Condensed Address of Mr T T Mboweni, Governor of the South African Reserve Bank,

at the eightieth ordinary general meeting of shareholders of the Bank on 29 August 2000

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Introduction

The South African Reserve Bank has once again met the many challenges posed by the changing domestic and international environment with great success during the past year. The Bank's resilience was proven without any doubt in coping with such changes as the implementation of an inflation-targeting monetary policy framework, the information technology and other problems arising with the new millennium, and maintaining financial stability during very volatile conditions. The Bank also succeeded in improving the efficiency and effectiveness of internal administrative procedures and completed a plan to effect employment equity in all occupational categories.

The domestic economy also adapted very well to volatile international financial markets. The economic recovery in many parts of the world, together with continued low inflation, was beneficial to South Africa. However, certain inherent weaknesses in the world economy had a negative impact on domestic financial markets and eventually also on the recovery in domestic production.

The external imbalances in the world disrupted financial markets during the first half of 2000. Risks of sudden changes in market sentiment were exacerbated by increases in share and property prices. In addition, international oil prices began to rise steeply when the Organisation of Petroleum Exporting Countries (OPEC) and several other oil producers curbed production. This had a material impact on the import bill and prices in South Africa. Despite these developments, South Africa's balance of payments remained inherently healthy, and the country's foreign reserves increased substantially.

International perceptions of South Africa deteriorated in 2000 because of developments in some parts of sub-Saharan Africa. Socio-political conditions in a number of countries remained unstable and led to conflicts in parts of the continent. In particular, events in Zimbabwe preceding its general election adversely affected domestic financial markets and unjustifiably raised questions regarding South Africa's economic prospects.

A fundamentally sound balance of payments

The regional events, a shift of funds away from commodity-based countries to high-technology and manufacturing-oriented economies, a rearrangement of portfolios as a result of the surging energy prices, and higher international interest rates led to large net sales of bonds by non-residents amounting to R15,3 billion in the six months up to the end of July 2000. At first an inflow of other capital was able to offset the net sales of domestic bonds by non-residents. However, in the second quarter of 2000 a net outflow of capital was recorded, totalling R5,9 billion.

Although the current account of the balance of payments moved into a deficit from the second quarter of 1999, the deficit did not exceed $^1/_2$ per cent of gross domestic product. In the second quarter of 2000 a surplus of R5,7 billion at a seasonally adjusted and annualised rate was recorded. The strong performance of the current account can largely be attributed to the growth in merchandise exports.

As a consequence of the effects of these developments on the current and financial accounts of the balance of payments, total net gold and other foreign reserves increased by nearly R28 billion from the end of 1998 to March 2000, before declining by R4,4 billion in the next three months. At the end of June 2000 the gross gold and other foreign reserves of the country nevertheless stood at R69,8 billion, which is the equivalent of the value of approximately 15 weeks' imports of goods and services.

As could be expected, this fundamentally sound balance of payments situation at first resulted in relatively stable conditions in the foreign exchange market. However, from the beginning of 2000 the nominal effective exchange rate of the rand declined by about $8\,^1/_2$ per cent up to 30 May 2000. Towards the end of May the behaviour of non-residents on the secondary bond market started to change and the weighted value of the rand, on balance, increased again to a level on 23 August 2000 that was about 5 per cent lower than at the beginning of the year.

Buoyant but volatile financial markets

The depreciation of the rand was one of the factors contributing to a temporary reversal in the downward movement of long-term interest rates and yields in South Africa during 2000. The monthly average yield on long-term government bonds fell from 18,3 per cent in September 1998 to a daily average of 13,3 per cent in mid-February 2000. The daily average yield on long-term bonds then shifted upwards to reach a peak of 15,2 per cent on 10 May 2000, before the return to more stable financial conditions reduced it to 13,7 per cent on 22 August 2000. The monthly average inflation-adjusted yield on long-term government bonds amounted to 5,5 per cent in July 2000, compared with 10 per cent in September 1998.

The share market entered a long and difficult recovery phase after the financial crisis in 1998. The daily average index of all classes of share prices fell by no less than 40 per cent from the end of April 1998 to the end of August 1998, and then rose gradually to a new all-time high on 17 January 2000 of 10 per cent above its previous peak in April 1998. Rising interest rates, the depreciation of the rand and corrections on major international bourses resulted in a decline in the daily average index of share prices of 28 per cent until 17 April 2000, when it began to recover again. On 22 August 2000 the daily average index of all classes of share prices was nevertheless still 9 per cent below its peak on 17 January 2000.

Trading activity in the secondary bond market was boosted by the uncertainty in international markets. A record annual turnover of R8,8 trillion was recorded on the Bond Exchange of South Africa in 1999, followed by R6,2 trillion in the first seven months of 2000. The value of shares traded in the secondary share market rose to R448 billion in 1999, which was 40 per cent more than in 1998. Volatility in share prices fuelled trading activity further during 2000. The value of shares traded in the first seven months of this year was 25 per cent higher than in the corresponding period of 1999.

In contrast to the unstable conditions in the bond and share markets, interest rates in the money market declined sharply during 1999 and remained largely unchanged during the first seven months of 2000. This stability was largely the result of the monetary policy stance pursued by the Reserve Bank.

A slowdown in economic recovery

The South African economy showed clear signs of a vigorous economic recovery during 1999. The annualised quarter-to-quarter growth in the seasonally adjusted real gross domestic product accelerated from 1 per cent in the first quarter of 1999 to $3\,^1/_2$ per cent in the fourth quarter. Moreover, the expansion in economic activity became far more widespread in the course of the year.

Contrary to general expectations, the rate of expansion in the economy slowed down in the first half of 2000. Growth in real gross domestic product fell to 1 per cent in the first quarter of 2000 and $1\,^1/_2$ per cent in the second quarter. To a large extent this was due to a decline in the output of the primary sectors, but manufacturing output was also affected by negative business sentiment.

As a result of these developments, the inventory accumulation moderated in the second quarter of 2000. After domestic final demand had declined in the first half of 1999, it increased at relatively modest rates of between 1 and $2^1/_2$ per cent in the four quarters until June 2000.

The modest economic growth over the past eighteen months was not conducive to meaningful employment creation. Further reductions were recorded in employment in the non-agricultural private sector as well as in the public sector, which were neutralised by increases in the informal sector. At the same time, the growth in nominal unit labour costs slowed down significantly because of lower increases in the labour remuneration per worker and a rise in productivity. The rate of increase in nominal unit labour costs declined from 8,9 per cent in 1998 to 3,2 per cent in 1999 and only 0,5 per cent in the first quarter of 2000, compared with the same period in the preceding year.

Discipline in fiscal policy

Disciplined fiscal policies and efficient public administration procedures brought the public-sector borrowing requirement down from R25,6 billion in fiscal 1998/99 to R10,9 billion in fiscal 1999/2000. A decline in investment spending by large public enterprises and corporations was responsible for approximately 25 per cent of the reduction in the public-sector borrowing requirement. The remaining 75 per cent saving in the borrowing requirement was largely due to the considerable restraint with expenditure allocations and more efficient procedures for collecting income and other taxes.

Greater price stability

The effective fiscal, monetary and other policy measures pursued by the authorities, in conjunction with lower international inflation, succeeded in creating greater price stability in South Africa. In 1998 and 1999 the rate of increase in the consumer price index excluding mortgage interest costs (CPIX) averaged 7 per cent per year. This rate of increase can be compared with inflation rates fluctuating around 15 per cent in the 1980s and early 1990s.

During 1999 the twelve-month growth rate in the CPIX slowed down from 7,3 per cent in March 1999 to 6,5 per cent in October, but then accelerated to 8,0 per cent in July 2000. The rise in inflation was largely due to shocks such as higher international oil prices, floods and volatile financial markets. When omitting the effects of the price rise in petrol, diesel and food from the CPIX, the rate of increase over twelve months in other consumer prices fell from 6,8 per cent in October 1999 to 6,7 per cent in July 2000.

Recent developments in monetary aggregates bode well for the inflationary outlook, provided that the direct impact of external shocks wears off and that the secondary effects of the increase in oil prices can be contained. The level of the broadly defined money supply (M3) at the end of June 2000 was virtually the same as at the end of 1999, whereas growth in bank credit extension, which had moved to single-digit levels in the second half of 1999, remained below 10 per cent in the first half of 2000.

Monetary policy in a volatile environment

The volatility in financial markets had a significant influence on monetary policy during the past year. At first, evidence that the emerging-market crisis of 1997/98 was abating made it possible to relax a very stringent monetary policy stance. The repurchase rate of the Reserve Bank was allowed to decline from a peak of 21,85 per cent in early October 1998 to approximately 12 per cent on 24 November 1999. After that, the Reserve Bank's objective was to achieve stable money-market interest rates to allay fears about computer problems with the year-end date change and from February 2000 because of volatile financial conditions.

Stable money-market interest rates were regarded as desirable to restrain volatility. In the circumstances, a rise in rates would have failed to counter the effects of the supply-side shocks on domestic prices. Moreover, a number of other factors indicated that the upside risks for inflation would probably be short-lived. Developments such as modest increases in nominal unit labour costs, fiscal discipline, excess production capacity, low growth in money supply and bank credit extension, and a prudent monetary policy stance, pointed to a favourable long-term inflation outlook.

In a further attempt to create greater certainty about the ultimate objective of monetary policy, an inflation-targeting monetary policy framework was formally adopted in South Africa as part of overall economic policy. This was announced in the Budget Speech by the Minister of Finance on 23 February

2000, with an annual average inflation target range of 3 to 6 per cent for the year 2002 being set. The new framework provides an anchor for the ultimate objective of monetary policy. The successful application of inflation targeting will depend on a concerted, co-operative effort by the key stakeholders, such as government, labour and business.

The adoption of an inflation-targeting monetary policy framework for South Africa has certain important implications. Firstly, the numerical inflation target becomes the overriding objective of monetary policy. The objective of the framework is, after all, to achieve the target. However, this does not mean that the central bank is left without any discretion.

Secondly, the pursuit of inflation targets does not mean that the Reserve Bank is not concerned about the achievement of sustained high economic growth and employment creation. Monetary policy cannot contribute directly to economic growth and employment creation. However, by creating a stable financial environment, monetary policy fulfils an important precondition for the attainment of economic development.

Thirdly, to be successful, inflation targeting requires nominal exchange rate flexibility. In an inflation-targeting monetary policy framework, 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 Reserve Bank nevertheless takes cognisance of the second-round impact of exchange rate movements on the inflation rate.

Fourthly, inflation targeting is a forward-looking approach. Monetary policy is based on the likely path of inflation. In any monetary policy framework a central bank has to decide how its current policy stance will affect future price movements. The difference between inflation targeting and other frameworks is that inflation targeting makes forecasting explicit and more transparent.

Finally, inflation targeting increases the transparency and accountability of monetary policy because the objective of price stability is expressed as a numerical target to be achieved over a specific period. A number of steps have therefore been taken to explain monetary policy.

At present it is also the objective of the Bank to reduce its net oversold position in foreign currency gradually whenever circumstances allow. By buying dollars in the market, the net open position in foreign currency of the Bank was reduced from US$23,2 billion at the end of September 1998 to US$9,9 billion at the end of July 2000. Such a reduction removes a factor adversely affecting market sentiment, reduces the volatility of the exchange rate of the rand and lowers the foreign currency exposure of the government. A lower currency exposure will make it easier to borrow funds abroad.

Maintaining stability in the financial sector

A stable financial environment requires not only low inflation, but also a sound financial sector. This involves stability in the financial markets where transactions can take place at prices reflecting demand and supply forces, and with healthy financial institutions capable of meeting contractual obligations without interruption or outside assistance. Stability in the financial sector and price stability are inextricably interrelated. Failure to maintain one form of stability creates an uncertain operating environment for the other, with causality running in both directions.

South Africa is fortunate to have a well-developed and sound financial system. South African banks are well run with sophisticated risk-management systems and corporate-governance structures. They are also well capitalised and had an average risk-weighted capital-adequacy ratio of 12,5 per cent at the end of June 2000. Although non-performing loans have increased since the international financial crisis, South African banks have made greater provision for bad and doubtful debts. However, lower income combined with higher operating expenses resulted in marginally lower returns on assets and equity in the first half of 2000.

The Reserve Bank strives to ensure an effective and efficient banking supervision structure. A recent assessment undertaken by the International Monetary Fund (IMF) and the World Bank in terms of a Financial Sector Assessment Programme found that South Africa complies with almost all of the Basel

Core Principles for Effective Banking Supervision. Where some requirements do fall short, proactive steps have already been taken to address them. The imminent promulgation of amendments to the Banks Act and revised Regulations thereunder should further enhance the country's status in the regulatory environment.

In view of the complexity of the financial system and the linkages of banks with other financial activity in the country, a Financial Stability Unit was established in the Reserve Bank in July 2000. This unit will research and analyse ways of promoting and maintaining a stable financial system. The aim is to focus on overall financial stability so as to enhance confidence in the domestic financial system, increase South Africa's attractiveness as a regional financial centre and attract foreign investment.

One of the most important functions of the regulator of banks is to authorise the establishment of new banks. The power to grant licences provides the mechanism for preventing the entry of banks whose presence might be prejudicial to the interests of depositors and the soundness of the banking system. In South Africa our approach is to grant licences to all applicants that comply with a stringent set of entry criteria.

Banks are monitored continuously to ensure that they remain fundamentally healthy. This has mainly been done through quantitative and qualitative off-site assessments. In 1999 the Bank began the preparatory work for on-site reviews of credit-risk management systems and evaluations of asset quality. The process is expected to become fully operational in the second half of 2000. Substantial progress has also been made with the development of consolidated supervision, i.e. in reviewing both banking and non-banking activities conducted by a banking group domestically and internationally.

Despite all these procedures, it is not possible to guarantee that banks will not experience some difficulties from time to time. In such cases, the policy of the Reserve Bank is to assist only banks which have a temporary liquidity problem, whereas insolvent banks are allowed to exit from the system in an orderly manner which does the least harm to the banking system and depositors.

When a bank experiences funding difficulties on a short-term basis, lender-of-last-resort assistance is provided to it. Lender-of-last-resort assistance is a recognised responsibility and practice of central banks. The objective of such assistance is to enable the bank concerned to implement corrective measures and to prevent the contagion effect of a run on the bank. The liquidity under the lender-of-last-resort function is provided on a short-term basis only and has to meet certain important preconditions.

In an integrated world economy, it is essential to have close co-operation and that information is shared internationally. This is becoming even more important with the increased foreign participation in the South African banking sector. The Bank continues to develop relations with other banking supervisors to meet the challenges posed by globalisation.

In addition to the banking supervision function, stability in the financial sector depends on the availability of currency in circulation and the maintenance of an efficient national payment, clearing and settlement system. The Bank incurs considerable expense annually to ensure the availability of high-quality currency in circulation in various denominations as a means to execute transactions.

Further advances have also been made in the national payment, clearing and settlement system to achieve same-day settlement. At present approximately 76 per cent of all payments in the South African Multiple Option Settlement (SAMOS) system are already made on a same-day basis.

Another important challenge is the financing of small, medium and micro enterprises (SMMEs) which do not have securities or other assets as collateral for needed funds. The Reserve Bank believes that the development of a microlending industry is essential for this purpose. Microlenders are well placed to provide such finance to SMMEs as they normally have an intimate knowledge of potential customers. Over the past few years, the Reserve Bank has actively promoted the microlending industry.

Broadening of external relations

Following the normalisation of South Africa's relations with the rest of the world, senior officials of the Reserve Bank have become more involved with multilateral financial institutions, other central banks and international private financial institutions. A number of meetings were attended at the IMF and the Bank for International Settlements in the past year where discussions were held with other central bankers on current economic and policy developments. The Reserve Bank took an active part in the development of standards for a new financial architecture. Further headway was also made with the enhancement of financial co-operation among the central banks of the Southern African Development Community (SADC).

Changes to internal administration

In the internal administration of the Reserve Bank a focus area during the past year was the establishment of a Budget Committee which is responsible for preparing and managing the Bank's operational and capital budgets. This committee gave considerable attention to the budgetary process and procedures followed in the Bank and established definite rules.

The Year 2000 project, which had started in July 1996 and culminated in the transition to the new millennium, was completed successfully. This was replaced by a number of new projects to ensure the most efficient, cost-effective information technology systems, including the dissemination of economic data and the upgrading of foreign exchange information.

A paradigm shift in exchange control is under investigation. In the new planned philosophy most transactions will be permitted, except for certain specified exclusions. Emphasis will be placed on the accurate reporting of cross-border transactions. The completion of this study should improve the compilation of the balance of payments.

Like many other central banks, the Reserve Bank is seeking to enhance its effectiveness and efficiency by focusing on its core activities. To this end, considerable emphasis has been placed on the strategic management process. Strategic reviews are undertaken more frequently. In addition, the Bank has embarked on the development of a long-term vision which will serve as the framework for future planning. As part of this Vision 2010 a comprehensive human resources plan has been developed that forms the basis for effecting employment equity.

The plan endeavours to achieve a staff complement comprising a minimum of 50 per cent Black people and 33 per cent females across all occupational levels by 2005. The achievement of these targets will be complemented by a number of action programmes, which include a special drive to recruit people from the designated groups, accelerated management development and promotions, dedicated training and development, early retirement and redundancy procedures, organisational restructuring, wellness and disability management, and affirmative procurement. By the same token, the Bank is cognisant of the need to retain the necessary corporate memory and skills within a transforming environment.

The Bank continues to regard the development of the skills and knowledge of its staff as a major responsibility. Emphasis is placed not only on the proficiencies required in its daily activities, but also on general human resources development. The South African Reserve Bank College concentrates on upgrading the central banking skills of individuals to the highest level.

Concluding remarks and acknowledgements

Events during the past year again illustrate how interwoven South Africa has become in the integrated world economy. Globalisation has many benefits for emerging-market economies. Unfortunately, like all good things in life, globalisation also has certain disadvantages. In particular, the integration of South Africa into the world economy has made the country more vulnerable to external shocks. These can take the form of supply, demand and financial shocks. In such an uncertain environment the pursuit of financial stability has become even more imperative.

In conclusion, I wish to thank the President and Deputy President of the Republic of South Africa, and the Reverend Frank Chikane, Director-General of the Presidency, for their support for the work of the South

African Reserve Bank. In particular, I wish to express my heartfelt gratitude for their support for the independence of the South African Reserve Bank. I also want to place on record my appreciation to Mr Trevor Manuel, Minister of Finance, Mr Mandisi Mphahlwa, Deputy Minister of Finance, Ms Maria Ramos, Director-General of National Treasury, and the staff of the National Treasury for their co-operation with the Bank over the past year. A word of appreciation is also appropriate to Mr Alec Erwin, Minister of Trade and Industry, Dr Alistair Ruiters, Director-General, and the staff of the Department of Trade and Industry, who have become important collaborators of the Reserve Bank. Informative meetings were held with the Parliamentary Portfolio Committee on Finance, which we found very helpful. I thank my colleagues on the Board, including the deputy governors, for their commitment and undivided loyalty to the Bank. Finally, a word of thanks is also due to the staff of the Reserve Bank for their work during the past year and for their loyal support.