Statement on Bank rate

Issued by Dr Gerhard de Kock, Governor of the South African Reserve Bank

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With the approval of the Government the Reserve Bank has decided to implement, with immediate effect, the recommendations of the Commission of Inquiry into the Monetary System and Monetary Policy relating to the future role of discount policy and Bank rate in South Africa.

Basically, this means two things:

Firstly, the Reserve Bank will make increased and more clearly defined use of its discount policy as a means of influencing the money supply, interest rates and total spending – as an integral part of overall economic stabilisation policy. This will be done in close co-ordination with the other main instruments of monetary policy, including public debt management and open-market operations.

Secondly, the Reserve Bank will reintroduce the traditional "Bank rate" as its formal rate for rediscounting Treasury bills for the discount houses. This rate will be set and varied at the Bank's initiative within the official monetary policy framework. The element of discretionary judgement involved in this procedure will be constrained by the need to meet any targets that might in future be set for money supply growth, as well as by the close interrelationship that exists between the money supply, interest rates and exchange rates.

With effect from Tuesday, 20 August 1985, the Reserve Bank will set its new formal Bank rate at 16 per cent. This means, in effect, a reduction of 1,75 percentage points in the Bank's rediscount rate for Treasury bills for discount houses from its present level of 17,75 per cent.

At the same time the Reserve Bank will reduce its rediscount rates for discount houses for Land Bank bills from 18,00 per cent to 16,25 per cent, and for liquid bankers' acceptances from 18,25 per cent to 16,50 per cent. Corresponding decreases will be effected in the Reserve Bank's rediscount rates for banks and in its interest rates on overnight loans to discount houses and banks.

It is anticipated that the Bank rate reduction will lead to a further decline in the prime overdraft rate of the commercial banks from its present level of 21 per cent to between 19 and 20 per cent. In due course, decreases in building society mortgage rates may also be expected.

The inducement for banks and their borrowing clients to use off-shore credits will not be diminished, as the Reserve Bank will make appropriate adjustments to the margins it quotes on forward exchange.

In taking this step the Reserve Bank was influenced by the following considerations:

(1) It is now abundantly clear that the restrictive monetary policy applied since August 1984 and the fiscal measures introduced in the March 1985 Budget have fully achieved their initial objective of curbing total private and public sector spending, i.e. the money supply multiplied by its velocity of circulation. Real gross domestic expenditure has now declined for five consecutive quarters. During the second quarter of 1985 it reached a level 9 per cent below that of the second quarter of 1984. Marked declines occurred over this period in all the main components of real expenditure, particularly in spending on durable consumer goods.

In addition, the annualised rates of growth of the money supply aggregates slowed down during the first half of 1985 to 7,2 per cent in the case of M1, 10,6 per cent in the case of M2 and 12,7 per cent in the case of M3.

Together with the latest statistical information on output, employment, sales and imports, these expenditure and money supply figures clearly show that excess demand or overspending has now been eliminated from the economy. Indeed, the real growth rate is at present negative and the lower turning point of the business cycle has probably not yet been reached.

As predicted, the rate of inflation has accelerated thus far in 1985, mainly owing to the delayed effects of the depreciation of the rand since September 1983, the related increases in administered prices, and the increase from 10 to 12 per cent in the general sales tax announced in the March Budget. As these effects peter out, however, the rate of inflation should begin to decline.

(2) The second major objective of the existing monetary and fiscal strategy, namely the transformation of the deficit in the balance of payments on current account into a surplus, has also been attained. Taken at seasonally adjusted annual rates, the current account changed from deficits of R2,5 billion during the first quarter of 1984, R2,0 billion during the second quarter and R2,1 billion during the third quarter, to surpluses of R0,6 billion during the fourth quarter of 1984, R4,3 billion during the first quarter of 1985 and R5,4 billion during the second quarter. It now looks likely that the current account surplus for 1985 as a whole will be of the order of R5 billion. This would be equal to about 4 per cent of gross domestic product, which is large by any standard.

(3) Substantial repayments of short-term foreign loans and credits have been made by the banking sector and private companies since September 1984. This has contributed to a decline in South Africa's net short-term foreign liabilities of about R5 billion during this period.

(4) The *net* official gold and foreign exchange reserves of the banking sector increased by R1,4 billion during the second quarter of 1985.

(5) Since the introduction of the Budget in March 1985 the "mix" of fiscal and monetary policy has improved greatly. After seasonal adjustment there has been a

marked reduction in both the rate of increase of government spending and the "deficit before borrowing". In addition, the government sector has made no net additional use of bank credit thus far in the present fiscal year. Indeed, after seasonal adjustment, the net claims of the banking sector on the government sector actually declined by R442 million during the April-June quarter.

(6) In its open-market operations the Reserve Bank has already sold a net amount of R2,3 billion of "tap" government stock for the 1985/86 financial year, as well as special tax anticipation Treasury bills of R600 million. Against this has to be set redemptions of government stock of R660 million.

The various developments and circumstances outlined above more than justify a further moderate easing of monetary policy in the form of a reduction in interest rates. The elimination of excess demand and the achievement of a large and sustainable surplus on the current account of the balance of payments have paved the way for a resumption of real economic growth. Moreover, the increased effectiveness of fiscal policy since the introduction of the March Budget in itself creates additional scope for justifiable interest rate reductions.

This conclusion is not fundamentally changed by the present abnormal political conditions prevailing in South Africa, including the township unrest, the state of emergency proclaimed in certain magisterial districts and the intensified threats of economic sanctions. Undoubtedly, these political developments have adversely affected overseas perceptions of the prospects for the South African economy and have resulted in some withholding of foreign capital and bank credit. This has been accompanied by a marked depreciation of the rand and a reversal of the downward movement shown by interest rates since March 1985. If the downward pressure on the rand had been associated with excessive money creation and overspending – as was the case during the first half of 1984 – the appropriate response of monetary policy would have been to allow interest rates to rise. But in the present recessionary conditions the situation calls for monetary measures to prevent the recent political developments from bringing about an undue contraction of money and credit accompanied by rising interest rates.

Monetary stability must and will be maintained. But now that overspending has been eliminated, an *unduly restrictive* policy stance must be avoided. The rates of increase of money and credit must be kept low enough to avoid rekindling the fires of inflation or harming the balance of payments, but high enough to promote rising investment, output and employment.