Condensed address of Mr T.T. Mboweni,
Governor of the South African Reserve Bank at the
eighty-first ordinary general meeting of shareholders

Introduction

The activities of the South African Reserve Bank, including our conduct of monetary policy, during the past year were strongly influenced by global economic developments. In trying to create and maintain stable financial conditions, the Bank took note of developments in the world economy including international commodity prices, inflationary pressures, financial markets, exchange rates and the global financial architecture. The South African economy coped well in a world being affected by these developments and, more particularly, by the slowdown in the United States economy.

Recent economic developments

The Reserve Bank's *Annual Economic Report* contains a comprehensive review of economic developments during the past year. In my address I therefore wish to highlight only the following developments:

Firstly, the South African economy has recorded continuous positive growth since the fourth quarter of 1998. However, economic growth slowed down in the fourth quarter of 2000 and in the first half of 2001. The slower growth in the fourth quarter of 2000 was essentially due to a decline in agricultural output from an exceptionally high level in the preceding quarter. From the beginning of 2001 a decline in the growth of export volumes resulted in a weakening of activity in most sectors of the economy, with the exception of the mining and financial services sectors.

Secondly, the relatively sound economic performance could not reverse the downward trend in recorded employment in the formal non-agricultural sectors of the economy. The number of workers in gainful employment and the considerable increases in productivity achieved by modern production techniques lowered the cost of labour per worker. In the manufacturing sector, the increase in unit labour cost came to only 0,7 per cent in 2000.

Thirdly, the rate of increase in real gross domestic final demand was relatively subdued in comparison with most preceding upturns of the business cycle. This was largely the result of low increases in real final consumption expenditure by general government, whereas consumption expenditure by private households rose steadily and growth in real gross fixed capital formation accelerated from 2 per cent in the first half of 2000 to 52 per cent in the first half of 2001.

Fourthly, the balance on the current account of the balance of payments changed from a deficit in the early stages of the economic recovery to a surplus from the fourth quarter of 2000. Although the slowdown in the world economy began to have a negative impact on the demand for South African exports, the competitive level of the exchange rate of the rand outweighed this effect. Growth in export values therefore exceeded growth in import values by a wide margin.

In the fifth place, South Africa had a surplus on the financial account of the balance of payments during 2000 and during the first half of 2001, but capital movements fluctuated considerably from quarter to quarter between large net inflows and net outflows. The extent of these capital movements depended mainly on the sentiment of non-residents towards investments in South African bonds and also the conclusion of a number of large direct investment transactions between residents and non-residents.

These inflows, together with developments on the current account, further increased the international reserves of the country. As at the end of June 2001, the total gross gold and other foreign reserves had reached a level equivalent to the value of 16 weeks' of the imports of goods and services. This can be compared with a level of only 6 weeks at the end of 1994. The improvement in the international reserves was obtained to a large extent through investment in shares by non-residents, i.e. without relying unduly on foreign debt.

In the sixth place, the rates of increase in money supply and bank credit extension in the current recovery phase remained relatively subdued until the beginning of 2001. The year-on-year growth in M3 then started to accelerate and reached 13,9 per cent in June 2001. This acceleration reflected increases in aggregate domestic demand, but M3 growth outpaced the rate of increase in the narrower monetary aggregates because of a comparatively strong rise in the long-term deposits of the public. Domestic credit extension changed broadly in tandem with the growth in M3.

Finally, the economic recovery was supported by the continued pursuance of a sound fiscal policy. Effective spending controls and efficient tax administration resulted in a continued low borrowing requirement of the non-financial public sector in fiscal year 2000/01. A large part of the government's borrowing requirement was financed by means of the proceeds from the restructuring of state assets, foreign loans, the drawing down of available cash balances and new issues of Treasury bills.

Monetary policy and operational procedures

The rapidly changing international environment and relatively favourable domestic economic conditions made decisions on an appropriate monetary policy stance challenging. On the one hand, external or exogenous factors were a threat to the monetary stability achieved in 1999. On the other hand, domestic inflation pressures remained benign. The problem was how best to deal with exogenous shocks in the inflation-targeting framework that had just been adopted by government and the Bank.

One possible solution would have been to make use of the escape clause allowing for the target to be missed in the event of shocks. But this course of action would have been too early an admission of defeat and might also have resulted in a loss of credibility, which is one of the cornerstones of an inflation-targeting framework. An alternative would have been to opt for a tightening of policy measures. This would clearly have demonstrated the determination by the Bank to reach the target at whatever cost to the economy. It might also have entailed an excessively tight monetary policy at a stage when most domestic economic developments favoured a more balanced policy approach.

In the end, the Monetary Policy Committee erred on the side of caution which meant that we aimed at meeting the inflation target, albeit rather close to the upper range of the band. The repo rate was accordingly kept unchanged from January to October 2000. With rising consumer prices this implied a moderate relaxation in policy. Moreover, long-term real interest rates tended downwards and the value of the rand depreciated significantly over the same period. With such a policy stance, the econometric projections of the Reserve Bank showed that the target would be reached, provided that the external shocks did not become more severe.

The Reserve Bank carefully monitored all international developments that could pose a threat to monetary stability. With the intensification of the crisis in the Middle East in October 2000, prospects of further oil price increases and the continuing depreciation of the rand, the Monetary Policy Committee became concerned about the possible effects of these developments on inflation. On 16 October 2000, it was accordingly decided that the repo rate should be raised by 25 basis points. This small adjustment was intended to indicate the direction that interest rates might take if the shocks persisted and fed through to the general price level, thus threatening the achievement of the inflation target. The motive was to send a signal that the Reserve Bank would increase interest rates if the underlying situation required such a step.

This action proved highly effective. Domestic conditions remained conducive to lower inflation and fortunately the impact of exogenous factors on prices calmed down. The inflation rate began to decline. This meant that real interest rates were rising, implying a progressive tightening of monetary policy - especially after the exchange rate of the rand began appreciating in the second quarter of 2001. At the same time, projections indicated that conditions had become more favourable for the attainment of the inflation target. Given these developments, the Monetary Policy Committee decided to reduce the repo rate by 100 basis points with effect from 15 June 2001. This decision was taken from a position of strength, showing that price stability could be obtained at a lower opportunity cost to the economy.

Besides deciding on the appropriate monetary policy stance, considerable attention was given to the application of monetary operational procedures during the past year. After extensive research and consultation, it was decided that the following changes would be made to the refinancing system to improve the transmission of monetary policy directives:

1. The spread between the repo rate and interbank call rates in the market will be narrowed by 100 basis points with effect from 5 September 2001 to enhance participation and competition in the main repo auctions and create a level playing field in the market. The repo rate will be lowered to 10 per cent for purely administrative reasons to bring the rate in line with current overnight market rates, but this does not imply any change whatsoever to the monetary policy stance. Banks and other financial institutions should not adjust any of their lending and deposit rates on account of this adjustment, since this would defeat the

purpose of the change.

2. The Reserve Bank will in future calculate and publish on a daily basis a South African average overnight reference rate which could serve as a benchmark for money-market interest rates.

3. The Reserve Bank will henceforth quote a fixed repo rate to eliminate any doubts whatsoever in monetary policy signals.

4. The tender amount and the amount allotted at the repo auctions will be announced after the tender from 5 September 2001 and the Bank will discontinue the practice of publishing the estimated liquidity requirement of the market in order to encourage banks to square-off in the interbank market.

5. Weekly repo tenders will take place from 5 September 2001 instead of the current daily tenders. The allotted repurchase transactions will have a maturity of seven days.

6. The Reserve Bank will, at its discretion, conduct daily final auctions or supplementary tenders to prevent large fluctuations in interbank rates. Final auctions will be entered into where changes in interbank rates are unacceptable to the Reserve Bank. To accommodate a short cash position, the final auction will be concluded at 1,50 percentage points above the current rate, whereas a long cash position will be accommodated by a final reverse-repo facility at 1,50 percentage points below the current repo rate. Where the Reserve Bank is satisfied with the level of interbank rates, but there is a long or short cash position in the market, supplementary auctions will be conducted at the prevailing repo rate.

With effect from the period starting from the fifteenth business day before the end of September 2001 up to the fourteenth business day of October 2001, the amount of vault cash qualifying as a deduction from the minimum reserve balances that banks must hold on account with the Reserve Bank, will be limited to 75 per cent of the vault cash held. This limit will be reduced by a further 25 percentage points per annum over a three-year period. This change will better align the calculation of cash reserve requirements in South Africa with international best practice and provide a more level playing field for the smaller banks.

Exchange rate policy and reserve management

The external value of the rand at times came under considerable pressure during the period under review. These pressures originated mainly from developments outside the borders of South Africa, which not only affected the rand but also many currencies in other parts of the world. Despite these circumstances, the Reserve Bank did not sell dollars in the foreign-exchange market to strengthen the exchange rate of the rand. This was in accordance with our stated policy which regards such intervention as undesirable because it is only effective if it signals a change in underlying policies, if it is strongly supported by participants in the market and if the central bank is prepared to intervene repeatedly and decisively.

In fact, the Reserve Bank continued to buy small amounts of dollars in the market to gradually reduce our net oversold open position in foreign exchange. The objective remains the gradual closing down of the net open position in foreign exchange, now amounting to US$4,8 billion. The attainment of this objective will eliminate the risk involved in carrying such a position and the negative influence it has on the perceptions of potential market participants. At the same time, it is important to bear in mind that the process of reducing this position may lead to a depreciation in the value of the rand, or prevent the rand from appreciating in value when an overall surplus is recorded on the balance of payments. Consequently, transactions aimed at lowering the net open position in foreign exchange based on portfolio and short-term capital flows, could provide speculators with a one-way bet. In order to counter such speculation, the Reserve Bank buys dollars in the foreign-exchange market only under exceptional circumstances, such as those where large direct investments or more permanent capital inflows are received.

The Bank's oversold forward book has an important influence on the way in which the country's foreign reserves are managed. No less than 85 per cent of the Reserve Bank's foreign-exchange holdings were held in US dollar-denominated assets on 31 July 2001 because the oversold forward book is denominated largely in US dollars. Although liquidity is still an important focus of reserve management, risk returns are also taken into account. The other objectives of the risk management strategy of the Bank are capital preservation, reciprocity with counterparts who extend credit to the Reserve Bank, risk aversion and prudence.

The Reserve Bank continued to follow a conservative approach to borrowing funds that would support the level of our reserve holdings. On 31 July 2001, the outstanding foreign loans of the Bank amounted to US$2,5 billion and the available facilities amounted to US$1,1 billion.

On 15 August 2001, the arrangements for the repayment of loans in terms of the Debt Standstill Agreements concluded from 1985 onwards, were ended. On that date, the final authorisation was issued for the repayment of all the outstanding capital on loans in the standstill net. This brought to an end an unfortunate part of our history. South Africa has, however, meticulously honoured all the capital redemption schedules and interest payments on this indebtedness in accordance with the agreements made with foreign creditors.

Stability in the financial sector

The objective of price stability depends to a large extent on stability in the financial sector. Financial stability requires a robust financial system with the capacity to prevent or withstand shocks originating domestically or internationally.

The Reserve Bank regards the monitoring and promotion of stability in the financial system as so important that a Financial Stability Committee was established in August 2000. The mandate of this committee is to enhance financial stability by continuously assessing the stability and efficiency of the financial system, formulating and reviewing appropriate policies for intervention and crisis resolution, and strengthening the key components of the financial system. To further ensure the maintenance of financially stable conditions, a Financial Stability Department was established in the Bank with effect from 4 May 2001. This department is concerned with monitoring and promoting the overall stability of the financial system.

One of the important tasks in maintaining financial stability is the identification of potential losses due to market and credit risks. To this end, an econometric model on bank stability was developed. With the aid of this model, potential risks to banks can be identified. The application of this model indicated that the distribution of future capital ratios of South African banks is healthy and that banks are well capitalised in comparison with risk levels. These results are confirmed by data regularly compiled by the Reserve Bank.

Following the liquidity difficulties that small banks experienced towards the end of 1999 and in the first few weeks of 2000, a consolidation process began that is still in progress. This resulted in some banks moving out of the system, restructuring their ownership structures and/or down-sizing their balance sheets. Once finalised, this process may lead to a reduction in the total number of banking registrations.

Towards the end of June 2001, Regal Treasury Private Bank Limited was placed under curatorship due to a loss of confidence in the bank and a subsequent run on deposits. As a result of the curator's investigations, it was deemed appropriate by the Registrar of Banks to appoint, for the first time, a commissioner to investigate the affairs of the bank, in terms of section 69A of the Banks Act, 1990, Act No. 94 of 1990.

Considerable attention was given during the period under review to creating more effective and efficient supervisory techniques. Two important developments in this regard were consolidated supervision and on-site supervision. Moreover, emphasis is also being placed on the use of other supervisory techniques to ensure financial stability, such as inter-agency co-operation, incentive systems, reliance on the internal governance of regulated entities, the role played by the boards of directors of banks and continuous surveillance.

Major risk-reduction measures have been taken within the national payment system during the year under review. General Payment Clearing House agreements were signed between participating banks to reduce further the interbank settlement risk emanating from clearing operations. A facility was introduced on 5 March 2001 allowing banks to secure their exposure in batch settlements by utilising their required cash reserve holdings at the Reserve Bank instead of arranging temporary collateral. Same-day settlement in the South African Multiple Options Settlement (SAMOS) system was implemented on 7 May 2001. Over and above these changes, the banks have agreed that item limits will be placed on payments such as cheques, electronic fund transfers, debit payments and SASWITCH transactions.

Economic co-operation in Southern Africa

The Reserve Bank again gave considerable attention to promoting economic co-operation in Southern Africa during the past year because this is regarded as essential for the long-run economic integration of the southern African region under the Southern African Development Community (SADC). It should, however, be realised that economic integration between such diverse economies is a long-drawn and challenging process. A natural starting point towards this ultimate goal is first to achieve closer co-operation and the harmonisation of activities. One of the most important developments in this regard has been the discussions amongst the central bank governors and ministers of finance regarding macro-economic convergence.

Internal administration

In the management of the Reserve Bank, continued emphasis was placed on regular strategic reviews. In view of the rapidly changing environment, the Bank embarked on an exercise to develop a vision for the year 2010 and introduced a number of fundamental changes to promote and improve institutional proficiency.

In keeping with the changes in South Africa, considerable progress was made with the transformation process to achieve a representative workforce in the Bank. This included the realignment of organisational structures and the revamping of management styles as well as of systems and procedures. An Employment Equity Plan has been lodged with the Department of Labour and various structures, such as an employee representative body and a management steering committee, have been established to facilitate communication and monitor the progress made in terms of the Employment Equity Plan.

The Reserve Bank continues to regard the all-round development of its employees as a major responsibility. Only through the loyalty and dedication of employees will the Bank be able to achieve its goals and fulfil its responsibilities towards the citizens of this country. Considerable time, effort and resources are invested each year in human resources development and the well-being of our staff.

The work of the staff has been supported by enabling effective business processes through information and communication technology. Lack of space at Head Office, however, has become a serious problem in recent years. Approval has therefore obtained from the Board to extend the Head Office building. Besides additional office space, the extensions will include the construction of a parking garage for our staff and conference and banqueting facilities. The latter two will be useful facilities for use by the Bank, the public sector and other interested parties. The construction will probably commence towards the course of 2001.

A new cash management strategy called Project Imali (money) was implemented during the year. The project makes provision for creating greater operational capacity at existing branches of the Bank and for providing contractual bulk cash services in Mpumalanga and the Northern Province, where the Bank is not represented by branches. A project to launch a new banknote series is currently in progress and local artists have been invited to suggest appropriate designs for these notes.

Finally, a new subsidiary, the South African Reserve Bank Captive Insurance Company Limited, was incorporated during the year to provide insurance cover for the Bank and its subsidiaries. This company is currently administered by the staff of the Bank.

Conclusion

The Reserve Bank has coped well with the many challenges of a rapidly changing domestic and international economic environment during the year under review. It is particularly heartening that the achievement of monetary stability has progressed so well. At present, most factors seem to be favourable for the attainment of the inflation target for the year 2002.

South Africa continues to be blessed with a stable and sound banking and financial system. The key to preventing or mitigating the impact of external events on our economy is strong financial institutions and efficiently functioning financial markets. We have learned from the experiences of other countries that the cost of resolving financial crises is exorbitant. Even more damaging are the indirect costs of restructuring and a slowdown in economic growth. It is imperative to nurture a healthy financial structure. A major future challenge is to manage the redesigning of the regulatory framework and the successful integration of the current regulatory agencies.

In conclusion, it is again a great privilege 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 continued support for the work of the South African Reserve Bank. On behalf of the Bank, I also wish to express 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 continued co-operation with the Bank over the past year. In addition, I also wish to thank Mr Alec Erwin, Minister of Trade and Industry, Dr Alistair Ruiters, Director-General, and the staff of the Department of Trade and Industry, for their co-operation in work of common interest. We have also held successful discussions on economic and monetary policy issues during the course of the year with the Portfolio Committee on Finance in Parliament. I would like to record our appreciation to this Committee for affording us the opportunity to be held accountable for our actions.

In addition, I wish to thank the member of the Board of directors of the Reserve Bank, including the deputy governors, for their support to me as Chairperson of the Board and for their selfless dedication to the Bank. In particular, I wish to express my appreciation to Mr Tim Thahane, former Deputy Governor and Mr W F de la Harpe Beck, former Director of the Bank, who retired during the financial year. I also want to express my deepest sympathy and condolences to the widow and family of the late Dr Bax Nomvete. In his term as Director of the Bank, Dr Nomvete made a valuable contribution to the work of the Board. Lastly, but by no means least, I want to thank the staff of the Reserve Bank for their excellent work, professionalism, loyal support and dedication.

I thank you for your attention.