Statement on monetary policy

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

5 May 1989

As an integral part of the package of economic stabilisation measures announced today by the Minister of Finance, the Reserve Bank will tighten monetary policy in order to reduce the rates of increase of bank credit, money supply and total spending.

The tightening will take the form of further steps to curb the Reserve Bank's own net domestic credit creation. This remains the key to effective control over the money supply, since under present conditions it is the Reserve Bank's credit extension that provides the banks with the cash reserves they require to enable them to expand their discounts, loans, advances and investments.

The measures to tighten the Reserve Bank's control over the banks' cash reserves are the following:

(1) The Reserve Bank will until further notice provide virtually no accommodation through repurchase agreements, the placing of funds of the Corporation for Public Deposits or other forms of open-market operations. These methods of granting accommodation will be used, if at all, only to smooth out *unduly large* month-end or other seasonal fluctuations in money market conditions.

(2) If necessary to counter any undue easing of money market conditions due, for example, to a flow of funds from the government to the private sector, the Reserve Bank will drain cash reserves from the banks by selling government stock and other suitable securities in the money and capital markets.

(3) Accommodation through the discount window will in the normal course of events be restricted to the actual rediscounting of Treasury bills, Land Bank bills and *genuinely liquid* bankers' acceptances. Only in exceptional circumstances, and then only for short periods, will overnight loans be extended against the security of liquid or non-liquid assets, and then only at the new penalty rates set out below.

(4) Given the existing and expected shortages in the money market, there is no need at present for any increase in the cash reserve requirements of banks and building societies – at present equal to 5 per cent of their short-term liabilities to the public and 2 per cent of their medium-term liabilities to the public. If necessary, however, to counter the effects of any undue easing of money market conditions, the Reserve Bank will not hesitate to use this additional instrument of monetary policy.

Given the prevailing high level of economic activity and the resultant strong demand for credit, the planned reduction in the Reserve Bank's provision of cash reserves to the banks will almost certainly lead to at least a temporary further rise in some short-term interest rates. This is an inevitable consequence of the tighter control over bank credit creation and therefore over money supply growth.

In line with this expected rise in short-term interest rates, the Reserve Bank has decided to raise its Bank rate – the rate at which it rediscounts Treasury bills – from 16 per cent to 17 per cent with effect from Monday, 8 May 1989. At the same time it will raise its rediscount rate for Land Bank bills from 16,15 per cent to 17,15 per cent, and that for liquid bankers' acceptances from 16,30 to 17,30 per cent.

To reinforce its decision to extend overnight loans only in exceptional circumstances and for short periods, the Reserve Bank will increase its interest rates on such loans by 1,5 percentage points, compared with the 1 percentage point increase in its rediscount rates.

This means that the rates on the Reserve Bank's overnight loans will be raised from 17,75 per cent to 19,25 per cent for loans covered by Treasury bills and short-term government stock; from 18,00 per cent to 19,50 per cent for loans covered by Land Bank bills; from 18,50 per cent to 20,00 per cent for loans covered by liquid bankers' acceptances; and from 1 percentage point to 1,5 percentage points above prime overdraft rate for loans covered by non-liquid assets.

It is anticipated that the tightening of the Reserve Bank's accommodation procedures will raise the cost of call money and other funds to the banks to an extent that will induce them to increase their prime overdraft rates by up to 1 percentage point, i.e. from 19 per cent to 20 per cent in most cases. This will bring prime overdraft rates into better alignment with the rates on Treasury bills, Land Bank bills and bankers' acceptances, which have already moved up in recent weeks in anticipation of some tightening of monetary policy.

Whether the yields on Government stock and semi-gilt-edged securities, which have risen substantially over the past six weeks, will be materially affected by the rise in short-term rates, remains to be seen. The forces that determine long-term interest rates are, of course, very different from those that determine short-term rates. And, particularly if account is taken of the Treasury's limited borrowing requirement for 1989/90 and the additional measures announced today by the Minister of Finance, the prospective supply and demand conditions in the capital market do not point to any marked further rise in long-term interest yields. On the contrary, as the intensified monetary and fiscal measures increasingly take effect and the economy cools down, long-term interest rates might well ease later in 1989.

The latest rise in interest rates forms an essential and integral part of official stabilisation policy. It also benefits savers, pensioners and others earning an interest income. At the same time, however, it inflicts hardships on certain categories of borrowers, such as farmers, small businesses and those home-owners whose mortgage costs are not heavily subsidised by their employers. To ease the burden of higher interest rates on at least some of these categories of borrowers, the monetary authorities will take the following steps:

(1) The Reserve Bank will extend special facilities at a low rate of interest to the Land Bank to enable the latter to keep its short-term lending rates unchanged. This should prove of great benefit to the farming community. The expansionary impact of this limited credit extension on bank reserves and the money supply will be offset by open-market operations.

(2) The maximum interest rates on money loans and on credit and leasing transactions laid down at present under the Usury Act, namely 31 per cent on amounts up to R6 000 and 28 per cent on amounts between R6 001 and R500 000, will remain unchanged.

(3) Additional financial assistance will be provided by the Department of Finance to the Industrial Development Corporation, the Small Business Development Corporation and other development corporations to enable them to keep their lending rates to small businesses as low as possible.

(4) The Government will consider ways and means of expanding interest rate subsidies on certain categories of housing loans extended by building societies and banks.

There are indications that the economic upswing is levelling off and that the monetary and fiscal stabilisation measures applied earlier are slowly but surely taking effect. But the latest available evidence shows that the rates of increase of total spending, the demand for credit and the money supply are all still excessive and must be curbed.

Following a good growth year in 1988, business confidence remains high, and fixed investment in the private sector has risen considerably in recent months. Real gross domestic expenditure, which increased by 4 per cent in 1987 and by an excessive 7 per cent in 1988 (22 per cent in nominal terms), is provisionally estimated to have risen at an annual rate of around 6 per cent in the first quarter of 1989. This is still far too high.

In addition, the broad money supply, M3, has continued to rise at an excessive rate, and at the end of March 1989 exceeded the upper limit of the target "tunnel" of 14 to 18 per cent for 1989 by about R2,8 billion or 2,2 per cent. On that date it was nearly 27 per cent higher than a year earlier. Even allowing for the "re-intermediation" of credit and a probable further increase in the demand for money as an asset to hold, this rate was clearly excessive.

The need for a further tightening of monetary policy has also been underlined by two recent external developments. The first is the decline in the dollar price of gold to around US$376 per ounce, compared with an average of US$437 in 1988, which naturally has adverse implications for both the balance of payments and the domestic economy. And the second is the recent increases in interest rates in Switzerland, Germany and several other European countries, following the earlier marked upward movement in interest rates in the United States and the United Kingdom. The resultant widening of the differentials between real interest rates in South Africa and those in the major industrial countries, together with the expectation of a further depreciation of the rand, has resulted in a new outflow of short-term capital from South Africa, mainly in the form of leads and lags in current foreign payments and receipts.

In combination with the excessive rate of increase of domestic spending, these external developments have helped to bring about a further depreciation of the commercial rand in terms of a weighted basket of foreign currencies of 4,4 per cent between the end of 1988 and 3 May 1989. This followed a depreciation of 13,1 per cent between the end of 1987 and the end of 1988.

The depreciation of the rand over the past 16 months has, in turn, contributed materially to the rise in the annualised quarter-to-quarter rate of increase in the consumer price index from 9,2 per cent in the first quarter of 1988 to 14,3 per cent in the first quarter of 1989.

Against this background it is imperative to reduce the rates of increase of bank credit, money supply and total spending and to achieve realistic rates of interest in order to

- prevent an undue further depreciation of the rand;
- first minimise and then reverse the current acceleration of the rate of inflation;
- encourage domestic firms to make more use of available foreign trade credits instead of switching to domestic sources of finance; and
- ensure the achievement of a large enough surplus on the current account of the balance of payments to finance the anticipated foreign debt repayments and to strengthen the gold and foreign exchange reserves in the course of 1989.