ABRIDGED ACTUAL ADDRESS BY MR T.T. MBOWENI, GOVERNOR OF THE SOUTH AFRICAN RESERVE BANK, AT THE SEVENTY-NINTH ORDINARY GENERAL MEETING OF SHAREHOLDERS OF THE BANK, 24 AUGUST 1999

INTRODUCTION

As has been shown in the presentation on economic conditions, the South African economy recovered remarkably from the contagion effect of the financial turbulence in Asia and Russia. A substantial decline in the holdings of South African bonds by non-residents and the deterioration in the current account of the balance of payments, forced the authorities to pursue restrictive policy measures. This proved effective and tentative signs of a return to financial stability already began to appear in the last few months of 1998.

The recovery of the financial sector was, however, attained at the cost of lower economic growth because of the restrictive measures that were applied, as well as the impact of a slowdown in international economic activity in many parts of the world and a slump in international commodity prices. The low production growth in the past year aggravated the unemployment problem and contributed to other negative social effects. Although there are still risks and uncertainties in the world economy, conditions seem to be far better now than they were during 1998. Domestically the economy is poised for higher growth in production provided that it is not again affected by setbacks in other countries.

THE FINANCIAL TURBULENCE AND MONETARY POLICY

The brunt of the adjustment process in 1998 fell on monetary policy, as it takes a long time to make changes in fiscal and other policy measures. The strains that developed in the foreign exchange market in 1998 caused the exchange rate of the rand and domestic interest rates to adjust automatically to the changed supply of and demand for foreign exchange and the impact of these developments on bank liquidity. In these volatile and uncertain circumstances, the monetary authorities could only influence the speed of the adjustments required by the market.

The Reserve Bank's response was to underprovide in the liquidity requirement of the banks and to intervene in the foreign exchange market so that financial stability could be restored at the least cost in terms of inflation and economic growth, and employment losses. As a result, the repo rate moved sharply upwards by about 7 percentage points from the beginning of May to 21,85 per cent on 28 August 1998. The accommodation system was made more effective to cope with the crisis by phasing in a wider spread from 1 to 20 percentage points between the repo rate and the marginal lending rate. These measures led to corresponding steep increases in other short-term interest rates.

In tandem with the rise in interest rates, the Reserve Bank at first intervened heavily in the foreign exchange market in May and June 1998 in an attempt to create some order in a market that had become extremely sensitive to any negative news or rumours. In view of the large risks and potential costs associated with a net open exposure, the Reserve Bank stopped using this intervention technique when it became apparent that the contagion impact of the emerging-markets' crisis would be more severe and longer lasting than originally expected. This decision was validated when it became known that highly leveraged funds had built up speculative positions against the rand through forward foreign exchange transactions. Later, when these leveraged funds incurred losses in emerging markets and were forced to buy back their short rand positions, these transactions contributed to the retracing of some of the rand's earlier losses.

Although financial conditions became more stable from the fourth quarter of 1998, general nervousness continued to prevail among international investors, and they withdrew funds from emerging-market economies whenever there were signs of any pressure on exchange rates. In these circumstances, the Reserve Bank deemed it prudent to guide the repo and other money market interest rates gradually down to lower levels. With brief interruptions, the repo rate then moved lower from its upper turning point of 21,85 per cent on 28 August 1998 to 13,65 per cent on 31 July 1999. Over the same period, the net open foreign currency position of the Reserve Bank was reduced by US$5,6 billion to US$17,5 billion at the end of July 1999.

Despite the initial wide fluctuations in the repo rate, the repo-based accommodation system that the Reserve Bank had introduced in March 1998 is proving of considerable value in general and during periods of instability in financial markets in particular. Most of the difficulties encountered shortly after the implementation of the system were due to general nervousness in the market and teething problems. The system was flexible enough to be adjusted easily to solve these problems. Changes to enhance the efficiency of the repo system included the shortening of maturities, the introduction of "square-off auctions" at the end of the daily clearing period, administrative adjustments to the management of cash reserves and a refinement of the signalling procedures of the Reserve Bank. After these changes had been made, short-term interest rates became more flexible without being too volatile or too slow in reacting to signals.

THE WAY FORWARD

The liberalisation and international integration of financial services make it imperative for South Africa to bring domestic inflation in step with that of the rest of the world and to maintain sound and efficient financial institutions and markets. If these goals are not achieved, the economy could be subjected to sudden reversals in international capital flows, exchange rate instability and volatile interest rates. The thrust of monetary policy in these circumstances should therefore be to establish and maintain financial stability, i.e. stability of prices, financial institutions and financial markets.

This does not mean that monetary policy ignores other objectives of economic policy, such as economic growth, employment creation and improved social conditions in the country. On the contrary, we regard financial stability as a precondition for balanced and sustainable economic growth and improved living conditions, because it improves the efficiency of the pricing system and economic decision-making; enhances the efficiency of financial intermediation; minimises the inflation risk premium in long-term interest rates; reduces the incentive to hedge against inflation; promotes a more equitable distribution of wealth and income; and facilitates investment decision-making. A monetary policy that maintains financial stability in a credible and lasting way will accordingly make the best overall contribution to improving economic growth, employment and living standards.

A market-oriented strategy will be followed to achieve this overriding goal of monetary policy because financial institutions and markets function best in the national interest if they are competitive, active and liquid, and if interest rates and exchange rates are flexible. The Reserve Bank will accordingly continue to discuss with government the relaxation of exchange controls when underlying conditions are conducive to taking such steps. The eventual removal of exchange control restrictions should contribute towards dismantling the oversold forward book and reducing the net open foreign currency position. Once residents have accumulated large amounts of foreign assets, they could use these assets to counterbalance short-term currency volatility if they perceive this to be an opportunity of profiting from a temporary undervaluation of the exchange rate.

In pursuit of the primary objective of price stability it is essential, as stated in the Constitution, that the Reserve Bank performs its functions independently and without fear, favour or prejudice. The Bank will maintain an attitude of economic-professional objectivity, but will, of course, at the same time be accountable to Parliament and the general public for its actions. Transparency in the interpretation of economic data and the monetary policy stance will be promoted further. Regular reporting on economic conditions and Reserve Bank operations to Parliament and the general public will receive high priority.

Although the Bank will strive to achieve closer co-operation and co-ordination with the authorities responsible for policy decisions in other macroeconomic and microeconomic fields, the autonomy of the

Bank will be preserved. There are structural deficiencies in the economy which impair saving, investment, production growth and employment creation, and increase the level of real interest rates. A number of initiatives announced by the President at the opening of Parliament are aimed at easing these supply-side constraints. The implementation of these structural changes could create further scope for lower nominal and real interest rates. Closer co-operation and co-ordination between the Reserve Bank and other national official bodies may expedite this process.

The Southern African Development Community (SADC) provides an opportunity for member states to face jointly the challenges of global financial integration. Considerable progress has been made over almost four years in promoting interaction in Southern Africa through the Committee of Central Bank Governors of the SADC. The South African Reserve Bank will continue to promote the effective co-operation and integration of the financial systems and markets of Southern Africa. For the time being this will be done informally before attempting to achieve officially-sanctioned harmonisation and integration of financial arrangements.

In applying monetary policy in South Africa it is advisable to move away from the "eclectic" or informal inflation-targeting framework to formal inflation targeting. The eclectic monetary policy approach has been a useful framework for containing inflation, but at times it created uncertainties about Reserve Bank decisions and actions which were perceived as being in conflict with intermediate objectives. The guidelines on the growth in money supply and bank credit extension have constantly been breached in recent years as a result of financial deepening. To the extent that a formal or explicit inflation-targeting framework would be more transparent than the previous framework, it ought to allay some of these uncertainties.

With the adoption of inflation targeting, it will become clear that the containment of inflation is not solely a Reserve Bank responsibility. Inflation targets should be set jointly by the Reserve Bank and government. Inflation targeting will be more effective when economic policies are well co-ordinated. Before inflation targeting is introduced, this co-ordination should be clearly spelled out and all stakeholders must be consulted, including business and the trade union movement. We are convinced that the government will ensure that the policy measures are properly co-ordinated.

Our considered view is that a policy target agreement should be drawn up that would be signed by the Minister of Finance and the Governor of the Reserve Bank to define precisely the co-ordinated effort needed to contain inflation in pursuit of the broader economic objectives of sustainable high economic growth and employment creation. In this agreement the instrumental independence of the Reserve Bank must be guaranteed. This stipulation and the rest of the agreement will, of course, have to be ratified by Parliament.

Inflation targeting is a complicated monetary policy framework that requires careful preparations before an announcement is made to apply it in practice. To facilitate the implementation of inflation targeting, the Bank is currently revising and reorganising the functions of the Economics Department, now renamed the Research Department. As the new name implies, the activities of the department will concentrate on research, i.e. analysing monetary issues and co-ordinating research in the Bank. Although an important part of the Research Department's work will still be devoted to the compilation of economic statistics that can be used in economic analysis, greater attention will henceforth be given to monetary policy assessment, econometric modelling, international economic developments, international relations, and labour and social research.

The Research Department is developing the technical support systems that are essential for the implementation of an inflation-targeting framework, namely the development of additional and more sophisticated inflation-forecasting models; the investigation of the transmission mechanism between changes in policy instruments and inflation; and the design and implementation of a survey-based assessment of inflation expectations.

Although these steps are necessary for the implementation of inflation targeting, this new framework should not in any significant way affect the conduct of monetary policy. Policy actions will still be guided by a medium-term inflation outlook, albeit in a more transparent manner. In order to arrive at an inflation outlook, the Bank will continue to monitor a wide range of economic indicators, including developments in money supply and bank credit extension. In this new framework the Bank's main operational instrument will continue to be the repo mechanism. The same fine-tuning and structural operational instruments will be used to influence interest rates, and the level of the exchange rate of the rand will be determined primarily by the impact of these actions on the supply of and demand for foreign exchange.

The Reserve Bank will also continue to monitor financial conditions carefully as part of its objective to maintain financial stability. Where unavoidable pressures do arise in the financial system, the Bank may have to carefully contain them directly as "lender of last resort". The lender-of-last-resort facility will not, however, automatically be made available to all banks in distress, but only in cases where the failure of a bank would pose a serious threat to the financial system as a whole. Criteria will be established to specify the exit strategy of the Reserve Bank. A deposit-insurance scheme is being developed to cover retail depositors. This scheme could provide more latitude in deciding whether to close an ailing bank, without the concern that depositors in financially healthy banks may lose confidence in the banking system as a whole.

Sound financial supervision is a prerequisite for financial stability and warranted the debate during the past year on the feasibility of establishing a single financial regulatory authority in South Africa. Most countries have securities commissions responsible for the regulation of investment services and in many countries there is still a separation of banking and insurance supervision. Current opinion in South Africa is influenced strongly by recent developments in the United Kingdom and Australia where banking supervision has been moved out of the central bank into a single financial regulator.

There are convincing arguments both for and against a single financial regulator. Arguments for such a single regulator include issues such as the bluring of functional dividing lines between different institutions, the development of financial conglomerates, the exploitation of gaps in financial regulation and the achievement of economies of scale and a uniform style of regulation. Arguments for the retention of bank supervision as a Reserve Bank function are based on the characteristics of banking, the special relationships between the Bank and the banking sector, the high systemic risks in banking, the importance of a healthy banking system for effective monetary policy and the Bank's ability to compete for scarce human resources. It is important that all these arguments be carefully considered by government to find an appropriate approach to this issue that can continue to assist in the execution of monetary policy.

A well-organised decision-making process is another important factor in the conduct of monetary policy. All monetary policy decisions are currently made by the Governors' Committee (consisting of the Governor and deputy governors), while the Monetary Policy Implementation Committee (MPIC) is responsible for carrying out monetary policy. Although this decision-making process works well, monetary policy issues demand more attention. It has therefore been decided to create a Monetary Policy Committee (MPC) for the formulation of monetary policy. The MPC will consist of the Governor and deputy governors as voting members and senior officials of the Bank as non-voting members.

The MPC will consider and evaluate the state of the economy, the current stance of monetary policy and the operational procedures in the conduct of monetary policy, and formulate the changes deemed necessary in monetary policy and operational procedures. The final decision-making power on monetary policy matters will nevertheless still vest in the Governors' Committee. The MPIC will continue to function as in the past.

In order to provide opportunities for public involvement in the monetary policy decision-making process, it has also been decided to create a Monetary Policy Forum (MPF). The Governor of the Reserve Bank will chair the MPF, and representatives of private business enterprises, labour and other interested institutions and organisations will be invited to participate in the meetings of the MPF. The MPF will meet twice a year to discuss macroeconomic developments and monetary policy issues.

INTERNAL ADMINISTRATION OF THE BANK

The internal decision-making process of the Reserve Bank will be changed in the coming year. In addition to the existing Currency, Payment and Financial Systems Committee and the Management Committee, a Budget Committee will be formed. The Budget Committee will have the authority to compile and monitor the implementation of the Bank's annual budget. Through a Subcommittee on Procurement, the Budget Committee will also be responsible for the procurement, management and control of supplies, services and assets of the Bank.

In a further attempt to achieve greater transparency, the Bank has decided to establish a fully-fledged Media Office. This office will be primarily responsible for focusing on external communication, thus assisting the media, national and provincial legislative structures and the general public to gain a better understanding of the Bank's policies, decisions and activities.

During the past year, considerable progress has been made with a number of other administrative projects in the Reserve Bank. These projects included the certification of year 2000 compliance of information technology systems; enhancing national payment system principles, practices and arrangements; improving the national notes and coin management distribution system; the completion of comprehensive recalculations of national accounts and balance of payments statistics; and the promotion of training in the Bank as well as in the SADC region.

A beginning has also been made in drawing up a human resources plan which will deal with progressive employment equity in the workplace by promoting equal opportunities and fair treatment. The plan will propose the implementation of affirmative action measures to redress the disadvantages of designated groups to ensure their equitable representation in all occupational categories and levels of the workforce. A renewed focus will be placed on recruiting from the target group and enhancing the skills profile through development and monitoring. This plan will, however, be put into effect in a manner that will ensure that the institutional memory does not drop below the critical level required for national and international excellence. To achieve these goals, a Subcommittee on Human Resources will be established under the auspices of the Management Committee to oversee the execution of the human resources plan.

CONCLUDING REMARKS

Events over the past year illustrate that the thrust of monetary policy in an integrated financial world should clearly be to pursue financial stability. Although such a policy stance does not provide unconditional protection against volatile international capital movements, it improves the country's ability to withstand international financial turbulence. When international financial disruptions affect the South African economy, adjustments will inevitably have to be made to the exchange rate of the rand, domestic liquidity and interest rates. The objective of the monetary authorities should not be to resist such changes, but rather to ease the adjustment process by pursuing consistent and transparent policy measures. Financial stability is a precondition for sustained economic growth and employment creation.

The changes to the monetary policy framework and the monetary policy decision-making process that are proposed in this address should assist the authorities in this difficult task. Inflation targeting is no panacea, but it should help to anchor inflation expectations and minimise the inevitable, but short-term, social and economic cost of achieving price stability. A more transparent decision-making process will further assist in reaching this goal.

In conclusion, I wish to thank the President and Deputy President of the Republic for their support and appreciation with regard to the functions of the South African Reserve Bank and its governors. I further wish to thank Mr Trevor Manuel, Minister of Finance, Ms Maria Ramos, the Director-General of Finance and the staff of the Department of Finance for their support of the Reserve Bank over the past year. I should like to thank the directors of the Reserve Bank, including the deputy governors, for their undivided loyalty to the Bank. On this occasion, it is also fitting to pay further tribute to Dr Chris Stals for his term of ten years as Governor and just more than 44 years in the service of the Bank. Dr Stals made numerous valuable contributions to the work of the Bank and for the benefit of South Africa during his career, for which we are deeply grateful. Dr Chris de Swardt, Deputy Governor for almost ten years, also retired recently after a distinguished career of nearly 44½ years in the Bank. We wish both Dr Stals and Dr de Swardt, as well as their wives, a happy retirement and fulfilling years ahead. Finally, I wish to thank the staff of the Reserve Bank for the professional manner in which they performed their duties in the past year. I am confident that with their continued loyal support, the Bank will meet the challenges that lie ahead