of inflation is the so-called demand-pull inflation. An increase in incomes, initiated by a surplus of total investment over total savings, unaccompanied by an equal increase in total output, immediately creates excess demand. The level of investment is so high as to generate a high level of incomes. This causes the demand for goods to exceed the supply. Furthermore there is full employment. Producers compete with one another to obtain the necessary raw materials and workers. The increased costs of production are passed on to consumers in the form of ever-increasing prices for finished goods.

New capital investment usually means an additional flow of production but it also means increased incomes and thus larger total expenditure. A point is reached where sooner or later the country's resources are fully employed and production will necessarily fall behind demand.

As prices rise businessmen increase investment and a further increase in labour is required in anticipation of increased profits. But because there is full employment, the level of wages is raised also, as this is the only manner left in which entrepreneurs can attract labour from other businessmen.

F. TRADE CAUSES OF CHANGES IN THE GENERAL PRICE LEVEL

Economic activity is not uniform. Apart from the daily and seasonal fluctuations which affect particular trades for reasons peculiar to those trades, there are fluctuations known as cyclic fluctuations. These are the periods of bad trade and pessimism, accompanied by low prices, and the periods of good trade and optimism, accompanied by rising prices, which have followed each other at fairly regular intervals ever since the Western European countries became industrialised. On account of their comparative regularity, these fluctuations in economic activity are referred to as the trade cycle.

Price movements resulting from trade conditions must also be taken into account when the effects of price fluctuations on the various sections of the community are being considered.

G. THE EFFECTS OF PRICE FLUCTUATIONS

1. INTRODUCTION

If it were at all possible for all prices, including the prices of labour and capital, to rise or fall simultaneously, the net position would remain unchanged in that no one would be in any way affected by the change, except in respect of the goods or money on hand at the time the change came into effect.

2. THE CLASSES OF SOCIETY

In view of the fact that a rise in average prices operates to the detriment of those who possess money or claims thereto, and to the advantage of those who owe money, and, in view of the fact that the opposite effect is experienced in the event of a fall, society falls into two main classes, viz., debtor and creditor, in connection with the topic under review. A more detailed classification, however, should be given in an examination question relating to the effects of changes in commodity prices.

Here is a more detailed account of the effects of a rise in prices on the various classes of persons:

(a) Borrowers tend to benefit, for the real value of loans they have contracted diminishes, so that the burden of repayment of principal and interest is lightened.

It has been calculated that if the rise in prices is very severe, the real value of repayment may be less than the original capital plus interest.

Thus, if in five years, the currency falls to 50%

of its previous value, a loan of R100 at 4% will be worth only R50 in actual goods; so that even the interest will not bring it up to R100 worth of goods at the old value. The total return will be only R50 plus 5 x R4 = R70.

(b) Lenders suffer for the same reason that borrowers gain. The real value of the repaid loan is less than the value at which it was contracted and the real value of interest payments is less.

(c) People with fixed incomes, such as pensioners, suffer because, although the money income remains the same, the real income falls.

(d) Wage earners as individuals, tend to suffer because, although eventually they will be able to secure rises in salary to offset the fall in the value of money, there is always a considerable lag between the depreciation of the currency and the increase in salaries. Very often this is a cause of industrial strife. Wage earners as a class, however, may benefit, as a result of the increased activity referred to under (e) below, because unemployment will tend to diminish.

(e) Businessmen are encouraged to greater activity because, owing to rises in prices, they make higher profits than they anticipated when production was started. Materials and finished goods on hand increase in value, and the real burden of fixed charges, such as rent and interest, is diminished. The new entrants who are attracted into the industry, however, compete for markets and will tend to drive prices down again.

(f) The government finds it increasingly difficult to balance the budget, and deficits tend to grow. This is because, owing to higher prices, expenditure is greater than was anticipated, while the yield from taxation does not increase so quickly, ie., there is a lag between expenditure and receipts at the new price levels.

The results of a fall in prices, or an appreciation in value of the currency are, in general, the contrary of those listed above.

H. CAN INFLATION BE AVOIDED?

If nothing is done to cure the illness, a spiral of inflation will develop and money will become worthless, as happened in Germany in the early twenties when thousands of marks were paid for a newspaper.

This state of affairs can be avoided by existing means of economic manipulation. Controlling bank credit and increasing the rates of interest, together with imposing taxation, are some of the familiar ways of combating the problem.

1. MONETARY MEASURES

(a) The bank rate may be raised, thus increasing rates of interest throughout the economy. It becomes expensive to borrow funds for investment and a businessman who has been paying 5% for investment funds will think twice if the rate increases to, say, 7%. Saving is encouraged.

(b) The cash ratio may be raised. This forces banks to reduce the volume of loans, by demanding a higher ratio of cash to deposits.

(c) The ease of borrowing may be affected by a Reserve Bank instruction to commercial banks to restrict overdraft facilities.

Banking credit policy plays an important role in regulating investment and the volume of expenditure. If credit is easily obtainable from banks and other financial institutions, the figure of total investment will soar and so will expenditure on consumer goods.

Physical Controls

Restrictions of hire-purchase are a well-known method,

effected by increasing the deposit necessary before an article is sold by hire-purchase.

2. FISCAL CONTROLS

These take longer to apply and act less rapidly, but are more thorough and far-reaching.

Income tax may be increased, thus reducing the net disposable income of the community. Similarly, compulsory savings levies may be introduced.

3. HOW CAN WE RECOGNIZE A PERIOD OF INFLATION?

We can recognize it by the following:

(a) The volume of new company registrations as recorded by the Register of Companies.

(b) Increased supplies of goods held by various middlemen, and warehousemen.

(c) Public investment, which includes capital expenditure on projects by the central and local government, municipalities and public utilities such as electricity undertakings.

(d) Building activity, such as plans passed by local authorities and expected investment in blocks of flats, office buildings and the volume of transactions by estate agents.

(e) The extent to which commercial banks are lending money on overdrafts and how much money is being lent in the form of loans by registered financial institutions. In addition, the level of hire-purchase financing.

(f) The index of retail prices will give an indication that prices of consumer goods are rising, so that the monetary value of the national income would increase more than the physical output of the national product.

(g) Imports will increase, which will cause a disturbance in the balance of payments.

(h) The volume of investment will be greater than the volume of savings.

(i) There will be a continual increase in the rates of interest and in the profits shown.

4. CONSUMER CREDIT

Buying on hire-purchase is an important feature of most booms. This is made easier by making deposits as low as possible and extending the period of repayment.

5. SPECIFIC CONTROLS

(a) When consumer demand exceeds the supply of goods, demand-pull inflation results, for which the only cure is a deflationary budget to reduce incomes to a level consistent with output.

(b) When the volume of funds available to investors exceeds the level of real investment opportunities, a speculative boom results, in which values are artificially inflated - the only cure is the tightening up of credit conditions.

(c) When world commodity shortages cause a spurt of imported price increases, the result is a temporary acceleration in the rate of increase of prices as a whole. The answer is to ride out the upsurge and wait for world conditions to ease - the price increases themselves have a deflationary effect on consumer spending power.

(d) Even without these inflationary conditions, economists may be faced with an institutional wage-price spiral of cost-push inflation. An answer is to try to control prices, not through the supply of money but through the demand for it. Direct price and income control by government is an unworkable solution. Voluntary co-operation is necessary.

In the U.K., the Trade Union Council's endorsement of the idea of tying real income differentials to real productivity gains is a good step. Indexing all wages, salaries and tax allowances to the cost of living index would eliminate "fiscal drag" and self-fulfilling fears of future inflation, and help to bring the wage-price spiral under control. Depreciation allowances and corporation tax should be tied to inflation-adjusted accounts.

I. IS INFLATION NECESSARILY DETRIMENTAL?

Many eminent economists are opposed to the concept of inflation, but it can be observed that the standard of living of the majority of the countries in the world has improved greatly during the last decade. Services and amenities in the form of social services, automation and quality of flats and dwelling houses, with the labour-saving devices that go together with these services, all make this possible. In many countries the five-day week is a reality at the present time.

There are interesting statistical comparisons to be made which indicate that there is a tendency for inflation and growth to go hand-in-hand. Although they cannot prove it to be so, some economists go so far as to say that inflation is conducive to growth.

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J. THE NEW APPROACH TO INFLATION

Modern analysts agree that, essentially, the total economy is divided into only four markets. Each market "clears" or forms its price, based on structural Demand and Supply conditions:

(a) Labour
(b) Goods and Services — becomes the investment savings curve (I S Curve)
(c) Money
(d) Credit — becomes the liquidity demand and Money Supply Curve (L M Curve)

intersection of the 2 determines the general price level and employment position.

This analysis of the IS and LM curves only stresses aggregate demand. It omitts aggregate supply and thus is incomplete. Once we introduce aggregate supply, we get the true determination of the macro-economic system.

Inflation is caused by a distortion in any one of the four markets. An excess demand causes demand push inflation and excess supply causes cost push inflation.

It's important to note that these four markets are really inter-dependent and difficulties arise when analysts attempt to separate these market causes.

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SUMMARY

THE VALUE OF MONEY AND THE PRICE LEVEL

The value of money may be regarded as the reciprocal of the general level of prices. If prices are doubled, the value of money is halved.

MEASURING CHANGES IN THE VALUE OF MONEY

Changes in the purchasing power of money, and hence in its value, are reflected in index numbers calculated from price statistics. These index numbers cannot be computed exactly, but they provide a reasonably accurate basis for comparing the value of money at different periods.

MONETARY CAUSES OF PRICE CHANGES

An over-issue of currency or an over-expansion of credit may lead to a sudden rise in the price level. A deliberate and continued inflation of the note issue would ultimately lead to the collapse of the currency.

Changes in the price level may also result from deflation and reflation.

TRADE CAUSES OF CHANGES IN THE GENERAL PRICE LEVEL

The relatively regular succession of periods of trade prosperity with rising prices, and trade depression with falling prices, which is known as the trade cycle, must be included in discussions on the effects of price fluctuations.

THE EFFECTS OF PRICE FLUCTUATIONS

If society is divided into debtors and creditors, it can be said that if prices rise, the former benefit while the latter suffer; if prices fall the latter benefit while the former suffer.

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PROGRESS QUESTIONS

1. Estimate the social utility of the credit system, and mention some of its defects.

2. Distinguish between cost of living and standard of living and indicate means of measuring each.

3. Discuss the economic consequences which follow upon changes in the value of money.

4. How are price indices used to measure changes in the cost of living?

5. Examine the difference between a cost and a demand inflation. Is it always possible to distinguish clearly between them in practice?

6. Outline the factors which govern the demand for and the supply of money.

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GUIDES TO THE ANSWERS

QUESTION 1

The advantages of the credit system are:

(a) It facilitates the exchange of commodities. Goods do not have to be marketed just at the time when the consumer is able to pay for them, in order to effect a sale. Buyers are enabled to make their purchases at the most favourable moment, even if they do not at the time possess sufficient ready cash.

(b) Production is carried on in anticipation of demand. Credit enables the producer to delay payment of part of the costs of production until the product, or part of it, is sold.

(c) The credit system, which has developed in conjunction with banking, helps to bring about the union of capital belonging to those who have no immediate use for it, with the business ability of those who are prevented from using their ability by the lack of capital. Bank advances also provide a simple method of increasing working capital by business houses during periods of temporary trade booms. In other words, bank credit gives elasticity to the organisation of production.

The chief drawbacks of the system of credit are:

(a) There are risks of an expansion of business beyond the scale warranted by general trade conditions.

(b) Inefficient firms may exist longer than they would without the use of credit.

(c) Credit tends to make business undertakings interdependent. The failure of one business which has been allowed considerable credit by several other businesses will have repercussions which affect a number of businesses.

QUESTION 2

This is a question which needs careful thought, though the clue to the answer is in the wording of the question. "Cost" of living refers to money - the expenses of living. Standard of living is a purely comparative term, and although the currency unit may be used as a means of measuring, it is not essential.

The cost of living must clearly be related in some way to an average consumer, and to the type of products which are normally bought. In published index numbers which indicate changes in the money cost of living from time to time, an average-sized family with an average income, and purchasing a "normal" group of commodities, is taken as the basis. This index indicates, in other words, changes in the value of the currency unit in terms of goods, and does not differentiate between changes which result from inflationary or deflationary trends in the quantity of money, and changes which result from fluctuations in the supply of the commodities or services to the prices on which the index is based.

The standard of living may fluctuate quite independently of prices, and to a large extent is a subjective concept, i.e., it cannot be accurately measured. We may say that the average standard of living in one country is higher than it is in another, or that it is higher now than it was twenty years ago. By reference to calories, vitamins, etc., these comparisons may convey an impression of accuracy when applied to foodstuffs only, but it can also be argued that increased variety, whether of foodstuffs, clothing or recreations, implies an increased standard of living, but this would be difficult to justify scientifically. And who is to say that a community with television sets and skyscrapers is better off - has a higher standard of living - than one from which these amenities are absent?

QUESTION 3

All the material necessary for an answer to the question is given in the lecture.

QUESTION 4

The material to answer this question is in the lecture, but I want to explain the relation between the cost of living and the value of money, to make sure that there is no confusion in your mind on this point. If the value of money falls, it can, of course, buy less. This means that in terms of money it costs more to live. All prices do not move at the same rate, however, and families which buy more of the things whose prices have risen fastest, will find that their cost of living is rising faster than that of families who buy the things whose prices have risen slowly. Thus rents may increase rapidly, and then those people who live in leasehold property will find their cost of living rising faster perhaps, than those who live in freehold houses.

The government Statistics Department which has the task of arriving at an index number which will reflect changes in the cost of living in the country as a whole, must take this point into account.

Accordingly, in arriving at the composite index, the statisticians "weigh" the indices calculated for the different

commodities and services in the proportions in which they enter into the plan of expenditure of the "average" family. Families of different income levels spend different proportions of their incomes on the various available commodities; the poorer people will spend nothing on cars and petrol - only indirectly through bus fares. These differences are taken into account in arriving at the "average" family.

QUESTION 5

The distinction between the two types of inflation is given in the lecture. In practice it may be difficult to determine which type of inflation is in progress. It often happens that an inflationary trend which is started by one group of factors brings other sets of factors into operation, so that both types of inflation are in progress at the same time. If the impetus to inflation comes from the demand side, the higher wages which have to be paid or the higher prices which have to be paid for materials resulting from increasing scarcity of labour and materials, are in effect increased costs. On the other hand, a rise in prices which follows a successful demand for increased wages may lead to a temporary increase in demand, because consumers may suspect that the price is going to rise still more. This sudden increase in demand may set a demand inflation under way.

QUESTION 6

This apparently elementary question covers, in fact, virtually the whole field of money economics, so we cannot refer you to any particular portion of any one lecture for the answer. Also, you cannot afford to go into any great detail.

(a) Briefly, the supply of money is in effect governed by the note-issuing activities of the central bank and credit creation by the entire banking system.

(b) Money is demanded for two main purposes; first, to act as medium of exchange, and secondly, to provide a store of value. The amount which is demanded depends upon such factors as the velocity of circulation, the degree of political stability (which influences the amount of money which people wish to carry around with them or keep in

reserve), price trends (because when prices are moving upwards, people tend to spend their money more freely in anticipation of further price rises) and the incidence of holidays. If a bank holiday is approaching, or at Christmas time for example, people will tend to hold more money in readiness for purchasing transactions.

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USE THIS PAGE FOR MAKING NOTES

THE ECONOMIC RESPONSIBILITIES OF THE STATE.

A. INTRODUCTION

If the state is brought into the private enterprise economy in any manner, its overall aim must logically be to maximise welfare.

We know that productive efficiency may be maximised when production is in the hands of large scale organisations. The functioning of a market normally ensures that people get what they want from the available resources; the banking and monetary systems facilitate exchange and enable people and factors of production to specialise.

We may understand "community" to mean the people in a certain country, and possibly may not consider further the problem of co-ordinating and supervising the activities of the people in this community. We may tend to take for granted the existence of some supreme authority, generally referred to as the "state". To be practical, however, we must now analyse this aspect more closely.

B. LAISSEZ-FAIRE AND SOCIALISM

These two forms of economic arrangements are at opposite ends of the political scale..

1. PERFECT COMPETITION

It is normal in economics to refer to a system of free individual enterprise as a system of laissez-faire. Although this means that the state does not interfere at all with the economic activities of the individual members of the community which forms the "state", it should be clearly understood that it really means a "limited degree of state intervention". In a country of reasonable size, complete laissez-faire would be out of the question; there must be at least some degree of state activity. Millions of people cannot be left to pursue their own individual ends without restriction; there must be some code of rules (or

"laws") to introduce a degree of order. We can say, however, that in laissez-faire the state interferes with the economic activities of the individual members of the community as little as is commensurate with the general welfare of all. Exactly to what degree this intervention should be carried is open to argument.

2. SOCIALISM

At the other extreme is a system in which there are no private property rights. All the resources of the community are vested in the state, and it is the state which decides how they shall be used, i.e. what and how much shall be produced. This entails also a control over the activities of individual members of the state, because if the control authority decides that a certain number of tons of steel shall be produced, it cannot ensure that this decision will be carried out unless it is in a position to order a certain number of men to work in steel foundries and coal mines.

In this lecture, we shall not discuss in detail either absolute laissez-faire or socialism. We shall discuss the manner in which the state has tended to assume and carry out, in a modern form of capitalist community, its responsibility of ensuring that the individuals who make up the community act in harmony in promoting their self-interest, and also, if not in the interests of the community as a whole, at least not contrary to them.

C. LAW AND ORDER

The market and price system described by economists could not function if the state did not establish legislation and a judiciary to ensure that contracts were enforced, that bargaining took place in peaceful conditions and that the physically strong were not able to enforce their will on others by violence or by threats of it. Most members of a community conform without demur to laws which they know are introduced in the interests of all.

D. PUBLIC GOODS AND SERVICES

There are a number of economic goods which will not normally be provided by private persons or undertakings in a system of free enterprise, either because they entail a capital expenditure which is generally beyond the means of a private undertaking, or because the profit (if any) which can be anticipated is not as high as that which could be anticipated by investing the same amount of capital in other directions. Examples of such goods are roads, bridges, swimming baths, hospitals; and under the heading of public services we may include the police and armed forces, and certain systems of transport.

Often these articles or services cannot be priced or sold in units; roads may be used by all and sundry. They must thus be financed from taxation, and the taxes need not be assessed on a basis which bears any relation to the use made of the public goods and services. There need not be, in other words, a "quid pro quo".

It is not possible to formulate a universally acceptable definition of a "public good". The scope of the state's activities in this direction is a matter of opinion. Some would favour a wide range of public goods while others would severely limit the variety of goods supplied free by the state. A century or less ago, the provision of free education by a state was almost unknown, but today the importance of education in general welfare is widely recognised, and most governments not only provide free education, but also make education compulsory, and exercise a supervision over paid or "private" education. In the more socialistic or "welfare" countries, the provision of basic foodstuffs at controlled prices is considered an essential public service. Indeed, the tendency is for more and more public goods to be included in the minimum which a state may provide without contravening the edict of "laissez-faire".

In most countries, including those where private enterprise is strongly favoured, the state has fulfilled the entrepreneurial function in some industries. These are usually industries, such as the collection and delivery of mail, which require monopoly control if they are to be administered efficiently, but they may also be industries which private enterprise has not established and which, it is felt for one reason or another, that the community should have. The capital is raised on a fixed interest basis in the form of a government loan, and the inaugurating Act

makes provision for the way in which profits or losses, if any, must be dealt with. Because these undertakings normally provide a public utility, they are often called public utility corporations. South African examples are the South African Broadcasting Corporation and the Electricity Supply Commission. The Iron and Steel Corporation (Iscor) is a special example, in that it represents the establishment by the state of an industry primarily for strategic reasons, for which private capital was not forthcoming.

E. MONOPOLY

The protaganist of laissez-faire is very likely to support a state intervention designed to restrict or eliminate monopoly power. The advocates of laissez-faire favour consumers' sovereignty; monopoly represents an interference with this sovereignty. Generally speaking, the price system under free competition ensures that people obtain what they want most, but through the development of financially powerful business organisations or "pressure groups", the price system may become distorted. If the output of particular goods is in the hands of one producer organisation, it may be restricted to keep prices up, and the price does not then correctly reflect the real cost in terms of sacrificed alternatives.

The argument that competition brings the greatest happiness for the greatest number is fulfilled only if certain assumptions remain true. Two of these are -

(a) that through competition the fittest and most efficient survive. The "marginal" firms, and those that "go under", are the least efficient;
- and -

(b) that the market valuation reached by competitive market conditions correspond with social valuations.

Neither of these assumptions will be true if there is monopoly. Inefficient and out-of-date production methods may be bolstered up by the high prices which the monopolist's control over output enables him to secure. The market prices which the consumer pays for these monopoly products is not a social valuation, but a reflection of distorted supply and demand.

Similar results may ensure from "agreements" between apparently competing producers, and, indeed, from the tendency for small producers to adopt prices fixed by large producers (i.e. price leadership). All these represent deviations from pure competition and an interference with consumers' sovereignty. In many countries

legislation has been introduced which gives the state power to control the development of such monopolistic practices. In the United States this legislation has probably gone further in scope than any other countries, but the theoretically suppressive American Anti-Trust laws have proved to be slow and costly in practice, and some monopolies have operated for many years before they have been eliminated. In the United Kingdom, reliance was placed for many years on laws which rendered illegal any action which was "in restraint of trade". This legislation proved to be inadequate, however, to deal with the problem as represented by present-day combines and interlocking company administrations, and there is now a "Monopoly and Restrictive Practices Commission" which investigates cases where it is alleged that competition is being prevented or restricted, and then, if necessary, it sets into motion machinery which ensures that the restrictive practices are eliminated or modified.

This Commission has now been replaced by the Competition Board. It is still distorting monopoly towards the perfect competition model. There are many viewpoints as regards the existence of monopolies in an economic system.

Prof. Lester Thurow maintains that the existence of monoplies can work in favour of the public interest.

Milton Friedman argues that monopolies are the creation <u>not</u> of market forces but of the government granting letters of patentry - i.e. a <u>licence</u> to monopolies. Koutsoyiannis says most forms of the enterprise because of economies of scale, tend towards monopoly - specifically oligopoly.

In South Africa, the Board of Trade and Industries originated from a committee appointed to investigate the problem of monopoly practices. The board is still in existence today, but forms part of the Department of Commerce, and one of the functions of this Department is to watch for undesirable monopolistic practices in terms of local law.

Similar in nature to monopolistic practices, in that they also lead to a distortion of consumers' choice and demand, are the methods used today to advertise products. This "high pressure selling", as it is sometimes called, has tended to transfer the "sovereignty" from the consumer to the producer; instead of the producer aiming to produce the goods which the consumer has indicated that he wants through the operation of the price system, he decides himself upon the product which he will produce and then sets out to persuade the consumer to buy it. It may happen that the same goods have been produced for some time by another producer under a different "brand" name, but by a skilful appeal to the consumer, possibly playing on emotions or sentiment, the producer leads the general public to believe that his is a new product. He has not, indeed, performed any service to the community as a whole by producing the commodity and whatever he sells, is merely counteracted by a reduction in other producers' sales. The advertiser has not met an expressed demand; he has not even created a demand; he has merely transferred the demand from a substitute to his own product.

It must not be assumed from this that all advertising interferes with consumers' sovereignty or prevents the maximisation of welfare. Some advertising is genuinely informative and has utility in that it draws the attention of consumers to new and needed goods or services.

F. UNEMPLOYMENT

It has been said that the two great defects of capitalism are monopoly and unemployment. Most economists agree that one of the overriding aims of the broad economic policy of a state should be the maintenance of full employment. In other words, it is a responsibility of the state to ensure that unemployment is not excessive. What degree of unemployment is consistent with "full employment" is a matter of opinion. To promote a high level of employment a state may undertake public works, may encourage spending through fiscal measures, or encourage investment by introducing a regime of cheap money.

If <u>all</u> economic activity were directed by the state as in socialism, there need be no unemployment at all. In terms of

Keynesian economics, unemployment is believed to result from the fact that under a system of free enterprise, the decisions to save more (i.e., buy fewer consumption goods) and to invest more are taken by two different sets of people (consumers and entrepreneurs). Under a fully planned economy, however, it would be the central planning authority which makes both decisions - fewer goods for consumers to buy and more labour to be devoted to capital production.

Thus, Keynes essentially argues that investment is the heart of the growth process. Whether investment is "caused" by government or private enterprise - is not the real issue.

G. INEQUALITIES

In a capitalistic economy, because of succession and inheritance, the payment of interest on savings invested, and for other similar reasons, there tends to develop a wide disparity between the richest and the poorest in the community. It is often considered by politicians and others that the broad economic policy of a state should be directed towards eliminating or minimising large inequalities in wealth and income. To what extent this policy should be carried is a matter which has to be determined in the political arenas, but in most countries, even those which are fully capitalistic, the larger inequalities are smoothed out by:

1. REDISTRIBUTIVE TAXATION

Income tax is made steeply progressive, i.e. higher incomes pay a much higher rate of tax. Death duties, steeply graduated according to the size of the estate, have the same effect.

2. SOCIAL SERVICES

By providing services such as education, insurance against unemployment, pensions for everybody, sickness benefits, milk and meals for school children, all free of charge or at prices much below cost, the state in effect helps the poor at the expense of the rich. People who could not otherwise afford these services are able to enjoy them and they are paid for mainly by the people who pay the highest taxes. The payment of cash allowances

to the parents of large families is a more direct way of subsidising those with heavy responsibilities at the expense of others whose responsibilities are lighter.

3. SUBSIDIES ON ESSENTIALS

The payment of subsidies by the state in an attempt to keep down to a stable level the prices of essential food-stuffs, helps to iron out differences in incomes. Although the rich may also consume the subsidised food-stuffs, their free supply is a greater proportionate addition to the smaller incomes, but it is the higher incomes which, through taxation, subscribe most towards the cost of the subsidies.

H. BUREAUCRACY ("bew-rock-rassy"!)

The greater the degree of state intervention, the more the individual citizens will find that their lives are governed by regulation, and the more frequently they will have to submit data and personal details to government officials, and wait for their decisions. Most of you will have discovered that in South Africa you cannot import what you want from abroad without the prior sanction of a government department; you will have found that in urban areas you cannot build a house just as and when you want to. In many places you will find that there are regulations governing your right to keep poultry, pigs or horses. You cannot run a car or do many other things unless you have a licence to do so.

Many people find this interference with their lives irksome, but others accept it as part of the price they must pay for the efficient direction of economic activity in the country, and a minimum of social welfare for all. Some will feel that state intervention goes too far; others may consider that it does not go far enough. It is in connection with state intervention in industry in particular that there is a good deal of controversy. It is claimed by many that the state is not an efficient entrepreneur. The fact that public funds are involved, and that the state must justify its actions before parliament and the electorate, tends to make the executives cautious, and the administration becomes cluttered up with "red tape". There is not the same profit incentive, and personnel are not prepared to make rapid decisions when these are called for. In private industry, greater risks can be taken; businesses can experiment, take risks in the hope of profits, and venture into new techniques.

We are all prepared to make the sacrifice of freedom of action which is necessary to ensure law, order and an organised economy. Beyond this we may be prepared to sacrifice further freedoms in order to get rid of unemployment, monopoly and other defects of capitalism, but only if we are of the opinion that through control of certain facets of the economy the state can eliminate these. Some will consider that it is not the state's business to attend to these; others may consider it the state's responsibility, but have no faith in the state's ability to do anything about them.

I. PATERNALISM

Although it does not result from an economic motive, the intervention of the state for paternalistic reasons may have results which are important economically. A state acts in a paternal fashion when it decides that certain commodities should not be available for purchase by the community, or that a certain service should not be provided. In this respect it may act positively or negatively.

1. POSITIVE ACTION

The state may intervene in the distribution of certain goods, to ensure, for example, that they go to the people who need them most. Thus, milk is considered desirable for children and may be distributed by the state free to certain pupils through the schools.

2. NEGATIVE ACTION

The general public may not be allowed to buy, or even to possess, certain commodities. Thus, in South Africa, nobody is allowed to possess dagga, and only certain persons are allowed to purchase alcoholic liquor. Gambling is permitted only under certain specified circumstances, and South African citizens are not allowed to participate in sweepstakes and pools unless they are operated outside the country. Certain flora and fauna may not be imported into South Africa, and the state reserves the right to say who may or may not possess a firearm.

Another form of state intervention which is paternalistic in a sense, though it has another motive as well, is the levying of high taxes on certain articles, such as tobacco. The tax discourages heavy consumption, but also raises revenue for the state.

J. MARKETING

We may divide our discussion of state intervention in marketing into four sections: manufactured goods; agricultural produce; international agreements; and miscellaneous.

1. MANUFACTURED GOODS

In a laissez-faire economy, a state does not normally intervene in the marketing of manufactured goods. Exceptions occur when for example, in a time of national emergency a state intervenes to ration a limited supply of goods among consumers, and when there is a need to protect consumers against the existence of impurities against which they cannot easily protect themselves, e.g. food and drug acts which require the ingredients of patent medicines and foods to be stated clearly on the containers. There may also be legislation regulating advertising so that consumers cannot be blatantly misled.

2. AGRICULTURAL PRODUCE

Some form of state control over the marketing of farm produce is commonly found. Thus, the South African Marketing Act provides for the formation of a National Marketing Council and for the operation of marketing schemes designed to raise or maintain the prices of agricultural produce above the levels which would otherwise prevail. This type of state intervention is usual because in the absence of some form of organisation, the bargaining power of farmers is notoriously weak, on account of:

(a) the specialised investment involved and the consequent reluctance to liquidate at a loss or to change the type of the product produced;

(b) the time taken from sowing to marketing. The "supply tap" cannot be turned off at will, and it may take months or even years to adjust output;

(c) the uncertainty of output due to climatic factors, and of the value of output because of the need to market quickly in many cases;

(d) inelasticity of demand in the short term. The products in question are often the subject of acquired tastes or traditional diet.

In South Africa, marketing control schemes are at present in operation for, amongst other products, wheat, mealies, citrus, tobacco, livestock and meat, and potatoes. Briefly, the basis of the operation of these schemes is for the control board to withdraw market surpluses and to hold these in reserve for remarketing when there is a relative shortage, and when prices are higher. The costs of administering these arrangements are met from a levy imposed on all growers of the crop concerned, on the basis of the quantity grown or the quantity marketed.

There are a few disadvantages of controlled marketing schemes in agriculture.

(i) With separate boards for different products, undue weight may be given to sectional interests.

(ii) While stability may be an improvement on the uncertainties of competition, it must not be carried so far that initiative is discouraged.

(iii) Inadequate safeguards exist for consumers.

(iv) Because of restrictions on output, continued scarcities may be the order of the day, rather than improved farming methods.

3. INTERNATIONAL AGREEMENTS

The marketing of a number of commodities entering into world trade has been brought under international control, generally through the promotion of agreements by producers anxious to avoid the accumulation of surpluses on the world market. Agreements of this nature in which South Africa participates, are the International Sugar Agreement and the International Wheat Agreement.

4. MISCELLANEOUS

Other forms of state intervention in marketing are:

(a) The development of foreign markets for the products of a country by trade agreements with other countries and the services of trade commissioners in important foreign centres. The functions of these trade commissioners are:

(i) to keep in close touch with the government, commercial authorities, markets and men, in the centres where they are established; to effect business introductions, and bring producers and consumers together where possible;

(ii) to study and report on laws, customs regulations and such legislation as affects banking or shipping, in order to facilitate the despatch of goods from their home countries;

(iii) to watch imports into the country with a view to furnishing as complete information as possible on the best methods of meeting competition;

(iv) to furnish reports on the financial and trade conditions in the country, indicating possible fields of exports for their own country's produce to the countries in which they reside;

(v) to collect information on contracts which become, or are likely to become, available, and for which tenders are, or will be, invited, and to give advice on possible developments likely to affect producers' interests;

(vi) to make annual reports on conditions and prospects of trade in the countries in which they are established, and to make such special reports on the general trend of markets as they deem will be of interest to firms in their home countries;

(vii) to examine consignments of South African produce at the point of unloading in order to report on its condition (particularly of perishable produce), its quality and its suitability for

the foreign market, and to indicate where there is scope for improvement in the grading and packing. To carry this duty to its logical conclusion, the commissioner may follow up the disposal of the imported produce at markets and auctions; and

(viii) to organise exhibitions or displays and to arrange exhibits at commercial and industrial fairs.

(b) The establishment of standards and their enforcement by frequent checking and occasional inspection, and the formulation of regulations relating to the sale of goods. These include, for example, regulations requiring producers to mention on containers the nett mass of the goods contained in them, or regulations requiring certain goods to be sold by volume.

K. WAGES AND WORKING CONDITIONS

An economic sphere in which many governments intervene through legislation, is the employment of labour. A government may set a level below which wages may not fall - i.e., may prescribe minimum wages. It is also usual nowadays for governments to prescribe maximum ordinary working hours, minimum standards for working conditions (e.g., ventilation, lighting, etc.) in factories, and safety measures which must be adopted in all dangerous trades. Many governments go further and insist on workers being insured against the consequences of accidents which occur in the course of their employment.

In South Africa, the conditions of work in industry are dealt with in the Factories Act, and workers in commerce and trade are cared for by the Shops and Offices Act.

There are two main systems of wage rate fixing - that provided by the Labour Relations Act, and that provided by the Wage Act.

The Labour Relations Act is concerned with conciliation in industry - conciliation between employers and employees, on a voluntary basis.

Conciliation can take place, of course, only if there are representative bodies to put forward the views of the employers and employees; it follows that an essential preliminary to the setting in motion of conciliation machinery is some degree of organisation among employers and employees respectively, i.e., trade or employers' associations and trade unions.

The Wage Act provides for the appointment of a Wage Board consisting of a chairman and two members. The duties and functions of this Board are to investigate and report to the Minister of Labour on the wages, hours of work and general working conditions in any trade specified by him, or in a trade in respect of which a registered employers' organisation or a trade union, or a number of employers or employees considered by the Board to be sufficiently representative, has submitted an application direct to it.

Working conditions (sanitation, ventilation and staff welfare amenities), hours of work and safety regulations which must be adopted by all establishments falling within the scope of a very wide definition of the term "factory", are laid down in the Factories, Machinery and Building Work Act.

L. STATE - "ISMS"

1. CAPITALISM

A system which leaves to the owners of property an open choice of the way in which their resources will be used, (subject to a respect for other persons' property rights), is known as a capitalistic system - or "capitalism". There is free enterprise in such a system, each property owner can produce what commodities he likes, how he likes, and may dispose of them as he pleases, but subject to exceptional cases governed by sentiment or some other non-economic motive, these three choices will be influenced by the price system. In a capitalist system, then, it is the market system, the desire to make profits and the price system which basically control economic activity.

2. SOCIALISM

Under a system of socialism all the resources remain the property of the state, and it is the state (through its officials) which determines the "what, how and for whom".

The planning officials must decide what is to be produced with the available resources, so they also decide, in effect, what the people will be allowed to consume. In other words, consumers will get, not necessarily what they would have liked, but what the state officials think they ought to have. This allocation, particularly if it is based on needs, may be a more scientific utilisation of resources than production of what the people want, these wants being influenced by tastes and fashions. To deal successfully with an extensive range of resources and requirements is a complicated mathematical problem, however, and some sort of limited pricing system is likely to be introduced as a guide to peoples' wants.

3. COLLECTIVISM AND COMMUNISM

These - "isms" represent different degrees of socialism against different political backgrounds. In an economic system in which the state arranges for the co-operative use of resources (e.g. it may arrange for all the peasants in an area to work on a large tract of agricultural land, receiving in exchange a share in the crops which are produced by paying a share towards the cost of tractors and machinery supplied by the state,)there is a degree of collectivism, but all the productive resources are not necessarily state-owned. Communism refers to the system operating in Russia, where all the resources are owned by, and all business operated by the state, but all the produce is not distributed to consumers. The primary objective is to make the state more powerful on the world scene, and a specified proportion of production is directed towards defence and new capital formation.

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SUMMARY

When men live in communities, there must be some form of government. The main function of the government will be to maintain law and order, and to obtain a general respect for private property rights if the community is based on private enterprise. Although the theory of competition argues that by promoting their own individual ends, men indirectly promote the welfare of the community as a whole, in practice there are serious qualifications to be made. Monopoly is perhaps the most important of these. These qualifications make it necessary for the state to intervene and make inroads upon the consumers' sovereignty. The extent to which these inroads can be justified is a matter of opinion, but it is generally accepted that it is the state's responsibility to restrict private endeavour so that self-interest does not conflict with community interest, and to modify the price system to ensure that it works as the classical economists claimed it did. It is also generally considered today that the state should assume responsibility for maintaining a high level of employment, and for ironing out wide inequalities in incomes. Capitalism and socialism are opposing political systems.

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PROGRESS QUESTIONS

1. What do you consider to be the legitimate role of the state as entrepreneur?

2. Explain and examine laissez-faire as the economic policy of a state.

3. State what is meant by "economic freedom", and consider whether the term is synonymous with "competition".

4. "In a modern state there are some functions bearing on economic life which a government must perform". Discuss.

5. What do you consider should be the role of the state in economic affairs? Illustrate your answer with reference to South Africa.

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GUIDES TO THE ANSWERS

QUESTION 1:

Here is a model answer to this question:

The entrepreneur's functions are briefly -

1. To estimate the demand for the product and to study the market for it.

2. To study the market for the raw materials and estimate the cost of production.

3. To devise means of raising the capital necessary to start the venture.

4. To bring together the factors of production - land, labour and capital.

5. To decide upon the location of the factory or business, taking into account the sources of supply of the agents of production and the transport charges of the raw materials and finished product.

6. To decide upon the policy of the business with regard to employees' pensions, recreational facilities, promotions, etc., and with regard to the expansion of the business - that is, whether expansion should proceed in a "horizontal" or "vertical" direction.

7. To undertake the risk of the venture, except in so far as this may be offloaded on to the shoulders of the ordinary shareholders.

The question arises as to how far these duties could or should be undertaken by the state. The general principle is that where private enterprise can and does produce a service or supply a product at a price lower than that at which the state would be able to supply a similar product or service, then state enterprise is not warranted.

Leaving out of account theories of communism or socialism, there are instances where public enterprise can produce a service at a cheaper rate than that at which private enterprise can produce the same service; and there are other instances where private enterprise has not provided, nor provides, the service at all.

Briefly, those instances where the state performs a legitimate role as entrepreneur are -

1. Where competition is wasteful, e.g., the duplication of water mains or electric standards and wires or railway lines.

2. Where the interests of the firm and the state conflict - e.g., central banking.

3. Where the security of the community requires public control - e.g., iron and steel and atomic research in the interests of defence.

4. Where the service, though vital, would not or does not attract sufficient private enterprise, e.g., education.

5. Where private industry does not provide the service or industry at all, e.g., naval and air forces.

6. Where the profit inducement is too meagre or remote to attract private enterprise, e.g., medical research.

7. Where private enterprise cannot provide what is regarded as an essential service at a price within reach of the middle and lower income groups - e.g., housing.

It is obvious that this list is by no means exhaustive. What is legitimate state enterprise today may be frowned upon in a generation's time; and what, a generation ago, was regarded as the preserve of private enterprise has, with time, come to be regarded as, more properly, a preserve of public enterprise.

Up to the present time, however, the trend has been towards more, rather than less, public enterprise; should there be a general depression in which private enterprise fails to render those services

expected from it, then we can expect a still further acceleration in the general trend. So far, however, governments have avoided participating in those ventures where the risk element is great, because tax-payers would naturally be reluctant to make up a deficit should the venture not succeed.

QUESTION 2:

To begin this answer you should explain what laissez-faire means and point out that if a community is to work in harmony for the joint and several interests of the members, complete laissez-faire is out of the question. There are a minimum number of directions in which state intervention is essential, and the tendency is for the minimum to grow. A state which carries on industrial or commercial undertakings which would be efficiently operated by private enterprise, which introduces state monopolies, which establishes quotas for producers and rations for consumers, would be going beyond the bounds of laissez-faire. It would be undertaking central economic planning.

QUESTION 3:

Although one of the main features of "economic freedom" or laissez-faire is generally considered to be free competition, the two terms are not synonymous because restrictions on economic freedom are often introduced specifically to preserve competition. To answer this question you should then proceed to show how the development of monopoly may lead to distortions in the price system, with the result that consumers are robbed of their sovereignty, and welfare is not maximised. On the other hand, in certain types of undertakings (e.g., water and public transport), it may be found advisable to check competition in order to maximise welfare. Competition in this type of undertaking could be very wasteful.

QUESTION 4:

This question bears directly on the lecture. The type of functions you must mention are: the preservation of property rights, the suppression of pressure groups and monopolistic practices, the maintenance of a high level of employment, the improvement of statutory weights and measures, the provision of a medium of exchange, the provision of public utilities, etc.

QUESTION 5:

In an economy based on private enterprise, the role of the state should be limited to the creation of an environment which is legally, economically and financially conducive to the maximum utilisation of the country's resources. Direct participation in production by the state should be limited to services which, though essential or advisable in the interests of public welfare, will not normally be provided by private enterprise. Such services would normally be postal services, transport services, water and electricity supply and other services which can only be satisfactorily provided on a monopolistic basis.

There is a tendency, however, for the scope of state interference in economic affairs to increase. It is now generally conceded that it is a responsibility of the state to see that a high level of employment is maintained in the community, and in terms of generally accepted economic theory, this necessarily involves state interference in financial and economic spheres with the object of maintaining monetary stability, encouraging investment when trade and industry are sluggish, and taking steps to control inflation when there appears to be over-optimism.

In South Africa, if there is to be a continuation of the vast improvement in living standards which has taken place over the past quarter of a century, a judicious governmental intervention must be undertaken to check undue inflation, and to prevent a state of depression from developing. This type of intervention is not unduly difficult to effect in view of the large part of national expenditure which government expenditure comprises, and the control which the government is able to exercise on private expenditure through taxation and credit manipulation.

In a developing country like South Africa, it is also particularly important that the government takes special measures to maintain a healthy balance of payments position. Without this, the capital which a young and growing country requires from abroad will not be forthcoming.

Other forms of state intervention in a developing country like South Africa will relate to -

(a) The encouragement of saving, and in South Africa, the attraction of capital from overseas.

(b) The promotion of maximum efficiency in the use of available labour resources, particularly through skilled management, adequate training facilities and the suppression of restrictive practices.

(c) The attraction of suitable immigrants. This applies particularly in the case of a developing country like South Africa.

(d) The protection of new or infant industries by suitable tariffs, subsidies or financial assistance in the provision of capital, e.g., Industrial Development Corporation in South Africa.

(e) The suppression of undesirable monopolies, or taking direct action where the operation of private enterprise would not be satisfactory - e.g., post office, dock and transport facilities.

(f) The provision of basic welfare services, such as old age pensions, unemployment insurance, health services, etc.

(g) Control of the credit position and the avoidance of inflation through monetary policy.

Notable state-fostered schemes to encourage industrial development in South Africa have resulted in the formation of bodies such as the Industrial Development Corporation, which has led to the development of several domestic industries, notably SASOL. The National Finance Corporation has achieved a high degree of success in establishing an organised money market here.

The criterion by which all government activity must be judged, however, is not only whether its results are satisfactory, but also whether private enterprise could have accomplished the same ends more cheaply, more profitably and more efficiently.

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USE THIS PAGE FOR MAKING NOTES

PUBLIC FINANCE AND TAXATION

I. PUBLIC FINANCE

A. WHAT IS PUBLIC FINANCE

Public finance is that branch of economics which deals with the economic aspects of the revenue and expenditure of governments and all other forms of public authorities.

B. PUBLIC AND PRIVATE FINANCE

The administration of public finance proceeds in a manner almost opposite to that of private finance administration.

The difference between these two types of expenditure may be summarised as follows:

1. An individual's expenditure is determined in the long run by the amount of his income, whilst the expenditure of a public authority largely determines the amount of its income. It should be noted, however, that a public authority may at times (e.g. during a depression) be forced to bring its expenditure into line with its income instead of, as in the usual way, determining its income after fixing its expenditure.

2. Whereas the efficiency of a public trading undertaking is judged by the relative cheapness of its products, the success of a private concern is measured by the amount of surplus of income over expenditure.

3. A surplus or deficit of either a private individual or of a public authority can be carried forward from one accounting period to the next. A deficit is frequently met, however, by raising a loan, and this action brings out an essential difference between the private individual and the public authority. The latter can raise a loan either internally, i.e. from people subject to its authority, or externally, e.g. from foreign investors,

or from other governments, but the private individual can raise only an external loan (obviously he cannot borrow from himself). The South African government, for example, may raise an external loan in London or an internal loan in South Africa.

4. Failure to make a profit may put a concern out of business, but cannot inhibit the state.

5. The private individual, if he consider the future at all, sometimes looks only a short way ahead and is inclined to discount the future considerably. He will, therefore, seize a small immediate gain rather than await a larger but problematical gain in the future. The public authority, however, which has no limit to its life, must in the determination of its policy always keep the future in view. The community outlasts the individual: the statesmen of today must look to the future gains from their policy rather than to immediate benefits.

C. THE PRINCIPLE OF SOCIAL ADVANTAGE

1. The doctrine of maximum social advantage claims that the state has an overriding duty "to secure the maximum level of economic activity and of social welfare which the resources of the economy permit" (Ursula Hicks). In recent years, the tendency has been to go further and place upon the state the responsibility of ensuring that every citizen enjoys an adequate and balanced diet, sufficient protection and shelter to maintain his health, and enough education to promote his efficiency. If these needs are not met by private enterprise then, many would argue, the state should itself provide the means of meeting them.

2. It is the effect of <u>public finance</u> on the social welfare of the community which has led some modern writers to claim that the analogy between private and public finance, to which reference was made at the beginning of this lecture, can be overdone. It is pointed out in this connection that:

(a) Whereas an individual should keep his expenditure within the limits of his income, a government may increase national income by spending in excess of revenue. This refers to the increased employment which may result from public works financed from loans.

(b) Whereas the success or failure of a private business can be judged from its balance sheet, a government's balance sheet alone cannot indicate the success or failure of fiscal policy. To measure the success of public finance policies, the trend of national income and its distribution is more important than an increase or decrease in public debt.

(c) Government borrowings, unlike private borrowings, do not represent a transfer of the disposable funds from one economic unit to another, with the burden of repayment distributed over a long or short future period. They are a means of raising money, fundamentally from the same source, by a means other than taxation, with different effects from taxation on production and the distribution of income. Repayment may be from taxation or from new borrowings. Whereas the repayment of loans by a private individual or business is always a good thing, a reduction in the public debt may have unfavourable effects on the national income or on the fiscal position of the state.

D. SOURCES OF PUBLIC INCOME

A government may obtain its income from a number of sources, the chief of which are:

1. Taxes (export and import duties, income tax, death duties).

2. Fines, stamp duty.

3. Income from state property (e.g. Suez Canal shares formerly held by the British Government).

4. Profits of public enterprises (monopolistic and non-monopolistic). Examples are:

   (a) Post office activities.

   (b) State railways, where they exist.

   (c) Ownership not only of the means of production but of the produce itself, and the profits derived from it, e.g. the manufacture of matches and tobacco is a government monopoly in some countries.

5. Fees (birth registration, etc.) for services rendered by public officials.

6. Voluntary loans, e.g. government stock.

7. Inflation. This is equivalent to a general tax on all persons. Owing to its disastrous repercussions on economic activity, it is rarely resorted to deliberately.

8. A levy on capital or the confiscation of private property. These methods are resorted to only in times of exceptional national emergency.

II. TAXATION

A. DEFINITION

Taxes are compulsory charges made by public authorities to meet the expenses of government and other services rendered by the authority in the interests of the general public.

The income of a public authority, however, seldom consists only of taxes. Charges are made for specific (as opposed to general) commodities or services supplied or rendered. These are usually voluntary, in the sense that there is generally an option to purchase; but even if there is no option, the charges do not rank as taxes if they are reasonable compared with the services rendered.

1. ESSENTIALS

Two essential points of a tax, then, are:

(a) it is a compulsory charge; and

(b) it has no reference to special benefits, i.e. there is usually no direct "quid pro quo".

Thus, income tax, import and export duties, fines and penalties constitute taxation revenue; revenue from telephones, postal services and some licence fees constitute "other" income.

2. PRINCIPLES

A number of principles may be considered on which to base tax:

(a) "Benefits-received" approach

According to this, the individual tax-payer should pay taxes to meet the services he receives, e.g. petrol tax on roads. Its scope is too limited for general use, as government services such as pensions, welfare programmes and defence would be ruled out.

(b) "Ability-to-pay" approach

Taxes are levied according to a person's ability to pay and theoretically vary inversely with sacrifice and inconvenience with relation to taxes.

(c) "Absolute equality" approach

Government spending divided amongst tax-payers - obviously impractical.

3. TAX BASES

There are a number of possible tax bases:

(a) Income - generally preferable.

(b) Consumption - sales tax, excise tax, etc.

(c) Ownership of real property - very unsatisfactory as real income cannot be judged.

(d) Poll (or capitation) tax - crudest of all.

4. TAX RATES

Once the tax base is chosen, the appropriate tax rates must be applied.

(a) Proportional taxation is one in which the rate of taxation is constant as the value of the tax base changes.

(b) A progressive tax is one in which the rate of taxation increases as the value of the tax base increases.

(c) A regressive tax is one in which the rate of taxation decreases as the value of the tax base increases.

(Note that a proportional tax structure will be progressive in effect if, for example, consumption or income up to a certain value is exempt from tax.)

B. CLASSIFICATION OF TAXES

1. DIRECT TAXES

Direct taxes are taxes collected from the persons who are intended to bear the charge, e.g. income tax is borne by the person from whose income it is deducted. Since the impact of a tax is on the person from whom the tax is collected, and the incidence of the tax is on the person who bears the burden, it follows that in the case of direct taxation, the impact and incidence are on the same person.

(a) Advantages of Direct Taxes

(i) They are comparatively cheap to collect.

(ii) The tax is not concealed in any way; the tax-payer knows exactly how much he is paying, and how much is due to be paid.

(iii) The yield can be fairly accurately estimated; an increase in the national income automatically produces an increased tax revenue.

(iv) The tax may be graduated on the basis of ability to pay.

(b) Disadvantages of Direct Taxes

(i) Evasion is comparatively easy. Income tax has been referred to as a "tax on honesty".

(ii) The tax-payer is subjected to the inconvenience of making returns, and new assessments must be regularly made.

(iii) The tax-payer feels the burden and tends to exaggerate it.

(Note that tax avoidance is legal, e.g. not buying cigarettes to avoid the tax thereon or investing in tax-free bonds; tax evasion is illegal, e.g. not declaring all income.)

2. INDIRECT TAXES

Indirect taxes are taxes collected from a person who does not bear the incidence, or burden of the tax. The person who bears the impact shifts the incidence.

This incidence may be shifted forward or backward. Thus an importer who pays customs duties on goods he imports may shift the tax forward to the consumers of the goods by raising their retail prices by the amount of the tax. A manufacturer, on the other hand, may

pass a tax on manufactured goods back to the producer of the raw materials by lowering the price he pays for these materials. Backward shifting will tend to take place when the seller finds that his sales decline if he adds the full amount of the tax to the selling price. Alternatively, the seller may bear part of the tax himself.

Excise duties on beer and cigarettes, and entertainment taxes, are examples of indirect taxes.

Excise Duty

This is a duty imposed on home-produced goods and domestically provided services. The reason for such a tax is to offset or limit the protective effect of the imposition of customs duties on similar goods imported from abroad. It is imposed on goods like cigarettes, liquor and other luxuries. It can be used to raise revenue, or to check the consumption of the commodities on which it is imposed.

(a) Advantages of Indirect Taxes

(i) The tax-payer does not notice the burden so much when it is spread over a large number of transactions.

(ii) The method of collection is easy and convenient to both collector and payer.

(iii) The taxes are not easily evaded.

(iv) Small incomes are reached without a disproportionate increase in administration and collection charges.

(v) The yield of an indirect tax levied on a necessary article can be easily adjusted by change in the rate.

(vi) They may have a moral value; e.g. the consumption of alcohol may be reduced if liquor is heavily taxed.

(vii) The state can tax casual visitors from overseas.

(b) Disadvantages of Indirect Taxes

(i) They may weigh unduly heavily on the poorer classes when they are imposed on necessities, e.g. sales tax.

(ii) The yield is uncertain when they are imposed on luxuries.

(iii) The effect of the tax is difficult to determine and the burden may fall where it was not intended.

(iv) Changes in these taxes may cause economic disturbances by diverting factors of production away from the industries producing a newly taxed commodity.

NOTE: A taxation system which includes only one tax is attractive by its simplicity, but has not been found satisfactory in practice; most modern systems are "multiple" and include an assortment of both direct and indirect taxes.

C. THE CANONS OF TAXATION

Four rules of taxation, generally referred to as the "canons" of taxation, quoted by Adam Smith in "The Wealth of Nations", were:

1. EQUALITY

"The subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to the revenue they respectively enjoy under the protection of the state".

Actually, a person's ability to pay taxes increases faster than does his income, for his surplus over necessary expenditure increases at a faster rate. Hence, taxation should be progressive, i.e. the percentage of incomes taken in taxation should increase as the incomes themselves increase.

The reverse of progressive taxation is regressive taxation. Most indirect taxes are regressive. The man with twice another man's income does not generally buy twice as much beer, tobacco, or any other item singled out for taxation; the tax enacted on a poor man's income in this way is, therefore, usually a greater proportion of his income than that levied on a rich man. The government must, however, consider yield as well.

In direct taxation, attempts to apply the principle of progression are most successful. The first stage is the exemption below a given minimum income. The next is the imposition of an increasing rate on income tax over this minimum, and finally an additional surtax (or supertax) on incomes over a much higher figure. Allowances are made throughout for family obligations.

2. CERTAINTY

"The tax which each individual is bound to pay ought to be certain and not arbitrary, the time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor, and to every other person."

Most of our present day taxation conforms to this canon, but uncertainty may arise on account of the frequent introduction of new taxes and provisions or the cancellation of old taxes. Such a vacillating taxation system leads to uncertainty because the taxpayers are never certain as to the amount they will have to pay; from this the saying "an old tax is a good tax" has been deduced. Moreover, a tax should not be so complicated that the majority of tax-payers are unable to

understand how it is arrived at; such a tax would be unduly autocratic in that it would place tax-payers at the mercy of the assessors.

3. CONVENIENCE

"Every tax ought to be levied at the time, or in the manner in which it is most likely to be convenient for the contributor to pay it."

Convenience should also be considered from the point of view of the disbursements which the government has to make. The amounts which have to be raised in modern communities are so great that some degree of inconvenience to the payer cannot be avoided.

4. ECONOMY

"Every tax ought to be so contrived as both to take out and keep out of the pocket of the people as little as possible over and above what it brings into the public treasury of the state." In other words, administration costs should be as low as is consistent with efficiency, and with the prevention of evasion or leakage.

From the point of view of economy, a small number of taxes is better than a large number of taxes which yield relatively small returns per tax, since administrative costs are lower.

Another aspect of the economy canon is the fact that a tax should interfere as little as possible with the productive capacity of the community. The effect on enterprise, saving, or personal efficiency, must be considered. A decline in the volume of production and in the efficiency of labour would eventually be unfavourable to the productiveness of the tax, even if it were highly productive for a short period, e.g. a tax levied upon a "responsibility allowance", granted to persons capable of undertaking responsibility and willing to do so, is deleterious - it is self-defeating. The capability of these persons is in no way affected, but most of them would avoid the tax by evading responsibility! The effects on the future accumulation of

capital, and on the standard of living, must, therefore, be taken into account.

Two other important principles of taxation which have been added by later writers are:

5. A tax should automatically produce a larger yield as the income and population of a country increase. A tax on income, even though the standard rate is fixed, produces a gradually increasing revenue annually, whereas a tax on land is unable to give a larger yield unless the rate of tax is increased.

6. A tax should be elastic in its yield. A tax, which when raised, gives an increasing revenue, is to be preferred to one which yields a fixed or even diminishing revenue. A tax on a commodity for which the demand is sensitive is not likely to be elastic in its yield. If the tax on cigars were increased beyond a certain point, there would be a decline in demand, and, therefore, a declining revenue from the tax.

These, then, are the prerequisites of a good tax. From the point of view of the government, productivity, certainty and elasticity are the chief points to be considered, while as far as the tax-payer is concerned, the tax should be certain, economical, convenient and simple.

When there is a conflict of advantages and disadvantages as laid down by the above canons and rules in connection with any particular tax, so far as possible the least important rule should be surrendered; it is generally agreed, for example, that uncertainty is a greater drawback than inequality, while a productive tax should not be sacrificed merely because it is inconvenient. Moreover, the rules should be applied to the system of taxation as a whole. Although one particular tax may be inequitable, this inequity may be offset by another tax with which it is combined. Finally, it may be adopted as a general rule that everybody should pay something.

D. SOME NOTES ON VARIOUS TAXES

1. THE EFFECTS OF INCOME TAX

(a) Saving

The prevailing system of direct taxation militates against saving. Income tax is imposed both on the capital sum when first earned, and again when interest begins to flow from this capital, unless the savings are invested in certain specifically exempted securities.

Although an income tax tends to reduce the spendable income of a person, it is difficult to dogmatise upon its effects on saving. In some cases, the tax-payer will be discouraged from saving by the prospect of the income from his savings being taxed, but in other cases, where he has made up his mind to accumulate sufficient capital to provide a definite annuity for himself on retirement, for example, he will cut down his expenditure in order to maintain his rate of saving.

The effects of income tax on the thrifty poor will tend to be different from the effects on the thrifty affluent, because in the case of the lower income groups:

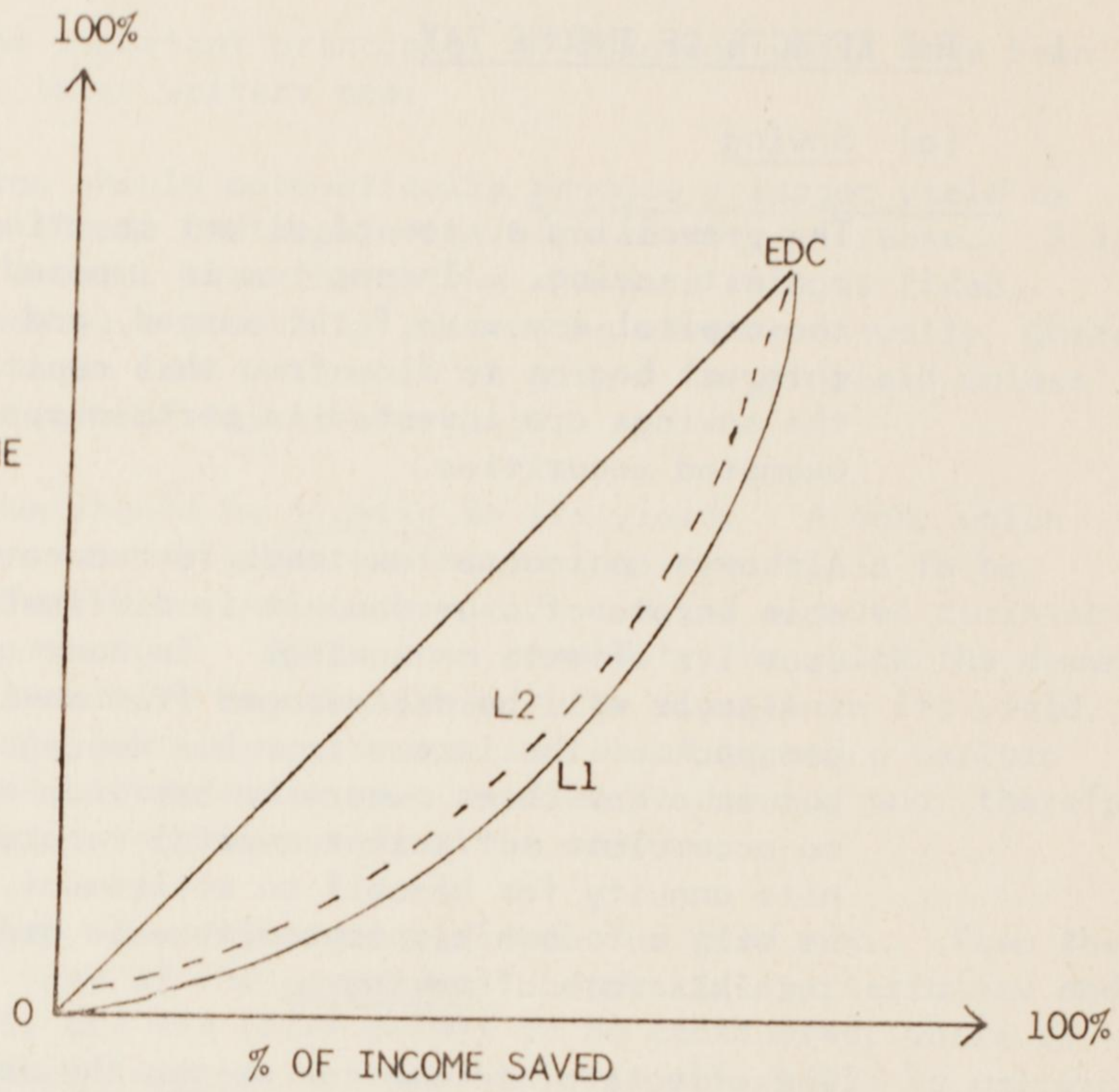
(i) the rate of tax is lower;

(ii) the urge to provide for old age is stronger among the poorer classes;

(iii) much of the savings of the lower income groups goes into insurance policies, on which there are income tax abatements.

The rich, on the other hand, are most likely to draw upon their savings in order to maintain their existing standard of living.

Income tax which is progressive will lessen the unequal distribution of income in an economy.



The curve L1, which is called a Lorentz curve, when compared with the equal distribution curve (EDC), shows how the level of income affects the percentage saved. This is reduced by taxation, e.g. L2.

(b) Incentive

Since every cent has a high utility to most of the earners of a lower income, the incentive of the workers will not normally be reduced by income tax until the tax reaches high levels. The incentive of investors and entrepreneurs may be affected, however, if anticipated profits are to be cut into by income tax, and this will apply particularly to the riskier enterprises. In this latter class of enterprise, which is often very beneficial to the economic progress of a community, high profits are

reward for running the risk of heavy losses, but investors will not be prepared to assume the risk if the reward of success is to be heavily taxed.

2. THE INCIDENCE OF IMPORT DUTIES

If there is no effective competition from within the importing country, a foreign producer may be willing to pay the whole or part of an import duty in order to keep out other competitive foreigners. If there is no competition from other foreign producers, however, the incidence will fall upon the home consumers, but:

(a) If the tariff-levying country is the sole market, the foreigner will find it difficult to raise his prices; if he has a wide choice of markets, he will supply his goods to the best market.

(b) If the demand is both elastic and exclusive to the purchasing country, the foreigner will be forced to bear possibly the whole duty. If the demand is inelastic, and there are no substitutes, the foreigner may be able to shift the whole duty to the consumers.

(c) If home production has been restricted because of the low price of the foreign goods, a rise in price will probably induce home marginal firms to re-enter the home market, and thus the demand for foreign supplies will be diminished.

There are thus two conditions under which consumers will probably pay the whole duty:

(i) where the duty is levied on the whole supply of the commodity (there being no home production at all);

(ii) where demand is inelastic.

Since these conditions are not usually present especially in the case of a manufactured import, the duty cannot fall in its entirety upon the home consumer.

3. THE INCIDENCE OF EXPORT DUTIES

The incidence of export duties depends largely upon whether the commodity is a necessity and whether it is supplied under competitive conditions. If the commodity is a luxury, a rise in price caused by the export duty will obviously cause a large diminution in the demand. Moreover, even if the commodity is a necessity, foreign customers would be able to obtain their supplies from other sources unless the country imposing the duty possessed a monopoly of the supply. If the supply is under competitive conditions, therefore, the producers must bear the duties although even if the producer has a monopoly, he will have to bear the duty if he is already charging a price which yields him the maximum net revenue.

In the case of export duties, therefore, it is very difficult to "make the foreigner pay".

4. TAXES ON COMMUNICATIONS AND TRANSPORT

These taxes have a bad effect on commerce since they tend to hamper the exchange of goods, and check commerical intercourse. The rates charged by transport services are usually fixed to yield the maximum net return on the basis of "what the traffic will bear", so that it would not normally be possible to pass a tax on transport services on to passengers.

5. TAX ON A JOINT PRODUCT

This tax will tend to spread itself over both products since a rise in the price of one will tend to check the demand, and hence the output, so that the output of the other will be reduced and its price will tend to rise.

6. ENTERTAINMENT TAX

This may be considered as a luxury tax. The tax is at first added to the price of admission, but if this tends to decrease the size of audiences, the proprietors of places of amusement may have to bear at least part of the tax.

7. ORDINARY SALES TAXES

The incidence will be determined by the elasticity of demand for the goods in question. The more inelastic, the more it will be borne by the consumer.

Sales tax (GST) in South Africa at the present time is a tax on expenditure on goods and services. It is general in that it is levied on the cost of goods and services, whatever they may be, in excess of 12c, and applies to all consumers, without discrimination; all bear both the incidence and the impact, the latter obviously laying a bigger burden upon the lower income groups than upon the affluent. The tax is regressive, for it takes the same absolute amount from rich and poor alike, thereby taking from the poor a larger proportional amount of their limited income; note, however, that the use of the word, proportional, above, does NOT mean that, in terms of the economics of taxation, the tax is a "proportional" tax!

8. DEATH AND GIFT DUTIES

The incidence, as such, falls on the donor (or the deceased estate), but the donee (or heir) may be held jointly and severally liable should the donor not pay.

9. CORPORATE TAX

This is usually a proportional rate of 25 - 50%. This is effectively a regressive tax on shareholders, as their ability to pay will differ. (It has been suggested that dividends should be taxed at shareholder level and undistributed profits at company level.)

10. CAPITATION TAX

Flat rate per head of population - very regressive.

11. PROPERTY TAX

Usually proportional according to value of property - regressive in effect.

III. FISCAL POLICY

We have seen that through the shaping of its credit policy, a central bank or other monetary authority may influence the level of economic activity. We have also seen that it is one of the responsibilities of governments to see that a high level of employment is maintained. Besides controlling money and credit through a central bank, a government may influence the level of economic activity through its taxation policy, and its plans for spending the proceeds of taxation and government loans. This is known as fiscal policy. The fiscal policy may be aimed at increasing the level of general expenditure, e.g. by building public roads, schools, engaging additional staff to work for the state, or by reducing taxation so that consumers have more to spend each week. Such a policy might be adopted, for example, when, because of some factor giving rise to uncertainty, there has been a falling off of private investment, and a threat of unemployment. Not only does the increased public expenditure and reduced taxation give rise itself to additional incomes, but it may induce a return of confidence which is followed by an increase in the level of private investment.

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SUMMARY

I. PUBLIC FINANCE

Public finance deals with the economic aspects of the revenue and expenditure of governments, but it sometimes borders on politics. Unlike private persons, a government decides upon its expenditure before its revenue is to hand; it does not determine its expenditure by the amount of its income, but it determines its income by the amount of its expenditure. A government may also raise loans both at home and abroad.

It is generally maintained that public expenditure should yield the maximum social advantage; this implies that the social disadvantages resulting from the raising of public income from various sources cannot be reduced by changing these sources, and that the expenditure of this income purchases the maximum possible increase in the economic welfare of the community.

Sources of Income

1. Taxes.
2. Fines, stamp duty.
3. Income from state property.
4. Profits of public enterprises.
5. Fees.
6. Loans.
7. Inflation.
8. Confiscation.

Public income may also be classified into "permanent" and "temporary" income, "gratuitous", "contractual" and "compulsory" income, or into "income from taxation" and "other income".

II. TAXATION

Taxes are compulsory contributions levied by public authorities on some other than a quid pro quo basis, to meet the general expenses of government.

Tax-payer = person from whom the tax is collected.

Tax subject = person who bears the tax.

A DIRECT TAX - is a tax collected from the persons who are intended to bear the burden; the impact is on the same person as the incidence is.

AN INDIRECT TAX- is a tax collected from one person and borne ultimately by another.

ADVANTAGES AND DISADVANTAGES OF THE CLASSES OF TAX

DIRECT TAXES

INDIRECT TAXES

ADVANTAGES

DIRECT TAXES

1. Cheap to collect.
2. Certainty - tax-payer knows exactly how much he has to pay.
3. State knows the source of revenue and can estimate yield.
4. Can be graduated with ability to pay.

INDIRECT TAXES

1. tax-payer does not feel burden directly.
2. Easy method of collection.
3. Evasion is difficult.
4. Small incomes are reached.
5. Yield from articles with inelastic demands easily adjusted.
6. Moral value.
7. Temporary visitors to the country are taxed.

DISADVANTAGES

DIRECT TAXES

1. Easy to evade.
2. Tax-payer feels burden directly and exaggerates it.
3. Inconvenience of making returns.

INDIRECT TAXES

1. Inequitable when imposed on necessities.
2. Uncertain yield.
3. Effects difficult to determine.
4. New taxes may cause economic disturbances.

MISCELLANEOUS

The effects of an income tax are most noticeable in connection with saving and incentive to enterprise; a high rate of tax has a strong tendency to inhibit both.

It is difficult to make a foreign producer bear a tax unless there is a monopoly demand or no alternative sources of supply or close substitutes are available.

III. FISCAL POLICY

When private investment and consumption spending are tending to set into motion an inflationary or a deflationary trend, the government may counteract this trend and attempt to maintain prices. The government may aim to preserve price stability and a high level of employment by adjusting its taxation and expenditure policies, or by modifying its monetary policy as enforced by the central bank.

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PROGRESS QUESTIONS

1. What do you understand by the term "maximum social advantage" as applied to the operations of public authorities?

2. Discuss the connection between:

   (a) taxation and the distribution of wealth; and

   (b) taxation and employment.

3. In the light of Adam Smith's canons of taxation, consider the following taxes:

   (a) A duty on all imports.

   (b) A tax on all incomes other than those derived from manual labour.

   (c) A levy on capital.

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GUIDES TO THE ANSWERS

QUESTION 1

The answer to Question 1 can be found in the text.

QUESTION 2

(a) Socialists claim that taxation should be utilised to smooth out "inequalities of income and wealth". The extent to which a government is socialistic will, therefore, influence its taxation policy. The more it desires to reduce the inequality of incomes, the more sharply progressive is the tax system likely to be.

A regressive tax, i.e. one which falls most heavily on those with lower incomes, increases inequalities in incomes. Taxes on necessities are usually regressive, since the smaller a person's income, the larger the <u>proportion</u> spent on essentials is likely to be.

(b) Taxes on the factors of production, i.e. primary taxes, tend to check enterprise and hence to react unfavourably on employment. It must not be overlooked, however, that unless the taxing authority spends the revenue resulting from the tax in a foreign country, some employment will result from the spending of the proceeds.

It would, therefore, be more correct to say that a tax tends to change the character rather than the volume of employment. A steeply graduated tax may diminish luxury spending, but at the same time is likely to stimulate public works, thus providing increased employment opportunities.

QUESTION 3

(a) <u>Duty on imports</u>

This duty would have to be paid alike by poor and rich consumers, so that it would be regressive in character, and contrary to the first canon.

Unless the consumer knew how much tax he was paying it would be contrary to the second canon also.

It may be convenient, but it would probably offend the fourth canon if the duties were high, because an expensive organisation would be necessary to prevent smuggling.

(b) Tax on all incomes other than those derived from labour

All persons would not be paying, so the tax would be contrary to the first canon.

Special legislation would be necessary to distinguish clearly between manual and non-manual labour, but once this has been settled, the tax would probably conform with the remaining three canons.

(c) A levy on capital

This would probably offend all four canons:

1. It would be a tax on certain forms of property only, and some members of the community would escape taxation entirely.

2. It would be difficult to assess some forms of property.

3. The payment of the tax might not be possible without breaking into the capital, and thus might lead to difficulties. The capital might, for example, be represented by a valuable diamond.

4. It would be expensive to collect, a special staff of valuers being essential, and there would very likely be many disputes.

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USE THIS PAGE FOR MAKING NOTES

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ECONOMICS

TEST LD2.

(Time allowed : 3 hours)

NOTE: 1. Credit will be given for neatness and method.
2. Scale of marks is indicated at the end of each question.
3. Leave sufficient space at the head of your answer paper for tutor's comments.
4. Answer all questions.

--------oOo--------

1. What are the main functions of money? What part does bank credit play in providing for the monetary requirements of the community?

(20 marks)

2. Explain the Quantity Theory of Money.

(20 marks)

3. Discuss the different types of taxes and their effects.

(20 marks)

4. Discuss briefly the operation of the South African money market, mentioning all institutions involved.

(20 marks)

5. Discuss cause and effects of inflation with reference to the general price level.

(20 marks)

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