SOUTH AFRICAN RESERVE BANK

Governor's Address

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

at the eighty-third ordinary general meeting of shareholders of the Bank on 26 August 2003 in Pretoria

Introduction

The South African Reserve Bank achieved considerable success on many fronts under difficult economic conditions during the past year. In the monetary field, prompt action during 2002 helped to restrain inflationary expectations as well as to maintain international confidence in the country's commitment to responsible macroeconomic policies. The strength of international confidence is reflected in the recovery in the rand's international value, which was a major factor in reining back inflationary pressures. In the process, the oversold net open foreign reserve position (NOFP) was finally expunged in May 2003. Against this background, it has been possible to lower interest rates in recent months.

In the banking sector, financial stability has been restored after the serious liquidity problems experienced in the first half of 2002. The banking sector remains soundly capitalised and well managed, and significant progress has been made in the further application of international best practices in banking supervision. The highly-developed structure and international competitiveness of the country's financial system as a whole remains a significant national strength.

In the administration of the Bank, costs were reduced significantly and in a number of instances departments were restructured, streamlined and staff numbers reduced.

The international economic environment

The economic recovery remains weak and fragile. Having improved towards the end of 2001 and during the first half of 2002, global economic activity suffered a setback in the second half of 2002 when business confidence was detrimentally affected by revelations of corporate accounting malpractices, further declines in equity values and the threat of war against Iraq. In the first half of 2003 equity prices generally began to rise and the war in Iraq was concluded without severely impacting on oil production. Yet growth in most of the large industrial countries failed to meet earlier expectations. In emerging-market economies growth on the whole was quite robust in Asia and in Europe, while it was moderate in Africa and weak in Latin America.

As could be expected under these circumstances, unemployment increased in most advanced economies as well as in Latin America and Africa. Employment creation in emerging-market economies remains one of the most pressing challenges facing the world to ensure the maintenance of stability and the reduction of poverty. With the exception of parts of Latin America and some countries in Africa, global inflation remained low.

The combination of low economic growth, increased unemployment and disinflation generally led to the adoption of expansionary monetary and fiscal policies in advanced economies. Interest rates were brought down to very low levels in most developed countries and fiscal deficits widened. However, these measures were unable to prevent some major corporate defaults. Of further concern is the volatility experienced in exchange rates and its effect not only on the financial sector, but also on real economic activity. In particular, the US dollar has weakened substantially, which could have major repercussions for the world economy.

Domestic economic developments

The weakness of the US dollar was a major factor in a significant recovery in the external value of the rand. Having declined by 34 per cent on a trade-weighted basis during 2001, the nominal effective exchange rate of the rand recovered by 24 per cent in 2002 and by a further 12 per cent up to the end of July 2003. Similarly, the real effective exchange rate of the rand recovered markedly over this period. The level of the real effective exchange rate of the rand is nevertheless still below the index values of early 2000, i.e. before the currency market turbulence. This indicates that South African producers are fairly price competitive, but the profitability of their international transactions has, of course, fluctuated considerably over the past three years.

Domestic output could not escape the impact of the still subdued global economy. Growth in real gross domestic product slowed down from 3½ per cent in the first half of 2002 to 3 per cent in the second half and 1½ per cent in the first half of 2003. The slower growth was accompanied by an increase in aggregate employment in the formal non-agricultural sectors of the economy in 2002. However, preliminary indicators point to a loss in employment opportunities in the first half of 2003.

The decline in the rate of economic growth was due to a fall in the volume of exports, whereas domestic demand continued to increase strongly. The level of short-term interest rates seems to have had little effect on domestic demand. The rate of increase in domestic final demand declined only marginally from 4 per cent in 2002 to 3½ per cent in the first half of 2003. The annualised growth in real gross domestic expenditure nevertheless remained at 4½ per cent in the second half of 2002 and in the first half of 2003.

Growth in real household consumption expenditure slowed only slightly from an annualised rate of 3 per cent in the second half of 2002 to 2½ per cent in the first half of 2003. The sustained high growth in consumption expenditure was made possible by relatively strong increases in personal disposable income as well as by a rise in household debt. The steadfast growth in household consumption expenditure was accompanied by an annualised increase in real government consumption expenditure varying from quarter to quarter between 3½ and 4 per cent throughout the past year.

The rate of increase in real fixed capital formation picked up during 2002 and reached an annualised level of 9 per cent in the second half of the year. This rate then receded to a still high 8 per cent in the first half of 2003, brought down by a decline in the fixed investment of the agricultural sector associated with lower profits of farmers because of the marked drop in the prices of some key agricultural products. Other sectors continued to spend large amounts on the replacement of obsolete capital equipment and the development of new ventures.

In contrast to the continued strong growth of domestic demand, exports performed less well. In fact, the volume of exports of goods and non-factor services declined by 1½ per cent in 2002 and by a further 2½ per cent in the first half of 2003. In 2002 the decline in the volume of exports coincided with an increase in the volume of imports. Despite a decrease in crude oil imports, the volume of total imports continued to increase in the first half of 2003. The terms of trade strengthened in both 2002 and the first half of 2003, while net dividend and interest payments declined. These developments could nevertheless not prevent the balance on the current account from reverting from a surplus in 2002 to a deficit of nearly 1 per cent of gross domestic product in the first half of 2003. This deficit was more than neutralised by a financial inflow from the rest of the world consisting mainly of foreign direct investment, borrowing by the South African government in international capital markets and net inflows of other portfolio capital.

On the monetary and financial fronts, the main developments during the past eighteen months can be summarised as follows:

1. The rate of increase in the monetary aggregates slowed down significantly. For instance, the growth in the broadly defined money supply (M3) measured over periods of twelve months declined from around 19 per cent in the early part of 2002 to less than 13 per cent in December 2002 and to single-digit rates during most of the first six months of 2003.
2. The public's demand for bank credit remained resilient. Having declined from 12,5 per cent in June 2002 to 7,8 per cent in December, the twelve-month growth rate in banks' total loans and advances to the domestic private sector picked up again to 12,7 per cent in June 2003.
3. The money market continued to be relatively liquid. The daily liquidity requirement of banks was maintained at around R11 billion by means of various operational procedures.
4. Short-term interest rates began to move downwards from April 2003. Having increased by about 400 basis points in conjunction with the repo rate during the first nine months of 2002 and then stabilising at this higher level for the next six months, short-term rates declined by approximately 200 basis points up to the end of July 2003.
5. Private-sector companies made increased use of the primary bond market to finance activities. The outstanding value of private-sector loan stock listed on the Bond Exchange of South Africa therefore increased from R29 billion in June 2002 to R42 billion in June 2003.
6. Long-term bond yields trended downward from late March 2002, reflecting the market's favourable view of the long-term prospects for inflation and the impact of a small public-sector borrowing requirement.
7. Share prices began to recover during 2003. Having declined by 37 per cent from 22 May 2002 to 25 April 2003, the all-share price index recovered by 20 per cent to the end of July.

Public finance

A more expansionary fiscal policy stance has been adopted by government since the 2001 Budget, while the policy remained supportive of lowering inflation and promoting stability. This cautious expansionary fiscal stance is set to be maintained over the medium term to increase the long-term growth capacity of the economy.

Monetary policy

Monetary policy was dominated in the past year by having to respond to the inflationary pressures arising from exogenous shocks in the form of a substantial depreciation in the external value of the rand in late 2001 and a sharp rise in international oil prices. These shocks were mainly responsible for a surge in the twelve-month rate of increase in the consumer price index for metropolitan and other urban areas excluding interest on mortgages (CPIX) from a low of 5,8 per cent in September 2001 to a peak of 11,3 per cent in October and November 2002.

As a result, the Monetary Policy Committee was obliged to increase the repo rate by 400 basis points in total during the first nine months of 2002. These increases were prompted by the fact that the inflationary pressures, which were at first mainly confined to rising food and energy prices, became more broadly based and in the end not only influenced the prices of goods but also the prices of services which are not directly affected by exchange rate developments. The increase in the repo rate was further based on factors such as rising inflation expectations, increasing nominal unit labour costs and high growth in money supply and bank credit extension.

Although it was still unclear at the meeting of the Monetary Policy Committee in November 2002 whether the higher interest rate levels would be effective, the repo rate was kept unchanged because a number of developments indicated that inflationary pressures could begin to abate. These included a decline in the quarter-to-quarter production price index from 26,0 per cent in the first quarter of 2002 to 11,2 per cent in the third quarter; a strengthening in the external value of the rand; a decline in international oil prices; slower growth in bank credit extension; and a deceleration in the pace of growth in the more broadly defined money supply aggregates.

By the time of the March 2003 meeting of the Monetary Policy Committee it was clear that the rise in inflation had been contained. The twelve-month rate of increase in CPIX had fallen to 9,3 per cent and that of the production price index to 6,2 per cent. In addition, the growth in money supply and bank credit extension had come down to single-digit levels and the rand had recovered remarkably in the second half of 2002. Despite this more positive picture, some other developments caused the Monetary Policy Committee to remain cautious about changing the policy stance prematurely. In particular, the Committee was influenced by the fact that the meeting took place on the day that the war in Iraq started. At that stage it was uncertain what the impact of the war would be on the global economy, and more specifically on oil prices. Other considerations that led to the decision to keep the repo rate unchanged included concerns about the level of wage settlements, rising unit labour costs, large increases in some administered prices and a forecast that CPIX inflation would be close to the upper limit of the inflation target in 2004.

At its June 2003 meeting the Monetary Policy Committee was confronted by a revision of the inflation figures by Statistics South Africa. Taking this revision and more recent economic developments into consideration, the Bank's forecast indicated that the inflation rate would move within the target range during the second half of 2003 and would come close to the mid-point of the target range in 2004. A number of other factors also influenced the decision to reduce the repo rate by 150 basis points at this meeting. First, the end of the war in Iraq had brought greater stability to the oil market. Second, it was clear that the exchange rate of the rand was maintaining its recovered levels in spite of continued volatility. Third, there were clear signs that inflation pressures emanating from abroad would remain weak. Finally, inflation expectations had declined in South Africa and domestic conditions generally favoured disinflation.

Another development at this meeting was the decision to increase the number of meetings of the Monetary Policy Committee from four to six per year. The previous decision to limit the number of scheduled meetings to four was prompted by the argument that the meetings should coincide with the availability of quarterly data. However, this led to long intervals between some meetings. It was therefore decided that even if the latest quarterly data were not available at each meeting, there should be enough high-frequency statistics to take informed decisions. More frequent meetings should have the added advantage of reducing the fear of sudden and unexpected interest rate adjustments, and in this way promote monetary policy transparency further.

On 14 August 2003, the Monetary Policy Committee announced a further reduction of 100 basis points in the repo rate to a level of 11 per cent. This decision was taken because the decline in the inflation rate continued to be in line with the Reserve Bank's projections and the inflation outlook generally remained favourable. However, the Committee expressed concern about the high rates of increase in some administered prices, the level of wage settlements, the continued strong performance of domestic demand and the acceleration in money supply growth in the second quarter of 2003.

Exchange rate policy

Exchange rate policy was left unchanged in the past year. As in the preceding year, the determination of the external value of the rand was left to the market and the Bank did not intervene in the foreign-exchange market to affect the level or direction of the exchange rate.

The exchange rate of the rand was quite volatile in the past year. Although the Bank would prefer to have greater exchange rate stability, fluctuations in the external value of the rand are unavoidable in the current international monetary system of generally floating exchange rates. We know from experience that even if the rand was pegged to another currency or to a basket of currencies, it would still float against most currencies and fluctuate widely at times.

The authorities can only aim at creating underlying economic conditions that are conducive to exchange rate stability. One of the factors that has contributed to the large fluctuations of the rand in the past has been the large oversold NOFP of the Bank. The Bank's stated objective has been to eliminate this open position, which stood at US$23,2 billion at the end of September 1998. During the past year the Bank purchased fairly modest amounts of foreign currency in the market at appropriate times, and also delivered the proceeds of the government's global eurobond issue of US$1,25 billion in May 2003 against the oversold forward exchange book of the Bank. These transactions converted the oversold NOFP of US$1,8 billion in mid-2002 to an overbought position of US$0,9 billion at the end of July 2003. Having removed this perceived vulnerability, the price discovery process in the foreign-exchange market has been displaying a better two-way trading pattern.

With the oversold NOFP now expunged, the Bank has shifted its focus to reducing its oversold forward book and to seeking over time to strengthen the official foreign exchange reserve position. The balance on the oversold forward book stood at US$4,1 billion at the end of July 2003, compared with US$7 billion at the time of the previous annual meeting of the Bank.

Stability in the banking sector

The liquidity problems experienced by smaller banks and the eventual erosion of the deposit base of some of the bigger banks in the first half of 2002, were resolved in a satisfactory manner during the past year. In this process, however, certain consequences for the banking industry could not be avoided. The activities of two of the larger banks, Saambou Bank Limited and BoE Bank Limited, were merged with those of the big domestic banks. In addition, the reluctance of depositors to place funds with smaller banks caused some of these banks to cancel their banking registrations, while others redesigned their ownership structures and downsized their balance sheets.

The turbulence experienced in the banking sector therefore resulted in a consolidation of activities before a return to stability was achieved. At the end of June 2003, approximately 83 per cent of total deposits by the public landed in the vaults of the big four banks. This has made it more difficult to start new banks or for small banks to remain in business, which could affect the availability of operational capital for new entrepreneurs.

Despite these developments, South Africa's banking system remains sound. Banks operating in the country are well capitalised, with an average risk-weighted capital adequacy ratio of 12,4 per cent at the end of June 2003. The liquidity of the banking sector was generally adequate, while the quality of assets remained high. A special independent investigation concerning corporate governance has also confirmed that South Africa's leading banks are committed to high standards of management. The banks adhere broadly to international best practice.

Although continued vigilance is required to ensure that banks comply with evolving standards, there are no major concerns in this regard. Banks are well on course to bringing their risk-management systems and data models in line with what could be required for compliance with Basel II in 2007. Following international corporate failures, accounting and auditing standards have been revised or are being overhauled. As part of the ongoing endeavours to ensure the quality and transparency of financial reporting, a shift was made during the past year away from historical cost to fair value accounting of financial instruments, i.e. the application of Accounting Statement AC 133. Compliance with these standards and new legislation are major tasks.

Another challenge facing the banking sector is to provide broader access to affordable financial services. A large portion of the population still does not have access to banking facilities. The financial sector is further in the process of developing a Financial Sector Black Economic Empowerment Charter to promote increased black ownership of and access to financial firms. Moreover, ever since the attacks on the World Trade Centre on 11 September 2001, the need for multilateral co-ordination to ensure continuity in financial systems has been high on the agenda of the banking sector. The Bank has assisted in the establishment of a Financial Sector Contingency Forum for such contingency planning.

Regional economic co-operation

The promotion of regional economic co-operation in Africa generally and in the Southern African Development Community (SADC) more specifically continues to form part of the other major activities of the South African Reserve Bank. The Bank fully supports the New Partnership for Africa's Development (Nepad) goals of accelerated growth and sustainable development, poverty eradication and reversing the marginalisation of Africa in the globalisation process. We will continue to play an active role towards the realisation of these ideals.

The Bank has also participated actively in the Committee of Central Bank Governors in the SADC region during the past year.

Internal administration

A number of changes were again made to the internal administration of the Reserve Bank in the past year. In particular, the reduction of costs without loss of productivity received high priority. Staff and operational costs were thoroughly scrutinised to minimise expenses. A moratorium was placed on appointments with effect from 1 August 2002 to reduce staff numbers. Moreover, voluntary early retirement packages were offered during April 2003 to staff members aged 50 and older to curtail costs. A total of 173 responses have been received to date, of which 114 staff members indicated that they accept the offer.

Cost reduction and improved efficiency in particular received attention in the fields of information and communication technology and in the cash handling strategy. To avoid duplication and save costs, the former Money and Capital Market Department and International Banking Department were also merged into one new department, the Financial Markets Department. Cost saving was also achieved in the Bank's subsidiaries by reducing staff, restructuring management and new marketing initiatives.

The training and development of staff continue to be important objectives of the Bank. In this regard the South African Reserve Bank College again played a major role by offering a variety of learning programmes. The various departments also put considerable effort into on-the-job training of staff members. The Bank is further committed to achieving its objectives for staff transformation by 2005, and reports annually on its progress to the Department of Labour in terms of the Employment Equity Act, No 55 of 1998.

In keeping with the decision of the shareholders on 25 April 2002 to terminate the listing of the Bank on the JSE Securities Exchange South Africa, an Over-the-counter Share Transfer Facility for trading Reserve Bank shares was established. This facility has delivered the desired results and 87 registrations in respect of 240 237 shares were effected up to 31 March 2003.

Finally, the extensions to the head office building, which were started in 2001, were completed. The building now meets the Bank's requirements in respect of office space, parking and conference facilities. Staff members who had to work in other buildings or who had to be relocated to other premises for the duration of the building alterations, have been moved back to the head office building.

Acknowledgements

All these improvements in the functioning of the Reserve Bank could only be achieved with the help of other persons and institutions. In conclusion, I therefore want to thank everyone who assisted the Bank to accomplish its objectives. In this regard I have to name the Presidency, the Government and Parliament for their support of our work. I also wish to express my appreciation to the Board of Directors of the Reserve Bank, including the deputy governors, for their commitment to the Bank. In particular, I want to thank Dr M T de Waal, who retired from the Board, for his contributions over the past years. Last but not least, I want to thank the management and staff of the Bank for the outstanding way in which they performed their duties.

This is a truly remarkable institution to be associated with.

Thank you.