



## The impact of monetary policy on bank lending rate in South Africa

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### Abstract

The pass-through of the policy rates to bank lending rate is an important subject matter because it measures the effectiveness of monetary policy to control inflation or stabilize the economy. This study investigates the long-run interest rate pass-through of the money market rate to the bank lending rate and asymmetric adjustment of the bank lending rate. The study applies the momentum threshold autoregressive and asymmetric error correction models. The asymmetric error correction results reveal that bank lending rate adjusts to a decrease in the money market rate in South Africa. The findings suggest that the South African commercial banks adjust their lending rate downward but the lending rate appears rigid upward, which supports the customer reaction hypothesis.

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### 1. Introduction

Embedded in the monetary transmission mechanism is the pass-through of the policy rate to a retail rate. The speed of the pass-through rate is usually taken as an indication of the effectiveness of monetary policy or how rapid the impact of monetary policy would be felt (Becker, Osborn, & Yildirim, 2012). Monetary policy is effective, when a change in policy rate is transmitted to bank lending rates, which in turn influence aggregate domestic demand, investment, and eventually output (Xu & Chen, 2012). The recent downturns in economies worldwide have put monetary policy in a new spotlight. Economists view monetary policy as the first line of defense against economic slowdowns, especially if quick action is needed to stabilize the economy. In a recent study that focuses

effectiveness of monetary policy, Kandil (2014) and Jain-Chandra and Unsal (2014) highlight the importance of monetary policy to stabilize the economy of developing countries. However, how fast economic stability is achieved depends on the pass-through to bank lending rate and financial market development among others.

The issue of pass-through rate is important in South Africa that has experienced financial reforms over the years, which may influence the effectiveness of monetary policy. Financial reforms in South Africa led to an increase in the number of banks and competition between banks and other financial intermediaries. However, due to the small profit margins, many banks consolidated in order to operate more efficiently. Thus the banking sector has become concentrated (South African Reserve Bank, 2013). This may affect the efficiency of the banking sector and thus influence the effectiveness of monetary policy to stabilize the economy. Despite the changing financial environment in South Africa, a systematic study of the long-run interest rate pass-through of the money market rate (MMR) to bank lending rate (BLR) and asymmetric

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adjustment of the BLR rate within the framework of [Enders and Siklos \(2001\)](#) model is hard to find in South Africa. The asymmetric error correction results reveal that bank lending rate adjusts to a decrease in the money market rate in South Africa. The findings suggest that the South African commercial banks adjust their lending rate downward but the lending rate appears rigid upward, which supports the customer reaction hypothesis.

The rest of the study is organized as follows. Section 2 explains policy rates and structure of South African banking. Section 3 reviews the literature on the interest rate pass-through. Section 4 describes the data and methodology. Section 5 discusses the results. Section 6 concludes the paper.

## 2. Overview of policy rate changes in South Africa

South Africa official interest rate is the repo rate. The repo (repurchase) rate is the rate at which the South African Reserve Bank buys back securities it has previously sold in the money markets. This is the rate at which central banks lend or discount eligible papers for deposit money banks. The South African Reserve bank (SARB) raises the repo rate to curb expected inflationary pressure. Increasing the repo (repurchase) rate make it more expensive for the banks to borrow money and should lower the bank lending activities. A reduction in bank lending reduces money supply in circulation, then inflation should fall, and vice versa ([SARB, 2013](#)).

The South African Reserve Bank (SARB) adopts various policy instruments in its attempt to effectively influence the quantity of money or interest rates. In contrast to the direct measures applied in earlier decades, the emphasis is now on market-oriented policy measures which seek to guide or encourage financial institutions to take certain actions on a voluntary basis. SARB repo (repurchase) rate is a good example of such a policy instrument. The repo rate is the rate at which the Reserve Bank grants assistance to the banking sector and therefore represents a cost of credit to the banking sector. When the repo rate is changed, the interest rates on overdrafts and other loans extended by the banks also tend to change. In this way the Reserve Bank indirectly affects the interest rates in the economy ([SARB, 2013](#)). Prior to the deregulation era of the late 1980's; monetary policy was conducted using direct control measures. The extensive controls of the 1970's period left little room for financial markets development and the system were from time to time characterized by extensive disintermediation.

After the deregulation period, monetary policy was conducted using the money supply targeting but targeting money supply became very difficult due to financial liberalization, and the increasing openness of the capital account. The SARB shifted to monetary policy guidelines between 1990 and 1995 and used eclectic monetary policy approach which supplements the money supply guidelines by a set of indicators such as exchange rates, asset prices, output gap, balance of payments, wage settlements, total credit extension and the fiscal stance ([Aziakpono & Wilson, 2010](#)). In an attempt to introduce more flexibility in the conduct of monetary policy, the

SARB introduced repo (repurchase) rate system in March 1998, and adopted informal inflation targeting. From February 2000 to date, the SARB conduct monetary policy using the repo rate and adopted formal inflation rate targeting. South Africa Reserve bank adopts the repo (repurchase) system because it improves efficiency, safety and flexibility of liquidity management ([Aziakpono & Wilson, 2010](#)).

### 2.1. Structure of South African Banking industry

Over the past 20 years, the South African Banking Sector has transformed through consolidation, technology, and legislation. In the early 1990s sector volatility created scope for consolidation through the mergers of several banks. The introduction of the Banks Act (94 of 1990) led to an industry growth spurt with a number of new banking licenses being issued and by the end of 2001 the number of registered banks totaled 43. There are large number of foreign banks establishing branches or representative offices in the country and others acquiring stakes in major banks such as the Industrial and Commercial Bank of China, Standard Bank and Barclay. Legislation, technology, products and the number of participants have changed the banking sector and injected high levels of competition. Thus, the banking sector has become more competitive ([Banking Association of South Africa, 2012](#)). Moreover, the South African banking has undergone tremendous changes over the last two decades. But the South African banking system is well developed, very competitive, and compares favorably with many industrialised countries as the World Economic Forum (WEF) Competitiveness Survey 2012/2013 ranks South Africa 2nd out of 144 countries. Generally, the South African banking sector is viewed as world class, with adequate capital, technology, infrastructure and a strong regulatory and supervisory environment. Currently, the SA banking industry consists of 17 registered banks, 2 mutual banks, 12 local branches of foreign banks, and 41 foreign banks with approved local representative offices ([Banking Association of South Africa, 2012](#)).

## 3. Literature review

A close link between bank lending rates and policy rate or money market rate implies a high interest rate pass-through. Higher pass-through from the money market rate to the bank lending rate signals more efficient banking system and effective monetary policy ([Fuentes, Heffernan, & Kalotychou, 2010](#)). The effectiveness of monetary policy on the economy has long caught the interest of monetary economists and policy-makers ([Mansor, 2005](#)). Bank lending rate may adjust asymmetrically to an increase or a decrease in the policy rate or money market rate ([Leuvensteijn, Sorensen, Bikker, & Van Rixtel, 2013](#)). The asymmetric adjustment of interest rate is explainable with two competing theories – the collusive behavior of banks and customer reaction theory.

The collusive behavior hypothesis relate to the degree of competition among banks and the level of concentration of the retail market. The hypothesis states that banks are unlikely to

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