Money supply guidelines for 1996

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1. Developments during 1995

The main objective of monetary policy in South Africa is to protect the value of the currency, that is, to keep inflation low in the interest of balanced and sustainable economic growth. The rate of increase in the consumer price index measured over twelve-month periods reached a low point of 6,3 per cent in October 1995, before rising again to 6,9 per cent in December. Over the year as a whole, the average rate of inflation of 8,7 per cent represented the lowest for any calendar year since 1972, when it amounted to 6,1 per cent.

The rate of inflation for production prices, however, increased slightly in 1995, averaging 9,6 per cent, compared with 8,2 per cent in 1994. Measured over twelve months, the all-goods production price index reached a low of 7,6 per cent in September 1995, before rising again to 8,5 per cent in December 1995.

At the beginning of 1995, the Reserve Bank indicated that a rate of increase of between 6 and 10 per cent in the M3 money supply in 1995 would be consistent with the Bank's objective of maintaining overall financial stability. As it turned out, the actual increase in **M3** from the fourth quarter of 1994 to the fourth quarter of 1995, was 14,3 per cent. This was the second year in succession that the actual increase in the money supply exceeded the guidelines, after relatively slow growth of only 8 per cent in 1993 and 7 per cent in 1994. Over the past four years, that is more or less during the full period of the current economic upswing, the average annual rate of growth in the **M3** money supply, as measured for money supply guideline purposes, amounted to 10,8 per cent.

Growth in the money supply in 1995 must be judged against the background of two important related financial developments. Firstly, the Reserve Bank's net gold and foreign exchange reserves last year rose by R9,6 billion which made it difficult for the monetary authorities to restrict the increase in the amount of liquidity available to the banking sector. Secondly, a strong credit demand emanated from the private sector for the financing of increased investment and consumer expenditure. Together with the continuing high overall funding needs of government, severe upward pressure was placed on the demand for credit. The total amount of bank credit extended to the private sector consequently rose by R47,1 billion, or by 17,5 per cent in 1995. This relatively large amount of bank credit extension was the main cause for the increase in the money supply.

Against the background of the strong demand for credit, money market interest rates, which had started to rise during 1994, increased steeply in the first six months of 1995 and remained relatively firm in the last half of the year. The rate on bankers' acceptances with a maturity of three months, for instance, increased from 12,50 per cent at the end of December 1994 to 14,20 per cent at the end of June 1995 and 14,60 per cent at the end of December 1995. The monthly average yield on long-term government stock initially receded from a high of 17,02 per cent in January 1995 to 16,62 per cent in July 1995, and then declined further to 14,56 per cent in December.

During the first three months of 1996, the financial markets first eased considerably, but were shocked by a sudden change of sentiment in the middle of February when the foreign exchange market came under severe pressure. The nominal effective exchange rate of the rand, measured against a basket of currencies, first appreciated by 0,6 per cent from 31 December 1995 up to 15 February 1996, but then depreciated by 5,1 per cent during the rest of February, and by a further 3,7 per cent during March 1996. The pressures continued during April and the rand depreciated further.

The turmoil in the foreign exchange market had a marked effect on capital market interest rates, particularly as foreign investors reduced their investments on the Johannesburg Stock Exchange. The yield on long-term government stock first declined from 14,22 per cent at the end of December 1995 to 13,30 per cent in the middle of February 1996, but then rose sharply to 15,60 per cent on 18 April 1996.

Short-term interest rates so far reacted surprisingly little and the rate on bankers' acceptances with a maturity of three months declined from 14,60 per cent at the end of December 1995 to 13,95 per cent early in February 1996, before rising again to 14,35 per cent on 23 April.

In January and February 1996, both the **M3** money supply and bank credit extended to the private sector continued to rise at the relatively high rates established last year, although there was some indication recently of a levelling out in these rates.

2. A new "anchor" for monetary policy?

It is sometimes argued that the money supply no longer provides an appropriate basis for monetary policy decisions in South Africa. It is true that the integration of South Africa in the global financial markets, and the innovations caused by the introduction of new payments and money transmission techniques, make the money supply a less useful indicator of potential underlying inflationary pressures in the economy.

It should be pointed out, however, that the Reserve Bank does not regard money supply guidelines as a rigid money rule for monetary policy in South Africa. The monetary policy model used by the Bank is based on developments in a wider range of financial aggregates, including changes in the amount of bank credit extended to the private sector, the deficit before borrowing and the overall borrowing requirement of government, the level and structure of interest rates, the level of and changes in the gold and foreign exchange reserves and changes in the nominal and real effective exchange rate of the rand. Relying on the money supply as a prime indicator of the development of underlying inflationary pressures, however, provides a consistent framework for monetary policy, accommodating inter-relationships and movements in all these aggregates.

It should furthermore also be pointed out that the Reserve Bank's monetary policy model is not isolated from developments in the real economy, and certainly not from changes in the real economic growth rate. A decline in the rate of expansion of the economy will normally be reflected in a lower demand for bank credit, a decline in the rate of increase in the money supply and less pressure on interest rates. Such developments will therefore trigger a more relaxed monetary policy.

At this juncture, there is no evidence that the present model for monetary policy, which has served the country well over the past seven years, should be changed or abandoned. South Africa is, for example, not yet ready to embark on a policy of targeting inflation directly, which requires a degree of co-operation between government, the business sector and labour, which will apparently not be achievable at this stage.

3. A new definition of the money supply?

In deciding on monetary policy, the Reserve Bank takes account of changes in all the components included in the broad definition of the money supply. Over the twelve months up to December 1995, for example, the percentage changes in the various components were as follows:

1.	Coin and banknotes in circulation plus cheque and transmission deposits **(M1A)**	16,8
2.	**M1A** plus other demand deposits **(M1)**	19,3
3.	**M1** plus other short and medium-term deposits **(M2)**	13,9
4	**M2** plus long-term deposits **(M3)**	15,2

There are some proponents of the use of an even more restricted definition than **M1**, referred to as **M0**, which should include only notes and coin in circulation outside the Reserve Bank plus deposits held by banking institutions with the Reserve Bank. This definition is, unfortunately, not very useful in South Africa as South Africans do not make extensive use of banknotes and coin in payment transactions, but rather use various means of credit (deposit money), e.g. cheque accounts and credit cards. At 31 December 1995, total notes and coin issued by the Reserve Bank amounted to only R20,3 billion, equal to 7,6 per cent of the total **M3** money supply. In fact, only R14,3 billion of this amount, representing 5,1 per cent of the total money supply, circulated outside of the banking sector.

It should also be noted that deductions made from changes in notes and coin issued by the Reserve Bank in recent years can be very misleading. These figures were distorted by:

- the introduction of automated teller machines which increased the demand for notes;
- the take-over by the Reserve Bank from government of the responsibility for coin issues. Coin in circulation was therefore only introduced as a liability of the Reserve Bank since March 1994; and
- technical changes introduced during the course of 1995/96 for the transfer of notes held by banking institutions at various SBV note depots to the Reserve Bank on a day-to-day basis.

These technical changes had nothing to do with underlying or implicit inflationary pressures in the economy and made actual changes in notes and coin in circulation as published worthless, even as an early indicator of such pressures.

Furthermore, it must be noted that, unlike in many other countries, banks do not hold free balances on deposit with the Reserve Bank, but only minimum cash reserves as prescribed in terms of the South African Reserve Bank Act. When the Reserve Bank raised these minimum requirements early in 1995, for example, **M0** showed a sharp rise, not because of an expansionary monetary policy, but rather as a result of a more restrictive approach.

The De Kock Commission of Enquiry into Monetary Policy provided convincing arguments in its report of 1985 that **M3** should be regarded as the more appropriate concept of the money supply to serve as an anchor for monetary policy in South Africa. There is no reason to believe that this situation has changed sufficiently to warrant any switch to a different definition of the money supply.

4. A longer-term approach to money supply guidelines?

Now that the rate of inflation in South Africa has remained relatively stable below the 10 per cent level for three years in succession, there is some merit in the argument that the Reserve Bank should focus on an acceptable rate of growth in the money supply over periods longer than just one year. Normally the broadly defined money supply **(M3)** only reacts to changes in the monetary policy stance after a time lag that could vary between four to eight quarters, or in some cases even over a longer period. Measures taken now, for example, will hardly have any effect on the course of **M3** in 1996.

Furthermore, changes in the money supply are affected by the phase of the business cycle. It was, for example, easier to keep the rate of increase in the money supply restricted in 1992 and 1993 when the economy was in a depressed condition. It became a more arduous task in 1994 and 1995 when real domestic demand increased more vigorously. Over the four-year period as a whole, however, the average rate of increase in the money supply was only 10,8 per cent, as already indicated.

This problem is partly accommodated by accepting a new base for the guidelines every year, calculated as the average amount of the **M3** money supply in the fourth quarter of the preceding year. Further research into the possibility of providing money supply guidelines for longer periods will be undertaken by the Reserve Bank's Economics Department during the course of this year.

5. Money supply guidelines for 1996

Taking account of financial developments in 1995, the disturbing events in the foreign exchange market recently, and the danger of price increases that may arise from the recent depreciation of the rand extending into an increase in overall inflationary pressures, there is not much scope for the Reserve Bank to relax on the monetary policy stance at this stage.

Estimates for real growth in gross domestic production in 1996 converge towards a possible 4 per cent. Should we want to continue to exert some downward pressure on inflation from last year's level (equal to 8,7 per cent on the average, and 6,9 per cent over the twelve months up to December 1995), the money supply should not increase by more than 10 per cent. In the light of the need for a more consistent approach over the medium and longer term, the Bank has therefore decided to retain guidelines for an appropriate rate of growth in the **M3** money supply from the fourth quarter of 1995 to the fourth quarter of 1996 at the level of 6 to 10 per cent. This is reconcilable with the overriding objective of maintaining financial stability in support of sustainable economic growth and development in the longer term.

It should again be emphasised that the Reserve Bank's guidelines for an appropriate rate of increase in the money supply should not be interpreted as a forecast for 1996, neither do they represent targets that must be achieved at all cost. These guidelines do provide, however, an important indicator for the Reserve Bank's monetary policy stance. Growth in the money supply at a rate well in excess of the upper limit of the guidelines on a persistent basis will prompt a more restrictive monetary policy approach by the Bank, and will require relatively high interest rates, a reduction of the demand for credit, and of the ability of banks to extend more credit.

At the same time, the system of providing guidelines for an acceptable rate of increase in the money supply contributes to greater transparency in monetary policy. Monetary policy decisions taken by the Bank must be conducted within a consistent framework that is intended to give effect to the mandate conferred on the Bank by Government – that is, to protect the value of the South African currency.

As in the past, we again appeal to all banks in South Africa for their support of these objectives, and for understanding the reasons for a restrictive monetary policy stance at this stage. Recent developments in the foreign exchange market did not make the task easier, but brought even more urgency to the need for preventing a general escalation of inflation in the wake of the depreciation of the rand. Any advantages that can flow to the South African economy from the depreciation of the rand will otherwise quickly be eroded by rising costs of production.