Governor's Address at the eighty-fourth ordinary general meeting of shareholders

Introduction

At the beginning of my second term as Governor of the South African Reserve Bank (the Bank) I am pleased and grateful to report that most of the objectives set out in my first *Governor's Address* on 24 August 1999 have been achieved over the past five years. With the exception of a short period during 2002 and 2003 when exogenous factors led to an acceleration in price increases, inflation has been restricted to generally acceptable levels and inflation expectations have tended downwards. An inflation-targeting monetary policy framework with a well-organised decision-making process has been implemented. The transparency of monetary policy formulation has been improved considerably. Sound banking supervision in accordance with international best practice has been applied. On top of this, the internal administration of the Bank has been streamlined.

The Bank was again successful on many fronts during the past year. By far the most significant accomplishment was the decline in the rate of inflation to within the target range of 3 to 6 per cent as specified by government. From September 2003 the twelve-month rate of increase in the consumer price index for metropolitan and other urban areas excluding mortgage interest cost (the CPIX) has remained in the target range. Monetary policy was assisted by a number of factors in bringing inflation down, such as fiscal discipline, the recovery in the exchange value of the rand and slower rates of increase in food prices. What made this achievement even more remarkable was that it was accompanied by the longest upward phase of the domestic business cycle ever recorded.

Considerable progress was also made in dealing with the management of the international liquidity position of the Bank, which for a long time had been regarded as a negative factor in the assessment of the country by international rating agencies and investors. The negative net open foreign-currency position was finally expunged in May 2003 and the oversold forward book of the Bank was closed out during February 2004. With the accomplishment of these goals, the focus of the Bank shifted to gradually increasing the gross and net official international reserves.

Other milestones in the past year included improvements to domestic liquidity management, banking supervision practices and the national payment system; the progress made with the upgrading of the security features of banknotes and the R5 coin to deter counterfeiting; active participation in efforts to create greater regional economic co-operation; the containment of staff and operational costs; the training and education of employees; the development of a more effective and efficient staff policy framework; and the implementation of new accounting requirements to conform to international best practice.

International economic developments

The achievements of the Bank in the past year occurred within the context of a global economy recovering from the mild recession at the beginning of the decade, with growth gathering momentum from the second half of 2003. While the economic recovery appears to be underway in all regions of the world, the intensity of growth varies from region to region. The upturn has been most evident in Asia, especially China, and in the United States of America. Exports and investment spending caused growth to accelerate in Japan, while the United Kingdom's economy continued to perform well. Unfortunately, the recovery is the least established in the euro area – South Africa's largest trading partner. But in the first half of 2004 there were indications of a more rapid recovery.

The unemployment rate in most of the major industrialised countries started displaying a distinct downward trend from the middle of 2003. By contrast, the ratio of unemployed persons to the economic workforce in the euro area continued to increase to about 9 per cent in June 2004.

The global economic recovery was accompanied by a sharp rise in international oil and commodity prices. At first it seemed as if these increases in the cost of production of industrialised countries would be absorbed in profit margins. From the beginning of 2004 global inflation began to accelerate somewhat. However, this acceleration came from low levels.

The low level of inflation made it possible for the industrialised countries to pursue stimulatory fiscal and monetary policies. The United States, in particular, encouraged economic growth by increasing government expenditure, cutting taxes and maintaining the federal funds target rate at 1 per cent. These stimulatory policies led to a large fiscal deficit which, together with the continued and growing deficit on the United States' current account of the balance of payments, is creating concerns that an unsustainable situation might be developing.

From the end of June 2004 the federal funds target rate was raised on two occasions, signalling the adoption of a tightening monetary policy stance. Interest rates have also been increased in some other countries, including the United Kingdom, Australia and New Zealand. However, the European Central Bank has kept its official interest rate unchanged since June 2003, while the Bank of Japan has continued with its quantitative easing monetary policy and Canada has lowered its overnight rate on three occasions since the beginning of 2004.

International financial market conditions have improved since the beginning of 2003 in response to the easier monetary and fiscal conditions and higher asset prices. With the global economic recovery becoming well established, the risks to financial stability have diminished. There are nevertheless certain risks that need to be monitored carefully, such as geopolitical uncertainties, high international oil prices, large external and fiscal imbalances, the state of the Asian banking sector and the future path of exchange rates.

Domestic economic developments

The South African economy has been in an upward phase of the business cycle since the fourth quarter of 1999. This is the longest recorded period of economic expansion in the history of the country. However, in 2003 the growth in domestic production slowed down, reflecting a period of hesitant growth in the world economy and a recovery in the exchange rate of the rand. Both these factors led to a horizontal movement in the volume of merchandise exports, while a larger proportion of domestic demand was satisfied by means of increased imports.

Increased government expenditure on infrastructural development, tax reductions, a lowering of interest rates and annual increases in salaries and wages stimulated domestic demand and resulted in a more rapid rate of increase in domestic production from the beginning of 2004. The annualised growth rate of the seasonally adjusted real gross domestic product increased from 1 per cent in the second half of 2003 to 3 per cent in the first half of 2004. This more rapid rise in production was discernible in all the main sectors of the economy.

The average annualised rate of increase in real gross domestic product amounted to 3 per cent during the current upward phase of the business cycle. Although this rate of increase exceeded the population growth and accordingly led to an increase in the income *per capita* of the country, it was accompanied by a decline in employment. In the twelve months ended March 2004 the new *Survey of Employment and Earnings* shows a decline of 1,1 per cent, or about 73 000 job opportunities, in the formal non-agricultural sectors of the economy. Certain structural impediments still have serious repercussions for the attainment of high employment-creating growth. It will probably not be possible to solve this problem quickly, but economic policy should continue to be directed towards reaching the full growth capacity of the economy while maintaining price stability.

The economic expansion over a period of nearly five years was supported by strong growth in domestic expenditure. The average annual rate of increase in domestic final expenditure on goods and services amounted to about 4 per cent in the current upward phase of the business cycle, while the ratio of industrial and commercial inventories to gross domestic product fluctuated around a level of 15½ per cent.

The growth rate in final domestic expenditure rose considerably from 3½ per cent in the first half of 2003 to 6 per cent in the first half of 2004. All the main aggregates of expenditure contributed to the acceleration in domestic final demand. Growth in final consumption expenditure of households rose from 2½ per cent to 4½ per cent over the same period largely owing to an increase in real personal disposable income, the reduced cost of borrowing and rising real-estate values. A significant portion of this increased spending was on durable consumer goods with a high import content.

Growth in final consumption expenditure by general government rose from 4 per cent in the first half of 2003 to 6½ per cent in the first half of 2004. This increase was to a large extent the result of the acquisition of vessels by the South African Navy, while government's commitment to fiscal prudence was evident.

More importantly from a development perspective was the sharp increase in the growth of real gross fixed capital formation from an annualised rate of 7 per cent in the first half of 2003 to 12 per cent in the first half of 2004. Real capital outlays by the public sector expanded substantially over this period mainly because of expenditure on infrastructural projects and the purchases of additional aircraft by the South African Airways. Private fixed investment also rose strongly in view of the fact that the value of the rand encouraged the import of machinery and equipment.

As the growth in domestic expenditure exceeded the growth in domestic production, the current account of the balance of payments turned from a surplus balance in 2002 to a deficit balance in 2003 and the first half of 2004. In particular, the rise in expenditure caused the real value of imports to increase sharply, while the volume of exports of goods and services declined. Fortunately, South Africa's terms of trade with the rest of the world rose owing to a substantial increase in international commodity prices, with the result that the deficit on the current account as a ratio of gross domestic product amounted to about 1 per cent in 2003 and 2½ per cent in the first half of 2004.

This deficit was more than neutralised by a large surplus on the financial account of the balance of payments, which caused the gross gold and other foreign reserves of the country to rise. Most of the main categories of capital contributed to this financial inflow, with the main sources of external funding consisting of trade finance, foreign bank loans and deposits, portfolio capital and the takeover of some domestic companies.

Monetary and financial developments

The monetary and financial developments were characterised by continued strong growth in the money supply. The twelve-month growth rate in the broadly defined monetary aggregate (M3) fluctuated around a level of 12 per cent from the beginning of 2003, reflecting the rise in domestic expenditure and relatively lower interest rate levels. Although it might be difficult to associate these growth levels with long-term price stability, they were nevertheless well below the higher turning point in M3 growth of 23,5 per cent in May 2002. The availability of ample liquidity in the economy is also illustrated by the decline in the income velocity of circulation of M3 to a record low level in the first half of 2004.

Contributing to the growth in M3, the twelve-month rate of increase in the total loans and advances of banks to the domestic private sector accelerated to and remained around a level of 12 per cent during 2003 and the first quarter of 2004. The growth in the total loans and advances of banks to the private sector then declined somewhat to 8,9 per cent in June 2004 mainly because of a decrease in the overdrafts granted by banks, as some corporate borrowers preferred making use of bond issues rather than bank credit. However, the demand for asset-backed credit extended by banks remained strong. Mortgage advances continued to increase significantly, reflecting the sustained strong increases in house prices. In the past four years house prices have nearly doubled in all the main residential areas in South Africa.

In line with international equity markets, share prices on the JSE Securities Exchange SA (the JSE) started to recover from April 2003 and increased by 51,9 per cent to the beginning of March 2004. Partly as a result of a lack of confidence in the ability of companies to sustain earnings growth, the all-share price index then declined by 7,8 per cent to 31 July 2004.

Bond prices, which had increased from the beginning of 1999, continued to rise in 2003. This was reflected in a decline in the yield on the R153 bond from 10,76 per cent on 2 January 2003 to 8,83 per cent on 17 December. Shorter-term yields declined more than longer-term yields, which caused the inverted yield curve to normalise in the second half of 2003. The declines in long-term bond yields were restrained by an increased supply of government and corporate bonds in this maturity area. This supply of bonds to the market and a global upward trend in bond yields contributed to yields increasing from the middle of December 2003. For example, the R153 bond yield rose again to 10,26 per cent on 15 June 2004. Subsequently, a marked strengthening in the external value of the rand brought the R153 bond yield down to 9,62 per cent on 31 July 2004.

Public finance

The government deficit before borrowing and debt repayment as a ratio of gross domestic product amounted to 2,4 per cent in the 2003/04 fiscal year, compared with a ratio of 1,1 per cent in the preceding fiscal year. This increase in the deficit reflected the change to a somewhat more expansionary fiscal policy stance adopted by government which emphasised infrastructural investment. The government deficit was financed by the issuing of Treasury bills and government bonds. Helped by revaluation profits on foreign loans, the total government loan debt as a ratio of gross domestic product remained more or less unchanged at 37 per cent during the 2003/04 fiscal year.

The National Budget for fiscal 2004/05 continued to be formulated within a framework of fiscal discipline. A slightly more expansionary fiscal stance than in the previous year, with higher growth in expenditure than in revenue, is expected to result in a national government deficit of fractionally above 3 per cent of the estimated gross domestic product. Despite this increase, the ratio of government debt to gross domestic product is projected to remain fairly low.

Monetary policy

As already indicated, monetary policy was highly successful in the past year as a driving force in the achievement of greater price stability. In the wake of the depreciation of the rand in late 2001 and increases in the prices of food, oil and other administered goods and services, CPIX inflation measured over a period of twelve months accelerated to a peak of 11,3 per cent in October and November 2002. As a consequence, the Monetary Policy Committee (MPC) increased the repo rate in four steps by 400 basis points to 13,5 per cent during the period from January to September 2002. At first it was unclear whether these policy measures would be successful in bringing inflation down due to the possible impact of geopolitical uncertainties on oil and other international commodity prices. The increases in the interest rates, together with a decline in food prices and the recovery in the external value of the rand, had the desired effect. CPIX inflation declined to within the target range in September 2003. It then reached a twelve-month low of 4,0 per cent in December 2003 before rising to 5,0 per cent in June 2004.

By the middle of 2003 it became clear that the inflation rate would move into the target range, which provided scope for a change in the monetary policy stance. The repo rate was then reduced by a total of 550 basis points at five successive meetings of the MPC up to December 2003. This downward movement brought the official policy rate to 8 per cent, i.e. its lowest level since 1980. The current situation is, however, completely different to that of 1980. In that year the inflation rate was approximately 14 per cent. The real official rate was accordingly negative, whereas the real repo rate if deflated by CPIX was positive at a level of about 4 per cent in December 2003.

The reduction in the repo rate during 2003 was justified on a number of grounds. Firstly and most importantly, CPIX inflation was expected to remain comfortably within the target range over the next two years. This was confirmed by forecasts prepared with the help of the Bank's econometric models as well as by the MPC's assessment of other factors that impact on inflation.

Secondly, production price inflation, which is an indicator of future short-term movements in consumer prices, declined significantly and turned negative from September 2003. The decline in production prices could be ascribed to the effect of the exchange rate of the rand on import prices, but the rate of increase in domestic prices also slowed down to low but still positive levels.

Thirdly, the nominal effective exchange rate of the rand increased by 16 per cent in 2003.

Fourthly, inflation expectations, which play a major role in the price and wage formation process, declined significantly. This was clearly reflected in various surveys as well as by long-term bond rates.

In the fifth place, international oil prices, which had threatened to accelerate with the war in Iraq, settled at the top end of the target range of the Organization of the Petroleum Exporting Countries (OPEC).

In the sixth place, the rate of increase in food prices started to decline from the end of 2002 to relatively low levels in the second half of 2003.

A number of other factors were also supportive of the MPC's decision to ease the monetary policy stance. These included continued fiscal prudence, a relatively stable overall balance-of-payments position, no signs of supply constraints and generally subdued global inflation. Furthermore, with the inflation rate falling and expected to fall even further, this implied that real interest rates would rise if the repo rate remained unchanged. Combined with the recovery in the external value of the rand, an unchanged repo rate would have led to a tightening of monetary conditions in a generally favourable inflation environment.

Although the inflation outlook remained positive in the first half of 2004, the MPC kept the repo rate at a level of 8 per cent. At the meeting of the MPC in February 2004 the forecasts made with the Bank's econometric models indicated that CPIX inflation would remain within the inflation target range, but the projected trend was for inflation to increase to just below the upper end of the target range by the end of this year and to decline marginally during 2005. The upside risks to the inflation forecasts included the high level of wage settlements which were influenced by the high inflation in 2002; strong domestic demand for goods and services, in part as a response to lower interest rates; and continued high administered price increases.

Food price increases were also a cause for concern at the February meeting, following a marked increase in the maize price brought about by the worsening drought in many parts of South Africa. Fortunately, by the next meeting widespread rains had improved the crop outlook substantially, and maize prices moved below levels prevailing at the beginning of the year. Fears of high food price increases dissipated.

By April the oil price was regarded as a major risk factor for the attainment of the inflation target because crude oil prices had continued to rise steeply. The Brent crude oil price eventually reached US$40 per barrel in May 2004. This rise was the combined result of oil supply concerns and a strong demand for oil. The uncertainty about world oil production was affected by delays in restoring Iraq's oil production to pre-war levels, OPEC's reduction of oil output quotas in November 2003 and April 2004, as well as the ongoing geopolitical tensions in the Middle East. The robust growth in oil demand, especially in China and the United States, added further upward pressure to oil prices. These prices started to decline in June 2004 to levels around US$35 per barrel after OPEC agreed to increase output quotas by 2,0 million barrels per day in July 2004 and by a further 500 000 barrels per day in August, but the Brent price increased again to US$42 per barrel in early August 2004.

Although these exogenous developments in the prices of oil and food caused a deterioration in the short-term inflation outlook, the MPC realised that there is little that could be done about such shocks. The committee's approach to exogenous shocks is to accept the initial price effects of these events, while taking determined steps to prevent second-round or more generalised subsequent effects on prices.

Apart from these developments, there are other risks that could have an impact on the promising inflation outlook. Internationally, there are signs that the recovery in the global economy could result in a general increase in interest rates which could reduce the interest rate differential between South Africa and the rest of the world. Domestically, robust demand conditions are impacting on imports contributing to a widening in the deficit on the current account of the balance of payments, which is seen as a threat to the inflation outlook through its possible impact on the exchange rate of the rand. The continued firm rates of increase in nominal unit labour cost and the stronger trend in money supply growth are also perceived as possible threats to price stability.

Despite these concerns, there are sufficient positive factors that convinced the MPC that the inflation target would generally be achieved over the forecast period of two years. These include the low or negative production price inflation, the low global inflation, the low levels of capacity utilisation, fiscal discipline, more restraint in administered price increases and generally lower inflation expectations. These developments, together with an increase of 7½ per cent in the nominal effective exchange rate of the rand from 10 June 2004 to 11 August, led to the decision of the MPC to reduce the repo rate by 50 basis points to 7,5 per cent per annum from 13 August 2004.

Monetary operational procedures

The outstanding amount of liquidity withdrawn from the money market in the form of required cash reserve balances and open-market operations was reduced further during the past year. This outstanding amount increased to a peak of R80,4 billion at the end of August 2002 mainly due to the losses incurred on the oversold forward foreign exchange book of the Bank and the assistance that had to be provided to some banks experiencing large withdrawals of deposits. As a result of the repayment of the loans provided to these banks, the profits realised on the Bank's maturing forward foreign exchange contracts arising from the appreciation of the rand against the US dollar, and the permanent drainage of liquidity through the maturing of short-dated bonds in the Bank's bond portfolio and outright sales of bonds by the Bank, the outstanding amount of liquidity withdrawn from the market was reduced to R25,8 billion at the end of December 2003, before it rose again to R42,3 billion at the end of July 2004.

This reduction in the amount of liquidity that the Bank had to drain from the money market increased the flexibility of the Bank in deciding what instruments should be used in operational procedures, and thereby substantially reduced the cost of these operations. From the end of November 2003 the Bank no longer used foreign exchange swaps with counter deposits to drain liquidity from the market. Liquidity is now withdrawn from the market mainly by means of longer-term reverse-repo transactions, the issuing of Reserve Bank debentures and outright sales of government securities held by the Bank.

Foreign exchange reserves

The external value of the rand is basically determined by supply and demand in the market for foreign currency. However, the Bank has been purchasing dollars from the market amounting to US$10,4 billion from the beginning of 2003 to 31 July 2004 with the objective of increasing the foreign exchange reserves. As a consequence of this policy and by acquiring the proceeds arising from the government's external borrowing programme, the Bank was able to expunge its negative net open foreign-currency position in May 2003. The oversold forward foreign exchange book was subsequently closed out in February 2004. We are convinced that over time the removal of these structural deficiencies should contribute to attaining a more stable exchange rate of the rand than that experienced in recent years. This should hopefully also make the country less vulnerable to external financial shocks and improve the prospects for further upgrades in South Africa's international credit ratings.

The policy followed by the Bank led to an increase in the official gross gold and foreign exchange reserves from US$7,8 billion at the end of December 2002 to US$11,8 billion at the end of July 2004, while the Bank's reserve-related foreign loans increased slightly over this period. Although cognisance is taken of a number of international benchmarks that can be used to determine an appropriate level of foreign reserves, the Bank does not target a specific level of reserves or a time frame within which such a level should be achieved. Reserves are gradually accumulated as permitted by market conditions and the prudent management of the Bank's balance sheet.

The continued and broad-based weakness of the US dollar in the international currency markets was one of the major factors which caused the rand to appreciate by 30 per cent against the US dollar and by 16 per cent on a trade-weighted basis during 2003. The external value of the rand was also supported by a combination of other factors, including greater price stability, rising precious metal and other commodity prices, relatively higher domestic interest rates than those of industrialised countries, the removal of the structural impediments in the foreign exchange market referred to above and generally improved international perceptions about the fundamentals of the South African economy.

The significant upward movement in the external value of the rand levelled off in the first five months of 2004, but then resumed in the next two months. At the end of July 2004, the nominal effective exchange rate of the rand was 9 per cent above its level at the end of December 2003. As a result of these nominal changes and the production price differential between South Africa and its main trading-partner and competitor countries, the real effective exchange rate of the rand increased by 18½ per cent from December 2002 to April 2004.

Financial stability

The success in attaining the objective of price stability depends to a large extent on stability in the financial sector. Financial stability requires a robust financial system, a sound regulatory environment, effective macroprudential surveillance and public confidence in financial institutions and markets. Although the Bank is not solely responsible for the overall financial stability in the country, it has four broad functions in the maintenance of stable conditions in financial institutions and markets, namely:

1. To provide an adequate supply of high quality banknotes and coin.

2. To ensure the overall effectiveness and integrity of the national payment system.

3. To promote the soundness of banks through the effective application of internationally acceptable regulatory and supervisory standards.

4. To identify and analyse potential systemic threats to and weaknesses of the financial system as a whole which could affect banks and reduce monetary policy effectiveness.

1. Currency in circulation

   An economy can only function smoothly when there is an adequate supply of domestic currency. In the past year the Bank again met all the distribution and circulation requirements of banks and the cash industry. At the end of June 2004 the value of banknotes and coin in circulation amounted to R43,6 billion, or about 16 per cent more than at the end of June 2003. This increase can be ascribed to the high growth in domestic expenditure. As a ratio of gross domestic expenditure, the banknotes and coin in circulation outside the Bank receded slightly to just below 3½ per cent over the same period.

   It is not only important to have an adequate supply of currency, but the banknotes and coin in circulation must also be of a high quality. The current banknote series has been in existence since 1992. This long period in which the banknotes have been in use makes them more prone to counterfeiting. The security features of the banknotes are therefore being upgraded to deter counterfeiting. A new R5 coin has been minted to ensure further quality maintenance. In addition, a campaign was launched to increase public awareness of and vigilance against fraudulent imitations.

2. National payment system

   Another important prerequisite for financial stability is an efficient payment system which facilitates the flow of funds between transactors. The need for central clearing and settlement facilities essentially arises because payment instruments drawn on one bank will in many instances be deposited at another bank. Settlement then has to take place between the two banks concerned with as little risk as possible.

   In line with international best practice the South African Multiple Option Settlement (SAMOS) system was introduced in 1998 to reduce risks involved in settling by catering for real-time gross interbank settlement. SAMOS provides the banks with multiple settlement options, including liquidity-optimising functions. The system also caters for the settlement of transactions in the bond and equity exchanges. In the past five years many risk-reduction improvements have been made to the system. In the 2003/04 financial year a revised cost recovery model was implemented to achieve full cost recovery of SAMOS operations during the year in which the costs are incurred, as opposed to the previous model which only allowed for full cost recovery on a five-year rolling basis.

Considerable progress was made in the past year towards the inclusion of the rand as a settlement currency in the Continuous Linked Settlement (CLS) system. In February 2004 the CLS Board granted approval, in principle, for the inclusion of the rand in the CLS system. Final ratification of the rand's inclusion will be given later in 2004. The objective of CLS is to reduce foreign exchange settlement risk. This is achieved by the synchronisation of the settlement of the two legs of a foreign exchange transaction in a single time zone within the CLS Bank in London.

The drafting of the National Payment System Amendment Bill was completed. The Bank has embarked on a consultation process to inform all interested parties of the changes proposed in the bill. The objectives of the amendments are to enhance the regulatory and supervisory powers of the Bank and to address the inclusion of the domestic currency in the CLS system.

3. Banking regulation

A major development in the field of banking regulation during the past year has been the finalisation of the new capital accord (Basel II) in June 2004. The Basel Committee on Banking Supervision finally reached consensus on the remaining outstanding issues and proposed, *inter alia*, that the more simple methods of measuring bank risks be applied from the end of 2006. The more advanced approaches to risk measurement will only be implemented from the end of 2007 after a further impact analysis has been completed. This decision is in line with the intended implementation of Basel II in South Africa that was adopted by the Bank and communicated to all stakeholders in February 2004.

In its first consultative document regarding the implementation of Basel II in South Africa, the Bank made it clear that it was not in favour of the operation of a dual supervisory system and that all banks will be required to change to any of the simpler approaches of Basel II from a specific date. In addition, the Bank indicated that it expects the more sophisticated banks to adopt the most advanced approaches over time so that the risk management practices of South African banks are in accordance with international best practice. Foreign bank branches and subsidiaries wishing to make use of the advanced approaches will be allowed to do so, but the home country supervisors will be expected to monitor this process. The Bank will, of course, adhere to the principles of cross-border implementation of the Basel Committee.

The Bank has established a consultative structure, the Accord Implementation Forum, to ensure that adequate consultation takes place with banks and that each aspect of the implementation of Basel II is carefully examined. Topics that have already been earmarked for discussion include the preparation of data that are necessary for the validation of internal risk models and the likely impact of the various policy options that could be followed by the South African regulatory authorities.

In co-operation with the National Treasury, the Bank is involved in a number of initiatives to strengthen further the risk management capacity of the banking system, such as:

(a) A comprehensive study of the effectiveness of competition between banks.

(b) A joint task team to consider the need for further integration of financial regulation. The objective is to review the existing financial regulatory environment and to recommend an institutional framework that is regarded as most appropriate for effective regulation.

(c) A new draft policy paper on the most suitable deposit insurance scheme for South Africa. The recommendations to be made in this paper will be an update of the proposals made in a previous investigation.

In the past year the Bank continued to monitor and support initiatives to broaden access to financial services. It participated actively in the NEDLAC Financial Sector Transformation Task Team, discussing issues such as the *Financial Sector Charter*, credit bureau regulation, support measures for co-operative banks and a review of consumer law. The Bank is a proponent of the *Financial Sector Charter*, which could facilitate access to financial services for poor households and communities and promote investment in transformation infrastructure, agricultural development, low-income housing and small and medium businesses. In order to encourage the extension of banking services to these entities further, the Bank has started with the drafting of legislation to create a second tier of dedicated commercial banks and is co-operating in the establishment of a third tier of community-based co-operative banks.

4. Stability of the banking sector

The South African banking system is sound. The turbulence experienced in 2002 was resolved relatively quickly, but led to a consolidation of activities and a reluctance on the part of depositors to place funds with smaller banks. From April 2003, however, deposits slowly started to flow back to the smaller banks as confidence in their viability started to improve. At the end of June 2004 the big four banks' share of total deposits amounted to 82,6 per cent, which was 2,5 percentage points lower than in March 2003 but is still more than 10 percentage points above the levels of early 2002.

Banks are well capitalised and their liquidity is adequate. The average risk-weighted capital adequacy ratio came to 13,3 per cent at the end of June 2004, which was somewhat higher than the 12,3 per cent at the end of June 2003 and well above the minimum regulatory requirement of 10 per cent. The average daily amount of liquid assets held by banks in June 2004 exceeded the minimum requirement by 22,8 per cent. Banks remained well managed and the efficiency ratio, the yield on equity and the return on assets improved over the past twelve months.

Total assets of banks grew rapidly in 2003 mainly because of changes in regulatory and accounting practices that require many previously off-balance sheet items to be included in balance sheets. As this strong growth was mostly of a technical nature, the upward trend was not sustainable and moderated in the first half of 2004. At the end of June 2004 the total assets of the banks had increased to R1 349 billion, compared with R1 345 billion at the end of June 2003.

Not only did the total assets of banks rise, but the quality of assets also improved. Non-performing loans, i.e. loans that are more than 180 days overdue or are considered to be irrecoverable, declined from R25 billion at the end of June 2003 to R21 billion at the end of June 2004. At this latter date the non-performing loans represented only 2 per cent of the total loan book. Provisioning by banks for non-performing loans remained more than adequate. At the end of June 2004, 65,6 per cent of non-performing loans and advances were provided for specifically and 37,9 per cent were covered by the market value of securities.

Broader indicators of credit risk also suggest that the South African banking sector is sound. The twelve-month growth rate in bank credit extension to the corporate sector has declined significantly over the past year from 14½ per cent in June 2003 to 2½ per cent in June 2004. The decline in the growth of bank credit to corporates was to some extent due to the use of funding outside the banking sector by means of corporate bond issues. The ratio of interest-bearing debt to total funding of industrial enterprises quoted on the JSE has, however, showed a distinct downward trend since the beginning of the decade, indicating that corporates are probably making more use of equity than debt financing.

Although household debt as a percentage of household disposable income has risen from 50,7 per cent in the fourth quarter of 2002 to 54,3 per cent in the second quarter of 2004, the level of this ratio is still low compared with levels recorded in the 1990s. The nominal cost of interest is also lower. Moreover, the number of insolvencies and liquidations has declined.

Regional economic co-operation

The Bank again gave considerable attention to promoting economic co-operation in Africa, and more specifically in Southern Africa, during the past year. The success of the New Partnership for Africa's Development (Nepad) in producing solutions for Africa's economic, political and social problems is crucial to attract foreign investment to the continent. A concerted effort is required to reverse the declining levels of savings and investment in many African countries, to promote intra-regional trade and to develop regional economic communities into competitive markets.

In Southern Africa, the Bank continued to be involved in the various activities of the Committee of Central Bank Governors in the Southern African Development Community, the Common Monetary Area and the East and Southern Africa Banking Supervisors Group. In addition, the South African Reserve Bank College again played a vital role in enhancing central banking skills by propagating internationally accepted best practice in its capacity-building initiatives.

Internal administration

In the internal administration of the Bank continued emphasis was placed on the reduction of costs without loss of efficiency. The moratorium on external appointments, which had come into effect on 1 August 2002 as part of the effort to reduce staff numbers, remained effective during the past year, but has been adjusted to enable selective external recruitment when specific skills are needed. In addition, the voluntary early retirement programme was concluded with 173 staff members aged 50 and older opting to take the enhanced retirement package. Because of these measures the Bank's staff complement was reduced from 2 338 on 31 August 2002 to 2 007 on 30 June 2004. Careful control over other operating costs restricted its growth to only 6½ per cent in the 2003/04 financial year if the costs of new currency issues are not taken into account.

Despite the reduction in staff numbers, the Bank succeeded in progressing towards its ultimate goal of a workforce reflecting at all levels of seniority the demographic and gender composition of the South African population. At the end of June 2004 the total workforce consisted of 54,1 per cent black people and 45,6 per cent females, a considerable improvement on the numbers five years ago.

The Bank continues to regard the development of its employees as a major responsibility. Considerable time and money are invested each year in the training and education of staff. The South African Reserve Bank College plays a leading role in this regard to promote the central banking skills of people employed by the Bank. On-the-job training received considerable attention and employees attended various courses at domestic and international educational institutions to improve their competencies. Apart from the proficiencies required in daily activities, the Bank is also concerned with the well-being of its employees. A number of awareness campaigns on health issues were held with the aim of promoting a healthy workforce.

Emanating from the emphasis on cost management and employment equity, a working group was established to review the Bank's *Staff Manual* and staff-related policies. As part of transforming the Bank, there is a need to modernise staff policies and bring them in line with the general practice in the market. The working group has reviewed 41 policies, which will comprise the new *Staff Manual* after approval by the Governor's Committee and consultation with the staff.

In the area of information and communication technology, several initiatives were undertaken which should result in lower costs, increased security and greater efficiency. A Security Management Centre was established to prevent hacking activities, virus attacks and other vulnerabilities. The firewall infrastructure was upgraded to improve protection against breaches through the Internet. In addition, an information security control framework consisting of high level policies, procedures, processes and standards is being developed to enhance control and compliance capabilities.

In the past year the Bank decided to comply with the new South African Statement on Generally Accepted Accounting Practice, Statement AC133. This statement is the equivalent of the International Accounting Statement IAS39, that is still the subject of intense debate in the accounting world. Preparation for its implementation placed a considerable burden on the Board, Audit Committee, management and external auditors of the Bank. The Bank now complies in all respects with the requirements of the statement except that gold reserves in terms of AC133 should be regarded as a commodity and not as a financial asset. As this is not acceptable, gold was valued at its statutory value and not at cost as is required for a commodity.

The Over-the-Counter Share Transfer Facility established for transfer of the Bank's shares continued to deliver the desired results. In the year to 31 March 2004, 23 registrations in respect of 71 201 shares were effected.

Another important administrative development during the past year was the conclusion of a Memorandum of Understanding between the National Treasury and the Bank which sets out a framework for a consultative process to oversee macroeconomic, banking, financial and regulatory issues. Three standing committees were formed under this agreement to achieve effective communication between the National Treasury and the Bank and to promote harmonisation of monetary and fiscal policies. These standing committees are the Macroeconomic Issues Committee, the Banking and Financial Markets Committee and the Financial and Regulatory Issues Committee.

Conclusion

From this brief description of the activities of the Bank, it can be concluded without any doubt that 2003/04 was a highly successful year. Of particular significance was the attainment of the inflation target, which allowed for a reduction in nominal money-market interest rates. It is of utmost importance that the current relatively low rates of inflation be maintained in the coming years so that inflation expectations become a minor factor in the planning of businesses and households. If this can be achieved, we shall have finally succeeded in bringing about price stability. Price stability is a precondition for reaching the full growth capacity of the economy, but it will not automatically lead to this desired outcome. High employment-creating growth can only be achieved if price stability leads to higher domestic savings and investment and becomes a major factor in the decisions of foreign investors to establish new enterprises in South Africa.

In the years ahead the Bank will continue to strive for the achievement of even greater excellence. The thrust of monetary policy will be the maintenance of price stability, while market-oriented operational procedures will be used in domestic and international liquidity management. Sound banking supervision based on international best practice will be applied, while risks in the broader financial sector will be monitored carefully. Great emphasis will also be placed on capacity building and enhancing skilled human resources.

Acknowledgements

All the accomplishments of the Bank were dependent on the assistance of a large number of people. Although I am unable to name them all on this occasion, I want to thank the Presidency, the Government and Parliament for the support that we received during the past year. The Board of Directors of the Bank again showed their commitment to the achievement of our goals, for which I thank them sincerely. In particular, I want to express my appreciation to Mr B P Gilbertson and Ms G Marcus who are no longer members of the Board. Finally, a word of thanks is also due to the senior management and staff of the Bank for their excellent work and the dedicated way in which they performed their responsibilities during the past year. Ours is truly a central bank to be proud of.