

Statement on interest rates

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

8 March 1988

After consultation with the Minister of Finance, and following discussions held with representatives of the clearing banks, the merchant banks, the general banks and the building societies, the Reserve Bank has decided to raise its Bank rate, with effect from 9 March 1988, from 9,5 to 10,5 per cent. Bank rate is the rate at which the Reserve Bank rediscounts Treasury bills for discount houses. 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.

The increase in Bank rate is a direct consequence of the marked improvement that has occurred in recent months in domestic economic conditions. The upswing in total spending, output, trade and general economic activity has gained considerable momentum, and the annualised growth rate of real gross domestic product amounted to nearly 5 per cent in the fourth quarter of 1987. In consequence the demand for bank credit and other loanable funds has increased sharply, the money supply has expanded at a greatly accelerated rate and most interest rates have increased from the abnormally low levels (negative in real terms) that prevailed during most of 1986 and 1987.

The Treasury bill tender rate, for example, increased from 8,64 per cent on 20 November 1987 to 10,23 per cent on 4 March 1988, while the rate on three-month bankers' acceptances moved up from 8,80 per cent on 12 November 1987 to 10,80 per cent on 4 March 1988. Most deposit rates also tended upwards. The only increase in the prime overdraft rate of the commercial banks during this period was a modest upward adjustment from 12,5 to 13,0 per cent in January 1988. In addition, most yields on government and other public sector stock increased from October 1987 onwards.

In these circumstances banks and building societies have experienced a marked rise in the average cost of their funds, and upward adjustments in at least some of their lending rates have accordingly become necessary. In line with these developments commercial banks have already consulted the Reserve Bank about their intention to raise prime overdraft rates from 13 to 14 per cent. The increase in Bank rate denotes the Reserve Bank's acquiescence in these market-determined interest rate changes.

While the increase in Bank rate is partly a technical adjustment to recent money market developments, it does signify the adoption of a less accommodative monetary policy stance. For some time now the Reserve Bank, in order to promote economic growth, has actively pursued a policy of reducing the upward pressure on interest rates. It has done so by creating substantial amounts of cash reserves for the banks by re-

discounting and extending loans against Treasury bills, bankers' acceptances and other money market assets at low interest rates, by buying public sector stock and bankers' acceptances (with or without repurchase agreements) and in other ways. But in the changed circumstances now prevailing there is a danger that excessive Reserve Bank credit creation would allow an inordinate rise in the money supply and in total spending, resulting later in new demand inflation, balance of payments difficulties and downward pressure on the rand in the foreign exchange market. To prevent any such overspending and, more specifically, to keep the growth of the broad money supply (M3) within the announced target range for 1988 of 12 to 16 per cent, the Reserve Bank sees a need in present circumstances to slow down its own rate of credit creation. The increase in Bank rate is both a consequence and an integral part of this less accommodative monetary strategy.

It bears some emphasis that the Reserve Bank's decision to take a less accommodative stance at this time is designed to prevent the emergence of conditions which might lead to sharp and disruptively large increases in interest rates later.

Since the increases in Bank rate and prime overdraft rates announced today will bring these rates into better alignment with the prevailing interest rates on Treasury bills, Land Bank bills, bankers' acceptances, short-term government stock and call money, these latter money market rates are not expected to show any further upward tendency in the period immediately ahead and might, in fact, tend to ease. On the other hand, while building society mortgage rates should not be directly affected by the increase in Bank rate as such, the prevailing tendency for the demand for home loans to outstrip the supply might well result in some upward adjustment in home mortgage rates.

As far as agricultural credit is concerned, the Reserve Bank wishes to express its appreciation to the banks for the financial accommodation they have provided to farmers suffering from the effects of droughts and floods, and makes an appeal to the banks to continue and, if possible, to expand such assistance. The Bank also wishes to reiterate its support for the provision of financial assistance to such farmers by the Land Bank and other bodies at *concessionary* rates of interest. But this should be done overtly by way of interest subsidies and not by any attempt to keep *all* interest rates at artificially low levels, as this latter course would seriously impair the effectiveness of anti-inflationary monetary policy.

With regard to the longer-term future, the Reserve Bank, after consultation with the Minister of Finance, has decided to accept a further recommendation made in respect of Bank rate policy by the Commission of In-

quiry into the Monetary System and Monetary Policy. That is the proposal that "to the extent warranted by changing conditions in the short-term financial markets, Bank rate ... be changed frequently and by small margins ... in a low key and as a technical matter, of interest principally to money market experts".

The Bank will not go as far as to adopt the procedure followed by some central banks of varying their Bank rate every week by linking it to the weekly Treasury bill tender rate at a fixed penalty margin of 0,5 percentage points above the latter – a technique that was also tried in South Africa between 1973 and 1983 but was subsequently abandoned, partly because it tended at times to bring about an undue "ratcheting up" of interest rates. The Bank will, however, in future follow a policy of responding to changes in money market conditions by means of *smaller and more frequent* Bank rate adjustments of a technical nature – downwards as well as upwards.