South African Reserve Bank

Governor's Address

Condensed Address of Mr T T Mboweni, Governor of the South African Reserve Bank, at the eighty-fifth ordinary general meeting of shareholders of the Bank on 24 August 2005 in Pretoria

Introduction

I am pleased to be able to report on another successful year for the South African Reserve Bank. This applies to all facets of the activities of the Bank. Against the backdrop of a fast-growing but uncertain international economy, we have been able to maintain and surpass our previous successes on the inflation front. The consolidation of inflation at low levels has enhanced macroeconomic stability and has contributed to the strong growth in the South African economy.

A stable and well regulated financial system is an important ingredient of sustained economic success. Financial sector stability has been maintained over the past year, and good progress has been made with preparations for the implementation of Basel II. Further highlights include modifications to the refinancing system of the Bank and the introduction of an upgraded series of banknotes and a new R5 coin.

Another indicator of success has been the sustained capital inflows into the country which have allowed for the continued build-up of the official foreign reserves. This, in turn, has contributed to increased exchange rate stability.

A significant milestone was reached when the rand was included in the Continuous Linked Settlement (CLS) system. The rand is now one of only 15 currencies settling through CLS.

International economic developments

Although global economic growth moderated in the second half of 2004, world output still grew at a rate of 5,1 per cent for the year as a whole. Real output growth in the United States of America generally remained firm while real economic growth in the euro area, South Africa's largest trading partner, was comparatively disappointing. Growth in most developing countries, including those in Africa, exceeded expectations. World inflation remained subdued.

Notwithstanding this positive environment, the world economic outlook remained clouded by large global imbalances and rising crude oil prices. The current-account deficit of the United States recently widened beyond 6 per cent of the country's gross domestic product.

The robust global economic environment boosted demand for energy. Despite several increases of official output quotas by the Organization of the Petroleum Exporting Countries (OPEC) since the beginning of 2004, crude oil prices reached new record high levels in nominal terms. This was exacerbated by historically low spare production capacity in OPEC, geopolitical tensions and the threat of oil production disruptions in a number of countries.

It is difficult to discern a world-wide trend in official interest rates over the past year. In the United States, the federal funds target rate was increased to 3,50 per cent in August 2005, the tenth consecutive 25-basis-point increase since the middle of 2004. The Bank of England decreased its key policy rate in early August 2005. The European Central Bank has kept interest rates unchanged since 2003, while the Bank of Japan last eased monetary policy in January 2004.

Despite these divergent policy directions, global official interest rates in general have remained relatively low. Credit spreads narrowed, and under these comparatively liquid circumstances, lending expanded briskly with real-estate and equity prices surging in many parts of the world.

Domestic economic developments

The South African economy has been in an upward phase of the business cycle since September 1999, the longest period of economic expansion in the recorded economic history of South Africa.

In the third quarter of 2004, economic growth reached 5,7 per cent at an annual rate. Subsequently, growth declined to an annualised rate of 3,9 per cent in the first half of 2005. This moderation in growth can be attributed mainly to a less favourable external environment and to the relative strength of the external value of the rand which curbed the competitiveness of the goods-producing sectors of the economy.

Economy-wide employment outside the agricultural sector responded with a lag to the improvement in domestic output levels and recorded successive increases in each of the five quarters to September 2004. This improvement was, however, not sustained in the subsequent two quarters.

Real worker remuneration increased over the past two calendar years. Together with the improvement in employment levels, these increases provided a strong boost to aggregate household income. Consequently, real final consumption expenditure by households grew by 6,1 per cent in 2004 and at an annual rate of 6,0 per cent in the first half of 2005.

Real general government final expenditure exhibited high growth rates of 7,2 per cent in 2004 and 5,3 per cent at an annual rate in the first half of 2005, thereby contributing to the expansion of aggregate real domestic expenditure.

Impressive growth in real fixed capital formation of 9,4 per cent in 2004 moderated somewhat to an annualised rate of about 9 per cent in the first half of 2005. Nonetheless, the ratio of gross fixed capital formation to gross domestic product is still only about 17 per cent.

With gross domestic expenditure exceeding gross domestic product over the past two-and-a-half years, the current account of the balance of payments recorded a deficit throughout this period. As a ratio of gross domestic product, the deficit on the current account widened from 2,9 per cent in the first half of 2004 to about $3^1/_2$ per cent in the first half of 2005. These deficits have been comfortably financed by substantial surpluses on the financial account of the balance of payments, leading to a rise in the country's gross gold and foreign exchange reserves.

Monetary and financial developments

The growth over twelve months in loans and advances extended to the private sector by monetary institutions accelerated vigorously to 22,1 per cent in June 2005. Low interest rates, strong business and consumer confidence, a rebound in the corporate sector's demand for bank-intermediated funding and the buoyancy of the real-estate and securities markets supported the strength of private-sector credit extension. Asset-backed credit has grown at twelve-month rates in excess of 20 per cent since October 2004. Household debt rose briskly to 61 per cent of annualised household disposable income by mid-2005. With lower interest rates, household debt service cost relative to household income, nevertheless, remained relatively low.

Linked to the buoyant credit extension, the money supply has also increased rapidly. Growth over twelve months in M3 accelerated from 11,1 per cent in May 2004 to 17 per cent in June 2005. The strong growth in M3 was a reflection of the persistently robust expansion of nominal domestic income and expenditure, augmented by rising asset values and the increased access to banking services enjoyed by previously unbanked segments of South African society.

The monthly average price level of all classes of shares listed on the JSE Limited increased by 45 per cent from July 2004 to July 2005 and new record-high levels were reached in August 2005. The yield on long-term bonds fluctuated around a declining trend as the prospects for sustained low inflation improved.

The real-estate market remained buoyant during the past year, but the rate of increase in real-estate prices tapered off in the course of 2004 and the first seven months of 2005.

Public finance

The quest for price stability in South Africa continued to be strongly supported by government's management of its financial affairs. The government deficit before borrowing and debt repayment as a ratio of gross domestic product, declined to 1,5 per cent in the 2004/05 fiscal year. The National Government Budget for fiscal 2005/06 was again formulated within a framework of fiscal discipline with more emphasis on infrastructure development.

Monetary policy

At the previous ordinary general meeting, I was pleased to report that changes in the consumer price index for metropolitan and other urban areas excluding mortgage interest cost (CPIX), had been within the target range of 3 to 6 per cent since September 2003. In the past year, this performance has been consolidated at lower levels and with lower variability. Since July 2004, CPIX-inflation measured over twelve months, has averaged 3,9 per cent.

In January this year, services price inflation fell below the 6-per-cent level for the first time since the introduction of inflation targeting. An important contributor to this trend was the behaviour of administered prices. Since July 2004, production price inflation also continued at a low level, averaging 1,7 per cent.

These favourable inflation developments and an improving inflation outlook resulted in an easing of monetary policy. The repurchase rate was lowered by 50 basis points in August 2004 and again in April 2005, down to 7 per cent per annum.

A development of note during the year was the evolution of inflation expectations. The effectiveness of monetary policy is dependent on its credibility which, in turn, is reflected in expectations of future inflation. Surveys conducted by the Bureau for Economic Research at the University of Stellenbosch, have shown a marked and consistent decline in inflation expectations over the past year. By the first quarter of 2005, inflation expectations of all categories of respondents, and for all three forecast years, had declined to within the inflation target range.

Over the past year, forecasts by the Bank have also shown a progressive improvement in the inflation outlook. Other positive factors that underpinned the improving inflation outlook were the continuing strength of the external value of the rand, the lack of capacity constraints in the economy, continued fiscal discipline, low food price inflation and low world inflation.

During the year, however, there were a number of factors which were perceived as threats to the inflation outlook. Foremost among these concerns has been the rise in international oil prices which resulted in significant petrol price increases over the period. At times, these increases appeared to threaten the sustainability of low inflation within the target band.

The Monetary Policy Committee (MPC) reaffirmed its view that monetary policy would not respond to first-round effects of such exogenous shocks, but would be vigilant with respect to possible second-round effects. Fortunately, the impact of the international oil price rise on domestic inflation has been far more muted than initially feared.

Another area of focus for monetary policy has been the strength of domestic demand, which resulted in higher retail sales, record motor vehicle sales and rising house prices. It also contributed to the widening current-account deficit on the balance of payments. Despite these developments, there was, on balance, little evidence of adverse effects on inflation. The current-account deficit was also felt to be sustainable, given the level of capital inflows.

The repurchase rate decrease in April 2005 was interpreted by some commentators as a change in the objective of the Bank, from low inflation to the external value of the rand. However, changes in the exchange rate are an important factor in the inflation process in South Africa. The stronger rand was expected to have a direct impact on inflation through the price of imports. At the same time, the strong exchange rate impacts negatively on the goods-producing sectors of the economy. This resultant widening in the gap between actual and potential output would also have a moderating effect on the inflation outlook. The reduction in the repurchase rate was, therefore, not a result of a focus on the strong rand, but on the favourable inflation outlook.

Monetary operational procedures

With effect from May 2005, the Bank introduced certain modifications to its refinancing system. The main objective of the changes was to reduce the daily involvement of the Bank in influencing money-market liquidity in order to facilitate a better functioning interbank market and liquidity management by banks.

The modifications to the refinancing system aim to streamline the refinancing operations of the Bank by making them simpler and more transparent. These changes should contribute to a more efficient and flexible framework for liquidity management in the money market, including wider access for banks to refinancing by the Bank. Banks are also encouraged to take more responsibility for managing their own liquidity needs.

The Bank is satisfied with the outcome of these changes. The banks now rely less on the Bank to square off their positions at the end of each trading day and, instead, they make frequent use of the standing facilities and their cash reserve balances held with the Bank.

Foreign reserves

The Bank continued to increase its foreign reserves by purchasing foreign exchange in the market as and when circumstances allowed. Over the past few months, this process was assisted by foreign exchange purchases arising from a large foreign direct investment transaction. As a consequence, the official gold and foreign exchange reserves improved to US$18,9 billion at the end of July 2005 compared to US$8,3 billion in February 2004, when the oversold forward foreign exchange book was finally closed out. The international liquidity position stood at US$15,4 billion at the end of July 2005.

The Bank does not target a specific level of foreign reserves or a time frame within which a particular level of foreign reserves should be achieved. Reserves accumulation continues to take place as permitted by market conditions and the prudent management of the balance sheet of the Bank.

The efficient management of the foreign reserves remains a strategic priority. At the end of July 2005, 15,1 per cent of the total foreign exchange reserves were managed by external fund managers, with the balance being managed internally.

The Bank continued to borrow around US$3,5 billion of its gross reserves. The Bank also took advantage of favourable market conditions by refinancing some of its existing loans in the international markets.

A formal process involving the National Treasury and the Minister of Finance was concluded in March 2005, whereby the definition of the statutory gold price was revised in line with international practice and reporting requirements to reflect the market value of gold reserves.

Exchange rate developments

The rand continued to be largely influenced by the value of the US dollar in the international currency markets, which itself was influenced by uncertainty about the strength and distribution of global growth, the outlook for inflation and interest rates and structural imbalances in the world economy.

The exchange rate of the rand ended the 2004/05 financial year almost unchanged from the levels prevailing twelve months previously. From the end of March 2004 to the end of March 2005, the nominal effective exchange rate of the rand depreciated by only 1,5 per cent. Over the same period, the rand appreciated by 1,5 per cent against the US dollar. During the course of the year, however, some movement was evident.

Mostly owing to the stronger tenor of the US dollar in 2005, the rand weakened by 6,8 per cent on a trade-weighted basis from the end of December 2004 to the end of March 2005. Over the same period, the rand weakened by 9,7 per cent against the US dollar. This softer trend for the rand endured into the new financial year, and to the end of July 2005 the rand weakened further by 1,3 per cent on a trade-weighted basis and by 5,9 per cent against the US dollar.

The real effective exchange rate of the rand appreciated by 3,1 per cent during the financial year. The average real effective exchange rate in the first five months of 2005 was marginally stronger than the average for 2004. The rand remains generally well supported by a number of factors. These include the continued strength in commodity prices, capital inflows, a sound macroeconomic policy environment and the upgraded sovereign ratings of South Africa.

Financial stability

While the pursuit of price stability is the primary focus of the Bank, we also have a role to play in the stability of the financial system. Financial system instability can cause considerable macroeconomic costs, impacting on the main task of monetary policy. While the supervision of banks focuses on the soundness of individual banks and, thereby, the protection of depositors, the financial stability function aims to monitor the stability of the financial system as a whole. The Bank contributes towards financial stability as part of a larger effort involving government, other regulators and self-regulatory agencies.

National payment system

The National Payment System (NPS) is a vital element of financial stability. The Bank continues to enhance the safety and soundness of the NPS by developing the payment system oversight capacity of the Bank and by maintaining a high standard in the provision of interbank settlement services. An important milestone was reached in December 2004 when the rand was included in the CLS system. The rand is now positioned as one of only 15 settlement currencies in the CLS mechanism.

Stability of the banking sector

The South African banking sector has benefited from the improved macroeconomic conditions. Banking-sector profitability, as measured by the return on equity, improved from a smoothed 12,6 per cent in June 2004 to 14,0 per cent in June 2005. Efficiency, as measured by the costs that have to be incurred to generate income, also improved. The banking sector remained well capitalised with the capital adequacy ratio amounting to 13,1 per cent in June 2005.

The asset quality of banks also improved despite strong growth in the total loan book. As at the end of June 2005, only 1,6 per cent of the total loan book was overdue, compared to 2,0 per cent in June 2004.

Banking regulation

As from 1 January 2008, South African banks will no longer be able to use the current capital accord. The Bank envisages that all approaches offered in terms of the new capital accord (Basel II) will, in principle, be available to banks in accordance with a number of guidelines.

The Bank is of the opinion that it will be possible for every registered bank in South Africa to migrate to the basic approaches of Basel II without major disruption or risk to individual banks or the banking system. Banks intending to choose an advanced approach will be required to apply formally and will be considered on the basis of their ability and capacity to implement these changes effectively.

Broadening access to financial services and targeted investment remain high priorities on the agenda for South Africa and our financial sector and the Bank continues to monitor and support new initiatives.

Draft legislation aimed at the provision of broader access to finance, namely the Dedicated Banks Bill for second-tier banks and the Co-operative Banks Bill for third-tier banks, was published for comment late last year. While these new forms of banking will introduce more competition in banking and potentially promote broader access to finance, they present a challenge to government and financial services regulators in terms of the form, manner and structure of supervision of these institutions.

When approval was granted to Barclays Bank plc to proceed with a formal offer to buy a majority stake in the local banking group, Absa Group Limited, it represented an important structural change in the financial sector. A major local bank will become controlled by an international bank. This transaction is the largest single foreign direct investment into South Africa to date, and is indicative of an increasingly positive investment outlook for South Africa.

Currency in circulation

The branches of the Bank were once again able to meet the currency requirements of the economy. At the end of June 2005, the value of banknotes and coin in circulation outside the Bank amounted to R49 billion, up by more than 12 per cent from the end of June 2004. In August 2004, a new bi-metal R5 coin was introduced in response to the perceived counterfeiting threat of the previous issue. An upgraded series of banknotes was introduced in February 2005.

International co-operation

The Bank continued to make a significant contribution to economic co-operation in Africa and specifically Southern Africa. The Bank liaised closely with the Association of African Central Banks regarding the implementation of the African Monetary Co-operation Programme. The Bank also participated in a study outlining the costs and benefits of the creation of a common central bank for Lesotho, Namibia, Swaziland and South Africa. The decisions in this regard will be taken by the political leaders of these countries.

Internal administration

Corporate governance in the Bank, which includes the development of an ethical code of conduct for management and staff, received special attention. A corporate governance framework was developed in conjunction with the Board of Directors to ensure compliance with best practice.

As part of its risk management strategies and in compliance with corporate governance guidelines, the Bank has implemented a comprehensive framework for business continuity management, not only at head office but also in the branches and subsidiaries.

In accordance with the relevant legislation, consultation on employment equity is a continuous process in the Bank. The Management Steering Committee (MSC), representing management, and the Employment Equity Consultative Body (EECB), representing employees, meet monthly. The fourth *Employment Equity Report* was compiled, consulted with staff and submitted timeously to the Department of Labour in October 2004.

In March 2005, the total employment equity representation in the Bank stood at 55 per cent black and 46 per cent female. At the management level, representation was 43 per cent black and 34 per cent female. This is evidence of further progress towards the ultimate goal of a workforce reflecting, at all levels of seniority, the demographic and gender composition of the South African population.

The Bank accepts co-responsibility for the development of its staff. In addition to various training and development interventions, the Bank also assists employees to study, while considerable attention is given to on-the-job training. The South African Reserve Bank College plays a pivotal role in upgrading the central banking skills of employees.

Good progress can be reported on the process of reviewing the *Staff Manual* of the Bank. The Governor's Committee has approved a proposed new staff manual and a Consultation Team has been appointed to consult with staff, the EECB and the South African Society of Banking Officials (SASBO) on the changes. The Consultation Team has already embarked on the process of engaging with the various stakeholders.

The Over-the-Counter Share Transfer Facility for shares in the Bank continues to function satisfactorily and, during the financial year, 20 transactions were concluded with 63 600 shares changing hands. As at the end of June 2005, the Bank had 620 shareholders.

The balance sheet totals of the Bank increased by a significant margin over the financial year, mainly as a result of the accumulation of official gold and foreign exchange reserves. This accumulation necessitated various transactions to drain liquidity in the domestic money market, significantly adding to the interest costs borne by the Bank. The income before taxation of the Bank, nonetheless, increased from the previous financial year. This was made possible primarily by profits realised on the sale of government bonds. Hence, continued vigilance will be required in the budgeting process and the management of costs.

Conclusion

The preceding review of developments over the past year provides ample evidence that the Bank has achieved considerable success in pursuit of its major objectives.

Of particular importance, CPIX-inflation has remained comfortably within the target range of 3 to 6 per cent and it was possible to decrease the repurchase rate to 7 per cent per annum. The consolidation of inflation at lower levels and with lower variability is an important contribution to economic growth and development in South Africa.

The improvement in the level of official foreign reserves has been impressive. Further reserves accumulation will take place depending on market conditions and the prudent management of the Bank's balance sheet.

The Bank will continue to supervise South African banks in accordance with international best practice, while retaining an interest in the stability of the financial system. Closer economic co-operation in the Southern African Development Community and on the African continent will increasingly become a key strategic focus area in the years ahead.

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