Report of the South African Reserve Bank
2017/18

Presentation to the Standing Committee on Finance
15 August 2018
Agenda

1. The role of the South African Reserve Bank (SARB)
2. Macroeconomic overview and outlook
3. Highlights from the 2017/18 Annual Report
THE ROLE OF THE SARB
The role of the South African Reserve Bank

- The SARB’s Constitutional Mandate:
  - To protect the value of the currency in the interest of balanced and sustainable economic growth

- Financial Sector Regulation Act, which came into effect in August 2017, mandates the SARB to maintain, promote and enhance financial stability in South Africa, in addition to its primary price stability mandate.
The SARB’s key functions

- Issues banknotes and coin
- Regulates and supervises the banking system
- Ensures the effective functioning of the National Payment System
- Manages the official gold and foreign exchange reserves of the country
- Administers the country’s remaining exchange control regulations
- Acts as banker to the government
The role of monetary policy

- Ensuring price stability or low inflation is a traditional function of central banks.
- All central banks have this mandate in some form but they may use different frameworks:
  - Inflation targeting
  - Fixed exchange rate systems
  - Targeting monetary aggregates
- However, monetary policy cannot determine the long run growth potential of the economy
- Many of the SARB’s functions have socio-economic impacts
Inflation tends to hit the poor harder

- Poorer people have less choice over spending as their consumption basket is taken up by a few basic items.
- It is harder for poorer people to protect their wages and savings against inflation.
- A monetary policy stance that lowers inflation can increase the expenditure of the poor.

Share of time inflation is over 6%

- Inflation above > 6%

% of months, 2010-2018

- Poorest 10% of households: 50%
- Headline: 27%

Source: STATS SA
South Africans at all income levels borrow – but for different things and at very different interest rates.

Debt composition by income group, 2014/2015

- Poorest 20%: 20% share of total household debt
- Second 20%: 20%
- Middle 20%: 20%
- Fourth 20%: 20%
- Richest 20%: 20%

Most vehicle & mortgage loans are held by the richest 20%

Average interest rates (2016-2018)

- Mortgage: 10%
- Vehicle: 12%
- Credit cards: 17%
- Micro loan: 28%
- Informal loan*: 30-50%?

Source: SARB. *There is no official data for interest rates on informal loans, but surveys suggest these loans pay around 30-50% annually.

Richest 20%: R173 000 per year
Richest 10%: R270 000 per year
Poorest 10%: less than R17 000 per year

Source: NIDS
If the report rate is reduced by 25 or 50 basis points, people with mortgages and vehicle loans see an immediate effect. BUT there is little or no effect on a micro loan. Micro loans and informal loans shaped by factors other than monetary policy:
- The high cost of offering loans
- Higher risk of default
- Lack of information about income

Repo rate changes mainly affect borrowing costs for the richest 20% of households.
The framework for managing financial stability

- A framework to monitor financial stability, which includes:
  - Monitoring and mitigating against risks to financial stability
  - Stress testing the South African banking sector
  - Evaluating the impact of regulatory reforms on the financial system and providing input into global regulatory, supervisory and financial sector standards

- We have a toolkit of macroprudential instruments for the financial stability committee to apply in mitigating potential systemic risks and restore financial stability if a systemic risk occurs

- A legal framework for resolving systemically important financial institutions
The Prudential Authority (PA)

- Launched on 01 April 2018
- The role of the PA is to:
  - Promote and enhance the safety and soundness of financial institutions that provide financial products and securities services
  - Promote and enhance the safety and soundness of market infrastructure
  - Protect financial customers against the risk of financial institutions failing to meet their obligations
  - Assist in maintaining financial stability
- A Deputy Governor has been designated as the CEO of the Prudential Authority
- A Prudential Committee chaired by the Governor has oversight over the PA
Bank resolution

- VBS Mutual Bank (VBS) was placed under curatorship with effect from 17:00 on Sunday 11 March 2018.
- SizweNtsalubaGobodo was appointed as curator of the bank.
- The curator indicated that there were inadequate and questionable governance and risk management practices within the bank.
- Appointment of a senior advocate to conduct a forensic investigation into VBS.
- Repayment of all retail deposits up to R100 000 per retail depositor.
- Preliminary findings of the forensic investigation were shared with the DCPI (Hawks).
- Recently the High Court issued provisional sequestration orders against five individuals and provisional liquidation order for Vele Investments.
The SARB is one of about 6 central banks that still have private shareholders

- There are 2 million shares in issue
- Over the past 3 years, average profit for the SARB has been about R1.2 billion a year
- Dividends are capped at 10 cents a share (maximum R200 000 a year)
- 90% of any remaining surplus accrues to government
  - After setting aside contingencies, reserves, tax etc.

The 1996 Constitution sets out the mandate of the SARB and provides for its independence
Since 1996, there have been several legislative changes to clarify the role of shareholders, reduce the influence of shareholders, limit the rights of foreign shareholders and reduce concentration through limiting the number of shares that related parties can hold.

The board of the SARB plays a role in ensuring good governance, but plays no role in policy or regulatory decisions of the SARB.

Government appoints 8 members of the board, including the four executives, while shareholders elect 7 members to the board.
Global growth is accelerating but risks also rising

- During the second half of 2017 global economic conditions were favourable for South Africa and other emerging markets as growth in advanced economies recovered.

- However, this was not sustained in the first half of 2018 as expectations of a faster pace of monetary tightening than previously expected began to emerge as the strong US growth was sustained.

- In addition, the strong dollar effect dominated global markets, which saw a reversal of capital flows from emerging markets.

- Prices of most commodity prices declined, while international oil prices continued to increase.

- There was a marked escalation of trade tensions following changes to US trade policy.

- Over the past two weeks, emerging markets have experienced a sell off as US sanctions against Turkey and Russia weighed on risk sentiment.
US economy outperforming peers and dollar appreciating…

Advanced economy growth

USD dollar index

Sources: Bloomberg and Haver Analytics

Source: Bloomberg
...prompting weaker exchange rates in emerging markets – with clear differentiation.

![Graph of Emerging Markets real effective exchange rate](image)

**Emerging Markets real effective exchange rate**

- **Index**
  - 2012: 98
  - 2013: 99
  - 2014: 100
  - 2015: 102
  - 2016: 104
  - 2017: 105
  - 2018: 106

- **Taper tantrum**
- **Current weakness**

**Movement of emerging market currencies against the US dollar between 2 Jan–14 Aug 2018**

- **Index**
  - 2018: 0
  - 2017: -10
  - 2016: -20
  - 2015: -30
  - 2014: -40
  - 2013: -50

- **Depreciation**

**Source:** JPMorgan and Haver Analytics

**Source:** Bloomberg
Domestic growth still too low

- Domestic GDP expanded by a moderate 1.3% in 2017 following a post-crisis low of 0.6% in 2016, largely due to a rebound in agriculture and mining.
- Improving terms of trade and more robust growth of our trading partners reduced the current account deficit to 2.5% of GDP in 2017.
- Domestic consumer price inflation decelerated rapidly throughout 2017, with notable declines in food and electricity prices.
- 2018 began with positive news of improving investor and consumer confidence as well as a stronger currency.
- However, this did not translate into strong macroeconomic outcomes.
South Africa’s growth and inflation ranked against the rest of the world

Sources: IMF and own calculations

Growth

Inflation

- Share of countries growing faster than SA
- Share of countries growing slower than SA
- Percentage rank

- Share of countries with higher inflation rates
- Share of countries with lower inflation rates
- Percentage rank

Sources: IMF and own calculations

20
Given the sharp contraction in economic activity at the start of 2018, is the economic recovery still on tract…. ?
The 2.2% contraction in 2018 Q1 was the largest since the global financial crisis. Mining, manufacturing and agricultural sectors contracted the most.

Source: Stats SA
The marked slowdown in growth in real Gross Domestic Expenditure in Q1 2018 was broad-based among the various expenditure components.

Contributions of expenditure components to growth in real gross domestic product

- Final consumption expenditure by households
  - Fourth quarter 2017: 2.2
  - First quarter 2018: 0.9
- Final consumption expenditure by general government
  - Fourth quarter 2017: 0.3
  - First quarter 2018: 0.2
- Gross fixed capital formation
  - Fourth quarter 2017: 1.4
  - First quarter 2018: -0.6
- Change in inventories
  - Fourth quarter 2017: 2.9
  - First quarter 2018: 0.1
- Net exports
  - Fourth quarter 2017: -3.8
  - First quarter 2018: -3.2

Source: Stats SA
South Africa’s official unemployment rate was 27.2% in Q2 2018, somewhat lower the 27.7% in the same period in the previous year.

Source: Stats SA
Growth in nominal unit labour costs continue to outpace formal non-agricultural labour productivity growth.

Labour productivity and unit labour cost

Percentage change over one year

- Unit labour cost*
- Henderson moving average
- Economy-wide unit labour cost
- Henderson moving average
- Labour productivity* (adjusted for election-related outliers)

* Formal non-agricultural sector

Sources: Stats SA and SARB
Slow recovery in household consumption but pressure from taxes and fuel price increases in 2018

<table>
<thead>
<tr>
<th></th>
<th>2016</th>
<th>2017</th>
<th>Q1 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real household consumption</td>
<td>0.7%</td>
<td>2.2%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Credit extension to HH (Before seasonal adjustment)</td>
<td>0.7%</td>
<td>3.8%</td>
<td>1.4%*</td>
</tr>
<tr>
<td>Real disposable income</td>
<td>1.9%</td>
<td>2.8%</td>
<td>0.2%</td>
</tr>
<tr>
<td>Household debt to disposable income</td>
<td>74.1%</td>
<td>72.0%</td>
<td>71.7%</td>
</tr>
</tbody>
</table>

* Not annualised
South Africa’s trade balance switched from a surplus of R74 billion in Q4 2017 to a deficit of R25 billion in Q1 2018, resulting in a significant widening of the deficit on the current account from 2.9% of GDP to 4.8% of GDP over the period.

Sources: Stats SA and SARB
The net inflow of capital on the financial account of the balance of payments increased from R50.3 billion in Q4 2017 to R53.2 billion in Q1 2018

Net financial transactions

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2018</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q1</td>
<td>Q2</td>
</tr>
<tr>
<td>Change in liabilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct investment</td>
<td>9.1</td>
<td>5.9</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td>25.9</td>
<td>74.7</td>
</tr>
<tr>
<td>Financial derivatives</td>
<td>-90.9</td>
<td>-59.6</td>
</tr>
<tr>
<td>Other investment</td>
<td>44.8</td>
<td>-28.4</td>
</tr>
<tr>
<td>Change in assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Direct investment</td>
<td>-11.2</td>
<td>-31.7</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td>-19.2</td>
<td>-8.0</td>
</tr>
<tr>
<td>Financial derivatives</td>
<td>90.6</td>
<td>58.4</td>
</tr>
<tr>
<td>Other investment</td>
<td>-35.4</td>
<td>-0.4</td>
</tr>
<tr>
<td>Reserve assets</td>
<td>14.2</td>
<td>-1.1</td>
</tr>
<tr>
<td>Total identified financial transactions*</td>
<td>27.9</td>
<td>9.7</td>
</tr>
<tr>
<td>As a percentage of gross domestic product</td>
<td>2.5</td>
<td>0.8</td>
</tr>
</tbody>
</table>

* Excluding unrecorded transactions
Inflow (+) outflow (-)

Source: SARB
Inflation outcomes surprise on the downside in the first half of 2018…
Domestic consumer price inflation slowed further in the first quarter of 2018 to a low of 3.8% in March, before accelerating to 4.6% in June.
Core inflation slowed to 4.1% in March 2018 – its lowest rate in six years – before accelerating to 4.5% in April following the VAT increase, subsequently decelerating to 4.2% in June.

- Early indications from monthly data is that VAT not fully passed through
Average headline inflation expectations moderating

**Headline consumer price inflation expectations**

(Per cent, as surveyed in the second quarter of 2018)

<table>
<thead>
<tr>
<th>Average inflation expected for:</th>
<th>Financial analysts</th>
<th>Business representatives</th>
<th>Trade union representatives</th>
<th>All surveyed participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>2018</td>
<td>4.9</td>
<td>5.5</td>
<td>5.4</td>
<td>5.2</td>
</tr>
<tr>
<td>2019</td>
<td>5.1</td>
<td>5.6</td>
<td>5.5</td>
<td>5.4</td>
</tr>
<tr>
<td>2020</td>
<td>5.1</td>
<td>5.7</td>
<td>5.7</td>
<td>5.5</td>
</tr>
<tr>
<td>The next five years</td>
<td>5.1</td>
<td>5.7</td>
<td>5.3</td>
<td>5.4</td>
</tr>
</tbody>
</table>

Source: Bureau for Economic Research, Stellenbosch University
## Inflation and growth projections

**Summary tables of the QPM projections**

<table>
<thead>
<tr>
<th>Percentage change (unless otherwise indicated)</th>
<th>Actual</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Targeted inflation</td>
<td>5.6%</td>
<td>5.7%</td>
<td>6.1%</td>
<td>4.6%</td>
<td>6.3%</td>
<td>5.3%</td>
<td>4.8%</td>
<td>5.6%</td>
<td>5.4%</td>
</tr>
<tr>
<td>2. Underlying inflation</td>
<td>4.6%</td>
<td>5.2%</td>
<td>5.6%</td>
<td>5.5%</td>
<td>5.6%</td>
<td>4.7%</td>
<td>4.6%</td>
<td>5.5%</td>
<td>5.3%</td>
</tr>
<tr>
<td>3. Gross domestic product</td>
<td>2.2%</td>
<td>2.5%</td>
<td>1.8%</td>
<td>1.3%</td>
<td>0.6%</td>
<td>1.3%</td>
<td>1.2%</td>
<td>1.9%</td>
<td>2.0%</td>
</tr>
</tbody>
</table>

Projections as at July 2018 MPC meeting
In summary

- The South African economy remains vulnerable
  - The recovery in economic activity is expected to be weak and choppy, especially as consumer demand (a historical driver of upswings) slowed anew in Q2 2018.
  - Fixed investment is also not expected to pick up meaningfully in 2018...
  - Weak demand should prevent an acceleration in consumer and capital goods imports, which is expected to contain the current account deficit during the remainder of 2018

- GDP growth is expected to be modest in 2018 and should be much lower than initial expectations.
  - The projected average growth rates of 1.2% for 2018, 1.9% in 2019 and 2% in 2020
While inflation remains within the inflation target band, risks are on the upside.

The main risks to inflation include:
- The weakening exchange rate
- Rising oil prices and increasing electricity prices
- Remuneration increases in excess of inflation and productivity

Anchoring inflation expectations at the mid-point of the inflation target range will ensure that inflation remains firmly within the inflation targeting range, thus limiting the need for MPC action.
About the SARB Annual Report 2017/18

- The Annual Report provides readers with
  - a holistic account of the SARB’s strategy
  - performance and
  - impact on society

- It contains financial and non-financial information that is material to the SARB’s ability to sustainably implement its mandate
Strategic Plan to deliver the SARB’s mandate

- Five strategic focus areas
- Together with supporting strategic objectives
- Cross-cutting activities
- Organisational capacity and capability objectives
<table>
<thead>
<tr>
<th>SFA 1</th>
<th>SFA 2</th>
<th>SFA 3</th>
<th>SFA 4</th>
<th>SFA 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintain headline inflation within the target range</td>
<td>Protect and enhance financial stability to achieve a safer financial system</td>
<td>Promote and enhance the safety, soundness, and integrity of regulated financial institutions</td>
<td>Enhance the South African economy’s resilience to external shocks</td>
<td>Ensure cost effective availability and integrity of notes and coin</td>
</tr>
</tbody>
</table>

- Maximise monetary policy effectiveness
- Anchor inflation expectations
- Enhance the crisis management and resolution framework
- Develop frameworks for systemic risk identification, monitoring, and mitigation through policy action
- Improve and enhance the regulatory, supervisory and oversight framework of the NPS
- Develop, improve, and integrate the supervision of regulated financial institutions
- Maintain an optimal level of reserves and enhance their management
- Establish mechanisms to effectively manage the impact of external shocks
- Optimise the notes and coin supply chain
- Enhance the quality and integrity of notes and coin

Leverage and maximise the Bank’s participation in regional and international forums

Improve targeted internal and external stakeholder communication and engagement

Improve the strategy management process, strategic risk management and alignment with performance management

Improve the enterprise information management and analytics processes

Establish and embed cybersecurity processes

Provide fit for purpose technology solutions to enable our strategic processes

Attract, develop and retain critical skills and competencies to drive our strategic processes

Improve our organisational effectiveness by reducing bureaucracy, silos and becoming more flexible and agile

Embed a culture of performance and innovation led by a team driven by our values
Financial highlights

Group results

- **Profit after taxation**
  Profit attributable to the parent of R2 164 million is R962 million higher than the previous year of R1 202 million.

- Increase in profits attributed to improved profitability at African Bank (R981m increase) and the SA Mint due to increased Kruger Rand sales (R122m increase), offset by reduced profitability at the SABN (R117m reduction).

Profit breakdown

<table>
<thead>
<tr>
<th></th>
<th>Group (R'm)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2018</td>
</tr>
<tr>
<td>CPD</td>
<td>91</td>
</tr>
<tr>
<td>SA Mint (attributable to parent)</td>
<td>421</td>
</tr>
<tr>
<td>SABN</td>
<td>-13</td>
</tr>
<tr>
<td><strong>Subsidiaries' profit contribution</strong></td>
<td><strong>499</strong></td>
</tr>
<tr>
<td>Share of profit/(loss) attributable to associate</td>
<td>424</td>
</tr>
<tr>
<td>Less intercompany dividends</td>
<td>-150</td>
</tr>
<tr>
<td>SARB's net profit after taxation</td>
<td>1 391</td>
</tr>
<tr>
<td><strong>Total Group profit attributable to the parent</strong></td>
<td><strong>2 164</strong></td>
</tr>
</tbody>
</table>

- Dividend of R0.2million paid to shareholders as required by the SARB Act.
- Transfer of R1.4 billion to the SARB Contingency Reserve.
Human resources highlights

- Conducted two employee surveys to gain insight on how the SARB can improve the employee experience
- Total SARB staff composition is 72% black and 28% white. Top management is 50% black and 50% white.
- Spent R35 million on training and development, reaching 80% of the workforce
- The coverage ratio of critical roles improved to 80% – (2016/17: 68%)
- Regrettable turnover ratio improved to 1.17% – (2016/17: 1.46%)
Social initiatives

- Granted external bursaries to tertiary students in the amount of R5.9 million
  - (2016/17: R4.2 million)
  - Of the 58 students granted bursaries, 49 are black (African, Coloured and Indian) and 33 are women.

- Extended the MPC Schools Challenge to seven provinces, with schools in the Eastern Cape, North West and Northern Cape provinces participating for the first time. The challenge will be extended to KwaZulu-Natal and the Western Cape provinces during the 2018/19 financial year.
Fintech & SARB Initiatives

- **December 2016** - Established together with National Treasury an Intergovernmental Fintech Working Group (IFWG). Comprises NT, FSCA, FIC, SARB & Competition Commission

- **August 2017** - Established a dedicated SARB Fintech unit since August 2017

- **During 2017/8** - Active participants on FSB Fintech Innovation Network and BIS CPMI Digital Innovation Working Group. Contribution to papers on fintech for e.g.
  - Impact of fintech on financial stability;
  - Distributed ledger technology in payment, clearing and settlement;
  - Central bank issued digital currencies;
  - Risks related to crypto-assets and;
  - Financial stability considerations of initial coin offerings and digital token sales.

1. Successfully co-hosted IFWG Outreach (April 2018)
   Workshopped 3 topics with Fintech community:
   (i) private crypto-assets & ICOs;
   (ii) financial deepening &;
   (iii) Innovation hubs & sandboxes.


2. Proactive effort to distil DLT potential (Project Khokha) (June 2018)
Questions and answers
The primary sector is not expected to contribute meaningfully to GDP growth in 2018

Annual percentage change in gross value added by the agricultural sector

Source: Stats SA

Source: World Bank, Stats SA and SARB
The value of mining exports in particular decreased strongly in Q1 2018, weighed down by the sharp decline in the rand price of mining commodities, which contributed to a significant deterioration in the terms of trade.
External debt developments…