South African Reserve Bank

Governor's Address

Condensed Address of Mr T T Mboweni, Governor of the South African Reserve Bank, at the eighty-fourth ordinary general meeting of shareholders of the Bank on 24 August 2004 in Pretoria

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* have been achieved over the past five years. 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. Considerable progress was also made in dealing with the management of the international liquidity position. Other milestones included improvements to domestic liquidity management, banking supervision practices and the national payment system; progress made with the upgrading of the security features of banknotes and the R5 coin; 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.

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. In the first half of 2004 some of the industrialised countries started to pursue somewhat less accommodating policies.

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. 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. This acceleration 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. Certain structural impediments still have serious repercussions for the attainment of high employment-creating growth.

The economic expansion was supported by strong growth in domestic expenditure. The average annual rate of increase in final domestic demand amounted to about 4 per cent in the current upward phase of the business cycle. 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, but significant from a development perspective was the growth of 12 per cent in real gross fixed capital formation.

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. 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.

In line with international equity markets, share prices on the JSE Securities Exchange SA 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. The increase in the supply of bonds to the market and a global upward trend in bond yields contributed to a rise in the R153 bond yield 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, emphasising infrastructural investment.

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. 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. These increases, together with a decline in food prices and the recovery in the external value of the rand, had the desired effect. CPIX inflation declined from 11,3 per cent in November 2002 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.

These results provided scope for a change in the monetary policy stance. The repo rate was accordingly reduced by a total of 550 basis points at five successive meetings of the MPC from June to December 2003. This downward movement brought the official policy rate to 8 per cent, i.e. its lowest level since 1980.

The reduction in the repo rate 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. Secondly, production price inflation declined significantly and turned negative from September 2003. Thirdly, the nominal effective exchange rate of the rand increased by 16 per cent in 2003. Fourthly, inflation expectations declined significantly. In the fifth place, international oil prices settled at the top end of the target range of the Organization of the Petroleum Exporting Countries. 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.

Although the inflation outlook remained positive in the first half of 2004, the MPC kept the repo rate unchanged because of certain upside risks. These risks included the high level of wage settlements which were influenced by the high inflation in 2002, strong domestic demand for goods and services and continued high administered price increases.

Food price increases were also a cause for concern at the February 2004 meeting, but fears of high food price increases dissipated with subsequent widespread rains. 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.

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. 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. 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. Liquidity is now withdrawn from the market only by means of longer-term reverse-repo transactions, the issuing of Reserve Bank debentures and outright sales of government bonds 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 negative net open foreign-currency position was expunged in May 2003 and the oversold forward foreign exchange book was closed out in February 2004. This policy also 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 reserve-related foreign loans increased slightly over this period.

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 on a trade-weighted basis by 16 per cent during 2003 and by 9 per cent in the first seven months of 2004. 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 and generally improved international perceptions about the fundamentals of the South African economy.

Financial stability

The success in attaining the objective of price stability depends to a large extent on stability in the financial sector. The Bank 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 high quality domestic currency. In the past year the Bank again met all the distribution and circulation requirements of banks and the cash industry. The current banknote series has been in existence since 1992, which 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. 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 the South African Multiple Option Settlement operations during the year in which the costs are incurred. Considerable progress was also made towards the inclusion of the rand as a settlement currency in the Continuous Linked Settlement system and the drafting of the National Payment System Amendment Bill was completed.

3. Banking regulation

A major development in the field of banking regulation has been the finalisation of the new capital accord (Basel II) in June 2004. It was decided, *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 application of Basel II in South Africa that was adopted by the Bank and communicated to all stakeholders in February 2004. The Bank has established a consultative structure to ensure that each aspect of the implementation of Basel II is carefully examined.

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 and it has continued to monitor and support initiatives to broaden access to financial services.

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.

Banks are well capitalised and their liquidity is adequate. Banks remained well managed and the efficiency ratio, the yield on equity and the return on assets improved over the past twelve months. The total assets of banks rose, but the quality of assets also improved. Non-performing loans declined from R25 billion at the end of June 2003 to R21 billion at the end of June 2004.

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 from 14½ per cent in June 2003 to 2½ per cent in June 2004. 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.

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 regional structures.

Internal administration

In the internal administration of the Bank continued emphasis was placed on the reduction of costs without loss of efficiency. As a consequence, 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.

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. In the area of information and communication technology, several initiatives were also undertaken which should result in lower costs, increased security and greater efficiency.

Other important administrative developments included compliance with the new South African Statement on Generally Accepted Accounting Practice, Statement AC133 and 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.

Conclusion

In conclusion, it must be emphasised that 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.