S O U T H   A F R I C A N   R E S E R V E   B A N K

Governor's Address

Condensed Address of Mr T T Mboweni, Governor of the South African Reserve Bank, at the eighty-second ordinary general meeting of shareholders of the Bank on 27 August 2002

Introduction

The South African Reserve Bank was again confronted by many challenges during the past year. I am, however, glad to say that, as on previous occasions, the Bank coped well. Although some ground was lost in containing inflation owing to exogenous shocks that affected the economy, remedial action has been taken to bring the inflation rate down towards the targeted levels. A period of consolidation in the banking sector was handled in an effective manner so as to ensure continued domestic financial stability. Attention was given to the regulatory structure of the banking sector to continue protecting the funds of depositors and to ensure that the intermediation of savings runs smoothly. The efficiency and effectiveness of internal administrative procedures were improved further and considerable progress was made with transforming the composition of the Bank's staff to better reflect the demographics of the country.

Recent economic developments

The South African economy also did well in a rapidly changing political and economic world. A comprehensive review of recent economic developments in South Africa is contained in the Reserve Bank's *Annual Economic Report*, which was released this morning. In my address I therefore wish to highlight only the following developments:

South Africa, like most other emerging-market economies, was affected considerably by the attacks on the United States of America in September 2001, the uncertainties that this created politically as well as in the business world, the continued relatively high levels of oil prices and the strong downturn in world economic activity. The most important effect of these developments on South Africa was that they contributed materially to the volatility in the external value of the rand. After the value of the rand had been relatively stable in the first six months of 2001, the nominal effective exchange rate decreased by about 34 per cent in the second half of the year.

Factors which contributed to the depreciation in the value of the rand included a weak export performance and a strong increase in imports and dividend payments to non-residents. The resultant deficit on the current account of the balance of payments was accompanied by a net outflow of portfolio capital. This outflow stemmed from the perceived higher risk of investing in emerging-market economies, the problems experienced in Argentina and later Brazil, instability in Zimbabwe, and unfounded expectations of imminent exchange-control relaxations in South Africa. Eventually, international investors began to regard the external value of the rand as a one-way bet, exporters delayed repatriating their foreign-earned currency and importers switched financing from foreign to domestic sources. In other words, there was a typical speculative bandwagon effect.

After the authorities had reminded the market about the sound economic fundamentals in South Africa in a statement on 20 December 2001, and it became clear that the exchange rate of the rand had over-reacted, this whole process was reversed. At the same time the current account of South Africa's balance of payments moved into surplus, mainly owing to a decline in dividend payments to the rest of the world and a rise in exports. This brought the nominal effective exchange rate of the rand on 31 July 2002 back to about 27 per cent below its level at the beginning of 2001.

The growth of the South African economy proved to be quite resilient to the world economic slowdown in the period under review. Despite a synchronised decline in the growth of most of our major trading partners, the growth rate in real gross domestic product only declined moderately from 3,4 per cent in 2000 to 2,2 per cent in 2001 and 2,3 per cent in the first half of 2002. The positive production growth in generally depressed world economic conditions could be attributed to continued strong domestic demand for goods and services. After declining in the second half of 2001, the volume of exports also began to rise in the first half of 2002.

As could be expected with the strong domestic final demand for goods and services, the saving performance of the South African economy remained at a low level. In the past five years, gross saving as a ratio of gross domestic product has continued to fluctuate between about 15 and 16 per cent, which is too low to finance the growth performance the country needs for creating enough employment opportunities.

The steady growth performance in South Africa was accompanied by substantially higher labour productivity. The real output per worker in the non-agricultural sectors had increased by only about 1 per cent per year in the period from 1985 to 1995, but rose at an average annual rate of nearly 4½ per cent from 1995 to the first half of 2002. Higher labour productivity was the combined result of an increase in output and a reduction in formal-sector employment. More than one million employment opportunities have been lost since the peak of the employment cycle in 1989. Unemployment therefore continues to be the major economic problem of the country.

Monetary policy

After pursuing a relatively neutral monetary policy stance during 2000 and the first half of 2001, the Reserve Bank relaxed monetary policy from the middle of 2001. The repurchase rate was reduced by 100 basis points on 15 June 2001 and by a further 50 basis points on 20 September 2001. This stance was adopted because most domestic factors remained positive for the containment of inflation. No signs of the secondary effects of the weaker currency could be discerned. In fact, inflationary expectations declined, nominal unit labour cost increased only moderately and growth in the money supply slowed down. Internationally the oil price declined, world economic activity began to slow down and interest rates were reduced aggressively. The twelve-month growth rate of the consumer price index excluding interest on mortgages (CPIX) was turned around and declined to 5,8 per cent in September 2001.

Subsequently, two important developments led the Reserve Bank to reconsider its monetary policy stance. Firstly, the inflation targets for the three years after 2002 were announced by the Minister of Finance. The target for 2003 was kept unchanged at an annual average rate of increase in the CPIX of between 3 and 6 per cent, but this range was lowered to an average of 3 to 5 per cent for the next two years.

Secondly, the external value of the rand began to depreciate sharply in September. As a result, inflationary pressures began to pick up during the last quarter of 2001. Food prices were initially the main factor contributing to the acceleration in inflation. Later the increase in consumer prices became more broadly based. As the depreciated rand pushed prices higher, the twelve-month rate of increase in the CPIX started moving upwards from the psychologically important level of below 6 per cent in September 2001 to 9,9 per cent in July 2002.

The first response of the Bank to the rising inflationary pressures was to convene an unscheduled meeting of the Monetary Policy Committee early in January 2002. Although the exact feed-through of the depreciated value of the rand to inflation was still unclear at that stage, a number of developments indicated that it might be prudent to adopt a more restrictive monetary policy stance. These developments included a reversal of the downward trend in oil prices, indications that higher inflation expectations were becoming entrenched, higher wage demands, a more rapid rate of increase in unit labour cost and large increases in money supply and bank credit extension. In view of these developments the Monetary Policy Committee decided to raise the repurchase rate by 100 basis points.

Monetary policy was tightened further at the March and June meetings of the Monetary Policy Committee. In both cases the repurchase rate was increased by 100 basis points, bringing the rate to 12,5 per cent on 14 June 2002. By March it was clear that inflation expectations had been adversely affected by the depreciation of the rand. In addition there was concern about the continued high rate of growth of money-supply aggregates and bank credit extension, the state of the balance of payments and the rising trend in unit labour cost. By June, it was apparent that the upward trends of inflation and inflation expectations had maintained their momentum, and that growth in unit labour cost and money supply developments remained unfavourable.

The latest forecasts of the Bank show that, given this tightened stance of monetary policy and barring any unforeseen negative shocks, the inflation target for 2003 could be met. However, the average annual rate of increase in the CPIX will probably be close to the upper end of the target range and the risks to the forecast are on the upside. As such, it seems unlikely that monetary policy will be relaxed in the foreseeable future.

Although the current stance of monetary policy may be perceived as negative for short-term growth and employment creation, such a view must be compared with the alternative of even higher future interest rate levels, if inflation is not brought under control. Furthermore, the tax concessions granted in the last budget should benefit consumption, and the significant depreciation in the external value of the rand should promote production, particularly of exported goods.

Exchange rate policy

As outlined previously, the rand has continued to be negatively affected by developments in emerging markets. For this reason the Reserve Bank strongly supports the government's policy that the remaining exchange control regulations should be very gradually relaxed.

Although the exchange rate of the rand is allowed to be determined essentially by supply-and-demand conditions in the market for foreign exchange, it remains the stated objective of the Bank to gradually close down the net oversold open foreign reserve position. The existence of this net oversold open position has been perceived as a source of weakness for the rand, and has contributed to negative sentiment towards the currency. However, it is also recognised that if the net open foreign reserve position is reduced too quickly, it could contribute to rand weakness. The Bank therefore announced in a statement on 14 October 2001 that we would reduce this position from cash flows derived from the proceeds of government's off-shore borrowing and privatisation. In accordance with this objective, the Bank has reduced the net open foreign reserve position to US$1,8 billion at the end of July 2002. At this level it should no longer be perceived as a source of vulnerability.

Financial stability

International developments also affected domestic financial stability during the past year. The attacks on the United States of America on 11 September 2001 illustrated an enormous systemic risk to financial systems worldwide as well as the key role that central banks must play in such circumstances. The increase in the international linkages among financial institutions adds to the risk in such events. In particular, trade and financial links expose South Africa to the contagion effects of recent adverse developments in Zimbabwe. This is closely monitored by the Bank.

Domestically the South African banking sector was characterised by a process of consolidation triggered by the difficulties of some small banks during the past year. This trend intensified after the announcement that Saambou Bank Limited, the seventh-largest bank in South Africa, would be placed under curatorship from 9 February 2002. As a result, there were significant withdrawals of deposits from some smaller banks in general and BoE Bank Limited in particular. This spurred the Reserve Bank to take a proactive and leading role in solving this problem, which led to an agreement between the private and public sectors on the management of liquidity by recycling cash flows and handling the orderly exit of Saambou Bank from the banking sector. The activities of Saambou Bank and BoE were eventually merged with those of some of the big four banks in South Africa. The liquidity problems of some of the smaller banks induced them to cancel their banking registrations and to carry on with niche operations. Other smaller banks are redesigning their ownership structures and in some cases downsizing their balance sheets.

Despite these developments, South Africa's banking system remains sound. Domestic banks are well-managed and have sophisticated risk management and corporate governance structures in place. Banks are well-capitalised, with an average risk-weighted capital adequacy ratio of 12,1 per cent at the end of June 2002. The liquidity of the banking sector is generally adequate. Non-performing loans amounted to R26 billion in June 2002. This represents only about 3 per cent of total loans and advances. Provisions made by banks for non-performing loans were also in line with international standards.

The single regulator

The problems encountered in the banking sector earlier this year illustrated in the most definite manner that it is important that banking supervision in South Africa should remain part of the functions of the Reserve Bank. Although the potential benefits of assessing the risk management functions of financial conglomerates on a holistic basis are very attractive for developed countries, experience in South Africa has shown that banking supervision is closely aligned with the other functions of the Reserve Bank. With the recent liquidity problems of some small banks, it was again evident that a least-cost resolution of a banking crisis would always depend on a special collegial interaction between the Registrar of Banks and at least four other departments in the Bank. The policy formulation, decision making, co-ordination and rapid execution of the many interventions that were necessary would have been almost inconceivable in a situation where the supervision of banks was not part of the Bank.

The banking supervision function in the Reserve Bank has caused many problems and frustrations, and the temptation to pass the responsibility on to another agency is great. However, the capacity to perform effective banking supervision is crucial to price and financial stability. After careful consideration of the issue, I am therefore convinced that it is in the best interests of the South African economy that banking supervision should remain in the Bank. At the same time, I also realise that close co-operation should exist between the different regulatory authorities to address the need for consolidated supervision. In this regard it is essential that co-operative working arrangements are established between regulators.

Regulating the banking sector

The different approaches adopted to handling the liquidity problem of banks have created considerable uncertainty about the principles applied in regulating the banking sector. This again emphasises that the execution of this function should be made as transparent and business-like as possible. The objective of bank supervision is to ensure stability, efficiency and depositor protection in banking. A stable financial environment is essential for the working of the economy and the attainment of price stability.

The registration of banks is the first step to achieve stability in the banking system. Stability is promoted by preventing applicants with potentially destabilising weaknesses from entering the system. In deciding on whether a banking licence will be granted to an applicant, an assessment is made of the institution's business plan, shareholding structure, capital base, directors and senior management, internal controls and projected financial conditions.

Once a bank has been established it must be monitored continuously to ensure that it remains fundamentally healthy. This monitoring process involves a quantitative and qualitative assessment of a bank's soundness. The quantitative assessment entails an analysis and evaluation of defined financial risk-based data received from banks on a monthly basis, to determine whether they are within prescribed prudential limits and whether their financial positions fall within acceptable norms. The qualitative assessment consists of the examination and evaluation of whether risks are being managed properly. This assessment is done within a framework of corporate governance structures.

Despite every effort by the supervisors to ensure a healthy banking system, they cannot guarantee the safety and soundness of individual banks at all times. Where a bank encounters difficulties, special contingency measures are applied. The general approach followed in providing financial assistance is that the bank in distress is experiencing only temporary liquidity problems. By contrast, an insolvent bank or one with ongoing liquidity problems is required to exit from the banking system in an orderly manner with minimum losses to depositors and the least harm to the public's confidence in the banking system as a whole.

Special action is taken in a case where a temporary liquidity problem is identified. As every case is different, these actions may vary from one case to another. Possible solutions may range from new capital injections by shareholders to measures designed to attract and retain large deposits. In addition, the relevant bank may be allowed to obtain liquidity by discounting liquid assets and by utilising its minimum cash reserves to cover cash outflows.

If none of these measures can solve the liquidity problem of the bank in distress, the Reserve Bank may, as lender of last resort, be approached for special assistance in certain circumstances. This special assistance is granted only against collateral of acceptable assets pledged by the bank or a government guarantee, because the Reserve Bank is prohibited by statute from making unsecured loans.

Two reports on the Bank's policy and practice of solving liquidity problems were published in the past year. One was on the failure of Regal Treasury Private Bank Limited. The other report was on the financial assistance package to Bankorp (and later to Absa) in the late 1980s and early 1990s. The Davis Panel found in the latter report that the assistance had averted a systemic crisis. The panel members also concluded that the procedure for dealing with banks in distress had been refined and now conformed to current international best practice.

The Bank is aware of the need to broaden the access of individuals and small and medium-sized enterprises to basic banking services and funding. To this end, the approach was to encourage registered banks to provide such services and to exempt certain approved non-bank financial institutions, such as *stokvels*, credit unions and village financial services co-operatives, from the requirements of the Banks Act provided that these institutions comply with certain specified conditions. Work is now in progress to reform the Mutual Banks Act by making provision for different classes of banks. This would create a more appropriate regulatory framework and give broader access to finance. The Bank also supports all initiatives aimed at finding a balance between facilitating socially responsible behaviour by banks and protecting the stability of the banking sector.

Internal administration

In view of the importance of maintaining an overall stable financial environment, a Financial Stability Department was established in the Reserve Bank. The functions of the new department are to identify, analyse and research any potential threats to and weaknesses in the financial system, and to make policy proposals on and encourage changes that will support the stability and effectiveness of the financial system.

Other administrative changes in the Bank included the establishment of an Over-the-Counter Share Transfer Facility to provide for trading in the Bank's shares, because of the decision by shareholders to end the listing of the Bank's shares on the JSE Securities Exchange SA with effect from 2 May 2002; the development of Bank-wide business continuity planning to ensure that the Bank can continue functioning and meeting its obligations in the event of any interruption or disaster; several initiatives in the field of information and communication technology to lower costs and improve efficiency; the implementation of the Bank's new bulk cash management strategy (Project Imali); and the development of new security features for the current banknote series (Project Bataki).

Major progress was also made with the reduction of settlement risk in the payment system when agreements were concluded with the payment clearing houses. After intensive consultation with the banking industry, same-day settlement now generally takes place. Satisfactory advances supporting regional economic integration were achieved through the Committee of Central Bank Governors in the Southern African Development Community. The Bank was also actively involved in initiatives to establish closer monetary and economic co-operation in Africa through participation in the Association of African Central Banks.

In keeping with the objective of transforming the composition of the Bank's staff to reflect the demographics of the country, an important milestone was reached in the past financial year when the total black staff complement exceeded the white staff complement for the first time since the inception of the Bank in 1921. This confirms the Bank's commitment to achieving its objectives for staff transformation. Further efforts will be made to achieve gender and race representivity at all seniority levels. We want the Bank's staff to reflect the diversity and unity of South Africa.

Extensions to the Bank's head office building, which started in 2001, are progressing satisfactorily and will be completed in 2003. Once completed, the building will meet the Bank's requirements for additional office space and for parking and conference facilities. The conference facilities will also be made available for use by the public, which should contribute to the improvement of activity in the Pretoria central business district.

Acknowledgements

All these changes to ensure the efficient functioning of the Reserve Bank could not have been accomplished without the help of a number of people and institutions. In conclusion, I therefore wish to express my appreciation to everyone who contributed to the success of the Reserve Bank in overcoming the challenges of the past year. I wish to thank the Presidency in particular, the government in general and Parliament for supporting the work of the Reserve Bank.

In addition, I wish to express my appreciation to the Board of Directors of the Reserve Bank, including the deputy governors, for their commitment and undivided loyalty. Mr J H Cross, Senior Deputy Governor, left the service of the Bank at the end of his term for health reasons and Mr I J Moolman retired. Both of them made valuable contributions to the work of the Bank and the Board, for which we are deeply grateful. Finally, I wish to thank the staff of the Reserve Bank for their professionalism, excellent performance and continued loyal support.