Statement on Bank rate

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

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Since February 1996, the exchange rate of the rand has now depreciated by more than 20 per cent. The average weighted value of the rand, measured against a basket of the currencies of South Africa's major trading partners, from 31 December 1995 declined by 14,6 per cent up to the end of June, by 18,1 per cent up to the end of July and by 22,2 per cent up to 20 November 1996.

Although the initial depreciation in February 1996 could be explained in terms of the underlying economic developments of 1995 and the early weeks of 1996, subsequent adjustments, and particularly the further depreciation of about 5 percentage points in October 1996, no longer reflected basic economic developments such as changes over time in purchasing power parity, the international competitiveness of the South African economy or cyclical trends in the current account of the balance of payments. The cumulative and excessive depreciation of the rand has reached a stage where it now holds the serious threat of an escalation of inflation next year and has forced the need for a more cautious monetary policy to protect the internal value of the rand.

On the side of the domestic economy, significant adjustments took place in the third quarter of 1996 when a further slow-down in the rate of increase in total domestic expenditure reduced pressure on the overall balance of payments. National accounts statistics for the third quarter are not yet available, but preliminary estimates indicate that, on a seasonally adjusted and annualised basis, the current account deficit declined by approximately R6 billion to about R10 billion from a revised deficit of about R16 billion in the second quarter of 1996.

These developments in real economic activity have not yet been reflected in the financial situation. Both bank credit extension and the money supply continued to increase at unacceptably high rates. The deficit on the current account of the balance of payments was again not covered by net capital inflows and the net foreign reserves of the Reserve Bank declined by R1,8 billion from the end of June up to the end of October 1996.

The continuous deficit on the overall balance of payments drained liquidity from the banking system and the money market deficit rose from R5,8 billion at the end of June to R9,3 billion at the end of September and R9,7 billion at the end of October 1996. During the first twenty days of November, the average daily money market shortage exceeded R9 billion.

The shortage of liquidity forced almost all money market interest rates to higher levels. Short-term interest rates in general increased by about 1½ percentage points from the end of September up to the third week of November 1996. The call money rate, for example, rose from 15,50 per cent on 30 September to 17,00 per cent on 20 November, and the rate on short-term negotiable certificates of deposit from 15,80 per cent to 17,15 per cent. The yield on long-term government bonds also rose by 1 percentage point to 16,12 per cent on 14 November, before declining again slightly to 15,92 per cent on 20 November.

The persistent money market shortage at a high level has created an additional demand for liquid assets eligible as collateral for obtaining loans at the discount window of the Reserve Bank. This increased the demand for Treasury bills at the weekly tender and kept the rate on 91 days Treasury bills artificially low. The level of the Reserve Bank's rate for loans to banking institutions at 16 per cent has now fallen out of line with other market interest rates, and the banks are increasingly relying on this source of relatively cheap funds for balancing their cash requirements.

In the circumstances, the Reserve Bank has two options, either to increase liquidity by injecting more money into the system, or to raise Bank rate. The former approach will obviously increase the already high rate of increase in the money supply and will add fuel to the rising pressures on inflation. The rate of increase in average consumer prices measured over a twelve-month period rose from 5,5 per cent in April 1996 to 9,1 per cent in October 1996. Taking account of the expected further pressures emanating from the depreciation of the rand, it will be a suicidal approach for the Reserve Bank to create even more central bank money in this situation.

The unstable conditions in the market for foreign exchange, recent developments in the domestic financial markets and the growing upward pressures on inflation all dictate a need for a tightening of monetary policy at this stage. The Reserve Bank has therefore decided to follow recent interest rate trends in the financial markets and to raise Bank rate, that is the rate at which the Bank is prepared to make loans to banking institutions on an overnight basis, from 16 to 17 per cent as from tomorrow, 21 November 1996. Other related interest rates of the Reserve Bank will also be raised by 1 per cent from their present levels.

Recent developments in real economic activity indicate that, after more than three years of increasing growth rates, the South African economy is now moving into a phase of consolidation. During this consolidation period rates of growth in some of the more important macroeconomic aggregates such as gross domestic expenditure will decline to lower but more sustainable levels. The period of consolidation also provides an opportunity for the restoration of equilibrium in the overall balance of payments, which should support a more stable exchange rate for the rand. At the same time, there is an opportunity now to achieve the necessary reduction in the rates of increase in financial aggregates such as bank credit extension and the money supply. Unless this opportunity is grasped, South Africa will have to face the tribulation of lower economic growth with higher inflation, a situation that will make the successful implementation of the Government's Strategy for Growth, Employment and Redistribution impossible.

To depress the unavoidable inflationary pressures arising from the excessive depreciation of the rand over the past year, decisive action is now necessary to restore both external and internal financial stability. The further depreciation of the rand in October represented a step in the wrong direction that now begs for action. The increasing tightness in money market conditions and the rising interest rates represent essential elements of the adjustment process during the phase of consolidation. By accepting the disciplines of these market forces, the way will be prepared for an early commencement of the next expansionary phase, during which the longer term economic growth potential of the country will hopefully move to a higher level.