Monetary policy in 1995

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

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Part I: Summary of monetary policy measures

The Reserve Bank regards it as essential that a more restrictive monetary policy shall now be pursued in order to prevent inflation from escalating in the period ahead. By implementing preventive measures against inflation now, the encouraging current economic expansion shall be supported and hopefully also extended over a longer period of time.

The Bank has therefore decided to introduce the following changes to existing monetary policy measures:

1. A guideline range for an acceptable rate of growth in the M3 money supply from the fourth quarter of 1994 to the fourth quarter of 1995 has been set between limits of 6 to 10 per cent, compared with the limits of 6 to 9 per cent set for 1994, and an actual increase of 14,6 per cent in 1994.

2. The Bank rate, that is the rate at which the Reserve Bank provides accommodation to banking institutions against the collateral of Treasury bills, Government stock and Land Bank bills, all with an outstanding maturity of less than 92 days, will be increased as from tomorrow, 21 February 1995, from 13 to 14 per cent per annum. The rate on overnight loans extended against collateral of the same financial assets with outstanding maturities of 92 days and longer, but less than 3 years, will be raised from 14 to 15 per cent per annum.

3. Banks are at present required to hold a basic minimum cash reserve of 1 per cent of their total liabilities minus capital and reserves on deposit with the Reserve Bank and/or in the form of South African coin and bank notes, plus an additional interest-bearing reserve deposit with the Reserve Bank equal to 1 per cent of their short-term liabilities. As from 21 March 1995, the basic minimum reserve requirement will be increased from 1 per cent to 2 per cent of the defined total liabilities of each banking institution. The additional interest-bearing reserve deposit of 1 per cent of short-term liabilities will be retained.

4. Each banking institution will be supplied with quantitative guidelines on the maximum amount of credit that it should extend to the private sector during the rest of this year to give effect to the monetary policy objectives of the authorities. These guidelines are not mandatory and an appeal is made on each banking institution to give its full support in the effort to contain inflation.

A detailed motivation of these decisions is attached as Part II of this Statement.

Part II: Motivation for monetary policy measures

1. Financial developments in 1994

Against the background of the major socio-political changes introduced last year, the effects on the economy of pre-election uncertainties and post-election violence and industrial actions and the unsteady recovery in the overall economic situation, the Reserve Bank followed a mildly expansionary monetary policy in 1994.

Although it became clear during the course of the year that actual growth in the money supply will exceed the guidelines of 6 to 9 per cent announced by the Reserve Bank at the beginning of last year as an acceptable rate of growth in the broadly defined money supply (M3), the Bank's actions remained fairly neutral in the financial markets during the major part of 1994. It was only towards the end of September that the Bank for the first time showed its hand by raising Bank rate from 12 to 13 per cent.

The result of the rather lenient monetary policy was relatively rapid expansion in the two financial aggregates regarded by the Bank as important indicators of possible future trends in inflation:

* Over the twelve-month period from December 1993 to December 1994 the M3 money supply increased by 16 per cent. The average amount of the money supply in the fourth quarter of 1994 (the guideline target period) exceeded the average amount of M3 in the fourth quarter of 1993 by 14,6 per cent.

* Over the twelve-month period from November 1993 to November 1994 (the latest information available), the total amount of bank credit extended to all borrowers in South Africa, that is the government and the private sector, increased by 20,9 per cent. Total claims of all monetary institutions on the private sector rose by 16,9 per cent over the same period.

It is clear that, in these circumstances, financial stability will not be sustainable and inflation can easily accelerate again if these growth rates in the money supply and in bank credit extension are not checked.

Reflecting the increasing demand for credit, market-related interest rates in South Africa rose quite sharply over the year:

* the three-month Treasury bill tender rate rose from 10,2 per cent in December 1993 to 12,7 per cent in December 1994;

* the rate on three-month negotiable certificates of deposit rose from 10,4 to 12,8 per cent over the year; and

* the yield on long-term Government stock increased from 12,3 per cent at the end of 1993 to 16,8 per cent at the end of 1994.

Market-related interest rates therefore rose much faster than the Bank rate and rates traditionally linked to Bank rate, such as the prime overdraft rate of banking institutions and the mortgage rate for home loans, which were raised by only one percentage point after the increase in the Bank rate from 12 to 13 per cent on 26 September 1994.

Significant changes in the balance of payments during 1994 also affected financial developments and the monetary policy stance of the authorities:

* a small surplus of R412 million on the current account during the first half of 1994 changed into a deficit of R2,5 billion in the second half;

* a net capital outflow of R3,6 billion in the first half of the year changed into a net inflow of no less than R8,8 billion in the second half. For the year as a whole, South Africa therefore had a net capital inflow of R5,2 billion – the first year since 1984 to register a net capital inflow;

* the country's total net gold and other foreign exchange reserves declined by R3,2 billion from the end of December 1993 to the end of June 1994, but then increased by R6,4 billion over the last six months of 1994; and

* the average weighted exchange rate of the rand in nominal terms depreciated by 12,1 per cent from 31 December 1993 to 13 July 1994, but then appreciated by approximately 4 per cent up to 31 December 1994.

These trends in the balance of payments, reflecting the beneficial effects of South Africa's new position in the global economy, afforded the Reserve Bank with an opportunity of a more relaxed monetary policy last year.

2. A more restrictive approach needed for 1995

In retrospect, monetary policy may have been too easy in 1994. Bank credit extension and the money supply cannot be allowed to expand at the relatively high rates of last year and will have to be contained within more tolerable limits.

It would not be correct to link the increases in both the producer and consumer prices last year too directly to the monetary policy of 1994 – there are normally time lags of more than 12 months involved in changes in underlying monetary conditions and in prices. Other factors such as the depreciation of the rand in late 1993 and early 1994 and adverse climatic conditions affecting food prices, were to be blamed for most of the price rises last year.

The facts are, nevertheless, that the rate of change in the consumer price index measured over twelve months bottomed out at 7,1 per cent in April 1994, and then increased again to 9,9 per cent in December 1994. The rate of increase in producer prices already turned around from 5,4 per cent in October 1993, to reach a level of 9,7 per cent in December 1994. It would be a dire mistake to accommodate these trends in prices by creating more money that could, in the current situation, easily lead to an entrenchment of inflation at the higher level on a permanent basis.

The economic recovery, which started in the first half of 1993, remained rather frail throughout the first two quarters of 1994. Available national accounts statistics indicate, however, that the economic upswing has gained considerable momentum during the second half of last year. In the fourth quarter, real gross domestic product expanded at a seasonally adjusted annual rate of 6 per cent, whereas total real gross domestic expenditure increased at a rate of about 8 per cent.

These trends had their effect on the balance of payments, with imports rising quite sharply to create a current account deficit equal to a seasonally adjusted annual rate of R7 billion in the fourth quarter. A large net capital inflow was more than sufficient to cover the current account deficit, but the magnitude of the current deficit calls for caution.

In order to avoid a further buildup of inflationary pressures, and to protect the balance of payments from developing into an untenable situation, both of which would be detrimental to a continuation of economic growth, it is appropriate to bring monetary policy now in line with the longer-term objectives of a stable overall financial environment. It is indeed a precondition for the maintenance of continued economic expansion in the longer run.

There is one further reason why it has become necessary to apply a more stringent monetary policy at this juncture. The objective of some relaxation in exchange controls, and particularly in the exchange controls applicable to non-residents, requires vigil and a financial environment that will be supportive of further capital inflows. It would be even more risky to relax exchange controls in an environment of excess liquidity, unrealistically low interest rates and rising inflation. Recent increases in interest rates in some of the major industrial countries, for example in the United States of America and in the United Kingdom, exerted some upward pressure on South African interest rates, despite the artificial protection still afforded by the existing exchange controls.

3. Money supply guidelines for 1995

Money supply guidelines do not serve as rigid rules for monetary policy in South Africa. They do provide,

however, guidance in decisions on monetary policy and serve as important indicators to the general public on what can be expected of monetary policy.

Last year, the Reserve Bank did not regard it as expedient to force the money supply to stay within the guidelines of 6 to 9 per cent for the growth in M3 as announced at the beginning of the year. Actual growth in M3 in the end exceeded the upper limit of the guidelines by a substantial margin. Over the past three years, however, that is from 1992 to 1994 inclusive, the M3 money supply increased at an average annual rate of 9,2 per cent, whereas the average annual rate of inflation over this period as measured by the gross domestic product deflator amounted to 11,3 per cent. The average rate of growth in real gross domestic product over the three years was only 0,4 per cent, with the result that the rate of increase in the money supply was below the rate of growth in the total nominal value of gross domestic product.

This did not apply in 1994, however, when the rate of increase in the money supply exceeded the rate of inflation and also the rate of growth in nominal gross domestic product. This situation, if continued throughout 1995, would lead to an escalation of inflationary pressures in the economy. It is therefore essential immediately now to apply some brakes on the rate of growth in the money supply.

Taking account of the overall situation, the Reserve Bank has therefore decided to set guidelines for an acceptable rate of growth in the M3 money supply from the fourth quarter of 1994 to the fourth quarter of 1995 of 6 to 10 per cent, compared with the 6 to 9 per cent for last year. The higher upper limit of 10 per cent takes account of potentially higher real growth in gross domestic product in 1995 (hopefully in excess of 3 per cent), whereas the unchanged lower limit of 6 per cent reflects the Reserve Bank's resolve that, over the longer term, South Africa will have to reduce its rate of inflation to bring it more in line with the level of the average rate of inflation in the countries with which South Africa trades and competes in the international environment. To begin with, inflation must at least be kept below 10 per cent per annum. Even this will not be an easy task in 1995.

4. Interest rate policy

The rising trend of market interest rates over the past year, and the further escalation of particularly short-term rates recently, partly reflected the underlying trends in the market, and partly also the expectation that the monetary authorities will in 1995 pursue a more restrictive monetary policy.

The Bank rate of the Reserve Bank is now coming under severe pressure from these market trends. At the weekly tender for 91-day Treasury bills a rate of 13,01 per cent was set on Friday, 17 February 1995 – a clear indication that, in terms of the market assessment, Bank rate at 13 per cent is now too low.

Bank credit extension to the private sector remains the main statistical "cause" of increases in the money supply. The demand for bank credit is relatively sensitive to changes in interest rates, particularly over the longer term. The interest rate policy of the Reserve Bank, implemented through changes in the Bank rate, therefore remains one of the major operational instruments used for the achievement of the money supply objectives. An unrealistically low Bank rate will make "cheap" money available to banking institutions at the discount window, and will encourage them to pursue a more aggressive marketing policy for the extension of more credit, that is to create more money.

Banking institutions have not in recent months made excessive use of accommodation from the Reserve Bank. The amount of the money market shortage did, however, increase from R3,9 billion at the end of September to R5,1 billion at the end of December 1994, and further to R5,3 billion at the end of January 1995. Money market liquidity has, however, in recent months been supplemented by a continuous relatively large net capital inflow from abroad, and the money market shortage did not truly reflect the strengthening in the domestic demand for credit.

In these circumstances and in support of the money supply guidelines for 1995, the Reserve Bank has decided to raise its Bank rate, that is the rate at which the Bank is prepared to extend overnight loans to banking institutions, as from 21 February 1995, by one percentage point from 13 to 14 per cent per year.

Overnight loans at Bank rate are made available to banking institutions only against the collateral of Treasury bills, Government stock and Land Bank bills with a maturity of less than 92 days. To fulfil its role as lender of last resort, the Reserve Bank also provides overnight loans against collateral of the same financial assets with a maturity of 92 days and longer, but less than three years, but then only at a penalty rate. Up to now, the penalty rate has been set at 1 percentage point above Bank rate. As from 21 February 1995, the margin will be widened to 1 percentage points, and Reserve Bank accommodation in the second tier will be provided at a rate of 15 per cent per annum.

These adjustments bring Reserve Bank rates more in line with market-related interest rates and carry a clear signal of the resolve of the monetary authorities to bring rates of growth in the monetary aggregates back to a level more in line with the objective of the authorities to reduce inflation gradually in South Africa to a more acceptable level.

5. Management of overall liquidity

Although the rate of increase in the money supply is to an important extent driven by the demand for bank credit, other factors also affect the level of money in circulation. One such factor, which is gaining in importance at this stage, is the net inflow of capital from abroad. As already

indicated, these net inflows have in recent months exceeded the current account deficits and have led to a welcome increase in the foreign reserves of the Reserve Bank.

The present situation provides interesting challenges for the management of overall liquidity and the money supply in South Africa. There is a dire need for the Reserve Bank to increase its foreign reserves to a more acceptable level. Indeed, the present amount of about R11,3 billion in foreign reserves held by the Bank is barely enough to cover six weeks' imports and should be raised to a level of at least three months' imports. The Bank therefore uses every possible opportunity to obtain surplus foreign currencies from the foreign exchange market to supplement its reserves.

Within the framework of the existing exchange controls on capital outflows, an excessive inflow of foreign capital could, at least before exchange controls are relaxed, exert pressures for an appreciation of the exchange rate of the rand in the foreign exchange market. To relieve these pressures, the Reserve Bank must therefore intervene regularly in the foreign exchange market to absorb the surplus foreign exchange, and to prevent an appreciation of the rand which will, at this juncture, contribute further to the erosion of South Africa's competitive position in the international markets.

In the longer run, South Africa can only improve its competitiveness by raising multi-factor productivity, and by restraining the remuneration demanded by the various factors of production. It is an illusion to believe that a country can be made more competitive merely by devaluing its currency. However, in the current situation and pending certain exchange control relaxations, the Reserve Bank will continue to intervene in the foreign exchange market in order to prevent an undue appreciation of the rand at this stage.

Intervention by the Reserve Bank in the foreign exchange market in this way, however, creates prime liquidity and, if not counteracted or "sterilised", adds to the ability of banking institutions to provide more credit to their clients. Over the past seven months, the Reserve Bank's net foreign reserves increased by R6,8 billion, resulting in a similar amount of liquidity being created by the central bank. This conflict of objectives, that is on the one hand, to increase the foreign reserves of the Reserve Bank and to prevent an undue appreciation of the foreign exchange rate of the rand, and, on the other, to keep the money supply under control, requires the activation of more operational instruments of monetary policy than just the Bank rate.

Variations in the minimum reserves that banking institutions must maintain with the Reserve Bank can be a useful instrument in this situation. It should be noted that, in terms of the Reserve Bank Act, minimum reserves for banking institutions can be required against total liabilities and/or against any part of total liabilities, for example only short-term liabilities, and/or against any increase as from a certain date in either the total or a defined component of total liabilities.

At this stage banking institutions are required to maintain with the Reserve Bank:

* a basic minimum reserve balance equal to 1 per cent of their total liabilities, minus capital and reserves. Banks may include South African coin and bank notes in their possession for purposes of maintaining these minimum balances; and

* a supplementary reserve balance equal to 1 per cent of their total short-term liabilities as adjusted. The Reserve Bank pays interest equal to a rate of per cent below the current Treasury bill tender rate on these reserve balances.

It has now been decided to raise the basic minimum reserve balance required from banking institutions from 1 per cent of total liabilities, minus capital and reserves, to 2 per cent of the total liabilities as adjusted of each banking institution. No interest will be paid on this total basic minimum reserve requirement and, as previously, banks will continue to be allowed to include their holdings of South African coin and bank notes in these minimum balances. The interest-bearing reserve deposit of 1 per cent of short-term liabilities will be retained.

The increase in the basic reserve requirement to 2 per cent will become effective as from the date of certification of the banks' monthly statements of Form DI 310 to be submitted to the Registrar of Banks not later than 21 March 1995. Based on the available statistics for November 1994, this requirement will "freeze" an additional amount of not more than R3 billion of the liquidity of the banks (to be reduced by the eligible amount of vault cash that can be included in terms of the existing arrangements).

6. The extension of credit to the private sector by banking institutions

The increase in the Bank rate is intended to reduce the demand for credit from banking institutions. The increase in the minimum reserve requirements is intended to restrict the amount of liquidity available in the banking system for funding loans to the private sector. The combined effect of these measures should be to gradually reduce the rate of expansion in the money supply.

The Reserve Bank remains averse to direct controls on the amount of bank credit extended by banking institutions. Such controls frustrate the working of the market system, and lead to distortions that will retard the maximum growth potential of the economy. In the end, it will lead to a weaker banking system.

It is, nevertheless, important for the Bank to monitor very closely future developments in the amount of credit extended by each banking institution. To achieve the

objective of a money supply growth of not more than 10 per cent in 1995, the amount of the total bank credit extended during 1995 should also not increase by much more than 10 per cent. The Bank has therefore calculated for each banking institution what its total claims on the private sector should not exceed as at the end of each of the four calendar quarters of 1995. These guidelines will be sent to each banking institution within the next few days.

Banking institutions are requested to co-operate with the authorities, and to manage their own activities in accordance with the guidelines provided, and in support of the overall monetary policy objectives. The more that can be achieved through such co-operation, the less painful will be further restrictive measures of a macro-policy nature that may be required to achieve the objectives.

7. Concluding remarks

The fight against inflation in South Africa is not confined to monetary policy alone. There are many other inflationary forces at work that could easily foil the efforts of the Reserve Bank to contain inflation. The Bank therefore needs the support of the fiscal authorities, the business community, the trade unions and indeed every man on the street to fight against the cancerous economic disease of inflation.

The objectives of the Reconstruction and Development Programme will be frustrated and will not be achievable in an environment of high inflation. The Reconstruction and Development Programme has therefore tasked the Reserve Bank to fight inflation:

"The main functions of the Reserve Bank are to maintain the value of the currency, to keep inflation relatively low, and to ensure the safety and soundness of the financial system".

The monetary policy measures announced today are intended to give effect to this assignment.