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

Introduction

We live in an ever-changing global environment, an environment that is characterised by opportunities and hope, but also fraught with risks. In this environment the South African Reserve Bank (Bank) must implement its mandate and manage the associated risks to ensure that South Africans benefit from opportunities emanating from a changing world. Today, I am pleased to report on another successful year in the eighty-five-year history of the Bank.

The achievement and maintenance of price stability remains the primary objective of the Bank. Indeed, the most significant accomplishment of the Bank has been the containment of inflation within the target range since September 2003. This does not imply that the other functions of the Bank are neglected. On the contrary, these remain crucial in the operations of the Bank.

Today we also release our *Annual Economic Report* which covers the broader aspects of the domestic and international economy that impact on many of the activities of the Bank. This address will highlight, where relevant, some of the salient economic developments which have affected our operations. The focus of this address is on the main operational areas of the Bank including monetary policy, monetary operational procedures, gold and foreign exchange reserve management, the national payment system, banking regulation and supervision, international co-operation and internal administration.

Monetary policy

Monetary policy during the past year was conducted against the background of a strongly growing international economy and buoyant commodity prices. This strong growth, combined with rising geopolitical tensions and other supply constraints, placed upward pressure on international oil prices, which reached highs of almost US$80 per barrel in recent weeks. Despite the high oil prices, world inflation initially remained subdued, but inflationary pressures have since begun to emerge in a number of countries. This has prompted the tightening of monetary policy by several central banks in the past few months.

Domestically, the economy grew by 4,9 per cent in 2005. In the first two quarters of 2006, economic growth remained robust but showed some moderation compared to 2005. An annualised growth rate of 4,2 per cent was recorded in the first quarter of 2006.

Inflation remained under control in the period under review, with changes in CPIX (that is the consumer price index for metropolitan and other urban areas excluding mortgage interest cost) remaining within the target range of 3 to 6 per cent. In the twelve months from 1 April 2005 to 31 March 2006, the year-on-year CPIX inflation rate averaged 4,1 per cent, but changes ranged between 3,5 and 4,8 per cent over the period. From March to June 2006, CPIX inflation accelerated from 3,8 per cent to 4,8 per cent.

Services price inflation continued to decline and had fallen below goods price inflation by the beginning of 2006. This was partly a reflection of the continued containment of increases in administered prices, other than petrol prices. The higher trend in goods prices was initially mainly due to petrol price increases, and more recently food price increases. During the first nine months of 2005, food price inflation averaged 1,8 per cent and therefore contributed to the downward trend in inflation. Following the strong increase in maize prices towards the end of 2005, food price inflation began to increase and had risen to 7,2 per cent by June 2006. By contrast, the prices of a number of categories of goods fell, particularly clothing and footwear, and furniture.

Production price inflation increased over the past year and averaged around 5,5 per cent in the first four months of 2006, compared to 2,3 per cent in June 2005. However, a further acceleration occurred in May and June 2006, when producer inflation reached levels of 5,9 per cent and 7,5 per cent, respectively. Changes in energy and food prices provided much of the impetus to higher production prices.

For much of the reporting period the inflation outlook was fairly stable and favourable. This allowed for an unchanged repo rate of 7 per cent for a prolonged period following the reduction by 50 basis points in April 2005. In the past year, there were a number of developments that supported a favourable inflation outcome. Lower inflation expectations appeared to have had an impact on wage settlements which have declined steadily. Unit labour cost increases were also moderate, with an average rate of increase of 3,4 per cent for 2005, significantly down from the rate of 6,5 per cent recorded in 2004. These developments, combined with the increased credibility of monetary policy as indicated by improved inflation expectations, were expected to support sustainable low inflation.

The inflation outlook was also supported by continued fiscal discipline, output growth in line with growth potential and low world inflation. The initial impact of the significant increase in international oil prices on world inflation, world growth and domestic inflation was minimal, confounding earlier fears of a repetition of inflation spirals seen during previous oil price shocks.

Some of the other determinants of inflation have remained favourable for much of the period, although their associated risk increased over the past year. The exchange rate remained within a fairly stable trading range over much of the period. However, following increased uncertainties in the international markets from May 2006, the rand came under pressure, along with the currencies of a number of other emerging-market economies. The rand exchange rate also reacted further to the publication in June of the first quarter current-account deficit of South Africa. Between the beginning of May 2006 and the beginning of August, the trade-weighted exchange rate of the rand depreciated by approximately 14 per cent.

Despite the positive developments in the inflation outcomes during the past year, there was a steady deterioration in the outlook of a number of the fundamental determinants of inflation, increasing the degree of upside risk to the inflation outlook. Of increased concern to the Monetary Policy Committee (MPC) was the continued strength of domestic demand. For the past two years, household consumption expenditure has grown at annual real rates of almost 7 per cent. Retail sales continued to grow strongly and consumer confidence reached an all-time high by the end of 2005. This was fuelled by high rates of credit extension which averaged over 20 per cent during the past year, and resulted in household debt rising to 66 per cent of disposable income in the first quarter of this year.

The strong growth in expenditure had little immediate impact on domestic inflation, although the MPC noted at its meeting in February 2006 that adverse price effects would be inevitable if these trends continued unabated. Increases in consumption expenditure, however, contributed to the progressive widening of the deficit on the current account of the balance of payments from 4,2 per cent of gross domestic product in 2005 to 6,4 per cent in the first quarter of 2006. This development was seen by the MPC to pose a potential threat to inflation through its possible impact on the exchange rate, should the deficit be regarded as unsustainable. Nevertheless, these deficits were adequately financed by capital inflows.

The sustained strong domestic demand, combined with threats posed by international oil prices, food prices, and exchange rate developments, increased the risk to the inflation outlook. In response to these heightened risks and the deteriorating inflation outlook, the MPC felt that pre-emptive action was required. Accordingly, the repo rate was increased by 50 basis points to 7,5 per cent on 8 June 2006 and by a further 50 basis points on 3 August 2006. However, future monetary policy decisions will depend on changes in the outlook for inflation and economic developments.

Monetary operations

The Bank uses open-market operations to provide and drain liquidity from the money market in order to maintain the liquidity requirement of banks at a level sufficient for the implementation of monetary policy in line with the stance determined by the MPC. Deposits of banks at the Bank in terms of the minimum statutory cash reserve requirement (2,5 per cent of liabilities, as adjusted) amounted to R28,7 billion for the June/July maintenance period. As at the end of June 2006, total outstanding debentures on issue by the Bank and longer-term reverse repurchase transactions amounted to R5,4 billion and R2,0 billion, respectively. The deposits of the Corporation for Public Deposits with the Bank, which amounted to R11,1 billion at the same date, also contributed to the draining of excess liquidity. Notes and coin in circulation also had a contractionary impact on liquidity, increasing from R49,0 billion on 30 June 2005 to R53,9 billion a year later.

Currency in circulation

The daily average value of banknotes in circulation in the period 1 April 2005 to 31 March 2006 amounted to R46,3 billion, while the average value of coin in circulation during the same period amounted to approximately R2,7 billion. While banknotes in circulation increased by 10,2 per cent over the previous corresponding period, coin in circulation increased by 9,1 per cent. A seasonal peak for banknotes and coin in circulation of R57,4 billion was reached on 23 December 2005.

The demand for coin has shown a substantial increase in the past few months. This is particularly the case in respect of the demand for the 5c coin, which shows an increase of approximately 30 per cent, compared to the corresponding previous reporting period.

The Bank has co-operated with commercial banks in the development of a more efficient and effective integrated national cash management system. The improved system has the potential to limit the cash holdings of banks, thereby contributing to a reduction in the cost of cash to the public.

Gold and foreign exchange reserves

The activities of the Bank in the domestic foreign exchange market are aimed at managing domestic money-market liquidity conditions through foreign exchange swaps, servicing the foreign exchange requirements of clients and increasing foreign exchange reserves in a prudent manner when conditions permit. The Bank does not aim to influence the exchange rate of the rand, but leaves its determination to the forces of demand and supply in the foreign exchange market.

The Bank continued to take advantage of favourable market conditions to increase the level of official gold and foreign exchange reserves. Gross reserves increased from US$15,9 billion at the end of March 2005 to US$23,95 billion at the end of June 2006. Over the same period the international liquidity position increased by US$7,79 billion to US$20,19 billion. The increase in the level of official reserves has been well received by market participants and rating agencies and has contributed to the improved perception of South Africa's fundamentals by international investors.

The Bank and the National Treasury co-operate very closely in the process of accumulating reserves. In making rand-denominated deposits with the Bank, the National Treasury assists with absorbing the excess liquidity created by the purchases of foreign exchange. As at the end of June 2006, government deposits at the Bank, the greater part of which related to this sterilisation initiative, amounted to R36,2 billion.

The higher level of foreign exchange reserves resulted in an increased focus on the management thereof to ensure safety, liquidity and an adequate return within conservative risk parameters. At the end of June 2006, the internally managed portfolios comprised 81 per cent of gross reserves, with the balance managed externally. Internal reserve management capacity and skills have been strengthened significantly through training and skills transfer agreements with external fund managers.

A securities lending programme was implemented in July 2005. In terms of this programme, securities held on behalf of the Bank by a custodian can be used in lending transactions against cash or other high-quality collateral. The income and fees generated by this programme help to defray some of the costs incurred as a result of the external fund management programme.

In April 2005 the National Treasury made a final payment in the form of zero-coupon bonds to the Bank as compensation for losses accumulated over many years in the Gold and Foreign Exchange Contingency Reserve Account.

Financial stability

As you are aware, the Bank is not the sole custodian of financial system stability, but contributes towards a larger effort involving the government, other regulators and self-regulatory agencies, and financial market participants.

The activities of the Bank relating to financial stability include the application of policies, instruments, norms and tools to prevent, detect and manage systemic instability of institutions, markets, and the payment and settlement system. The robustness of the financial regulatory system was continually assessed and reported on in the bi-annual *Financial Stability Review* of the Bank. Confidence in the domestic financial services sector remains high.

National payment system

The Bank published its new strategic framework and strategy for the National Payment System (NPS), known as Vision 2010, in April 2006. Vision 2010 provides strategic direction for the payment system and its bank and non-bank participants up to 2010, identifying five major challenges for the payment system. These challenges include accessibility; transparency; security; support for payment, clearing and settlement initiatives of the Southern African Development Community (SADC); and keeping abreast of international developments.

The monthly value of settlement in the South African Multiple Option Settlement (SAMOS) system amounted to R4,6 trillion in June 2006, or approximately R200 billion per day. This includes the settlement of transactions stemming from the equity and bond markets, as well as the rand leg of domestic foreign exchange transactions. Approximately 90 per cent of settlement through SAMOS is effected on a real-time basis during the day, while the remaining 10 per cent, which emanates from the retail batch environment, is settled in the evening. An upgrade of the SAMOS system, providing for the handling of dematerialised money-market instruments, was successfully implemented in June 2006.

The Bank continued to facilitate a low-cost payment solution between the different role players in the low-income collection environment. The first directive for conduct in the payment system for banks participating in the low-income collection environment was issued by the Bank during the period under review.

Banking regulation and supervision

The South African banking regulatory framework has to be amended to provide for the requirements of the new international Capital Accord (Basel II) for banks. During the period under review, two drafts of amendments to the Banks Act, No 94 of 1990, and the regulations thereto, were circulated for comment to the Accord Implementation Forum (AIF), comprising representatives of the Bank, the National Treasury, the banking sector and The SA Institute of Chartered Accountants.

All registered banks, branches of foreign banks and mutual banks in South Africa were requested to perform a gap analysis and self assessment, including an impact study of prescriptions for their capital-adequacy requirements, to determine their readiness for the implementation of Basel II. In order to capture the risks faced by an entire banking group, Basel II will be applied on a consolidated basis to internationally active banks.

The Bank participated in a joint project with the National Treasury to investigate the requirements necessary to implement a deposit-insurance scheme for South Africa. Once certain issues have been resolved, a final proposal will be submitted to the Minister of Finance for consideration.

A corporate governance review of 14 South African banks (including two mutual banks, but excluding the five biggest banks) was undertaken during the period under review. Its purpose was to assess the compliance of the banks under review with sound corporate governance practices as laid down in the Banks Act or the Mutual Banks Act, No 124 of 1993, the regulations to these acts, the recommendations of the Myburgh Report on the Standard of Corporate Governance in the Five Largest Banks, and the second King Committee on Corporate Governance.

International co-operation

The Bank continued to play an active role in the international arena. The Bank and the National Treasury will jointly chair the G-20 in 2007 and the Bank has been very active in preparing for this. The Bank has established a G-20 Unit for this purpose, which works closely with the G-20 Secretariat in the National Treasury. Established in 1999, the G-20 is a forum where central bank governors and ministers of finance of developed and systemically important emerging and developing economies deliberate on issues related to global economic and financial stability in support of global growth and development. The Bank and the National Treasury will undertake the preparations necessary for hosting meetings and seminars of the G-20 next year. In August 2005, a G-20 seminar on economic growth was held at the Bank, jointly hosted by the South African Reserve Bank, the Bank of Mexico and the People's Bank of China.

The Bank is an active member of the Bank for International Settlements (BIS) which acts as the central bank for the central banks of member countries. In May 2005 the Bank bought further shares in the BIS which represented a pro rata allocation of the redistribution of a portion of US shares in the organisation. I regularly attend the meetings of the BIS, until recently representing the only African country. I am pleased to say that after many years of persuasion by ourselves for the admission of another African country, Algeria is now a shareholder of the BIS.

Our co-operation with the International Monetary Fund (IMF) continues. In May 2006, I was appointed by the Managing Director of the IMF, Mr Rodrigo de Rato, as a member of the Committee of Eminent Persons to study the long-term sustainability of the finances of the IMF. There is little doubt that international organisations such as the IMF should become more accountable to their membership regarding their operations. It is my strong view that the financing of any organisation has an important bearing on its accountability and transparency. It is envisaged that the Committee will meet four or five times over the next six months, and will table its report in early 2007.

The Bank continues to improve its international co-operation efforts with global partners. During this year the Bank has signed Memoranda of Understanding (MoUs) with the central banks of Argentina and Ukraine. Discussions on co-operation agreements have advanced significantly with the central banks of China and Peru, and completion and signing off of such agreements are expected in due course.

With regard to regional integration activities on the continent, the Bank continues to host the Secretariat of the Committee of Central Bank Governors (CCBG) in SADC. Good relationships with central banks in the region have been boosted this year as three MoUs in the areas of information technology, exchange control and payment systems have been signed by central bank governors.

The Bank participated in the annual regional payment conference for countries in SADC, which focused on general payment system developments. In addition, three payment-system workshops were hosted for SADC countries during the period under review. The aim of these workshops was to evaluate the payment system of each SADC country in accordance with the Financial Sector Assessment Programme of the IMF and the World Bank. These evaluations and the report to the IMF and the World Bank will form the basis of the annual regional payment conference to be held later this year.

The South African Reserve Bank College continued to play a key role in training staff members of central banks and financial institutions in Africa. It also co-organised the IMF Financial Programming and Policies course and a Financial Markets Analysis course presented by the Joint Africa Institute.

Internal administration

The *Annual Report* of the Bank was distributed to shareholders before this meeting. The balance sheet totals of the Bank show an increase from R129 billion at the end of March

2005 to R168 billion at the end of March 2006. The increase was mainly the result of the accumulation of official gold and foreign exchange reserves and was financed in the main by an increase in government deposits. The profit before taxation of the Bank increased from R866 million for the previous financial year to R1 038 million for the financial year ending 31 March 2006.

Budgeted expenditure of the Bank for the current financial year amounts to R1 615 million, compared to actual expenditure of R1 530 million in the financial year to 31 March 2006. This represents an increase of 5,56 per cent in budgeted expenditure compared to actual expenditure for the previous financial year.

The four subsidiary companies of the Bank achieved their objectives during the financial year. After a review of reports by their Boards of Directors, and internal and external auditors, the Bank is satisfied that these companies are managed in accordance with their objectives and best corporate governance practice. The results of the subsidiaries are reported on a consolidated basis with those of the Bank in the financial statements.

During the financial year to 31 March 2006, 40 transactions in respect of 123 808 shares of the Bank were concluded. On 31 March 2006, the Bank had 615 shareholders and by the end of June this number had remained unchanged.

Improved operational efficiency has been achieved since the introduction of a revised organisational structure of the Bank in August 2005. As was envisaged, this structure allows the Governor and deputy governors to devote more time to policy and strategic planning, while the executive general managers are responsible for the general management, supervision and control of the Bank departments reporting to them.

The Bank has embarked on a number of capital projects. The existing infrastructure of the head office building is currently under improvement to ensure maintenance and optimal utilisation. The Bank has also made considerable progress with the practical implementation of its business continuity management and disaster recovery strategies. A dedicated disaster recovery site for head office operations has been completed and will be fully functional towards the last quarter of 2006. Business continuity planning for the seven branch offices and the subsidiaries has also been completed.

In the year under review the total staff complement of the Bank declined further to 1 956 as at the end of March 2006 and 1 937 at the end of June 2006. This can be compared to a staff complement of 2 288 in March 2003. Staff turnover in the Bank has increased from 4,3 per cent in the 2002/03 financial year to 7,1 per cent in the financial year ending 31 March 2006. These trends could eventually impact on the employment equity targets of the Bank, as many of the resignations occurred from the designated groups at middle management level.

The Bank contracted an external party to conduct an organisational culture and climate survey during February and March 2006. The study achieved a high level of voluntary participation among staff members. Although the study has identified a number of areas where the Bank should focus initiatives to improve staff morale, it has also indicated that staff members are satisfied with many other aspects relating to the Bank as an employer.

The Bank has also engaged an external service provider to conduct voluntary HIV/Aids prevalence testing among its staff, after launching its HIV/Aids Response Programme in February 2006. Preparation is currently taking place for the roll-out of the initiatives of this programme on a Bank-wide basis, covering matters such as HIV/Aids awareness and education campaigns, and the training of management and employees in HIV/Aids counselling.

The Bank is viewed as an industry leader in complying with the requirements of the Employment Equity Act, No 55 of 1998 (EE Act), and the Skills Development Act, No 97 of 1998. The mandates of the structures created for consulting in terms of the EE Act have been amended during the period under review to encompass consultation on the workplace skills plan before its annual submission to the Bankseta.

The Bank has made significant improvements in employment equity in recent years. The employment equity representation at the end of June 2006 was 56 per cent black and 46 per cent female in total. At management level the figures were 43 per cent black and 36 per cent female, respectively. However, we have not entirely achieved the target of 50 per cent black at all levels of seniority as was envisaged in the original *Employment Equity Plan* submitted six years ago.

A draft second employment equity plan has been completed and is currently the subject of consultation with staff. The draft plan, to be submitted to the Department of Labour in October 2006, proposes an increase in the target for female employment from 33 per cent to 50 per cent of the staff complement at all levels of employment. A target of 2 per cent of employment for people with disabilities is also under consideration.

A number of training and development interventions were conducted during the 2005/06 financial year. A total of 1 346 employees benefited from these interventions, including 626 staff members who attended courses at the South African Reserve Bank College. In addition, 230 staff members received study aid during the year to 31 March 2006 to improve their formal qualifications.

The Bank has concluded an extensive consultation process with staff, the Employment Equity Consultative Body and the finance union SASBO regarding the modernisation of staff-related policies. In this process the original policies proposed by the Bank have been amended to incorporate many of the views expressed by these stakeholders. A process has been embarked upon to familiarise staff with the new policies and it is anticipated that implementation will take place on 1 October 2006.

Conclusion

Reflecting on another successful year in the long history of the Bank, the preceding review provides ample evidence of the achievement of the various objectives of the Bank. Monetary policy has contributed to the containment of CPIX inflation to within the target range against the background of various risks to the inflation outlook. The MPC will remain vigilant and will not hesitate to adjust the monetary policy stance when necessary. The Bank is committed to the pursuit of low and stable inflation as a major contributing factor to the growth and development of South Africa.

The Bank will carefully monitor the progress of South African banks towards ensuring their readiness for the implementation of Basel II on 1 January 2008.

As always, the internal management of the Bank will receive the necessary attention. The Bank values its human resources very highly and this is borne out in the new and modernised staff-related policies that will be implemented later this year. The Bank is committed to the training and development of staff which will be done in pursuit of transformation as envisaged in the new employment equity plan. We will continually strive towards creating an organisational culture that makes the Bank an employer of choice.

Acknowledgements

I want to thank the Presidency, the Government and Parliament for their continued support. The Minister and Deputy Minister of Finance, and the Director General of the National Treasury and his staff also supported the Bank in the conduct of its business.

I want to express a hearty word of thanks to the Board members for their commitment and service to the Bank. It is an honour and privilege to work with such a diverse and distinguished group of people. During this year, Ms A M Mokgabudi stepped down from the Board and as Chairperson of the Remuneration Committee because of professional commitments. Her service to the Bank is greatly appreciated.

Although I have paid tribute to Mr I Plenderleith at the previous general meeting, he officially retired as Deputy Governor in January 2006. It is accordingly appropriate to thank him again on this occasion for his dedication and service to the Bank. Finally, the Bank cannot achieve its goals without the loyalty, service and dedication of its management and staff. I wish to thank the deputy governors, management and staff of the Bank for their contributions.