PART ONE

THE AUTONOMY AND OBJECTIVES OF THE BANK

11 The Bank has been given an important degree of autonomy for the execution of its responsibilities in respect of domestic monetary policy. The autonomy and objectives of the Bank are entrenched in the Constitution. The Bank, in pursuit of its primary object, must therefore in terms of section 224(2) of the Constitution perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters.

12 As far as exchange controls are concerned, the Bank has far less autonomy. As was explained in the statement by Mr Bruce-Brand, (General Manager, Exchange Control Department of the Bank) the Bank is responsible for the day-to-day administration of exchange controls in the Republic of South Africa. While the Bank implements exchange controls, policy decisions rest with the Government and more specifically, the Minister of Finance.

13 With regard to exchange rate policy, the Bank and the Government are jointly responsible for determining the framework of policy. The day-to-day implementation of that policy is the function of the Bank. However, if the day-to-day management of exchange rate policy would require (as it did prior to July 1998), intervening in the foreign exchange market using the forward book mechanism, consultation with the Government was undertaken since any losses incurred on the forward book are for the account of the fiscus.

14 In terms of Section 32 of the Act, the Bank publishes a monthly statement of its assets and liabilities. In addition, the Minister of

Finance tables before Parliament, an annual report on the implementation of monetary policy. The Bank is therefore accountable to Parliament and by so doing, to the citizens of South Africa. As Governor of the Bank I hold regular consultations with the Minister of Finance, as directed by the Constitution and also as a prudent approach to macroeconomic policy coordination. I also have periodic discussions with members of the Parliamentary Portfolio Committee on Finance.

15 The Bank, like most 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 domestic monetary policy has remained one of the cornerstones of its activities.

16 The Bank has used different monetary policy frameworks over time, i.e. credit ceilings and credit controls in the 1970s, money supply growth and credit extension 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 middle 1990s. In February 2000, an official inflation target was specified for the first time, and the adoption of this target entrusted a single monetary policy objective to the Bank: namely domestic price stability. I issued a statement on 6 April 2000 containing details of this new monetary policy framework. A copy of this statement is included in the Bundle at pages 164 to 168.

17 With the advent of inflation targeting as a monetary policy framework, the emphasis has, in compliance with the dictates of the Constitution, focused on domestic price stability, ie. the attainment of inflation at lower levels, in order to contribute towards balanced and sustainable economic growth.

18 Inflation targeting is a monetary policy framework implying the targeting of the inflation rate directly. Other intermediate variables influencing

inflation such as money supply, credit extension or the exchange rate are then not targeted directly, although they obviously still play an important role in the determination of inflation. Inflation targeting is a monetary policy framework characterised by a public announcement of a numerical target for the inflation rate that is intended to be achieved over a specified period of time. Inflation targeting is therefore the Bank's current monetary policy framework.

19 Inflation for targeting purposes is measured as CPIX (mu)*. CPI (consumer price index) is a measure of the general level of prices based on the cost of a typical basket of consumer goods and services. CPIX is the CPI excluding the impact of changes in mortgage interest rates. The CPI and CPIX are measured and compiled by Statistics South Africa, a body independent of the Bank.

20 In technical economic terms, it should be pointed out that a decline in the exchange rate affects the domestic price level via the prices of imported goods such as oil. If this adjustment in the domestic price level leads to an increase in inflationary expectations and further adjustments in wages and the prices of goods and services, an inflationary spiral could be the consequence, threatening the inflation target.

21 The initial target range for the calendar year 2002 was set at an annual average of 3 to 6 per cent. In October 2001 subsequent targets were announced. The target range remained unchanged for 2003, while it was set at an annual average of 3 to 5 per cent for 2004 and 2005.

22 The inflation target is set by the Government after consultations between the Bank and the National Treasury. This implies that the Bank does not have total autonomy in choosing the inflation target (so-called goal independence), but it does have independence in the monetary policy

* For metropolitan and other urban areas

decisions aimed at achieving the target (so-called instrument independence).

23 The autonomy entrusted to the Bank in the use of monetary policy instruments implies that the Bank has to be accountable for these decisions, and should therefore ensure transparency. To this end, the Bank publishes Monetary Policy Reviews on a bi-annual basis, while regular regional Monetary Policy Forums are also arranged to provide a platform for discussions of monetary policy with broader stakeholders from the community. More importantly, the Bank's annual report which is submitted to Parliament, combined with my regular testimonies before Parliament, ensure that there is a democratic structural methodology of enforcing accountability and transparency. A copy of my annual address in August 2000 to the ordinary general meeting of shareholders of the Bank, as well as the report of the eighty-first ordinary general meeting of shareholders of the Bank in August 2001 are to be found at pages 169 to 241 of the Bundle. Monetary Policy Reviews issued in March and October 2001 are included at pages 242 to 298 of the Bundle.

24 Inflation targeting has recently become internationally recognised and has been adopted by a number of significant central banks. Central banks in the following countries, for example, have adopted this framework: New Zealand (1990), Chile (1991), Canada (1991), United Kingdom (1992), Sweden (1993), Australia (1994), Czech Republic (1998), Poland (1998), Brazil (1999), Colombia (1999), Switzerland (2000) and Thailand (2000).

25 An inflation targeting framework was introduced in South Africa because of certain advantages such as :

25.1 making the objective of monetary policy clear and thereby improving planning for the private and public sectors and the public at large;

25.2 forming part of a formalised, publicly announced, and co-ordinated effort to contain inflation in pursuit of the broader economic objectives mentioned above, ie. sustainable economic growth and development;

25.3 helping to focus monetary policy and enhancing the accountability and transparency of the central bank to the public; and

25.4 providing an anchor for expectations of future inflation which should influence price and wage setting.

26 The Bank is responsible for achieving the inflation target through the formulation and implementation of monetary policy. The primary instrument of monetary policy available to the Bank is its influence on the level of short-term interest rates through our refinancing system, the so-called repo system.

27 The commercial banks have to maintain cash reserve balances at the Bank based on their total liabilities. These cash reserves create a liquidity requirement in the money market. The Bank provides liquidity to the commercial banks mainly through repurchase transactions at a fixed repo rate.

28 Monetary policy is decided upon by an internal Bank structure referred to as the Monetary Policy Committee (MPC). It is composed of myself as the Governor, the Deputy Governors Ms Gill Marcus and Dr Xolile Guma, chief economist Dr Ernie van der Merwe, the advisor to the Governors Mr Bertus van Zyl, senior deputy chief economist Mr Bernie de Jager and the deputy chief economist Mr Brian Kahn. In making its decision, the MPC ordinarily meets over two days to deliberate the stance of monetary policy. On the second day a decision is taken on the monetary policy stance. This is explained in a statement released by the Bank. The statements released by the MPC during 2001 are to be found at pages 299 to 326 of the Bundle.

29 The Bank's repo rate influences short-term market interest rates in two ways -

29.1 firstly it directly influences the marginal cost of funding of banks; and

29.2 secondly it reflects the Bank's monetary policy stance.

30 Changes in the repo rate consequently impact on other interest rates in the market and can affect the exchange rate through its impact on domestic demand and capital movements. (See graph on Monetary Policy Transmission Mechanism at page 53 of the Bundle).

31 As far as domestic demand is concerned firms and individuals respond to an increase in interest rates by altering their investment and spending patterns. As a result consumer spending and fixed capital formation should decline, lowering real aggregate demand. The volume of imports should then decline in response to the change in domestic demand. These could lead to an improvement in the current account of the balance of payments, which in turn could lead to a build up of foreign exchange reserves. Rising levels of foreign exchange should usually be associated with a stronger currency.

32 In the case of capital movements, rising levels of domestic interest rates relative to foreign interest rates could make domestic assets more attractive to international investors. This could lead to an increase in the net capital movements to a country, a rise in foreign reserves and a stronger domestic currency.

33 The precise impact of interest rates on exchange rates is, however, uncertain as the external value of a currency is affected by many other factors.

34 In an inflation targeting monetary policy framework, the repo rate is adjusted pre-emptively to influence future inflation. Thus the repo rate

is not changed to directly influence the exchange rate, as the target is inflation.

35 In the medium to longer term, however, successful inflation targeting should also contribute to a more stable exchange rate for the rand.

THE ROLE OF THE BANK IN THE FOREIGN EXCHANGE MARKET

36 It is to be expected that against the background of a move towards inflation targeting, the role of the Bank in the South African foreign exchange market has changed considerably over the years.

37 The Bank's involvement in the forward market* developed over many years, not only as a consequence of intervention, but also because the Bank was for many years responsible for providing cover against exchange rate fluctuations on behalf of Government.

38 Serious efforts in the early 1980s to extricate the Bank from the forward market proved to be difficult against the background of sanctions against apartheid South Africa. The interaction between isolation from the rest of the world, international sanctions, low domestic savings and low foreign reserves, necessitated the continued participation of the Bank in the forward market.

39 After the debt standstill in 1985, residents were increasingly reluctant to hold offshore debt, because of losses suffered on revaluation of foreign debt when the exchange rate depreciated by some 31 per cent at the time. In view of the strict exchange control requirements, no resident was permitted to hold foreign currency and banks were permitted to do so within strict limits. Under these circumstances, the Bank provided

---

* A market in which foreign currency, and some money market instruments, are traded for future delivery. There are no MARGIN requirements to be met in this market. Most transactions are closed directly between the buying and selling parties, and it is difficult to cancel a contract.

forward cover to residents in respect of their offshore exposure. The forward cover mechanism was used to encourage long-term borrowing offshore, as well as access to shorter-term offshore finance.

40 It should be remembered that in the sanctions environment, it was not possible for Government to borrow in the offshore capital markets. The forward cover mechanism was thus used to enable corporate South Africa to access international credit lines. These available credit lines were, to a considerable extent, related to trade

41 During the 1980s and most of the 1990s, the Bank was an active participant in the foreign exchange market; initially by virtue of its responsibility to assist with the development of a foreign exchange market in South Africa but later to assist in achieving a relatively stable exchange rate. On various occasions over the years, the Bank intervened in defence of the rand. As the Bank did not have adequate foreign reserves, the obligations to deliver foreign exchange into the market were converted into forward obligations. Such interventions took place in 1996 and 1998.

42 The forward book of the Bank reflects all unsettled future foreign exchange commitments of the Bank. As described the forward book of the Bank was used, inter alia, to provide forward cover to residents in respect of their offshore loans. This resulted in an oversold (negative) balance on the forward book. The oversold balance implies that the Bank's commitments to deliver foreign currency at future dates are greater than its future commitments to buy / receive foreign currency. In addition to the above-mentioned reason for using the forward book, the forward book was also used as a way to finance intervention. Net intervention, may have been viewed as forward cover provided in excess of the outstanding foreign debt of the private sector and parastatals**.** The Bank, for example, sold US dollars into the spot foreign exchange market in order to support the exchange rate of the rand and then swapped the US dollars back onto its forward book by buying US

dollars spot and simultaneously selling them forward. According to the Act all profits and losses in respect of providing forward cover are for the account of Government.

43 Over the years, as I shall demonstrate in Part Three of this statement, huge losses were made owing to the existence of the net open forward position ("NOFP")*, all for Government's account (ie the taxpayer). Consequently, not only because of the move to inflation targeting, but also because of the exposure for Government's account and the consequent losses, the Bank did not intervene in the aforegoing manner in support of the rand in 2001. Any intervention would again have increased the NOFP, exposing the Government to further risk of loss in the future.

44 Both the Bank and the National Treasury have regularly made known their intention to reduce their participation in the forward foreign exchange market. Significant steps in this direction have already been taken and in early 1997, the Bank withdrew from the provision of long-term forward cover. Moreover, in an effort to promote the development of the forward foreign exchange market in South Africa, the limits on the total amount of foreign currency that authorised dealers in foreign exchange can hold offshore were abolished in early 1998.

45 I shall point out in greater detail in Part Three of this statement that the Bank has succeeded in significantly reducing the NOFP in recent years, thus decreasing the Government's exposure to further losses.

* NOFP is expressed in US dollar terms and is defined as the sum of the net reserves (gross gold and foreign currency reserves minus foreign loans) of the Reserve Bank and its oversold forward book, i.e. the extent to which the Reserve Bank's future obligations to deliver US dollars are not covered by the Reserve Bank's net reserves.