Statement on monetary policy

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

4 May 1988

As an integral part of the package of economic stabilisation measures announced today by the Minister of Finance, the Reserve Bank will take a number of steps to restrict its credit extension to banks and discount houses with a view to curbing the currently excessive rate of increase of the money supply.

This decision follows a marked further improvement in domestic economic conditions and an increase in real gross domestic expenditure during the first quarter of 1988 to a level more than 10 per cent higher than in the first quarter of 1987. While this upsurge in demand imparted further momentum to the upswing in real output and income, it showed signs of exerting undue pressure on both domestic resources and imports, at a time when exports were declining. If not curbed timeously, the rise in spending might therefore result in new demand inflation, balance of payments difficulties and downward pressure on the exchange rate of the rand.

The exceptional rise of total spending was made possible by an increase in the broad money supply, M3, at a seasonally adjusted annual rate of about 24 per cent during the first quarter of 1988. This brought the provisional March figure for M3 to well above the announced target range for 1988 of 12 to 16 per cent.

The main reason for the accelerated rise in M3 was an excessive increase in credit extended by banks and building societies to the private sector, including consumer credit and home mortgage loans. After rising at an annual rate of 22 per cent during the fourth quarter of 1987, the total credit extended by monetary institutions to the private sector increased at an estimated annual rate of 26 per cent during the first quarter of 1988. To support this increase the banks had to obtain additional cash reserves in the market, and their efforts to do so naturally placed upward pressure on short-term interest rates. Although the Reserve Bank responded to the resultant rise in short-term interest rates by raising its Bank rate from 9½ per cent to 10½ per cent on 9 March 1988, it continued to moderate the upward movement in interest rates by providing accommodation to the banking system in a variety of ways. In the circumstances that have now arisen, however, the Reserve Bank deems it imperative to take further steps to restrict its own credit creation.

In adopting this course the Reserve Bank is implementing a policy first outlined in discussions with the banks and building societies in early December 1987. Already at that stage the Reserve Bank indicated that it would not necessarily continue to relieve or prevent shortages in the money market by means of repurchase agreements or the provision of tender funds from the Corporation for Public Deposits (CPD) to the same extent as before. Instead, the Bank would insist on a larger proportion of such accommodation being provided through its discount window. Pronouncements to this effect were repeated in the Reserve Bank's meetings with banks and building societies in early March 1988 and in the Bank's statement on its Bank rate increase of 9 March 1988.

Following further discussions held with the banks and building societies on 28 April 1988, the Reserve Bank has now decided to introduce the following policy changes:

(1) To give effect to its intention of meeting a larger proportion of the banks' needs for cash reserves through its discount window, the Reserve Bank will in future provide considerably less accommodation through repurchase agreements, CPD tender funds or other forms of open-market operations than in the past. These methods of granting accommodation will only be used to smooth out unduly large month-end and other seasonal fluctuations in money market conditions.

(2) Accommodation through the discount window will normally be provided only by rediscounting, or extending overnight loans against the security of, *liquid assets* such as Treasury bills, Land Bank bills, liquid bankers' acceptances and short-term government stock. Only in exceptional circumstances will overnight loans be extended against the security of non-liquid assets.

(3) In recognition of the inevitable upward pressure that these curbs on the Reserve Bank's accommodation will exert on short-term interest rates, the Reserve Bank will raise its Bank rate from 10½ per cent to 11½ per cent with effect from 5 May 1988. Bank rate is the rate at which the Bank rediscounts Treasury bills *for discount houses*. The Bank's rediscount rates for Land Bank bills and liquid bankers' acceptances for the discount houses will similarly be raised by 1 percentage point from 10,65 per cent to 11,65 per cent and from 10,80 per cent to 11,80 per cent, respectively.

(4) The rediscount rates for Treasury bills, Land Bank bills and liquid bankers' acceptances *for banks* will, as before, be quoted at levels of 0,50 percentage points above the rates that apply to the discount houses for the rediscounting of these various instruments. This means that these rates will also be raised by 1 percentage point from 11,00 per cent, 11,15 per cent and 11,30 per cent to 12,00 per cent, 12,15 per cent and 12,30 per cent, respectively.

(5) The Reserve Bank's rates on overnight loans *to the discount houses* will be increased by 1 percentage point. This means that this rate is raised from 12,00 per cent to 13,00 per cent for overnight loans that are covered by short-term government stock and Treasury bills; from 12,25 per cent to 13,25 per cent for loans that are covered by liquid Land Bank debentures and bills; and from 12,75 per cent to 13,75 per cent for loans that are covered by liquid bankers' acceptances.

(6) The Reserve Bank's rates for overnight loans *to banks* will, as before, be quoted at levels of 0,75 percentage points above the rates that apply to overnight loans to discount houses in cases where such loans are covered by short-term government stock and Treasury bills, by liquid Land Bank debentures and bills, and by liquid bankers' acceptances, respectively. This means that these rates will also be raised by 1 percentage point from 12,75 per cent, 13,00 per cent and 13,50 per cent to 13,75 per cent, 14,00 per cent and 14,50 per cent, respectively.

(7) Overnight loans extended to banks *in exceptional circumstances* against the security of non-liquid assets will be granted at 16 per cent for the first day, and this rate might be increased progressively for any bank that is deemed to be making excessive use of the facility.

It is anticipated that this tightening of the Reserve Bank's accommodation procedures and the accompanying increase of its refinancing rates will be followed by an increase in the banks' prime overdraft rates from 14 to 15 per cent. This will bring these rates into alignment with the prevailing interest rates on bankers' acceptances, short-term government stock and other similar money market assets, which have to a large extent already discounted the Bank rate increase and may therefore not show any marked further changes in the period immediately ahead. On the other hand, the prevailing tendency for the demand for home loans to outstrip the supply might well result in further upward adjustments in the home mortgage rates of banks as well as building societies.

In addition to their expected effects on the domestic economy, the higher interest rates and the Reserve Bank's new accommodation restrictions should encourage South African importers and exporters to make relatively more use of foreign trade-related credits and relatively less of domestic credit. This would help to arrest or reverse the tendency that has prevailed for some time now for importers and exporters to switch from relatively expensive foreign sources of finance to relatively cheap domestic sources. Such a development would strengthen the capital account of the balance of payments and support the gold and foreign exchange reserves.

In addition to the measures set out above, the Reserve Bank requests all banks and building societies to slow down the rate at which they are expanding their credit to the private sector and, in particular, to practise restraint in extending consumer credit and mortgage loans for the financing of luxurious private homes. Among other things, care should be taken not to encourage the financing of consumption spending by means of home mortgage loans.

The Bank would also like to repeat its appeal to the banks to continue to provide financial accommodation to farmers who have suffered from droughts and floods, and to do so on terms that will assist these farmers in re-establishing a sound financial footing.

Like the other measures announced today, the adjustments to monetary policy are essentially designed to correct and forestall excesses in credit extension, money creation and domestic spending that would eventually create a need for more severe corrective measures. The main effects of the steps being taken now to bring the M3 growth rate closer to its target range will only become evident in several months' time. That is why timeous action in this field is so important. But monetary policy as a whole remains conducive to the attainment of a growth rate of real gross domestic product of between 2 and 3 per cent in 1988.