Money supply guidelines for 1994

Statement issued by Dr C.L. Stals, Governor of the South African Reserve Bank

25 March 1994

1. Background

It is now eight years since the Reserve Bank in March 1986 first introduced predetermined targets for the growth rate in the money supply. At that time, an acceptable rate of growth of 16 to 20 per cent in the M3 money supply for 1986 was announced. In the event, the actual rate of increase in M3 for 1986 turned out to be only 9,3 per cent. Subsequently, in 1988, the growth rate in M3 accelerated to 27,2 per cent, when a target range of 12 to 16 per cent applied.

The Reserve Bank's experience with money supply targeting since 1986 has been mixed. As originally envisaged, the Bank never applied a rigid or overriding "money rule" – discretion continued to play a role. Account had to be taken from time to time also of movements in the level of interest rates, the level of the foreign reserves and exchange rate changes. The "causes" of changes in the money supply could also not always just be ignored.

On balance, the Bank is of the opinion that money supply targeting remains, at least in the present South African context, the most sensible anchor for monetary policy and for guiding the authorities in their decisions in executing their monetary policy responsibilities. It is true that in many other countries, the money supply has lost some of its appeal as an anchor for monetary policy purposes, and, in some instances, has been abandoned and replaced by a different basis, e.g. the exchange rate. In some countries – for example in the United Kingdom, New Zealand and Canada – the authorities are now pursuing inflation targets more directly, instead of through an intermediate target such as the money supply. This approach, however, requires a degree of co-operation between government, private businesses, trade unions and the central bank which will in the present phase of socio-political reforms in South Africa be extremely difficult to obtain.

The Reserve Bank will therefore at this juncture continue with the existing policy of using changes in the money supply as the most important monitor for its decisions regarding the implementation of monetary policy.

2. The balance of payments threat to financial stability

The overall domestic financial situation remained relatively stable over the past year. The twelve-month growth rate in the M3 money supply decreased from 8,0 per cent in December 1992 to only 1,9 per cent in July 1993; in the subsequent six months, however, it rose to 7,0 per cent in December 1993, and then further to an estimated 9,6 per cent in January 1994. The average level of the M3 money supply in the fourth quarter of 1993 was 5,6 per cent higher than the average level of M3 in the fourth quarter of 1992. The rate of increase was, therefore, slightly lower than the lower limit of the guideline range of 6 to 9 per cent announced by the Reserve Bank at the beginning of last year.

The twelve-month growth rate in domestic credit extension to the non-bank private sector by monetary institutions likewise receded from 8,7 per cent in December 1992 to 5,7 per cent in May 1993, before rising to 9,6 per cent in December 1993.

Money market conditions, however, remained relatively tight throughout the year. This was mainly due to an almost continuous decrease in the net foreign assets of the Reserve Bank. As a result of a huge net capital outflow now estimated at R16,3 billion for the calendar year, that is, substantially in excess of the estimated surplus of R5,9 billion on the current account of the balance of payments, the country's net foreign reserves declined by R10,3 billion in 1993. Sales of foreign exchange to the market by the Reserve Bank drained liquidity from the system. The Bank, however, intervened and, through a series of other actions, injected a huge amount of additional liquidity to prevent interest rates from rising. These actions were even sufficient to support some further decline in market interest rates. In the process the Bank:-

- reduced the minimum cash requirement for banking institutions in April 1993 and again in August 1993. These reductions released approximately R2,2 billion of cash reserves previously held with the Reserve Bank;

- redeemed all outstanding Reserve Bank debentures amounting to R0,5 billion. These debentures had previously been issued to sterilise some surplus cash in the money market;

- increased the Reserve Bank's own portfolio of government stock by a net amount of R0,7 billion from 31 December 1992 to 31 December 1993. The additional stock was acquired from the market through normal open-market operations of the Bank;

- adjusted the asset portfolio of the Corporation for Public Deposits by investing more of the Corporation's available funds in the money market, and less with the Treasury. These transactions had an easing effect on money market conditions of about R1,6 billion; and

- transferred Treasury cash balances previously held on deposit with the Reserve Bank to private banking institutions. This new procedure was introduced in June 1993 in anticipation of a proposed system of Tax and Loan Accounts for Treasury funds to be finalised and implemented during 1994.

These intervention operations of the Reserve Bank in the money market therefore played a major role in maintaining financial stability in 1993, and supported a further downward drift in interest rates, albeit at a slower tempo. The inter-bank call money rate, for example, decreased from 16,00 per cent at the end of 1991 to 12,25 per cent at the end of 1992, to 10,00 per cent at the end of December 1993, and to 9,50 per cent at the end of February 1994.

The Reserve Bank lowered Bank rate on two occasions during 1993 by one percentage point to its present level of 12 per cent. In total, Bank rate has now been reduced by 6 percentage points, or by one-third from the peak of 18 per cent reached late in 1989. Other market-related interest rates, such as the prime lending rates of banking institutions, followed suit and were also reduced further during 1993.

At the same time, the Bank's support to the foreign exchange market prevented the exchange rate of the rand from depreciating unduly. The nominal effective exchange rate of the rand nevertheless declined by 8,7 per cent in 1993, compared with 4,4 per cent in 1992. The depreciation of the rand in 1993 exceeded the difference in the inflation rates between South Africa and its main trading partners, with the result that the real effective exchange rate declined by 4,9 per cent in 1993.

3. Positive results on inflation

After a period of relative financial stability and annual rates of increase in the money supply of well below 10 per cent in each of the last two years, inflationary pressures in the economy at last subsided. The rate of increase in the all-goods production price index declined from 15,2 per cent in 1989 to only 6,6 per cent in 1993 – its lowest level since 1971.

The rate of increase in the consumer price index also declined to below 10 per cent last year. With this rate at a level of 9,7 per cent, 1993 represented the first year since 1973 to show a single-digit rate of consumer price inflation. From April 1993, the month during which value-added and other indirect taxes were increased, until January 1994 the seasonally adjusted and annualised rate of increase in the consumer price index came to only 7,4 per cent.

There are normally long time lags involved between changes in the underlying economic forces behind inflation and in the eventual changes in consumer prices. Whilst it can therefore be predicted with some confidence that the rate of inflation should remain subdued in the rest of this year, we must guard against taking actions now that will in the longer run lead to the re-emergence of stronger inflationary pressures in the economy. As the experience of the past few years has proved, it is extremely difficult to bring inflation down once it has become entrenched in the minds of people.

4. Money supply guidelines for 1994

The Reserve Bank now has to decide on money supply guidelines for 1994 without the advantage of first having had insight into the Government's Budget programme for 1994/95. It is, of course, essential that monetary and fiscal policy be harmonised and the guidelines for an acceptable rate of increase in M3 for 1994 were, as is normal practice, only decided on after consultation with the Minister of Finance.

After the positive results of the past year, it is tempting now to speed up the battle against inflation, and to tighten the monetary policy applied for this purpose even further. More than just a tight monetary policy will be needed, however, to knock this obnoxious disease completely out of the system. In the present phase of major socio-political reform, it will be extremely difficult to put a total economic package deal together that will stop inflation in South Africa completely at this stage, despite the obvious and extensive advantages such a policy may have for future economic development.

The Reserve Bank has therefore been influenced by the following considerations in deciding on an acceptable range for the increase in the money supply in 1994:

- The present fledgling economic recovery should not be allowed to falter. Monetary policy should not be used to stimulate the recovery artificially, but should also not restrict it. The increase in the money supply should be sufficient to accommodate real growth of at least 3 per cent in gross domestic product in 1994.

- The balance of payments situation, which is still vulnerable, should be protected. An excessive increase in the money supply at this stage will facilitate further outflows of capital from the country.

- The underlying rate of inflation, which is currently running at around the level of 7 per cent, is still relatively high if compared with current rates of inflation in almost all industrial countries. Monetary policy must therefore continue to exert downward pressure on inflation in South Africa.

- There is further scope for total monetary expenditure to increase even without any increase in the money supply, because of the still relatively low level of the velocity of circulation of the existing money supply.

Against this background, the Reserve Bank has decided to retain the guideline of 6 to 9 per cent used for 1993 as an acceptable range also for the rate of increase in M3 for 1994. It will be compatible with the objectives of the Bank for the maintenance of overall financial stability if the average level of the M3 money supply in the fourth quarter of 1994 will fall within a 6 to 9 per cent range above the average level of M3 in the fourth quarter of 1993.

Major deviations from these guidelines should trigger pro-active monetary policy actions by the Bank, although it must again be emphasised that the Bank does not intend to follow a rigid money rule linked to these guidelines at all times. Temporary deviations from the limits of the guidelines may again occur, as has often happened in the past, and may be caused by balance of payments or other temporary changes in the causal factors behind the money supply statistics. The Bank will nevertheless have to act timely whenever distinct longer-term trends develop for the money supply to move out of the boundaries of the "cone" established by the accepted guideline rates of 6 to 9 per cent growth in M3 in 1994.