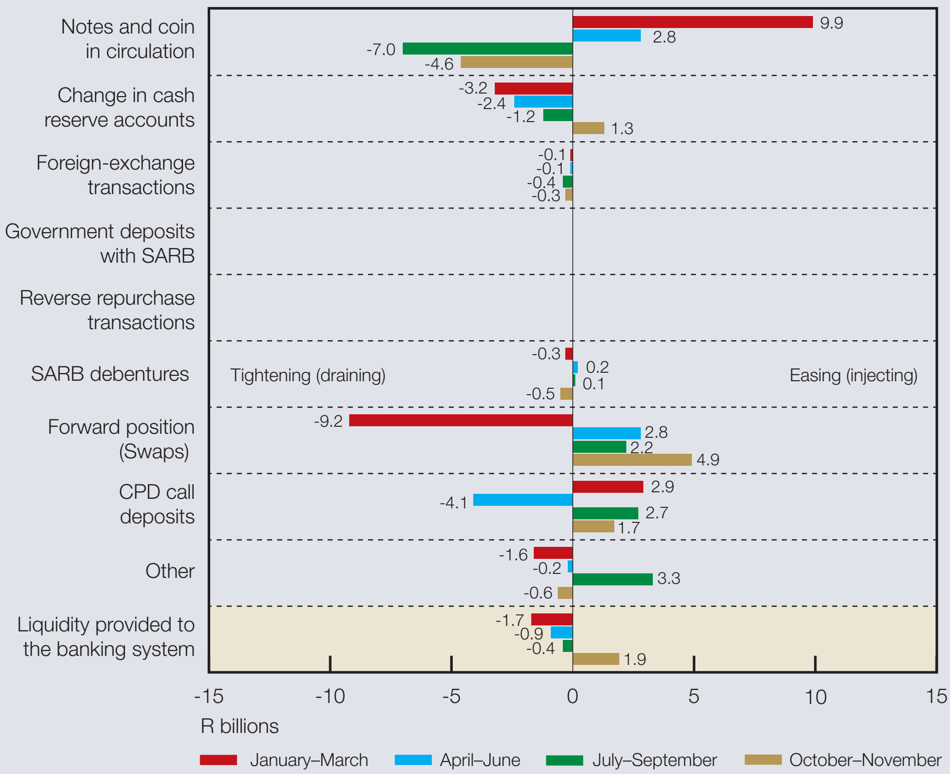
Box 4 Drivers of money market liquidity in 2018[1]

The South African Reserve Bank's (SARB) monetary policy decisions[2] are implemented through market operations[3] conducted with commercial banks, at or with a spread to the repurchase rate (repo rate). To make the repo rate effective in the pursuit of achieving the inflation target[4], the SARB creates a money market liquidity shortage which compels banks to borrow from the central bank.

The SARB's refinancing system is classified as a *classic cash reserve* or *liquidity deficit* framework. In March 1998, the SARB changed its accommodation system to a repurchase-based refinancing system, which was refined in 2001, 2005, 2007, 2010 and 2013. The consultation paper on interest rate benchmarks in South Africa, released for public comment on 30 August 2018[5], is intended to enhance transparency of liquidity conditions and the pricing in the overnight money market as well as to enhance the effectiveness of monetary policy implementation and its transmission to the economy as a whole.

Money market liquidity conditions are influenced by non-autonomous factors under the control of the SARB and autonomous factors over which the central bank has no control, and which are therefore unmanaged.

Factors influencing money market liquidity conditions in 2018



Source: SARB

These autonomous factors include the following: Changes in *notes and coin in circulation* outside the SARB, which are determined by the public's demand for cash from commercial banks that need to be acquired from the SARB. A net decline of R1.1 billion in notes and coin in circulation from January 2018 to November

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1 This box relates to statistics published in the tables on pages S–28 and S–29 of this *Quarterly Bulletin.*

2 The Monetary Policy Committee (MPC) of the SARB makes decisions regarding the appropriate monetary policy stance in South Africa.

3 The liquidity shortage is refinanced through *weekly main repurchase auctions,* on Wednesdays, where commercial banks sell eligible liquid assets – rand-denominated government bonds, Land Bank bills, SARB debentures, Treasury bills and Separate Trading of Registered Interest and Principal of Securities (STRIPS) – as collateral to the SARB for a period of seven days, in return for cash at the repurchase rate. In addition, banks may also utilise cash-reserve balances as well as supplementary auctions and standing facilities in the daily end-of day square-off operations. Other open-market transactions (explained in more detail later) are also used by the SARB in its liquidity management operations.

4 The SARB's inflation targeting mandate aims to maintain price stability in the interest of balanced and sustainable economic growth in South Africa.

5 The current monetary policy implementation framework focuses on the size of the money market shortage or the quantity of bank reserves in the system. The SARB is considering changing from a shortage to a target rate-based framework. The SARB's 'Consultation paper on selected interest rate benchmarks in South Africa' proposes refinements to current interest rate benchmarks as well as a suite of new interest rate benchmarks that could serve as reference interest rates. These reforms are consistent with the efforts of global regulators and central banks to provide credible, accurate and trusted interest rate benchmarks and reference rates. The proposed interest rate benchmarks will also enhance the SARB's monitoring of monetary policy transmission and financial stability conditions.

resulted in a decrease in banks' refinancing requirement from the SARB and therefore a decline in the money market shortage.

Changes in the cash reserve accounts of banks: Commercial banks are required to hold 2.5% of total liabilities[6] in their cash reserve accounts with the SARB in terms of the Banks Act 94 of 1990. Banks may access these balances on a daily basis, subject to complying with the statutory cash reserve requirement on an average basis over a maintenance period of 28 business days. The increase in banks' cash reserve balances held with the SARB in the 11 months to November 2018 drained funds from the money market, thereby resulting in a R5.5 billion tightening in market liquidity.

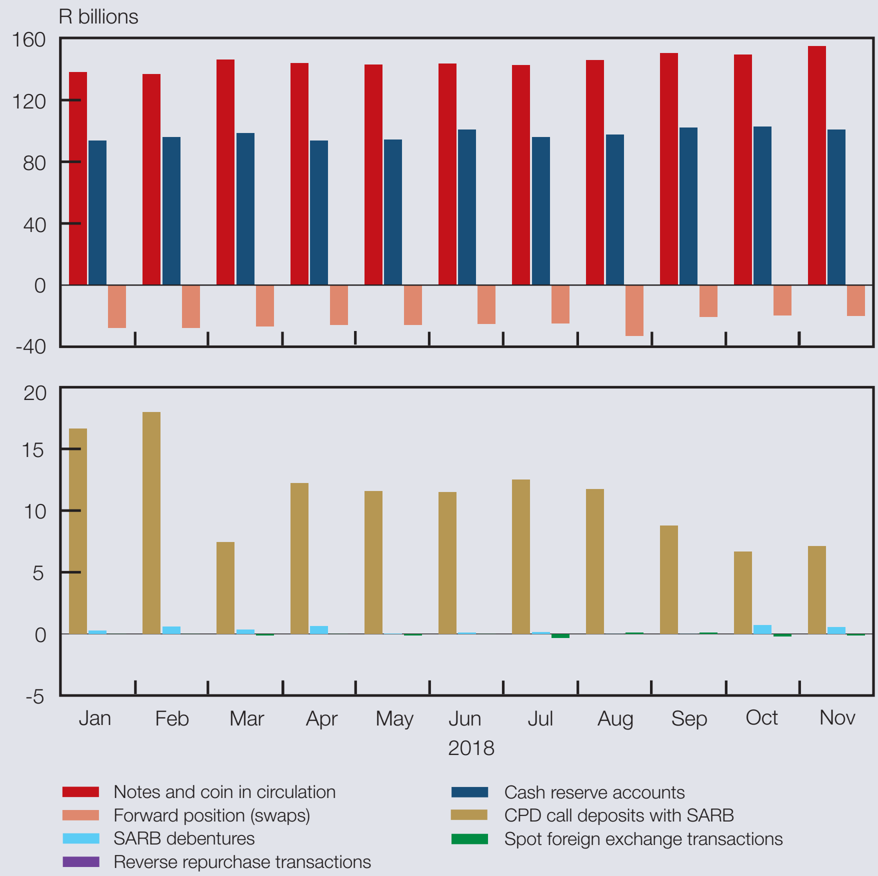
The SARB also manages money market liquidity by conducting various open market transactions with the commercial banks. Since September 2016, the SARB has maintained the money market shortage at a level of about R56 billion by conducting the following money market operations: *Spot foreign exchange transactions* occur when the SARB buys or sells foreign exchange in the spot market, for example, when the SARB wants to accumulate foreign exchange reserves, or when conducting foreign exchange transactions on behalf of clients. Such transactions drained R0.9 billion from the money market in the 11 months to November 2018.

*Government deposits with the SAR*B reflect the withdrawal or deposit of funds with the SARB. An increase in government deposits with the monetary authority drains liquidity from the money market, whereas withdrawals inject liquidity. The net effect of deposits and withdrawals on money market liquidity was zero from January to November 2018.

Through *reverse repurchase agreements*, the SARB drains liquidity from the money market by selling bonds on a repurchase basis. In recent years, lack of demand resulted in dwindling participation and currently there is no outstanding balance on reverse repurchase transactions as banks rather place excess funds elsewhere, at a higher interest rate.

SARB debentures – short-term transferable fixed-rate instruments with maturities of 7, 14, 28 and 56 days, issued at weekly auctions on Wednesdays – drain liquidity from the money market when purchased by commercial banks. At present, the demand for SARB debentures is low with only a small cumulative balance of negative R0.5 billion in the 11 months to November 2018, with only a marginal net effect on money market liquidity.

Outstanding balances of selected liquidity factors



Source: SARB

6 The effective percentage held is somewhat lower since commercial banks are allowed to exclude certain liabilities from the base amount.

*Foreign exchange swap transaction*s are used to manage money market liquidity or to sterilise the purchases of foreign exchange. These swaps, with maturities of up to 12 months, involve the swapping of US dollar for rand, which drains liquidity. Liquidity is injected when US dollar for rand swaps mature, or when rand is swapped for US dollar. In the first 11 months of 2018, the cumulative value of maturing foreign exchange swaps exceeded the value of swap transactions entered into, adding a net R0.7 billion in liquidity into the market.

The Corporation for Public Deposits (CPD), a wholly-owned subsidiary of the SARB, accepts deposits – from the public sector – that are held either at the SARB, with private-sector banks or in money-market instruments. The SARB manages these deposits as part of daily liquidity management operations. An increase in these deposits with commercial banks injects money market liquidity. In the 11 months to November 2018, a net increase in such deposits injected 3.2 billion into the money market.

Notes and coin in circulation and cash reserve accounts, both autonomous factors, have the largest balances of all these instruments on the SARB's balance sheet, and changes in these two balances are often prominent factors influencing money market liquidity conditions. Despite the relatively small balances of non-autonomous factors, such as CPD call deposits with the SARB and forward position (swaps), these factors nonetheless also impacted liquidity conditions materially thus far in 2018.