Money supply guidelines for 1997

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1. Outcome for 1996

At the beginning of 1996, the Reserve Bank indicated that an appropriate rate of increase in the broad money supply (**M3**) between the fourth quarter of 1995 and the fourth quarter of 1996 would fall within the range of 6 to 10 per cent. These guidelines were regarded to be consistent with the medium and longer-term monetary objectives of the Reserve Bank and with the overriding goal of maintaining financial stability in support of sustainable economic growth and development.

The realised growth in **M3** over this guideline period, however, amounted to R41,2 billion, or 15,2 per cent. The actual month-end values of the broadly defined money supply also exceeded the corresponding projected values of the upper limit of the guideline range throughout 1996. The year 1996 represented the third consecutive year in which the growth in **M3** was considerably higher than desirable growth rates as indicated by the Reserve Bank. Owing to the high demand for money, the rate of increase in the broad money supply aggregate averaged 14,7 per cent from the beginning of 1994 up to the end of 1996. If allowance is made for business cycle developments and the two low economic growth years 1992 and 1993 are included in the comparison, the average annual growth in **M3** over the past five years comes down to a lower level of 11,6 per cent. Over this longer period the growth in **M3** therefore still exceeded the upper limit of 10 per cent of the money supply guidelines, and more or less equalled the growth rate in nominal gross domestic product, which indicates a relatively accommodative monetary policy stance.

The transaction motive for holding money, related to large increases in real expenditure and an almost explosive increase in the turnover in financial markets in recent years, was an important contributing factor to the high rates of increase in money supply. Certain structural changes, such as the integration of South Africa in international financial markets and the absorption of more South Africans in the market economy, also caused the growth in money supply to remain high for a longer period than would normally have been the case during the course of the business cycle. In addition, the high growth in money supply during 1995 and 1996, and particularly in the shorter-term components of **M3**, reflected an enhanced confidence in money as a store of value in view of more favourable yields on deposits.

The main statistical counterpart for this growth in money supply was a vigorous rate of increase in credit extension by monetary institutions to the private sector that fluctuated around a level of 17 per cent throughout 1995 and 1996. Credit extension was boosted on the demand side by strong consumer and investor confidence as fears of political instability subsided and economic growth improved. Restructuring in employment policies generally leading to a replacement of older by younger people and also a switching from foreign to domestic financing of international trade transactions arising from the instability in the foreign exchange market in 1996, contributed further to the steady high increase in credit demand. On the supply side, banks actively promoted the use of credit facilities, while retail outlets encouraged consumers to increase their spending by means of in-house credit cards.

In view of these developments and in pursuing its mission to protect the value of the rand, the Reserve Bank had no other option but to adopt a more restrictive monetary policy stance. The first Bank rate increase of one percentage point was already made on 26 September 1994, followed by two further increases in 1995 to bring Bank rate to a level of 15 per cent at the end of June 1995. Shorter-term as well as longer-term market interest rates and yields similarly moved up sharply in the first half of 1995, before the rates in the capital market started to contract in the second half of that year.

This downward movement in longer-term rates was reversed with the sudden decline in the net inflow of capital from abroad that occurred in the first quarter of 1996. A number of adverse developments at the time continued to trigger an outflow of short-term capital. Combined with a relatively large balance of payments current account deficit at that stage, an overall balance of payments deficit developed that created immediate shortages in the market for foreign exchange and forced a sharp depreciation in the exchange rate of the rand. The initial depreciation created negative expectations and caused leads and lags in trade financing to move strongly against South Africa, which brought about a further depreciation of the rand.

With only limited foreign exchange reserves and other means at its disposal to finance the external deficit, South Africa had no alternative than to reduce the deficit on the current account of the balance of payments to a more manageable level. A part of the needed adjustment process in any case resulted from the unavoidable secondary effects of the depreciation of the rand. A simultaneous decline in domestic liquidity was also reflected in a higher level of interest rates, which not only served to discourage the outflow of capital but also reduced the demand for bank credit and the growth in domestic expenditure. In these circumstances monetary policy was directed actively to support the market adjustment process. Bank rate was accordingly increased further in two steps during 1996, in each case by one percentage point, to reach 17 per cent at the end of November.

The consistent restrictive monetary policy stance, together with other factors such as a slower growth in nominal unit labour costs, reductions in tariffs on imported prices and a relatively stable exchange value of the rand until the middle of February 1996, achieved considerable success in bringing the inflation rate down to single-digit levels. After having recorded rates of increase in the consumer price index verging around approximately 15 per cent since the early 1970s, which reached 18,6 per cent in 1986, consumer-price inflation moved to a level below 10 per cent in 1993. Moreover, the average annual rate of increase in the consumer price index declined from 9,7 per cent in 1993 to 7,4 per cent in 1996 – its lowest level since 1972.

2. Re-emergence of inflationary pressures

During the course of 1996, however, the downward trend in consumer-price inflation was reversed and the quarter-to-quarter rate of increase in the consumer price index (seasonally adjusted and annualised) accelerated from a lower turning-point of 7,8 per cent in the second quarter of 1996 to 11,6 per cent in the fourth quarter. Measured over periods of twelve months, the rate of increase in consumer prices also rose from a low of 5,5 per cent in April 1996 to 9,4 per cent in both December 1996 and January 1997.

To some extent this acceleration in consumer-price inflation can be ascribed to exceptional circumstances, such as the increase in food prices and the effect of higher interest rates on the cost of home ownership. More significantly, however, the underlying inflation rate (i.e. the change in the overall consumer price index, excluding the prices of food and non-alcoholic beverages, the cost of home ownership and value-added tax) also rose noticeably during 1996. Thus, the quarter-to-quarter seasonally adjusted and annualised underlying inflation rate accelerated from 6,4 per cent in the first quarter of 1996 to 12,4 per cent in the fourth quarter. Measured over periods of twelve months, underlying inflation rose from a low level of 6,3 per cent in May 1996 to 9,3 per cent in January 1997.

This increase in the underlying inflation rate clearly points to the fact that more fundamental factors were responsible for the rise in consumer-price inflation in the latter half of 1996. The reappearance of inflationary pressures apparently did not arise because of an overheated economy. This deduction is confirmed by an actual decrease in gross domestic expenditure in the second half of 1996, a decline in the utilisation of manufacturing production capacity from the second quarter of 1995 and a relatively large gap between potential and actual gross domestic product.

A rise in nominal unit labour cost (i.e. the change in the ratio between nominal remuneration per employee and the real output per worker) seems to have been an important contributing factor in the resurgence of price inflation. The year-on-year growth in nominal unit labour costs rose from 3,7 per cent in the second quarter of 1995 to 7,9 per cent in the third quarter of 1996 (latest available information), despite a relatively sharp increase in productivity over this period. The depreciation of the rand during 1996 also became an important factor in the acceleration of consumer-price inflation towards the end of 1996. Measured over a period of twelve months, the rate of increase in the prices of imported goods rose from 3,2 per cent in April 1996 to 4,7 per cent in September and then much more rapidly to 9,3 per cent in December.

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Under these circumstances it has become imperative to bring the current high growth in money supply and bank credit extension to the private sector to lower levels. A continuation of excessive increases in the money supply under present conditions will provide fuel to emerging and existing inflationary pressures. If not controlled at this stage, the situation could easily lead to a new cycle of continuous increases in the rate of inflation. Should the Reserve Bank fail in its efforts to protect the value of the currency, the goals set by government for economic reconstruction and development as well as the implementation of the **Strategy for Growth, Employment and Redistribution** will not be attainable. The present situation therefore clearly calls for the retention of a restrictive monetary policy stance.

Taking account of the overall economic situation, the Reserve Bank has therefore decided to set the guidelines for an acceptable rate of growth in the **M3** money supply again at 6 to 10 per cent for the period from the fourth quarter of 1996 to the fourth quarter of 1997. These guidelines are in agreement with the consistent approach over the medium and longer term that the Bank has been following in recent years, and indicate the Bank's resolve to bring the money supply growth down to a level compatible with lower inflation. The upper limit of 10 per cent takes account of a possible growth in real gross domestic product of between 2 and 3 per cent in 1997, whereas the unchanged lower limit of 6 per cent reflects the Reserve Bank's determination to reduce the rate of inflation over the longer term to levels more in line with the average rate of inflation of South Africa's main trading partners and competitors. For 1997, however, the challenge is to keep inflation to a level of below 10 per cent.

The provision of annual guidelines for an appropriate increase in the money supply contributes to a more transparent monetary policy. Major deviations from these guidelines should trigger pro-active policy actions by the Reserve Bank, but it must again be emphasised that the Bank does not intend to follow a rigid money rule linked to these guidelines at all times. The money supply guidelines provide banking institutions and the public in general with a clear indication of the more important underlying forces that will determine monetary policy actions.

The experience of some other countries where some form of financial liberalisation took place in recent years shows that there is a tendency towards a strong expansion in bank credit during a period of structural economic transition. It is for this reason that the Reserve Bank will continue to exercise discretionary judgement in deciding what combination of money supply growth, bank credit extension, interest rates and exchange rates in any given set of circumstances will best serve its objectives of protecting the value of the currency in support of balanced and sustainable economic growth. The Bank's discretion to influence any one of these variables independently is, however, constrained by the high degree of interdependence that exists between these aggregates.