Statement on monetary policy

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1. Background

Further progress has been made over the past year towards the creation of an environment of financial stability in South Africa. Such an environment is an essential precondition for sustainable economic growth in the long term.

In the domestic financial situation the following progress was made:

– The rate of growth in the M3 money supply slowed down from 27 per cent in 1988 to 22 per cent in 1989, 12 per cent in 1990 and 10,8 per cent over the 12 months period from February 1991 to February 1992 – that is since the new Deposit-taking Institutions Act established a new basis for banking statistics.

– The rate of increase in total bank credit extended by the banking sector to the private sector likewise declined from 28 per cent in 1988 to 20 per cent in 1989, 16 per cent in 1990 and an estimated annual rate of 10,9 per cent over the eleven months period from February to January 1992.

Developments in 1991 in the major components of the balance of payments contributed towards more stable financial conditions, also in South Africa's international financial relations:

– The surplus on the current account increased further from R5,8 billion in 1990 to R7,4 billion.

– In general the net withdrawal of foreign funds from South Africa has subsided considerably over the past two years. A substantial switching of foreign trade financing from foreign to domestic banking sources in the fourth quarter of last year, however, caused the total net capital outflow to rise from R2,9 billion in 1990 to R6,1 billion in 1991.

– With the current account surplus in excess of the net capital outflow, the country's net gold and foreign exchange reserves showed a further increase of R1,4 billion in 1991. During the first two months of 1992, the Reserve Bank's net gold and foreign exchange reserves rose by another R1,4 billion.

– The effective exchange rate of the rand has remained relatively stable and the average weighted value of the rand against a basket of currencies of South Africa's major trading partner countries depreciated in nominal terms by 6,3 per cent during 1991. This is somewhat less than the inflation differential between South Africa and these countries, with the result that the exchange rate appreciated marginally in real terms.

Against this background of greater stability in both the domestic and international financial conditions, it is disappointing that the rate of inflation stubbornly remained at an unacceptably high level:

– The year-to-year rate of increase in the consumer price index rose marginally from 14,4 per cent in 1990 to 15,3 per cent in 1991. In January 1992, this index was 16,2 per cent above its level of a year ago.

– The performance of the production price index, however, gives more reason for satisfaction. The year-to-year rate of increase in the total production price index declined from 15,2 per cent in 1989 to 12,0 per cent in 1990 and to 11,4 per cent in 1991.

2. Monetary policy in 1992

Recent developments in the financial conditions are encouraging, but provide no conclusive justification for a general relaxation in monetary policy. At this juncture it is important that policy changes will not only take into account the short-term cyclical problems of the South African economy, but will also accommodate the need for longer-term structural adjustment.

Monetary policy for 1992 must also take into account expected developments in fiscal policy for the year. Notwithstanding extremely difficult circumstances, the Budget presented by the Minister of Finance on Wednesday provides for the non-inflationary financing of a relatively large deficit before borrowing. The need for financial discipline aimed at macro-economic stability was again stressed and trends in the major components of the Budget reconfirmed the need for the retention of a relatively restrictive monetary policy.

Lastly, as during the past few years, political developments in South Africa during the rest of this year will have a profound influence on financial conditions, particularly in so far as they will affect the balance of payments. The result of this week's referendum will undoubtedly expedite the normalisation of South Africa's international economic relations — a process that is already in progress.

On balance and taking into account the latest available data on the present economic situation,

the Reserve Bank is of opinion that a marginal reduction in interest rates can be justified at this stage. The monetary authorities will, however, have to remain cautious not to re-stimulate inflation with any excessive monetary expansion. The adjustments to monetary policy announced today are therefore intended to acknowledge the progress made so far in our efforts to reduce underlying inflationary pressures in the economy, without abolishing the financial disciplines needed to bring down the nominal rate of inflation to a more acceptable level.

3. Money supply guidelines for 1992

Last year, guidelines of between 8 and 12 per cent were announced for an appropriate rate of increase in the M3 money supply from the average level in the fourth quarter of 1990 to the fourth quarter of 1991. As it turned out to be, the actual money supply increased by 14,8 per cent over this period. Monetary statistics were, however, distorted by the implementation of a new basis for banking statistics with the introduction of the new Deposit-taking Institutions Act which came into effect on 1 February 1991 and which led to the transfer of existing off-balance-sheet items back onto the balance sheets of monetary institutions. The growth rate in M3 from the end of February 1991 to the end of February 1992 (preliminary statistics) amounted to only 10,8 per cent, that is well within the guideline range for 1991.

In view of the need for a continuation of a relatively restrictive monetary policy and pending more visible results in the battle against inflation, the Reserve Bank is of the opinion that the present rate of expansion in the money supply, that is approximately 10 per cent per annum, should be retained for 1992. At this level, the rate of growth in M3 is significantly below the current rate of inflation and the existing downward pressure on inflation through monetary policy will be upheld.

After the usual consultation with the Minister of Finance, the Reserve Bank has therefore decided to set guidelines for an acceptable rate of growth in the M3 money supply of between 7 and 10 per cent from the fourth quarter of 1991 up to the fourth quarter of 1992. It is the lowest level for the money supply guidelines which has been announced since the Reserve Bank in 1986 first set targets for this purpose and this step confirms the determination of the authorities to continue with a relatively restrictive monetary policy in order to gradually reduce the unacceptably high rate of inflation in South Africa.

In deciding on this rather limited scope for the increase in the money supply in 1992, account was also taken of the relatively low velocity of circulation in the money supply in 1991, and the substantial increases in liquidity in recent months, inter alia as a result of the continuing rise in the Reserve Bank's net gold and foreign exchange reserves. These developments leave ample scope for increases in total monetary demand without any undue upward pressure on interest rates. The guidelines for 1992 should therefore contribute towards the goal of greater financial stability, without unduly constraining economic growth.

4. Exchange control measures

With the introduction of economic sanctions against South Africa and the withdrawal of foreign investment and loan funds from the country in the middle-eighties, various exchange control measures were introduced which were intended to protect the country's gold and other foreign reserves. The amount of foreign loan funds originally blocked in South Africa in terms of the Debt Standstill Arrangements of 1 September 1985 was gradually reduced from US $13,6 billion to less than $6 billion at this stage. The present Third Interim Debt Arrangements with foreign creditors will have to be re-negotiated before the end of 1993, when the outstanding balance will amount to approximately $5 billion.

The financial rand system which was abolished in February 1983 and re-introduced on 1 September 1985 as part of the intensified exchange control policy, does not permit the repatriation of foreign equity investments from South Africa at the expense of the country's official gold and other foreign assets. This system contributed towards the protection of the balance of payments and the domestic economy against the adverse effect of disinvestment transactions, but it also caused considerable administrative problems. It enticed malicious contraventions and abuses of the system, and it scared off some potential foreign investors from investing in South Africa.

As sanctions are now being lifted, unnecessary exchange control restrictions should also be phased out. A stage has not yet been reached where the financial rand system can be abolished. The Minister of Finance has, however, agreed to a proposal from the Reserve Bank for some active intervention by the Bank's Gold and Foreign Exchange Department in the market for financial rand in the same manner that the Bank already intervenes in the market for commercial rand.

As from Monday, 23 March 1992, the Bank will, at its discretion regarding the timing of transactions and amounts involved, be prepared to enter into buying and selling transactions in financial rand against US dollars with South African authorised foreign exchange dealers. The exchange rate for such transactions will be determined by the Reserve Bank and will relate to the current finan-

cial rand/US dollar exchange rate in the market.

Through its intervention the Bank will be able to exert some influence on future developments in this market, with the following advantages:

- The total supply of financial rand will gradually be reduced, that is, if the Bank over time turns out to be a net purchaser of financial rand.

- The Reserve Bank's intervention may bring about a smaller discount between the financial rand and the commercial rand. The Bank, however, has no preconceived target range for this discount and may at times even disengage itself fully from the market. The Bank's operations in this market will rather be determined by the rate of increase in its foreign exchange reserves.

- Intervention by the Reserve Bank in the market for financial rand could also lead to greater stability in this market, particularly in the exchange rate of the financial rand. The great volatility in this exchange rate in the past discouraged many foreign investors from investing in South African equities.

- The application of a part of any further increase in the gold and foreign reserves for this purpose provides a useful additional instrument that can be used by the Reserve Bank to regulate trends in overall domestic liquidity.

- Foreign creditors holding claims within the debt standstill net against South African borrowers have the right to convert these claims into financial rand at the current commercial rand exchange rate, and to sell the acquired financial rand to other non-residents against foreign currency. In terms of the new arrangements, it will be possible for them to sell such balances indirectly through authorised dealers in foreign exchange to the Reserve Bank. To the extent that foreign creditors avail themselves of the facility, the remaining balance within the debt standstill net will, of course, be reduced.

The intervention operations by the Reserve Bank in the financial rand market will create profits and/or losses, depending on movements in the exchange rate and in the discount between the financial and commercial rand exchange rates. It has been agreed with the Minister of Finance that such profits and/or losses will be transferred to the Forward Contracts Contingency Reserve Account of the Treasury with the Reserve Bank.

The Bank's Exchange Control and Gold and Foreign Exchange Departments will within the next few days by means of circulars provide all authorised foreign exchange dealers in South Africa with further technical and administrative arrangements in this regard.

5. Interest rates

Since the Reserve Bank reduced the Bank rate from 18 to 17 per cent on 11 March 1991, the Bank allowed money market interest rates to gradually float downwards. Thus the rate for three-months liquid bankers' acceptances declined slowly from 17,40 per cent on 11 March 1991 to 15,80 per cent on 20 March 1992. At the same time the rate on 91-day Treasury bills declined from 17,04 per cent in March 1991 to 15,48 per cent on 20 March 1992.

These lower interest rates were accompanied by a general extension in liquidity, which is related to sustained increases in the net gold and other foreign assets of the Reserve Bank and a gradual decline in the rate of increase in domestic bank credit extension. The Reserve Bank did indeed from time to time counteract the extension in liquidity through its money market transactions and by using short-term rand-for-dollar swap transactions but was, in general, satisfied with the gradual easing of money market conditions.

A stage has now been reached where the Bank should either deliberately act to reverse this trend in the markets or endorse the changed conditions by reducing the Bank rate. After careful consideration of the latest changes in financial aggregates such as the money supply, bank credit extension, the gold and other foreign assets, exchange rates and the consumer and producer price indices, and after the usual consultation with the Minister of Finance, the Bank has decided to reduce from Monday, 23 March 1992 the Bank rate and other interest rates as follows:

- Bank rate, for the rediscounting of Treasury bills will be reduced from 17 to 16 per cent.

- The rate for the rediscounting of Land Bank bills will be reduced from 17,15 per cent to 16,15 per cent.

- The rate for the rediscounting of liquid bankers' acceptances will be reduced from 17,50 per cent to 17 per cent.

- The "penal" rate for overnight loans against the collateral of acceptable other financial paper will be fixed at a rate equal to 1,50 per cent above the prevailing prime overdraft rate of the banks.

- All other normal lending rates of the Reserve Bank will be reduced by 1 per cent from their present levels.

These adjustments at the same time give further

cognisance to one of the Bank's longer term structural objectives, namely to re-establish Treasury bills as the central instrument for use by banking institutions in obtaining accommodation from the Reserve Bank's discount window. During the past year this process has been supported by the issuing of more Treasury bills as an instrument of raising funds for the Government. The total amount of Treasury bills outstanding increased from R2,0 billion at the end of March 1991 to R4,6 billion at the end of February 1992.

Under present circumstances it can be expected of most deposit-taking institutions to reduce their lending rates accordingly. There is, however, no legal obligation on deposit-taking institutions to follow all changes in the Reserve Bank's Bank rate. There exists only an unwritten convention that the *prime* lending rates of deposit-taking institutions should not be more than 3 percentage points above the Bank rate. There has already been a deviation from this convention when most deposit-taking institutions found it necessary to increase their lending rates by 0,25 per cent in October 1991 in order to recover from their clients a new tax levied by the Treasury on banking services.

Deposit-taking institutions are in any case free to determine their other lending rates according to their own discretion and judgement. These rates will normally retain a relatively stable relationship with Bank rate, especially under conditions where institutions regularly make use of the Reserve Bank's accommodation facilities. In order to introduce more flexibility into the market system, the Reserve Bank is at this stage prepared to abolish the convention of a fixed ratio between the Bank rate and the prime lending rate of deposit-taking institutions. It is hoped that this step will not lead to any disorderly developments in the market, but the Bank will hold further discussions with deposit-taking institutions regarding the implications of this step.

The reduction in Bank rate to 16 per cent, that is below the latest available figure of 16,2 per cent for the rise in the consumer price index over the twelve months up to January 1992, can only be justified on the assumption that inflation will decline during the course of 1992. If not, the stance of monetary policy will have to be reconsidered.