Statements on monetary policy

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

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After consultation with the Minister of Finance the Reserve Bank has decided to raise its Bank rate – the rate at which it rediscounts Treasury bills for discount houses – from 12,5 to 14,5 per cent, with effect from 3 November 1988. Corresponding increases will be effected in the Bank's other rediscount rates and in its interest rates on overnight loans to discount houses and banks.

This step signals a further tightening of monetary policy with the *intermediate* objective of reducing the prevailing excessive rates of increase in the money supply and in total spending, and with the *ultimate* aims of countering inflation and removing the existing downward pressure on the exchange rate and the gold and foreign exchange reserves – as a necessary precondition for sound and sustainable real economic growth.

The key to success in this endeavour is effective restraint over the Reserve Bank's own net domestic credit creation. It is this credit creation which provides the banks with the cash reserves they require to support increases in their discounts, loans, advances and investments. Given the high level of economic activity and the resultant strong demand for credit that still exists, any marked reduction in the Reserve Bank's accommodation, and therefore in its creation of cash reserves for the banks, necessarily implies at least a temporary rise in short-term interest rates. The further upward adjustment in the Reserve Bank's rediscount and other refinancing rates is therefore both a *consequence* and an *integral part* of the further tightening of monetary policy.

In retrospect it is clear that from the third quarter of 1987 onwards the upswing in the South African economy gained much more momentum than most observers had expected. Present indications are that the rate of growth of real gross *domestic* product will again reach 2½ per cent in calendar 1988, following 2½ per cent in 1987 and 1 per cent in 1986. It is relevant to note, however, that, mainly owing to an improvement in the terms of trade and a reduction in interest payments to foreigners, real gross *national* product increased between the second quarter of 1986 and the second quarter of 1988 at a rate of about 5 per cent per year. This means that per head of the population it increased over this period by nearly 3 per cent per year.

This good growth performance of the economy is, of course, most gratifying. But during the course of 1988 the rise in gross domestic expenditure that provided the main driving force behind the upswing clearly reached excessive proportions. During the first half of 1988, for example, real gross domestic spending was 10 per cent higher than in the first half of 1987. Its main component, real private consumption, was 4 per cent higher in the second quarter of 1988 than in the second quarter of 1987, and 8 per cent higher than in the second quarter of 1986. Moreover, preliminary estimates suggest that real consumer spending showed a further marked increase during the third quarter of 1988, at an annual rate approaching 6 per cent. In addition, real fixed investment spending appears to have risen at an annual rate of around 13 per cent during the third quarter.

The excessive increase in total investment and consumption during the past year was made possible by an inordinate rise in the broad money supply, M3. Compared with the official 1988 target range for M3 of 12 to 16 per cent, M3 showed quarter-to-quarter increases, at a seasonally adjusted annual rate, of 25 per cent in the second quarter of 1988 and 28,6 per cent in the third quarter.

The accelerated rise in M3 largely reflected an increase in credit extended by banks and building societies to the private sector. This increase, in turn, was made possible by a rise in Reserve Bank credit creation.

As a result of the excessive spending, imports at one stage increased faster than exports. The result was that the current account of the balance of payments, at a seasonally adjusted annual rate, showed a small deficit of R410 million in the first quarter of 1988. This was followed, however, by (annualised) surpluses of R1,0 billion in the second quarter and R4,5 billion in the third quarter. The current account is therefore responding well to the monetary and other policy measures introduced earlier this year and, as such, does not constitute a problem.

The weakness in the overall balance of payments remains the capital account. The net outflow of foreign capital amounted to only R0,7 billion in the first quarter of 1988, but then increased to R2,1 billion in the second quarter and to an estimated R2,1 billion in the third quarter. This outflow included much more than anticipated debt repayments. A substantial part of it consisted of unfavourable leads and lags in foreign payments and receipts. This included a shift of trade financing from foreign to domestic sources of funds.

A major reason for this large outflow of capital was the increased real interest rate differentials between South Africa and the major financial centres following the substantial *pro rata* increases in interest rates in the main industrial countries since early June 1988. In the United Kingdom, for example, the nominal prime lending rate of most banks increased from 8,5 to 13 per cent between early June and August 1988. After correcting for inflation this meant a substantial widening of the gap between real interest rates in South Africa and in the United Kingdom.

Against this background the Reserve Bank's gold and foreign exchange reserves, which increased from R3,2 billion (US$1,6 billion) in April 1986 to a peak of R7,0 billion (US$3,4 billion) in August 1987, declined to R4,6 billion (US$1,9 billion) in October 1988.

In addition, the effective exchange rate of the commercial rand depreciated by 10,3 per cent in the first half of 1988, by a further 4,9 per cent in the third quarter, and by a further 2,2 per cent in October.

The rate of inflation has also begun to rise again. After declining from 24,9 per cent in the first quarter of 1986 to 9,2 per cent in the first quarter of 1988, the annualised quarter-to-quarter increase in the consumer price index moved up to 13,9 per cent in the third quarter of 1988. It is likely to rise further before a new downward movement can commence.

Against this background it has become imperative to tighten monetary policy along the lines indicated earlier.

Given the strong credit demand that still exists in the economy, it is anticipated that the Reserve Bank's less accommodative policy stance will result in increases of up to 2 per cent in the prime overdraft rates of commercial banks. This will bring these rates into alignment with a number of other money market rates that have already increased by up to 2 per cent in recent weeks.

In the nature of the case the higher interest rates will have an adverse effect on those farmers who are still recovering from the recent drought and other adversities, as well as on the small business sector and first home-owners. Ways and means of providing assistance in deserving cases are being investigated and further announcements in this regard can be expected soon.

Since monetary policy always works with a time lag of many months, the main effects of the steps announced today will not be felt until the first half of 1989. Certainly, the monetary authorities will not attempt to return the broad money supply to the target tunnel in the remaining two months of this year, as this could have disruptive effects on the economy. But the stricter monetary policy now being applied and the return to interest rate levels that are materially positive in real terms should contribute in a fundamental way to the strengthening of the balance of payments and the exchange rate of the rand in the period ahead.

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The Reserve Bank has decided to keep its Bank rate – the rate at which it rediscounts Treasury bills for discount houses – unchanged at 14,5 per cent for the time being. In present circumstances the Bank also sees no need for any further increase in the prime overdraft rates of commercial banks above the present level of 18 per cent.

This decision follows the joint statement issued yesterday by the Minister of Economic Affairs and Technology and the Minister of Finance, which furnished comprehensive up-to-date information on the Government's accounts for the current fiscal year and provided for an additional levy on domestic fuel sales.

Of particular importance from the point of view of monetary policy is the firm indication that the actual deficit before borrowing for the 1988/89 fiscal year will be about R10,6 billion. This figure exceeds the original Budget estimate by only R0,7 billion and is considerably smaller than many of the estimates that have in recent months done the rounds in financial circles.

On the basis of this new information the monetary authorities see little difficulty in financing the deficit before borrowing in a sound manner and without putting undue upward pressure on interest rates.

The decision to keep Bank rate unchanged at this juncture was also influenced by the following developments:

- Although total spending, output and general economic activity remain high, the cyclical upswing in the economy appears to have levelled out.
- Although the rate of increase in the broad money supply, M3, has been quite excessive in recent quarters, this rate now appears to be slowing down.
- The demand for bank and building society credit is moderating.
- The annualised surplus on the current account of the balance of payments increased from just under R1 billion in the second quarter of 1988 to R4,5 billion in the third quarter.
- The net outflow of (non-reserve-related) capital, which amounted to R2,1 billion in the second quarter of 1988 and to R2,4 billion in the third quarter, has diminished thus far in the fourth quarter, partly reflecting a decline in adverse leads and lags in foreign payments and receipts.
- The gold and foreign exchange reserves of the Reserve Bank increased from R4,6 billion (US$1,9 billion) at the end of October 1988 to R4,9 billion (US$2,1 billion) at the end of November.
- The commercial rand appreciated from R2,51 per US dollar on 1 November 1988 to R2,28 on 1 December 1988, i.e. by 9,8 per cent. Against a weighted basket of currencies, the appreciation between these two dates was 7,6 per cent.
- The financial rand moved up from R4,13 per US dollar on 26 September 1988 to a peak of R3,49 on 28 November, before declining to R3,65 on 1 December 1988.

The Reserve Bank has furthermore indicated to the banks that it will counter the anticipated seasonal tightening of money market conditions in December by means of repurchase agreements and other forms of open-market operations. In this way it will act to prevent *purely seasonal* forces from unduly raising the cost of call money and other funds to the banks.

In no way, however, does this imply any easing of the underlying basic monetary policy. It remains the objective of monetary policy to reduce the rates of increase of the money supply and total spending in order to counter inflation and to strengthen the balance of payments.