



South African Reserve Bank

# Introduction to the South African Reserve Bank



## Establishment of the Bank

The South African Reserve Bank (the Bank) is the central bank of the Republic of South Africa. The Bank was established in 1921 in terms of a special Act of Parliament, the Currency and Banking Act of 1920 (the Act), and was the direct result of the abnormal monetary and financial conditions that had arisen during and in the period immediately following World War I. At that time central banks existed mainly in the United Kingdom and Europe. It is the oldest central bank in Africa and in the southern hemisphere.

## Who owns the Bank?

Since its establishment, the Bank has always been privately owned and today has more than 600 shareholders. Except for the provision of the Bank that no individual shareholder may hold more than 10 000 shares of the total number of 2 000 000 issued shares, there is no limitation on shareholding. The Bank's shares are traded on an over-the-counter share trading facility managed by the Bank.

After allowing for certain provisions, payment of company tax on profits, transfers to reserves and dividend payments of not more than 10 cents per share per annum to shareholders, the surplus of the Bank's earnings is paid to the Government. The Bank's operations are therefore not driven by a profit motive, but by serving the best interests of all the people in South Africa.

The Bank holds an annual general meeting of shareholders at its Head Office in Pretoria. This is the occasion where the Governor, as Chairperson, delivers an annual address on the state of the economy and monetary policy, which is covered widely in the media.

## Structure of the Bank

The Bank has a board of fifteen directors. Among them are the Governor and three deputy governors, who are appointed by the President of the Republic of South Africa for five-year terms. Four other directors are appointed by the President for a period of three years.

The remaining seven directors, of whom one has knowledge and skills in agriculture, two industry, two commerce or finance, one labour and one mining, are elected by shareholders for a period of three years.

## Autonomy of the Bank

The Bank has been given an important degree of autonomy in the execution of its duties. In terms of the Constitution (Act No. 108 of 1996): "The South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet minister responsible for national financial matters."

In terms of section 32 of the South African Reserve Bank Act, 1989 (Act No. 90 of 1989) the Bank must publish a monthly statement of its assets and liabilities, and an annual report to Parliament. The Bank is therefore accountable to Parliament. The Governor of the Bank holds regular discussions with the Minister of Finance and appears before the parliamentary Portfolio and Select Committees on Finance from time to time.

## Mission of the Bank

The Bank, like central banks in other countries, has a unique position in the economy as it performs various functions and duties not normally carried out by commercial banks. Although the functions of the Bank have changed and expanded over time, the formulation and implementation of monetary policy have remained one of the cornerstones of its activities.

The Bank has used different monetary policy frameworks over time, i.e., credit ceilings and credit controls in the 1970s, money supply growth targets from the middle of the 1980s, money supply growth guidelines by the early 1990s, and an eclectic monetary policy with an informal inflation target from the mid-1990s. In February 2000 an inflation target was specified for the first time, and the adoption of this target entrusted a single objective to the Bank: price stability.

South Africa's inflation target is specified as increases in CPIX (year-on-year increase in the consumer price index excluding mortgage interest costs for metropolitan and other urban areas) of between 3 and 6 per cent to be achieved on a continuous basis. CPI (consumer price index), in turn, is a measure of the general level of prices based on the cost of a typical basket of consumer goods and services. The headline inflation rate reflects year-on-year percentage changes in the CPI. The CPI is measured and compiled by Statistics South Africa.

The targeting of monetary aggregates became the norm internationally in the 1980s, but the difficulties experienced with this framework ultimately led to the adoption of inflation targeting. Inflation targeting is a monetary policy framework characterised by an announcement of a numerical target for the inflation rate that is intended to be achieved over a specific period. Inflation targeting is a framework and not a rule, the numerical rate is made public and a definite time horizon is specified. The new framework was introduced because of certain perceived advantages, such as :

- making the objective of monetary policy clear and thereby improving planning in the private and public sectors;
- forming part of a formalised, co-ordinated effort to contain inflation and pursuit of the broader economic objective of sustainable high economic growth and employment creation;
- helping to focus monetary policy and enhancing the accountability of the central bank to the public; and
- providing an anchor for expectations of future inflation which should influence price and wage setting.

The inflation target is set in consultation between the Governor and the Minister of Finance. This approach implies that the Bank does not have complete goal independence (i.e., the setting of the objective to achieve), but has operational independence (i.e., the choice of instruments and the autonomy to adjust such instruments) in monetary policy decisions aimed at achieving the target.

However, the independence entrusted to the Bank in the use of monetary policy instruments implies that the Bank has to be accountable for its policy decisions, and should therefore ensure transparency in policy decisions. To this end, the Bank publishes monetary policy reviews biannually, while regular regional Monetary Policy Forums are also arranged to provide a platform for discussions of monetary policy with broader stakeholders from the community.

This approach ensures transparency in monetary policy. Any changes in interest rates not justified by the danger that the target range for inflation will not be achieved, will confuse the market.

The Bank abandoned any attempt to target money supply or exchange rates specifically when the inflation-targeting monetary policy was adopted. To be successful, an inflation-targeting monetary policy framework implies nominal exchange rate flexibility. When the objective of the Bank was designed in terms of "the protection of the value of the rand" or "the domestic and external value of the rand", it was much more acceptable to intervene in support of the exchange rate. With the focus clearly on inflation, exchange rate intervention becomes more difficult to justify and would be done only in exceptional instances.

Exchange rates should essentially reflect the domestic monetary and fiscal policies of the authorities, and be determined by the supply of, and demand for, currency in foreign-exchange markets. This will result in fluctuations in the exchange rate of the rand, but should at the same time promote domestic economic stability. The Bank, in its policy deliberations, nevertheless takes cognisance of the potential second-round impact of exchange rate movements on the inflation rate.

### Importance of low inflation

The Bank's mandate is set out in the Constitution as protecting the value of the currency in the interest of balanced economic growth. This objectives are answered by containing inflation. Inflation also has other negative social and economic effects.

Inflation has important implications for the redistribution of income and wealth. To the extent that inflation is unexpected, savers and people on fixed incomes will tend to suffer most, while the borrower will gain. Inflation also distorts the tax system, as most tax systems do not allow for inflation. Even if incomes rise with inflation, they often move into a higher tax bracket.

One of the consequences of inflation targeting has been greater interest rate stability. A stable monetary policy will lead to a stable environment of low inflation and low interest rates, although this in itself is not a guarantee of high growth, which is determined by other real factors in the economy.

### The Bank's system of accommodation

The Bank's refinancing system is the main mechanism used by the Bank to implement its monetary policy. Through its refinancing system, the Bank provides liquidity to banks, enabling them to meet their daily liquidity requirements. "Liquidity" in this context refers to the banks' balances at the central bank that are available to settle their transactions with one another, over and above the minimum statutory level of reserves that they have to hold. In terms of its monetary policy implementation framework, the Bank creates a liquidity requirement (or shortage) in the money market, which it then refinances at the repurchase (repo) rate – a fixed interest rate determined by the Monetary Policy Committee.

The Bank's repo rate influences the interest rates charged by banks, the general level of interest rates in the economy, and

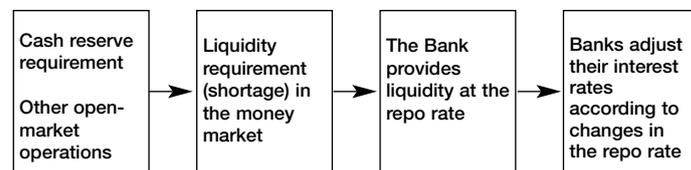
therefore other economic aggregates such as money supply, bank credit extension and ultimately the rate of inflation. The Bank's monetary policy implementation framework can be simplified as follows:

The repo rate influences market rates in two ways: First, it directly influences the banks' marginal cost of funding and, second, it reflects the Bank's stance on monetary policy. Therefore, even the interest rates of banks that do not participate in the repo auctions are adjusted when the repo rate is increased or decreased.

Money-market interest rates are determined by a combination of market forces and the repo rate. Fluctuations in the demand for, and supply of, liquidity in the market can influence market rates, for example, causing some interest rates to increase over the month-end and to decrease again when liquidity pressures subside. Alternatively, market interest rates may not always change by exactly the same margin as a change in the repo rate, depending on factors such as the extent to which a change in the repo rate has been anticipated and priced in.

### Creating a liquidity requirement

To ensure that its repo rate remains effective, the Bank has to compel banks to borrow a substantial amount (i.e., the liquidity requirement) from the Bank. The Bank therefore has to intervene regularly in the money market to create such a shortage, that is, to drain excess liquidity from the money market. In addition to levying a cash reserve requirement on banks, the Bank also uses three types of open-market instruments, namely Reserve Bank debentures, longer-term reverse repos and foreign-exchange swaps to drain excess liquidity.



### Current functions of the Bank

The Bank is responsible for achieving the inflation target through the formulation and implementation of monetary policy. The Bank also performs a number of additional functions to achieve this objective. Its current functions can be grouped into five major areas of responsibility.

#### 1. Formulation and implementation of monetary policy (aimed at achieving inflation target)

##### 1.1 Refinancing system and interest rates

The essence of the Bank's monetary policy transmission is its influence on the level of interest rates through its refinancing system.

##### 1.2 Open-market operations

Open-market operations are conducted for two reasons: First, to neutralise or smooth the influence of exogenous factors on the liquidity position in the money market. Second, to maintain a liquidity requirement in the market at the level of the cash reserve requirement in order to influence interest rates.

## 2. Service to the Government

### 2.1 Gold and foreign-exchange reserves

The Bank is the custodian of the major part of the country's gold and foreign-exchange reserves. The Bank accumulates foreign reserves from international trade, foreign investment inflow into South Africa and borrowing abroad.

### 2.2 Banker and adviser to the Government

Main services provided are administering the auctions of government bonds, administering the auction of Treasury bills, participating in the National Treasury's debt management meetings, and managing the flow of funds between the Exchequer Account and the tax and loan accounts.

### 2.3 Administration of exchange control

The Bank is responsible for the administration of government's exchange control policy.

## 3. Provision of economic and statistical services

The Bank collects, processes, interprets and publishes public information, economic statistics and other information, and uses this information in policy formulation.

## 4. Financial stability

### 4.1 Bank supervision

The purpose is to achieve a sound, effective banking system in the interest of depositors of banks and the economy as a whole.

### 4.2 The national payment system

The Bank is responsible for overseeing the safety and soundness of the national payment system. The main aim is to reduce interbank settlement risk with the objective of reducing the potential of a systemic risk crisis emanating from settlement default by one or more of the settlement banks.

### 4.3 Banker to other banks

The Bank acts as custodian of the cash reserves that banks are legally required to hold or prefer to hold voluntarily with the Bank.

### 4.4 Banknotes and coin

The South African Mint Company (Pty) Limited, a subsidiary of the Bank, mints all coin on behalf of the Bank. The South African Bank Note Company, another subsidiary of the Bank, prints all banknotes on behalf of the Bank.

### 4.5 Lender of last resort

In terms of its "lender-of-last-resort activities", the Bank may in certain circumstances provide liquidity assistance to banks that are experiencing liquidity problems.

### 4.6 Monitoring financial stability

In view of the interrelationship between price stability and financial system stability, the Bank monitors the macroprudential aspects of the domestic financial system. The objective of financial stability is to prevent costly disruptions in the financial system of the country.

## 5. Provision of internal corporate support services and systems

To ensure its own smooth operations and administration, the Bank provides its own integrated internal control system, supported by information technology and human resources.

### Human resources

The Bank had a staff complement of 2 215 at its Head Office in Pretoria as at end of March 2011. The executive management comprises the Governor, deputy governors and heads of department who report to the governors.

### Functions of branches

The Bank has branch offices in Pretoria North, Johannesburg, Cape Town, Port Elizabeth, East London, Durban and Bloemfontein.

In terms of the South African Reserve Bank Act, the issue of currency is one of the primary functions of the Bank. It is the responsibility of the branches to ensure that there is an adequate supply of new notes available to meet the demand, and to replace unfit notes destroyed by the branches.

To provide an efficient service to the banks and satisfy their requirements for banknotes, the Bank has ensured that there is sufficient storage capacity in branch vaults to meet the normal demand, and a "buffer" amount to meet exceptional or seasonal demands. The branches all have electronic note-processing machines to sort the notes deposited with them. In this way, the Bank ensures that good quality banknotes remain in circulation. The Bank destroys soiled or "unfit" notes. The branches are responsible for the quality of banknotes in circulation in their respective regions.

The branches of the Bank, the South African Police Service and commercial banks work together to combat the counterfeiting of banknotes. Claims for mutilated banknotes are also settled by the branches.

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This is the first in a series of fact sheets on the South African Reserve Bank, compiled by Jannie Rossouw and distributed by the Strategy and Communications Department.

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