

# Note on South Africa's liquidity measures<sup>1</sup> in response to the COVID-19 pandemic

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## Introduction

The South African Reserve Bank (SARB) introduced a range of measures to ease liquidity strains<sup>2</sup> in domestic financial markets, similar to that of many other central banks globally, to cushion the economy against the effects of the COVID-19 pandemic.

This note provides a brief overview of the recent liquidity measures that were implemented by the SARB, while also reflecting on changes to monetary policy operations<sup>3</sup> since 2010. In addition, these measures are also contextualised relative to the absence of the need for such interventions during the 2007–09 global financial crisis<sup>4</sup> (GFC). South Africa's current financial market conditions reflect similarities to those experienced by other countries during the GFC, when central banks in developed economies introduced so-called unconventional monetary policies.<sup>5</sup>

## Response to the global financial crisis

South Africa was not severely affected by liquidity disruptions at the time of the GFC as the domestic banking system was relatively well insulated and hence did not require any unconventional monetary policy measures.

At the time, there was no need to amend market operations or to implement quantitative easing<sup>6</sup> (QE). The money market shortage,<sup>7</sup> which fluctuated between R9 billion and R14 billion, reflected the amount of liquidity provided through standard refinancing auctions. The South African interbank market continued to function effectively, with only negligible increases in money market rates when the London Interbank Offered Rate (LIBOR)<sup>8</sup> increased significantly.

Nonetheless, the SARB significantly eased the monetary policy stance by lowering the repurchase (repo) rate from 12.0% in December 2008 to 5.5% in November 2010.

## Changes to monetary policy operations since 2010

The SARB's monetary policy operations were reviewed in 2010, in response to a concern that a decline in participation in the auctions for SARB debentures and reverse repos could result in a decline in the money market shortage, thereby affecting the efficiency of the monetary policy operational framework.<sup>9</sup>

In August 2010, an automated final end-of-day square-off process in the South African Multiple Option Settlement (SAMOS) system<sup>10</sup> at the prevailing standing facility rate was introduced, while the penalty facility at which banks were charged the repo rate plus 500 basis points when obtaining funding from the SARB was abolished. The spread between the rates for standing facilities was also widened from 50 basis points to 100 basis points below and above the repo rate to encourage interbank funding and dissuade banks from depositing surplus funds with the SARB. The use of longer-term foreign exchange swaps with maturities of up to 12 months was also introduced to manage money market liquidity more effectively.

1 The statistics of liquidity management operations in table KB131 on page S-29 and the discussion in the money market section of the *Quarterly Bulletin* reflect these measures. The liquidity measures also show up in the statistics of liabilities and assets of the SARB on pages S-2 and S-3 and of the banking sector on pages S-6 to S-10, for liquid assets and cash reserves on page S-14 as well as the monetary analysis on page S-24 in this edition of the *Quarterly Bulletin*. The purchases of government bonds are indicated in the monetary aggregates on page S-23.

2 Liquidity strains occur when there is either an insufficient amount of cash or a shortage of funding available in the money market.

3 Monetary policy operations are central bank actions to influence overall money market liquidity and credit conditions in the economy, and can take the form of either injecting or draining liquidity as determined by conditions and requirements at the time.

4 The GFC refers to the period of extreme stress in global financial markets from mid-2007 to early 2009.

5 Unconventional monetary policies include liquidity management practices such as the large-scale purchases of government bonds by the central bank to inject cash into the banking system.

6 Quantitative easing is a monetary policy tool whereby a central bank purchases predetermined amounts of government bonds in order to inject money directly into the economy.

7 The SARB maintains an appropriate liquidity shortage in the money market which ensures that banks have to refinance daily liquidity requirements at the central bank.

8 LIBOR is a benchmark average interbank interest rate at which a selection of banks in the London money market are prepared to lend to one another.

9 This is a framework which enables monetary policy decisions to feed through to short-term money market interest rates.

10 SAMOS is an automated interbank settlement system provided by the SARB for banks to settle obligations on an immediate real-time basis, or in a delayed settlement arrangement which provides guaranteed settlement.



11 Supplementary auctions can either be in the form of a liquidity-providing repo transaction or a reverse repo transaction, which drains surplus liquidity from the money market.

In March 2016, supplementary<sup>11</sup> end-of-day auctions were re-introduced to provide relief for banks that ended up being either long or short of cash due to factors beyond their control, such as unforeseen changes in notes and coin in circulation outside the SARB and movements in the cash balances of the Corporation for Public Deposits. Such auctions are offered at the discretion of the SARB, on an exceptional basis, and are conducted at the prevailing repo rate. Interest rates on the automated standing facility were left unchanged at 100 basis points above and below the repo rate.

## Liquidity measures in response to COVID-19

The COVID-19 pandemic changed market participants' sentiment and led to a sell-off of financial assets globally. In South Africa, this was exacerbated by sovereign credit rating downgrades by rating agencies, which negatively affected non-resident demand for domestic government bonds and constrained liquidity in parts of the financial system, while higher bond yields increased the cost of government borrowing considerably. Domestic and foreign exchange (FX) forward markets also showed signs of strain and experienced liquidity shortages as reflected in rand-implied rates which traded above the repo rate.

The SARB introduced a number of changes to monetary policy operations to inject liquidity:

- **Intraday Overnight Supplementary Repurchase Operations**

The SARB's end-of-day discretionary supplementary facilities were replaced by Intraday Overnight Supplementary Repurchase Operations (IOSROs) to increase liquidity to support the daily flow of funds in the banking system. The IOSROs are offered at the repo rate and allocated on a pro-rata basis, with the amount determined by the prevailing liquidity requirement of the market. The additional liquidity provided to clearing banks will lower the money market shortage (MMS) to below the current target level of R56 billion and make it easier for banks to extend credit to clients. The SARB initially maintained the size of the Main Refinancing Operations (MROs) at R56 billion, but has subsequently reduced the weekly shortage to R45 billion as an additional support to money market liquidity.

- **End-of-day Standing Facility<sup>12</sup> rates**

The Standing Facility (SF) borrowing rate was adjusted lower from the repo rate less 100 basis points to the repo rate less 200 basis points. It was subsequently announced that further amendments to the SF rate could be considered should it become evident that liquidity is not adequately transmitted. The reduction in the SF rate aims to stimulate interbank funding and discourage banks from hoarding cash.

The SF lending rate at which the SARB provides overnight liquidity to banks was lowered to equal the repo rate, where previously it exceeded the repo rate by 100 basis points. This supports liquidity in the interbank market as banks rely on the SARB to provide liquidity for end-of-day square-off transactions in the payment system without penalty.

- **Main Refinancing Operations**

The MROs, normally offered on a weekly basis for periods of seven days, remained unchanged while additional offerings of longer term refinancing operations with maturity of 91-days were announced to add liquidity to the money market. Refinancing operations of 91-days are offered at the repo rate plus 30 basis points, significantly lower than equivalent money market interest rates. Facilities could also be extended to maturities of up to 364 days if deemed necessary. The new refinancing measures were supported by the recent reduction in the weekly money market shortage from R56 billion to R45 billion.

- **Purchases of government securities**

The SARB introduced a programme to purchase government securities in the secondary bond market across the maturity spectrum of the yield curve. These purchases will remain unsterilised<sup>13</sup> as it is intended to increase the money supply and encourage lending while promoting the smooth functioning of domestic financial markets. The amount and maturity of bonds purchased are at the discretion of the SARB and are added to the monetary policy

12 SFs are auctions conducted at penalty rates above or below the prevailing repo rate.

13 Unsterilised implies that additional liquidity in the money market is not drained through any counter-transactions by the central bank.



portfolio<sup>14</sup> of instruments. Purchases are conducted on a bilateral basis with a variety of counterparties, with both the amounts and counterparties undisclosed. The counter-entry to the subsequent increase in the assets of the central bank is reflected as an increase in private sector banks' deposits at the SARB.<sup>15</sup>

Conceptually, the bond purchase process is as follows: for the purpose of implementing monetary policy, the SARB has the ability to create money on the liability side of its balance sheet along with a simultaneous increase in cash on the asset side. The cash asset is then used to purchase government securities, which increases cash liquidity and circulates through the financial system, among other things, enabling banks to provide additional credit to households and companies. This process of creating additional liquidity is repeated for the duration of the programme. Ultimately, the only movements visible on the balance sheet of the central bank<sup>16</sup> will be an increase in the SARB's bond portfolio and an increase in bank deposits at the SARB. With some of the created money ending up back at the SARB, the change in cash holdings held by the public is partly negated. However, the multiplier effect of money in circulation has a lasting impact on money market liquidity, the overall money supply and credit extension.

- **The Prudential Authority<sup>17</sup> also introduced relief measures**

The Prudential Authority (PA) introduced the following measures to improve the flow of funds in the banking system:

- Capital relief on restructured loans that were in good standing before the COVID-19 pandemic, with such loans not attracting a higher capital charge.
- The liquidity coverage ratio<sup>18</sup> (LCR) for banks was lowered from 100% to 80%.
- Allowance of temporary capital relief, if required, by setting out the criteria for the utilisation of capital buffers. A reduction in the reserve requirements, Pillar 2A capital requirements, to zero on a temporary basis to facilitate banks' continued lending.
- Guidance to the banking sector on the implementation of *International Financial Reporting Standard (IFRS) 9*<sup>19</sup> during the period of economic stress.

## Conclusion

In response to the COVID-19 pandemic, the SARB eased monetary policy through significant reductions in the repo rate, amounting to a cumulative 275 basis points between January and May 2020, and introduced some extraordinary changes to both monetary policy operations and prudential regulations to ensure the adequate flow of funds in the banking and financial systems. These measures eased liquidity strains in domestic financial markets and will be reassessed continually to ensure effective mitigation of risk through an appropriate liquidity management strategy.

14 Part of the instruments used to manage money market liquidity, either to add or drain liquidity from the money market.

15 These government bond purchases through private sector banks' deposits at the SARB increase the monetary base, which comprise central bank liabilities that support the expansion of credit and the money supply. For the underlying methodology, see pages 197 to 200 of the *Monetary and Financial Statistics Manual and Compilation Guide, 2016 of the International Monetary Fund*.

<https://www.imf.org/en/Publications/Manuals-Guides/Issues/2018/09/21/Monetary-and-Financial-Statistics-Manual-and-Compilation-Guide-43001>

16 This is reported in the statement of assets and liabilities of the SARB. See pages S-2 and S-3 in this edition of the SARB's *Quarterly Bulletin*.

17 The PA is responsible for the regulation of the financial sector and operates as a juristic person within the administration of the SARB, and consists of the following four departments: the Financial Conglomerate Supervision Department; the Banking, Insurance and Financial Market Infrastructures Supervision Department; the Risk Support Department; and the Policy, Statistics and Industry Support Department.

18 The LCR requires banks to hold sufficient cash or high-quality liquid assets that can easily be converted into cash, which matches or exceeds projected cash outflows that may potentially occur during a stress-induced scenario over a 30-day period. Its purpose is to enhance the banking industry's ability to absorb shocks resulting from financial and economic stress.

19 IFRS 9 is an accounting standard that specifies how expected credit losses in the banking sector should be calculated over a business cycle.



## References

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