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Quantifying the tightness or looseness of monetary policy in South Africa¹

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¹ This paper was prepared for the meeting. The views expressed are those of the authors and do not necessarily reflect the views of the BIS, the IFC or the central banks and other institutions represented at the meeting.

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Johan van den Heever¹ and Danie Meyer²

Abstract

The central bank's accommodation rate, the repurchase rate, is the key policy instrument through which monetary policy finds expression in South Africa. Since the global financial crisis the relationship between the central bank policy rate and several other key interest rates in the financial system has changed. This paper describes this development and presents a number of alternative benchmark interest rates and indicators of the tightness or looseness of monetary policy that are relevant to South Africa.

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Introduction

In South Africa the central bank's accommodation rate, the repurchase rate, is the key policy instrument through which monetary policy finds expression. Since the global financial crisis the relationship between this policy rate and several other key interest rates in the financial system has changed. This paper describes this development and presents a number of alternative benchmark interest rates and indicators of the tightness or looseness of monetary policy that are relevant to South Africa.

In the next section of the paper attention is given to the basic framework that guides monetary policy in South Africa, before turning to alternative interest rate barometers that may be used to augment the repurchase rate as indicator of the monetary policy stance. Subsequently attention is given to quantity-based indicators of the stance of monetary policy. In the penultimate section the focus shifts to the impact of regulatory changes on lending behaviour; while not monetary policy decisions, such changes can have a major influence on key variables that monetary policy focuses on. This is followed by a concluding section.

The monetary policy framework in South Africa

Since February 2000 the South African authorities have formally adopted an inflation targeting framework for monetary policy. The target is set by government in consultation with the South African Reserve Bank (the SARB). It has for almost all of the past 16 years been set at between 3 and 6 per cent inflation per annum, and relates to the twelve-month rate of increase in the consumer price index. This framework is applied with flexibility – which practically means that if exogenous shocks cause a deviation of actual inflation from the target range, the SARB can use a gradual approach rather than shock treatment to get inflation back within the range. The SARB has instrument independence and can therefore apply its monetary policy instruments as it deems fit to pursue the inflation target.

The workhorse instrument of monetary policy in South Africa is the SARB's accommodation rate, the repurchase rate. The accommodation rate is made effective through a system in which the central bank routinely provides short-term financing to banks with a temporary liquidity shortfall. The central role of the accommodation rate goes back to the early 1980s, when the authorities adopted a more market-oriented approach to monetary policy and decided that the price of credit should be the kingpin of monetary policy implementation. Previously the authorities used credit ceilings as an important element of monetary policy implementation, but when the ceilings were abolished in September 1980 the interest rate mechanism came to its full right as the main channel through which monetary policy works.

In practice the interest rate mechanism has therefore since the early 1980s involved that the private-sector banks set their lending and deposit rates in alignment with the central bank's key accommodation rate. The level of lending rates moderates the quantity of credit demanded; in simplistic terms the quantity of credit and the size of the banking sector's balance sheet is demand-driven, with such demand for credit being established at the level of lending rates that is congruent with the central bank's policy interest rate. (Of course other variables also enter the demand-for-credit function, but that is not the focus of this paper.) Credit in turn influences aggregate expenditure, and expenditure influences inflation. (There are

more mechanisms at work through which monetary policy is transmitted to inflation, but again that is not the focus of this paper.)

Interest rate barometers

The first interest rate barometer of monetary policy is obviously the central bank's policy interest rate itself. It is central in the announcement of the monetary policy stance – in South Africa, as in many other countries, this communication follows after each meeting of the central bank's Monetary Policy Committee. Simultaneously it measures the cost of wholesale credit at the central bank's accommodation window. This measure of monetary policy tightness is quite clear and statistics on it go back to the establishment of the SARB in 1921. In the strictest sense the series is not fully comparable over the period of 95 years: the rate quoted at times was a discount rate and at times (as at present) a yield, and the period over which it applied was also not uniform (weekly at present, daily in some of the earlier sets of arrangements). Accordingly, when converting the announced policy rate to a compound annual yield rate to make it strictly comparable over time, there would be small differences between the various sets of arrangements at the accommodation window. However, these would be of such minor magnitude that for macroeconomic analysis they could safely be disregarded. (Of course for the people managing the accommodation window and the private-sector banks' staff managing the financing of their short-term liquidity shortfalls these details are important, since they really have an impact on the relevant cost centre's bottom line.)

There are no formal regulations or legislation compelling banks, when lending to clients, to charge an interest rate that is a specific quantum above or in a specific ratio to the SARB's policy rate. In fact that would clash with the market-oriented approach adhered to in the conduct of monetary and financial policy. However, there are constraints on lending rates in the form of maximum rates formally set by government to protect vulnerable consumers from abuse. These maximum rates are quite high – high enough to be well beyond the lending interest rates usually established in the normal course of bank business in South Africa. Yet it should be noted that at least some bank lending to households takes place at these maximum rates; this would largely be relatively risky unsecured loans. While the total amount of such lending is small relative to other types of lending such as mortgage loans and instalment sale loans, the number of such loans is large (and the average amount per loan therefore fairly small). In these instances the relevant interest rate is mechanistically linked to the SARB's repurchase rate; for instance, since 6 May 2016 the maximum interest rate on unsecured credit transactions is the SARB's repurchase rate (currently 7 per cent per annum) plus 21 per cent per annum, therefore capping rates at 28 per cent per annum. The accompanying table illustrates the maximum interest rates that may legally be charged on a number of key categories of loans.

Maximum prescribed interest rates in South Africa from 6 May 2016		Table 1
Sub-sector	Maximum prescribed interest rate	
	Formula	Value with RR = 7%
Mortgage agreements	RR + 12% per annum	19% per annum
Credit facilities	RR + 14% per annum	21% per annum
Unsecured credit transactions	RR + 21% per annum	28% per annum
Developmental credit agreements:		
- For small business development	RR + 27% per annum	34% per annum
- For unsecured low-income housing	RR + 27% per annum	34% per annum
Short-term credit transactions:		
- First loan	5% per month	5% per month
- Subsequent loans within a year	3% per month	3% per month
Other credit agreements	RR + 17% per annum	24% per annum
Incidental credit agreements	2% per month	2% per month

RR is the repurchase rate of the South African Reserve Bank, and amounted to 7% at time of writing

Source: Republic of South Africa. Government Gazette No 39379, 6 November 2015

The bulk of lending in South Africa, however, takes place at rates well below these maximum interest rates. A benchmark interest rate of particular importance is the banks' prime lending rate, since it is used as reference rate in numerous credit agreements. Based largely on risk considerations, the most creditworthy borrowers would typically be charged a rate at a fixed margin below the prime rate, while riskier clients would typically have to pay interest at a fixed margin above the prime rate. Since in value terms most lending is conducted at variable interest rates, when the prime rate changes, the interest rate charged on the lion's share of the banking sector's lending book changes by a similar quantum.

While banks are not forced to maintain a constant margin between the SARB's repurchase rate and their prime lending rates, by convention that margin has for many years been 3,5 percentage points; the current repurchase rate of 7 per cent per annum gives rise to a prime rate of 10,5 per cent. This convention-driven margin has not been altered by the global financial crisis and its aftermath.

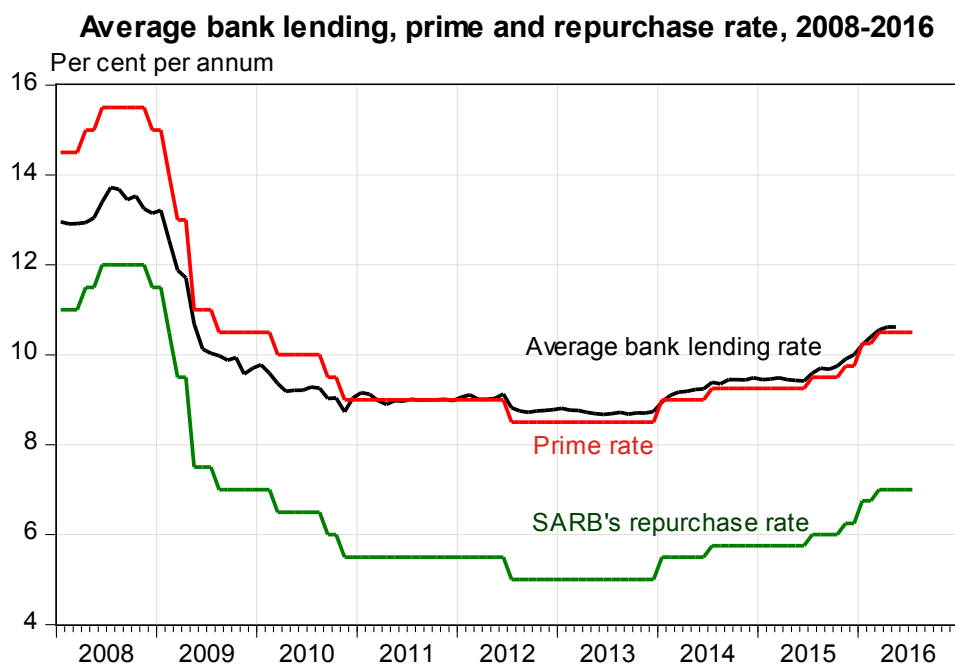
Generally from a borrower's perspective the prime interest rate is likely to be closer to the rate actually charged to him or her by the bank than the SARB's repurchase rate. The prime rate is accordingly often used as a proxy for bank lending rates in South Africa.

While the repurchase rate and prime rate have traditionally been used to capture the monetary policy stance in a nutshell, it is clear that the average interest rate actually charged on lending would add valuable information when formulating or analysing monetary policy. In this connection various options present themselves.

Firstly, the average lending rate across all bank lending may be calculated. This can readily be done using information submitted by the banks in their monthly regulatory returns. The average lending rate deemed most relevant when focusing on monetary policy refers to domestic currency-denominated arms-length lending to the private sector, which includes both households and companies. Lending in other currencies, albeit only a small fraction of total bank lending in South Africa, is therefore excluded since the relevant interest rate is not influenced by the domestic

monetary policy stance. Staff loans and lending to associated businesses are not considered arms-length transactions and are also excluded. Lending to the government sector is also excluded, since this type of lending is usually not the target of monetary policy and since different disciplines apply to government.

The graph below shows the average interest rate on bank lending to the private sector, along with the prime and repurchase rate.

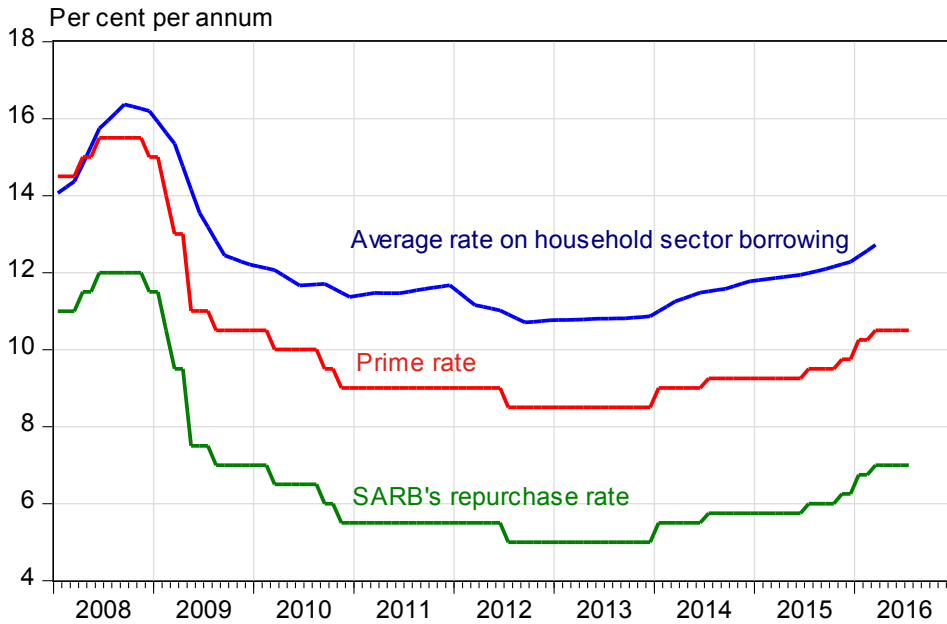


Whereas in 2008 the average lending rate was almost 2 percentage points below the prime rate, the differential narrowed thereafter, partly as a reflection of higher risk premia being included in lending rates after the surge in debt writeoffs in the wake of the financial crisis. In 2011 and the first half of 2012 the two rates essentially fell right on top of each other, while from mid-2012 the average bank lending rate has generally been slightly higher than the prime rate. Changed patterns of borrowing, described in the paragraphs below, also contributed to the reversal of the differential.

Secondly, the average interest rate paid by household sector borrowers on their borrowing may be used to proxy monetary policy tightness. Although most credit extension to the household sector originates with the banking sector, it should be kept in mind that some household borrowing is sourced from other institutions such as nonbank car finance companies and nonbank microlenders. Estimating the average interest rate on household borrowing is a laborious task, involving a matrix of loan types and lending institutions. Appendix A shows the components of household borrowing used to calculate the average interest rate on household borrowing. A different interest rate, relevant to each loan type and lending institution, is applied to each component to derive the average interest rate on household borrowing.

The graph below shows how the gap between the average interest rate on household sector borrowing, on the one hand, and the prime rate and repurchase rate, on the other, has widened over time.

Household borrowing, prime and repurchase rates, 2008-2016

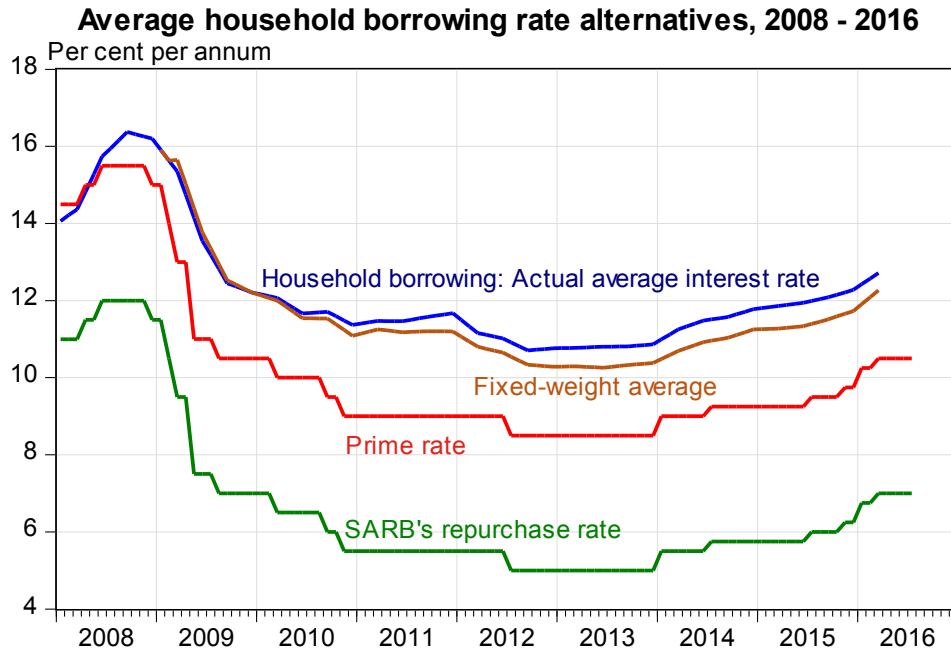


There are at least two reasons why the gap has widened since 2008. Firstly, in the wake of the global financial crisis the frequency of borrower defaults rose sharply and to unexpected heights, suggesting that lending rates should incorporate a higher risk premium than had been the case previously. Lenders accordingly raised their lending margins on new business. On existing business this could generally not be done since lending rates had contractually been linked with a fixed margin to a benchmark rate such as the prime rate; repricing could only be effected if a client applied for a re-advance or a new loan. Secondly, mortgage finance fell from grace following the bursting of the bubble in the real-estate market. Both the demand for and supply of mortgage loans therefore dwindled. However, the average interest rate on mortgage loans is lower than that on most other types of lending, so that a shift in loan demand and supply towards non-mortgage loans immediately implies a higher average rate on overall credit extension.

The second phenomenon highlighted in the previous paragraph is not really a *de facto* tightening of monetary policy but a shift in preference between loan types. To isolate the impact of higher risk premia only on margins above the prime and repurchase rate, fixed weights (based on the relative importance of each type of loan in the base year – say 2008) may be applied to the interest rates actually charged on the various types of loans. This will yield an indication of the average increase in lending rates assuming no shift between loan types has taken place. The fixed-weight average actual interest rate paid by households on their debt is a third barometer of actual monetary policy tightness at the coalface, and is depicted in the graph below. It was calculated using the fixed weights shown in Appendix A. The resulting fixed-weight average series is shown in Appendix B, along with the actual average series.

As can be seen from the graph, the fixed-weight alternative remained very close to the actual average interest rate that was charged on household borrowing until late in 2010, and only thereafter started drifting lower. The margin between the two has in recent years typically been between 0,4 and 0,7 percentage points. This is limited in magnitude, but certainly not insignificant. While the fixed-weight alternative is therefore noteworthy, the value it adds is comparatively limited in the current South African environment since average lending rates to households are not

testing the zero lower boundary but are rather around 12 per cent per annum. The “pain reduction” associated with the alternative measure is not large, relative to the overall burden of household debt service costs.



A final point which can be made in this connection is that the ideal measure of the tightness of monetary policy through interest rates should measure how the interest rate faced by a borrower with a specific set of risk-related characteristics (indebtedness, inflation-adjusted income, time in current job, inflation-adjusted assets owned, etc) and borrowing for a specific purpose and inflation-adjusted amount has changed over time. Against this ideal, the measures which are available or within reach are relatively crude. Nevertheless, improved access to large datasets covering comprehensive information on loan applications and outcomes may bring economic statisticians closer to that ideal.

Quantity-based indicators

In the South African setting monetary policy has since the discontinuation of credit ceilings in 1980 focused on the price of credit – the interest rate – as the primary channel through which monetary policy works. This was the case despite the adoption of money supply targets in the mid-1980s and of money supply guidelines for most of the 1990s. The targets or guidelines for growth in the broad money supply were never pursued in a mechanistic way, and the authorities refrained from making aggressive use of open market operations to achieve a specific quantitative outcome for the money supply. The chain of command ran from policy interest rates to bank lending rates to credit and expenditure, and through that to money supply and inflation. With the adoption of formal inflation targeting in 2000, moreover, the attention paid to the money supply dwindled further.

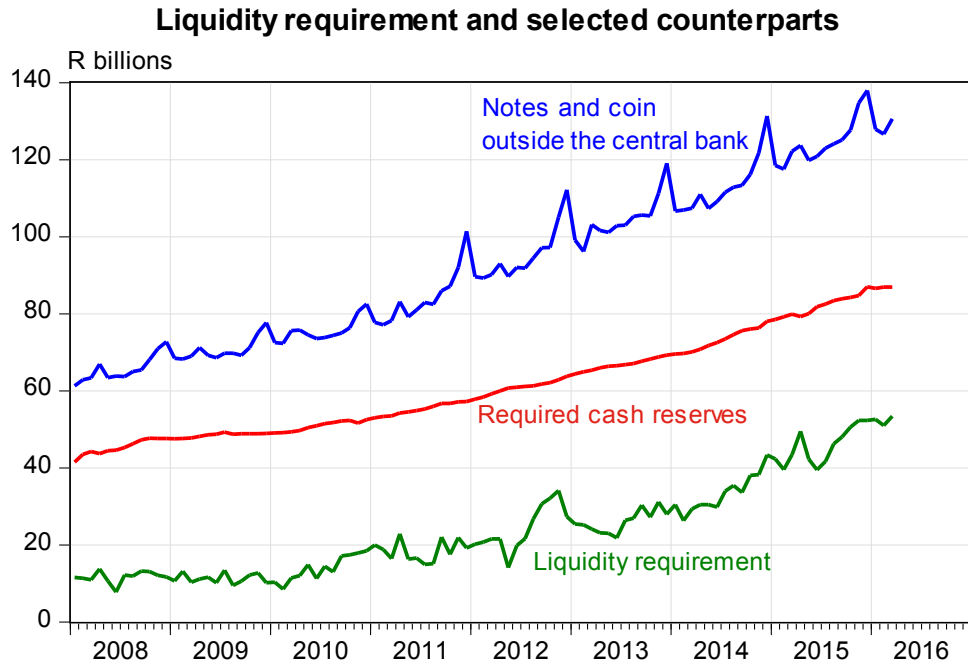
With the targeted rate of inflation fluctuating around an average of 6 per cent per annum over the past 16 years, no testing of the zero lower boundary for interest rates and no appetite among the policy-makers to artificially push down long-term interest rates, South Africa has not adopted a policy of quantitative easing at any point in the wake of the financial crisis – and neither did it do so at any earlier point before the financial crisis.

Monetary policy has therefore not come to a strict quantity-based approach at any point since late 1980. The interest rate mechanism has remained central. However, to ensure sound transmission of the SARB's repurchase rate to the general level of interest rates, the SARB has had a preference for maintaining a "money market shortage" or "liquidity requirement" of adequate size. By making sure that the banks have to borrow sizeable amounts at the accommodation window, the SARB's repurchase rate is made effective.

In this context, the nearest that the country has come to quantitative easing has been a by-product of the considerable efforts made to build up the gross international reserves of the SARB. As the SARB purchased foreign exchange in the market it created rand and increased liquidity in the domestic money market. Had this been fully sterilised (for instance by issuing SARB debentures) the domestic money market shortage would have continued to trend higher, driven by the rising amount of rand banknotes and coin in issue as well as higher cash reserve deposits that banks are required to hold with the central bank as their balance sheets expand. However, up to 2013 the central bank often did not fully sterilise the rand liquidity injected as it purchased foreign exchange. The liquidity injections were often simply offset by the draining effect of higher required cash reserve deposits and currency in circulation. On balance the money market shortage therefore did not rise by much during this period – this dimension of monetary conditions remained relatively easy in the wake of the Great Recession.

A systematic programme to gradually increase the banks' liquidity requirement (and thereby reinforce the effectiveness of the SARB's policy interest rate) was adopted in 2013. This essentially entailed allowing the liquidity requirement and therefore the amount of accommodation granted (on the asset side of the central bank's balance sheet) to reflect the organic growth in (1) the value of notes and coin supplied to the economy by the SARB; and (2) the value of required reserve balances that banks have to keep with the SARB (both on the liability side of the central bank's balance sheet). Tracking the amount of liquidity provided therefore supplements the standard information on policy interest rates; the higher the liquidity requirement of the banks, the more funding they receive at the SARB's repurchase rate and the clearer the need to fully reflect the repurchase rate in their lending and deposit rates. That said, the banks have since the transition to market-oriented monetary policy in the early 1980s consistently and to a fair degree reflected the repurchase rate or its predecessor accommodation rates in their lending and deposit rates. Some tightening of spreads has however followed in the wake of the tighter liquidity conditions in the money market brought about since 2013. For instance, the spread between the South African Benchmark Overnight Rate on deposits (Sabor) and the prevailing repurchase rate has narrowed over this period as banks were forced to become more competitive for short-term funds. This is evident from the higher rates that banks are willing to pay for overnight funding from their top 20 clients; these rates are included in the Sabor calculation.

The graph below illustrates the gradual upward trend in the SARB's note and coin liability and liability arising from cash reserve balances, and in the amount of liquidity provided to the banks by the SARB.



Other quantity-based indicators of the tightness or looseness of monetary policy include the rate of growth in aggregate bank credit extended to the domestic private sector, the pace of growth in various subcomponents of total bank credit, and the rejection rates recorded when prospective borrowers apply for loans. Needless to say that these indicators all warrant close scrutiny.

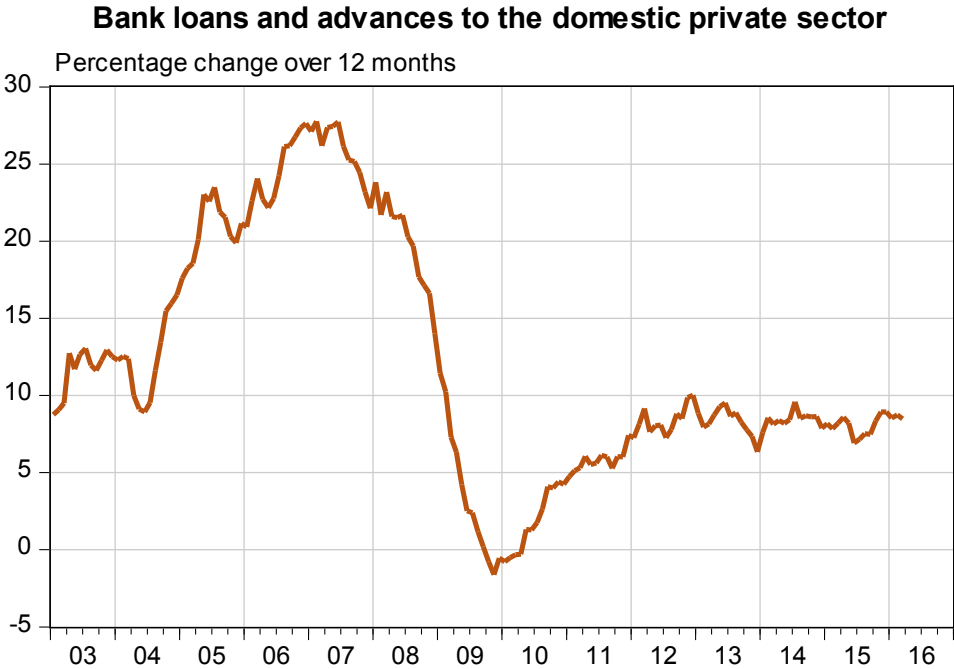
Regulatory changes

Regulatory changes often have a significant impact on lending and deposit-taking behaviour. While such changes are not monetary policy decisions, they can have a major impact on key variables that monetary policy focuses on – although such impact can be difficult to measure and disentangle from the effects of other developments.

Over the past ten years the South African government has focused considerable energy on the protection of the consumer, inter alia taking steps to reduce over-indebtedness and eliminate reckless lending practices. On 1 June 2007 the National Credit Act replaced the Usury Act, the Credit Agreements Act and the Exemption Notice to the Usury Act, the latter being specifically applicable to microlenders. The National Credit Act controls and regulates all credit agreements, therefore governing key aspects of the activities of institutions engaging in the provision of credit.

Upon the implementation of key provisions of the National Credit Act, lending institutions were inter alia required to undertake more rigorous screening of loan applications before granting credit to consumers. The end result was a rapid

deceleration in the rate of growth in credit extension – but since at the same time the real-estate market in South Africa started to run out of steam after several boom years, and the global financial crisis started to unfold, the exact contribution of the Act cannot be pinpointed. The accompanying graph shows how quickly bank loans and advances lost momentum during that episode.



More recently, in September 2015 regulations for loan affordability assessment were implemented, as part of the revisions to the National Credit Regulations. Previously the regulations only prescribed that a loan affordability process has to be followed. A more detailed approach is now followed: The criteria in the new regulations stipulate certain norms for minimum living expenses per income category. The regulations require credit providers to ensure that the consumer has sufficient income available to fund the proposed credit instalment. Amounts to be deducted from gross income include statutory deductions such as income tax and unemployment insurance contributions, maintenance payments as well as all other committed payment and debt service obligations, including such obligations as may appear from the credit applicant’s credit records as held by any credit bureau. After the above-mentioned subtractions, the amount available to the consumer from his or her income must be enough to service the new debt being applied for and he or she must still have enough left to cover the stipulated necessary expense norm.

South Africa is one of a number of countries phasing in the Basel III global reforms to strengthen bank supervision and regulation. Banks have inter alia been focusing on the gradual build-up of high-quality liquid assets to ensure compliance with the phasing in of the Liquidity Coverage Ratio disclosure framework, which became effective on 1 January 2015. They have also been devoting energy to the implementation of the Basel III Net Stable Funding Ratio, promoting a more stable funding profile and enhancing overall liquidity risk management. However, all these regulatory reforms are perceived by banks as affecting their ability to support credit

growth. Increased capital buffers and the minimum liquidity requirements affect costs, raising the cost of providing credit.

Conclusion

The SARB's repurchase rate is the first port of call when describing and analysing the monetary policy stance in South Africa, for good reason. It anchors short-term interest rates in the economy. However, it is not the Holy Grail, and the focus on this central variable should be augmented by a number of other barometers and analyses in order to obtain a comprehensive picture of the stance of monetary policy. A suite of indicators is therefore appropriate.

In the post-crisis period the margin of average lending rates above the repurchase rate has increased significantly, suggesting that borrowers are experiencing more pressure than suggested when studying just the repurchase rate and prime rate. Various regulatory developments are also inserting some sand into the wheels of finance.

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Appendix A: Composition of South African household debt underpinning household debt interest calculations

	Percentage of total in final quarter of 2008	
Mortgage loans		61.0
Housing mortgage loans from banks	56.3	
Farming mortgage loans from banks	0.3	
Other mortgage loans	4.4	
Other loans		16.0
Cash credit and long-term advances from the Land and Agricultural Bank	0.1	
Overdrafts and other loans and advances from banks	8.1	
Credit card advances	4.8	
Loans to individual farmers	0.4	
Loans against policies - Insurers	0.3	
Total micro-lending	1.6	
Loans from non-bank financial companies and financial public corporations	0.6	
Other loans	0.1	
National Student Financial Aid Scheme student loans	0.3	0.3
Leasing and instalment sales		18.4
Leasing finance from banks	2.4	
Leasing contracts issued by non-bank financial companies	0.4	
Instalment sale finance from banks	9.7	
Instalment sale finance from commerce sector	5.8	
Other accounts		4.3
Open accounts	2.4	
Indebtedness to local authorities	1.9	
Total household debt.		100.0

Note: Components may not add to totals due to rounding

Source: South African Reserve Bank

Appendix B: Average interest rate on South African household debt

Quarter	Actual interest rate	Fixed-weight interest rate
4th qr 2008	16,2	16,40
1st qr 2009	15,3	15,65
2nd qr 2009	13,6	13,77
3rd qr 2009	12,5	12,52
4th qr 2009	12,2	12,21
1st qr 2010	12,1	11,99
2nd qr 2010	11,7	11,54
3rd qr 2010	11,7	11,53
4th qr 2010	11,4	11,08
1st qr 2011	11,5	11,25
2nd qr 2011	11,5	11,18
3rd qr 2011	11,6	11,21
4th qr 2011	11,7	11,20
1st qr 2012	11,2	10,80
2nd qr 2012	11,0	10,65
3rd qr 2012	10,7	10,34
4th qr 2012	10,8	10,28
1st qr 2013	10,8	10,29
2nd qr 2013	10,8	10,26
3rd qr 2013	10,8	10,33
4th qr 2013	10,9	10,38
1st qr 2014	11,3	10,69
2nd qr 2014	11,5	10,92
3rd qr 2014	11,6	11,04
4th qr 2014	11,8	11,25
1st qr 2015	11,9	11,27
2nd qr 2015	12,0	11,33
3rd qr 2015	12,2	11,52
4th qr 2015	12,4	11,73
1st qr 2016	12,9	12,26

Fixed-weight interest rate calculated using 4th qr 2008 as base

Source: South African Reserve Bank



Irving Fisher Committee on
Central Bank Statistics

BANK FOR INTERNATIONAL SETTLEMENTS

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Outline

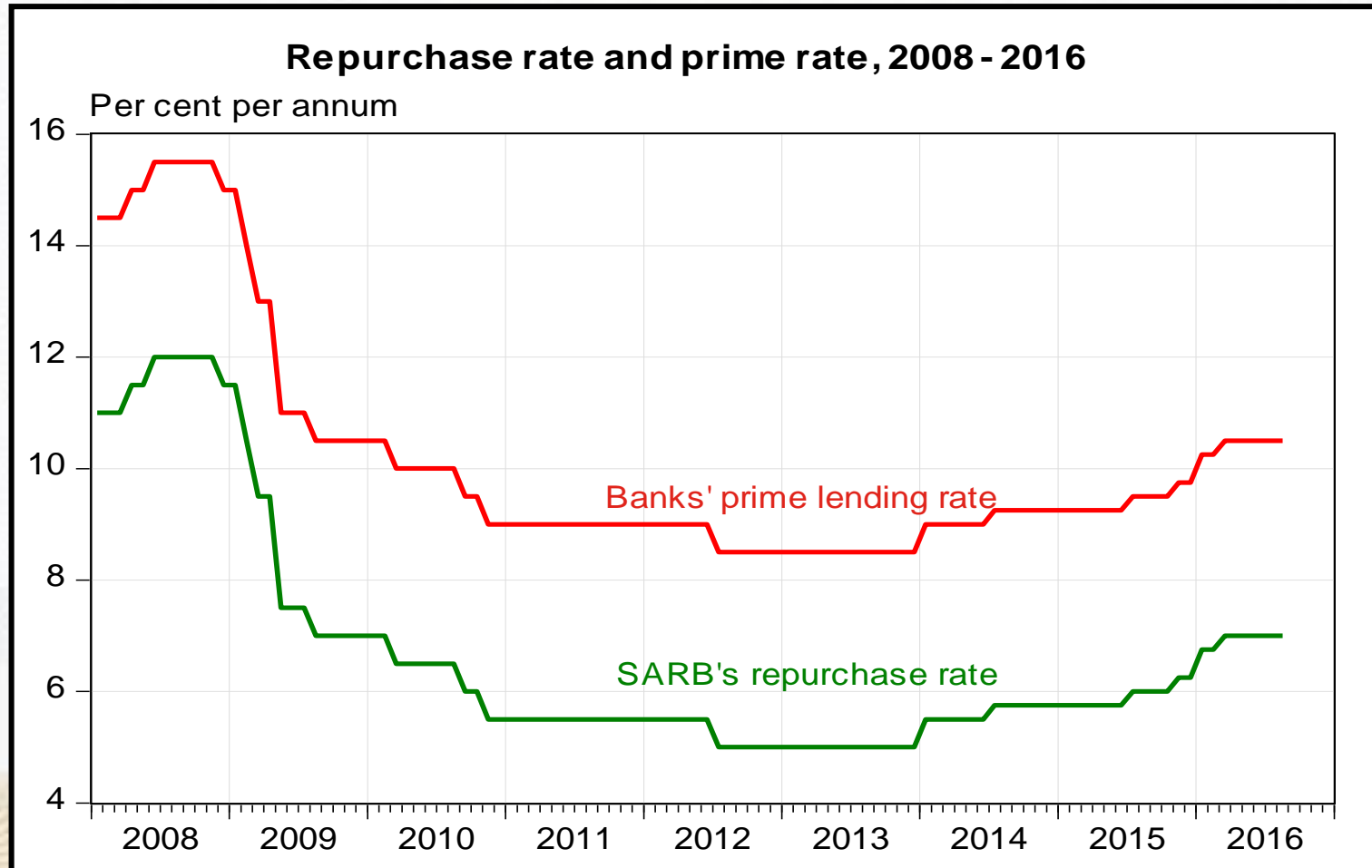
- Introduction
- The monetary policy framework in South Africa
- Interest rate barometers
- Quantity-based indicators
- Regulatory changes
- Conclusion

The monetary policy framework in South Africa

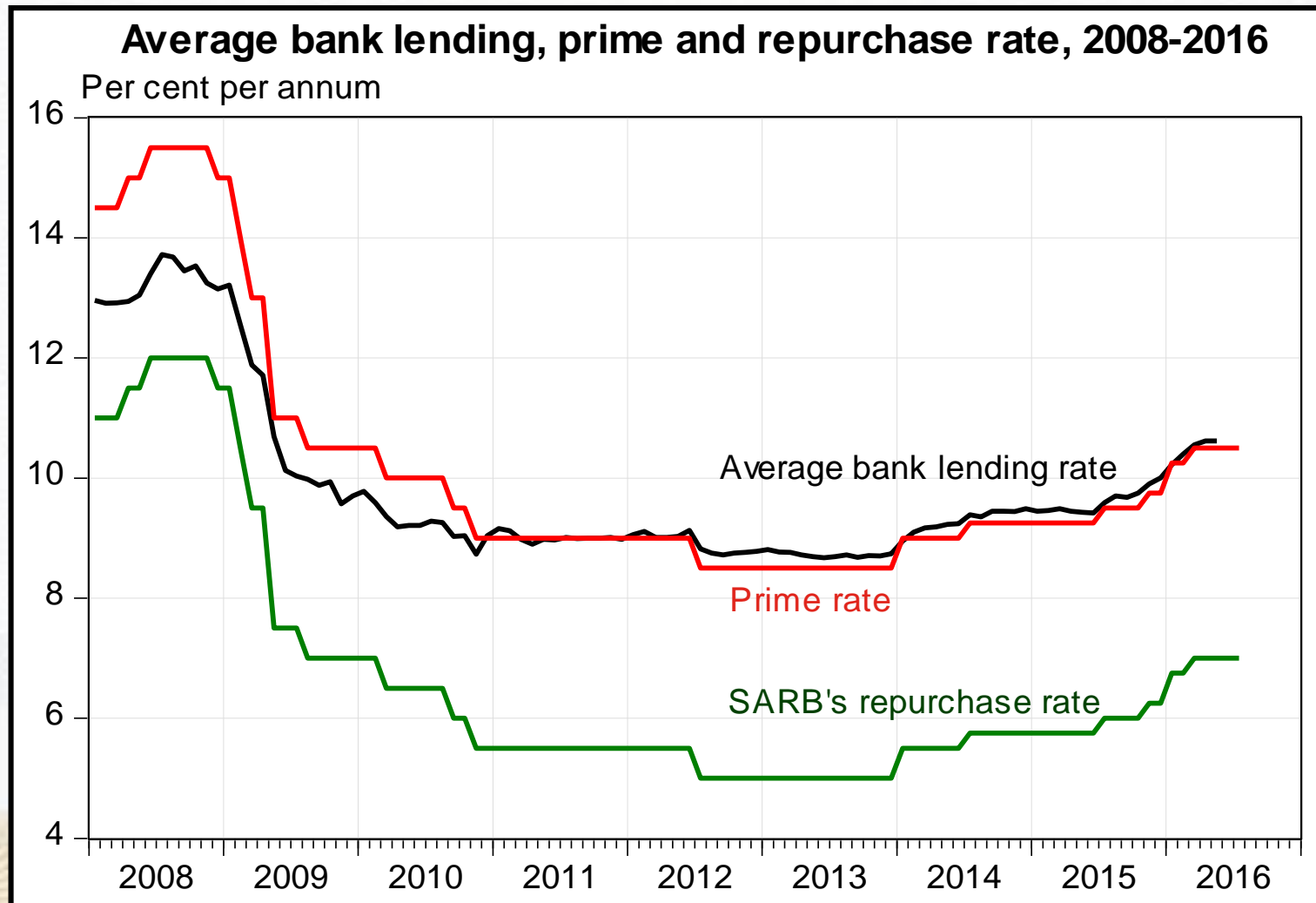
- Inflation targeting was adopted in 2000
- Target for consumer price inflation is set by the SA government
- Target range: 3-6% per annum
- SA Reserve Bank has instrument independence to reach the target
- Main instrument: SARB's refinancing rate which is transmitted to short-term interest rates
- Short-term interest rates influence credit extension
- Credit extension influences expenditure
- Expenditure influences inflation

Interest rate barometers: The standard measure of monetary policy tightness or looseness in South Africa has been the central bank's key accommodation rate...

...and the banks' prime lending rate, which serves as reference rate in numerous lending contracts



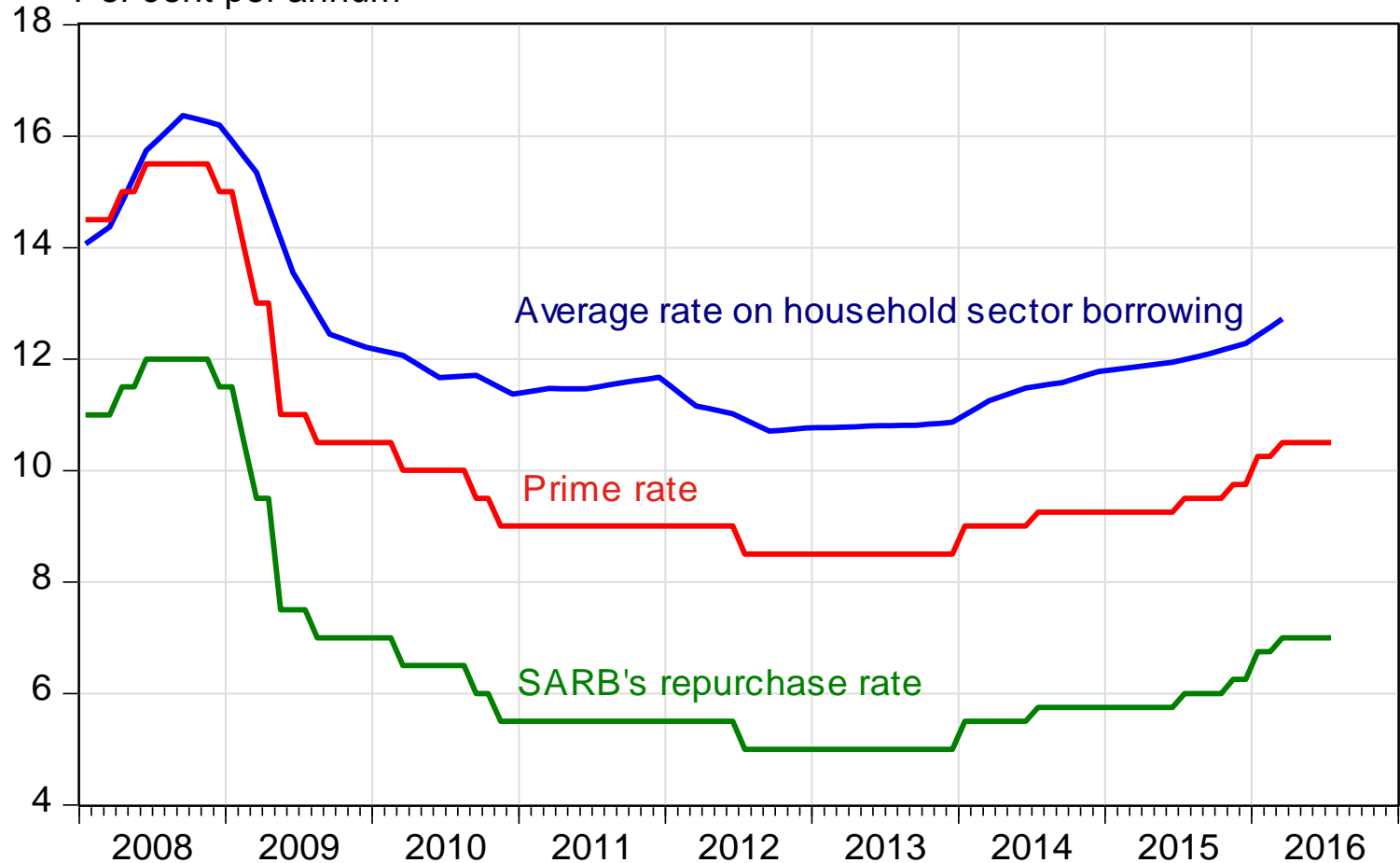
However, the margin between the repurchase rate and the actual average rate on all bank lending has not been constant



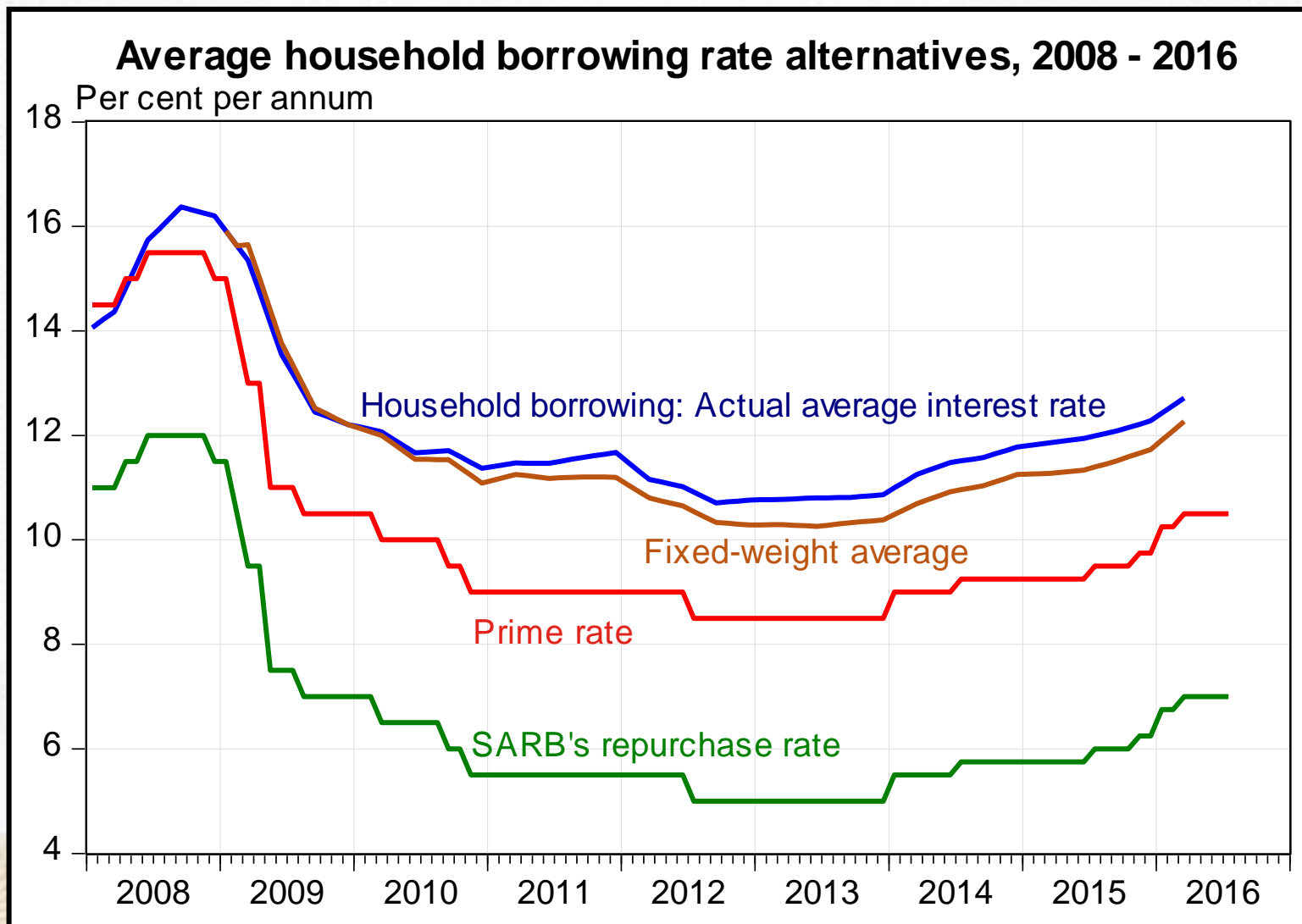
The actual average interest rate on all borrowing has been pushed up by a movement away from home loans (which carry relatively low interest rates)...

Household borrowing, prime and repurchase rates, 2008-2016

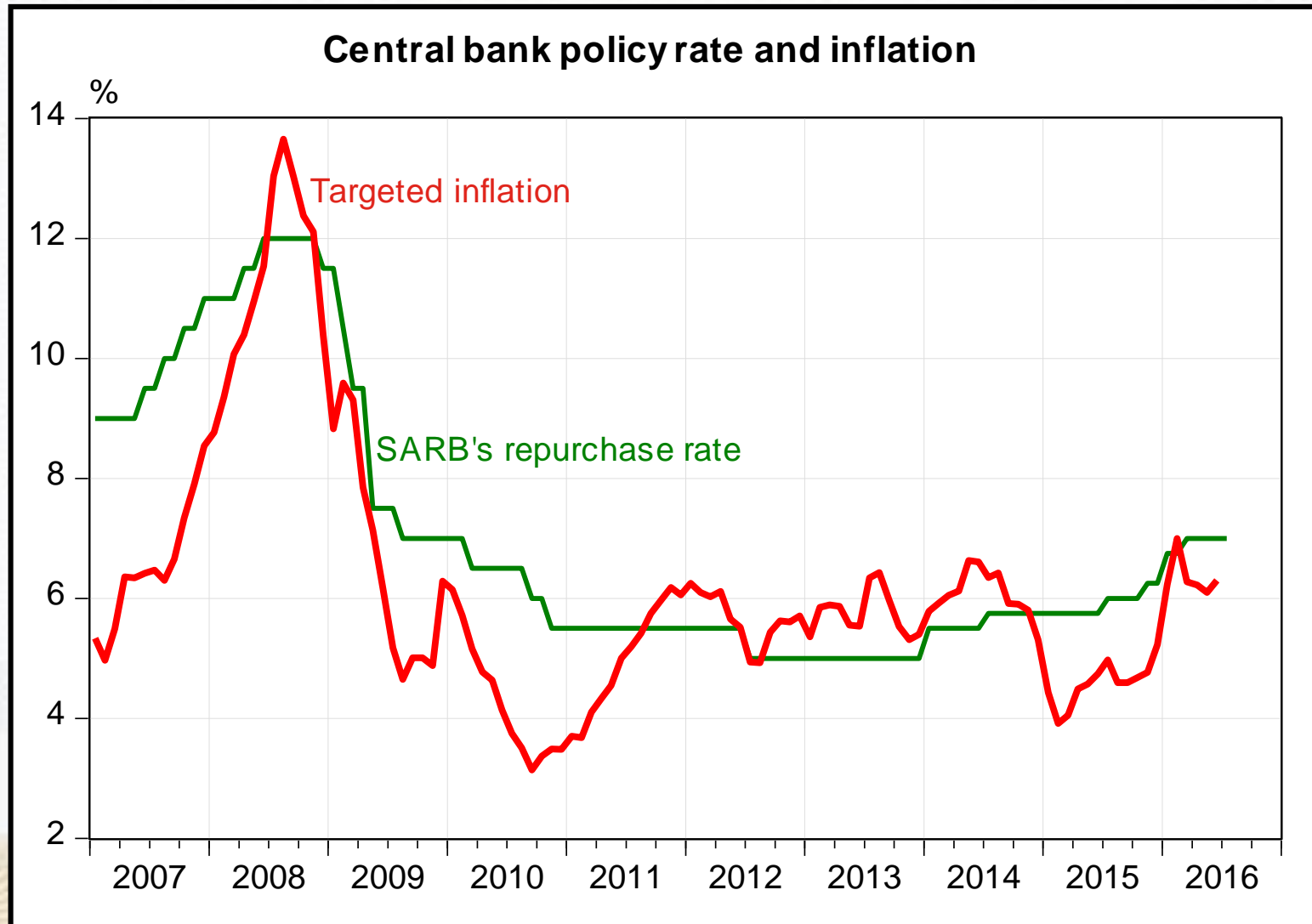
Per cent per annum



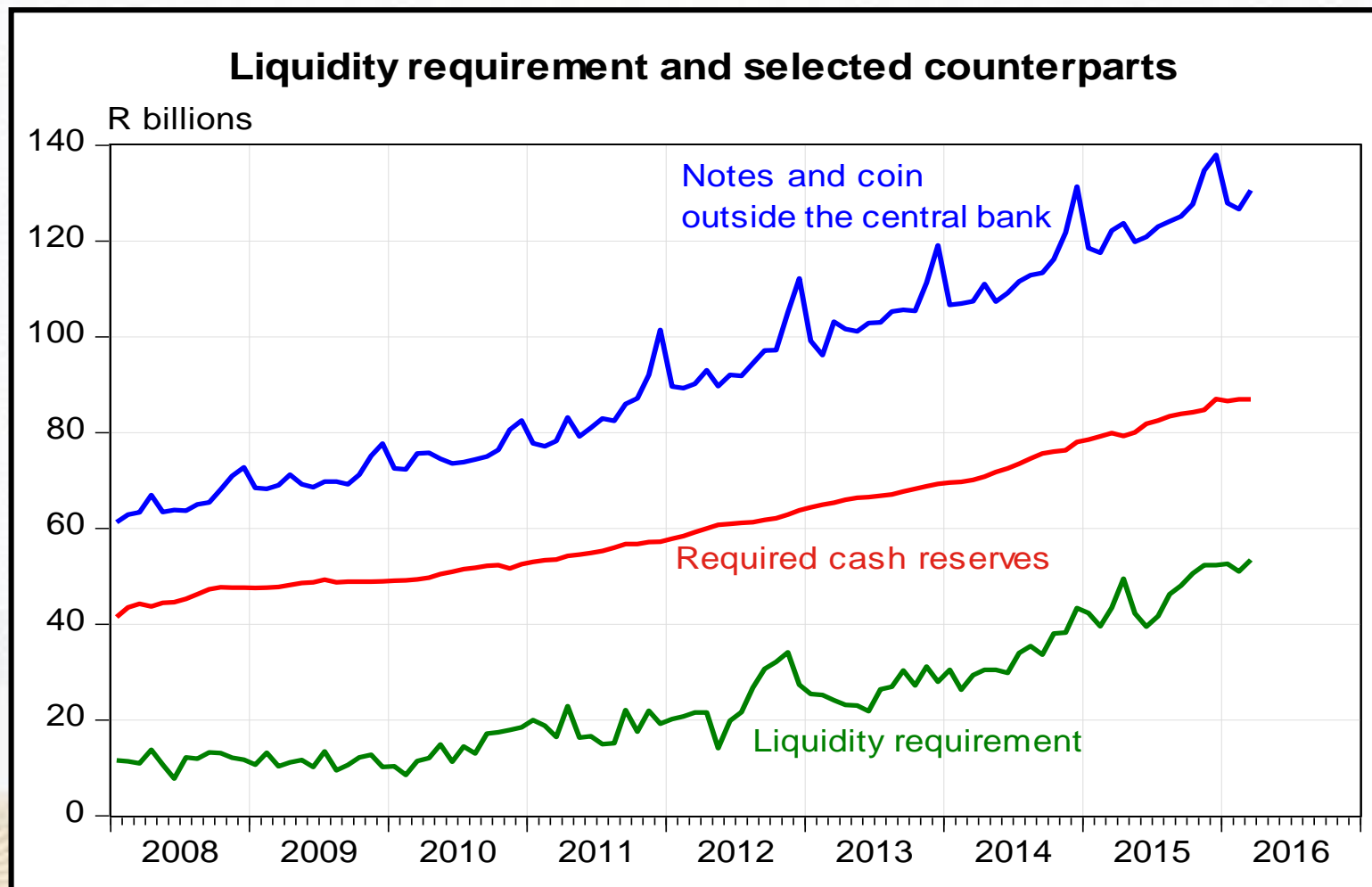
...so it is sensible to also trace what the average interest rate would be on a fixed basket of loans



Quantity-based indicators: No need for quantitative easing with inflation around 6% per annum and interest rates far above the “zero lower boundary”



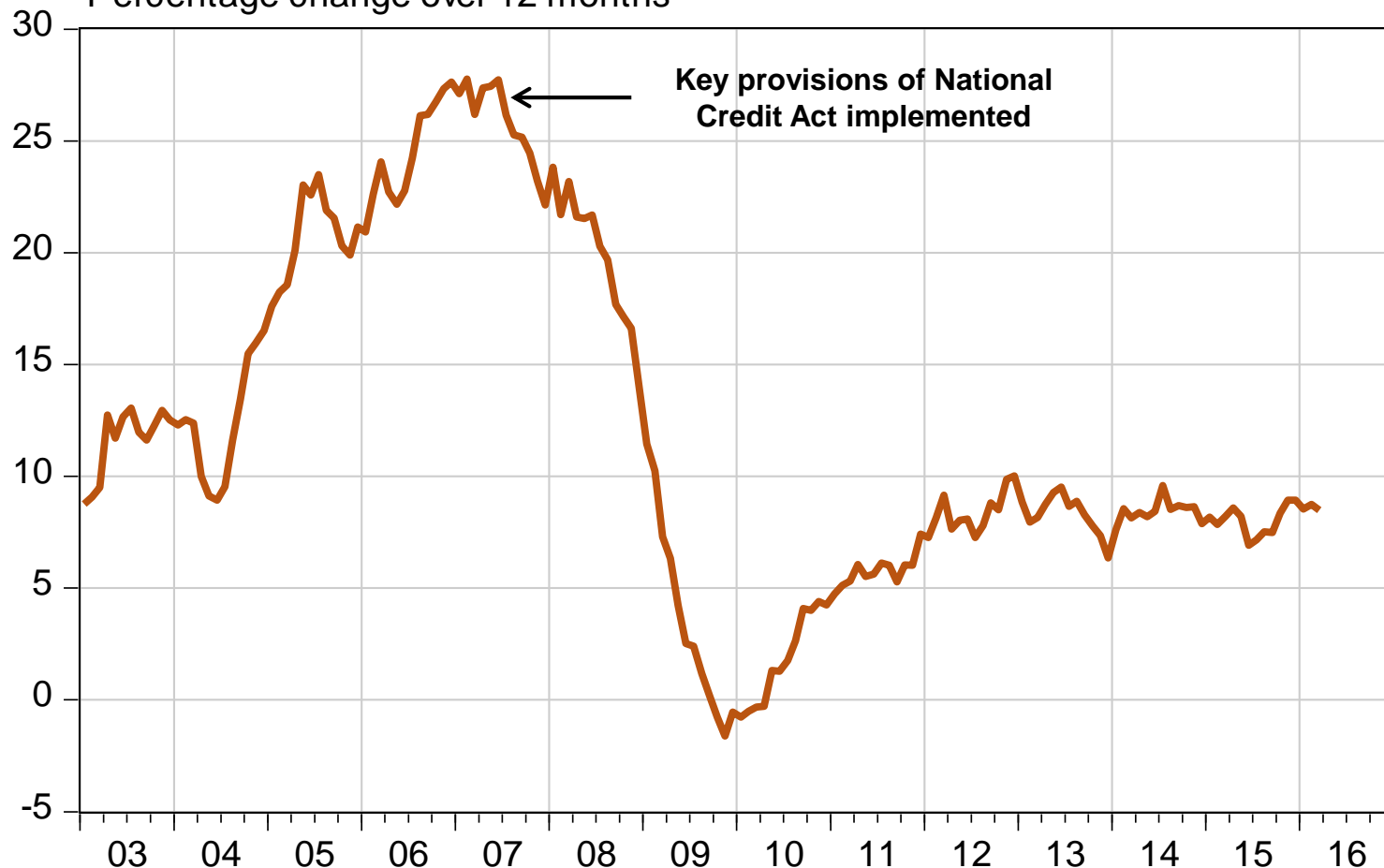
Still some attention is paid to quantitative indicators, such as the liquidity requirement of banks, since greater dependence on borrowing from the central bank suggests better transmission of the central bank's policy rate



Regulatory changes: The National Credit Act enforced more rigorous screening before granting loans to individuals, contributing to slower growth in credit extension

Bank loans and advances to the domestic private sector

Percentage change over 12 months



Conclusion

- In the post-crisis period the margin of average lending rates above the central bank policy rate has increased significantly in South Africa
- Accordingly borrowers are experiencing more pressure than suggested when studying just the movements in the policy rate
- Quantifying this additional pressure requires the development of further barometers and analyses in order to obtain a comprehensive picture of the stance of monetary policy
- Various regulatory developments are also throwing some sand into the wheels of finance

Thank you