Governor's Address at the eighty-eighth annual general meeting of shareholders

Introduction

The past year has been a difficult one for the global economy. The repercussions from the sub-prime mortgage crisis in the United States of America (US) are still being felt in terms of continued turmoil on the international financial markets and a slowing global economy. The South African banking sector has been relatively insulated from these financial market uncertainties. Nevertheless, greater vigilance has been required in supervising and regulating the domestic banking sector and payment and settlement system.

At the same time, the Bank has faced particular challenges with respect to monetary policy as significant increases in global oil and food prices, combined with strong domestic demand caused inflation to exceed the upper level of the inflation target range. In carrying out our mandate of achieving and maintaining price stability, we progressively tightened the stance of monetary policy over the past year.

Internally, we have retained our focus on maintaining and improving the efficient workings of the Bank. It is in this context that I report to you today on the main operational areas of the Bank.

Recent financial market developments

Significant developments have shaken global financial markets in recent weeks. We are witnessing extraordinary times, the likes of which have not occurred in our lifetimes. Previous financial crises that spring to mind have either been associated with the collapse of single systemically important institutions, or have emanated from a build-up of imbalances in emerging markets. The current turmoil is essentially raging in the developed world, mainly affecting the US and Europe. The pace of globalisation and financial innovation in recent years has facilitated the rapid spread of this crisis to various continents.

Following significant intervention by the major central banks in financial markets from the last quarter of 2007, the nationalisation of the UK bank Northern Rock in February 2008 and the takeover of Bear Sterns by JP Morgan in March 2008, market participants started to hope that the worst of the sub-prime crisis could be over. Large losses have been declared and assets written down and numerous global banks have succeeded in raising additional capital, albeit at punitive rates. Indeed, in the second quarter of this year we saw appetite for riskier financial asset classes returning to global markets, contributing to some recovery in equity markets, narrower credit spreads and stronger emerging-market currencies.

Discomfort surfaced again in August 2008, with increasing concern about the health of the two government-supported housing giants in the US – Freddie Mac and Fannie Mae, causing the share prices of these companies to lose about 90 per cent of their values at one stage. There was much relief when the US Treasury announced on 7 September that it had taken over these institutions and allowed them to restructure.

However, this relief was of short duration. Rumours during the first week of September centred around a possible takeover of what has become the latest casualty of large losses and write-downs – Lehman Brothers. Several possible candidates were mentioned in the financial news as being interested in taking over Lehman Brothers. However, as you are aware, all attempts failed and Lehman Brothers, one of the highest profile investment institutions in the US that was founded in 1850, filed for bankruptcy on 15 September. On the same day, the Bank of America confirmed that it was taking over Merrill Lynch. So within a few days, the whole landscape of the US (and global) financial markets had changed, with two of the biggest global investment banks disappearing, and fears rife that they may not be the last. American International Group (AIG) – the US insurance giant – was high on the list of possible candidates, until the US Federal Reserve (Fed) granted it a very expensive lifeline of some USD85 billion on 16 September.

In the days following Lehman Brothers' bankruptcy, global financial markets experienced the most severe reaction since the 9/11 attacks in 2001. Equity markets across the globe declined sharply and investments in riskier assets were immediately reduced. In the first 11 trading days of September, the S&P 500 index declined by 5,4 per cent, the main European indices by around 8 per cent , the FTSE 100 in the

UK by over 10 per cent and the Japanese Nikkei index by 9,5 per cent. The Emerging Market Bond Index (EMBI) spread of emerging-market debt over US Treasuries widened by 116 basis points in the first half of September, from 300 to 416 basis points – its widest since October 2004. Overnight interbank rates in the US and Europe increased by several hundred basis points, much higher than target policy rates. On 16 September, the federal funds rate stood at more than 6,0 per cent, compared to the target rate of only 2,0 per cent. In reaction, various central banks injected additional liquidity into the system in order to alleviate pressures and illiquidity in the interbank market, and some also issued statements to reassure markets.

To date, the South African Reserve Bank has not been required to take any special action to intervene in domestic liquidity conditions. As reported in detail in the Annual Report of the Bank Supervision Department, South African banks had little direct exposure to the US mortgage-backed securities market, and continued to operate relatively smoothly.

The South African Reserve Bank conducted its monetary and open-market operations as normal. However, South African financial markets have not been spared the indirect effects of the global market turmoil and the sharp re-pricing of risk. Our own equity market has reacted in line with global markets, and the all-share index (Alsi) on the JSE Limited declined by 7,0 per cent in the first half of September 2008. In the month to 16 September, non residents sold a net R4,3 billion of South African equities, taking their sales in the year to that date to almost R18 billion. Likewise, they sold bonds amounting to R5 billion on a net basis in the first two weeks of September 2008. The spread on South Africa's foreign-exchange denominated government debt, as measured by South Africa's sub-component of the EMBI+ index, widened to 312 basis points – the widest ever and more than six times the spread of 50 basis points that prevailed just before the onset of the sub-prime crisis in May 2007.

Increased market volatility, a significant repricing of risk, rising costs of international capital and less capital flows to emerging markets clearly pose threats to the domestic economy and financial markets. With South African financial markets being integrated into the world markets to the extent that they are, spill-over effects become likely. In this regard, the Bank will continue to monitor market developments closely. During the past year the domestic financial system was assessed as sound.

Bank regulation and supervision

As part of our bank supervision function, the South African Reserve Bank focused on the impact of international financial market developments on our banking sector. In mid-2007 the Bank requested a selection of South African banks to provide detailed reports on their exposure to the prevailing risks. It was found that local banks had no direct exposure to the sub-prime mortgage market, while certain of the banks' international franchises had only limited exposure. However, indirect effects, such as increased funding costs, were observable. In view of the developments in financial markets, the Bank embarked on a process to evaluate the appropriateness or otherwise of incentive schemes in the South African banking system during 2008.

A major change to the South African banking regulatory and supervisory framework occurred as a result of the successful implementation of Basel II on 1 January 2008. The amended Banks Act, 1990 and Regulations relating to Banks, as well as the revised supervisory process were implemented at the same time.

The Bank, in close co-operation with the Financial Intelligence Centre, continued to monitor the compliance of banking institutions with legislation relating to anti-money laundering and to combating the financing of terrorism. In August 2008 the Bank participated in the Financial Action Task Force evaluation of South Africa's anti-money laundering and counter-terrorism financing system.

Monetary policy

The challenges facing the Bank on the monetary policy front intensified during the year. The inflation rate has increased significantly, initially influenced by strong domestic demand pressures, and sustained and significant international oil and food price increases. Since April 2007 CPIX inflation has exceeded the upper end of the inflation target range of 3 to 6 per cent and it has risen persistently since then. In July 2008 CPIX inflation reached a level of 13,0 per cent.

The Monetary Policy Committee (MPC) has consistently recognised that there is little that monetary policy can do to avoid the impact of first-round effects occasioned by exogenous relative price changes on domestic inflation. The MPC was always cognisant of the need to focus on preventing these first-round effects from influencing inflation expectations and feeding through to a more generalised or broad-based increase in the inflation rate. Recently it has become evident that inflation has become more generalised.

Inflation expectations have also deteriorated somewhat. During 2008, expectations, as reflected in the inflation expectations survey conducted on behalf of the Bank by the Bureau for Economic Research at Stellenbosch University, increased significantly above the upper end of the inflation target range for all years in the forecast period. This deterioration is consistent with other market-based measures of inflation expectations.

During the past year there have been a number of factors that impacted adversely on inflation and influenced monetary policy decisions. The international oil price continued to put pressure on domestic inflation. By July of this year the price of North Sea Brent crude oil had doubled since September 2007, before moderating in recent weeks. The combined effects of the international oil price and rand-exchange-rate developments have resulted in a cumulative increase in domestic petrol prices of about 40 per cent since September 2007.

Food prices, driven to a large extent by international food price increases, also continued to place upward pressure on inflation. Domestically, between August 2007 and July 2008, food prices contributed an average of 4,1 percentage points to average CPIX inflation of 9,3 per cent.

Pressures from food and oil prices have also influenced global inflation rates. Despite a more generalised economic downturn in most of the developed economies, the monetary policy stance in a number of countries has been tightened in recent months in response to heightened inflation pressures.
Since early 2008, the exchange rate has also had a major impact on the inflation outcome. More recently, the rand exchange rate appreciated somewhat from its earlier lows. The trend in unit labour cost also posed an increasing risk to the inflation outlook. Electricity price developments also had an adverse effect on the inflation outlook.

After a long lag, household consumption expenditure showed a definite response to the tighter monetary conditions whilst growth in bank credit extension to households declined moderately. Asset price developments, in the form of lower equity prices and a subdued housing market, reduced the pressure on inflation emanating from wealth effects. Output growth, which measured around 5 per cent per annum during the past four years, showed signs of moderating and the economy currently appears to be growing somewhat below the estimated potential output growth. Fiscal policy also remained supportive of monetary policy.

In response to the impact of these developments on the inflation outlook, the monetary policy stance was tightened progressively over the past year. The repurchase rate was increased by 50 basis points after each of four of the six MPC meetings held since the previous annual general meeting. Since the tightening cycle began in June 2006, the repurchase rate has been increased by a cumulative 500 basis points.

At its most recent meeting in August 2008 the MPC kept the monetary policy stance unchanged. The committee decided that despite the continued upside risk to the inflation outlook, the degree of risk had subsided somewhat, particularly in the light of the continued slowdown in household consumption expenditure, the widening output gap and the lower international oil prices. The inflation forecast of the Bank showed that inflation was expected to peak in the third quarter of 2008 and then begin to decline, and to return to within the target range by the second quarter of 2010.

The fact that inflation has been outside the target range for some time has been regarded by some as an indication of the failure of the inflation-targeting framework. It is generally accepted that a flexible inflation-targeting regime should allow for a temporary deviation from the target range in the event of exogenous shocks, to avoid excessive output variability. Our framework also allows for deviations from the target in such instances. However, to prevent second-round effects, it is important that expectations remain well anchored. Failure to respond appropriately could inevitably cause expectations to become dislodged and result in a further acceleration of inflation. The Bank remains committed to bringing inflation back to within the target within a reasonable time frame.

Accumulation and management of reserves

The level of official gross gold and other foreign-exchange reserves increased from US$29,8 billion at the end of August 2007 to US$34,3 billion at the end of August 2008. Over the same period, the international liquidity position increased from US$27,4 billion to US$33,5 billion. The Bank does not regard the current level as excessive and we will continue accumulating reserves at a moderate pace when market conditions permit.

Enhancing the reserves management processes of the Bank has been a strategic focus area for a number of years, commensurate with the growing responsibility associated with higher levels of reserves. The primary focus during the period under review was the formulation and partial implementation of a strategic asset allocation system, which involved the quantification of risk tolerance and a risk budget to facilitate the active management of reserves. In line with these developments, the roll-out of the internally managed portfolio was initiated to move closer to the approved strategic asset allocation.

Currency distribution

In celebration of former President Nelson Mandela's 90th birthday on 18 July 2008, the Bank issued five million pieces of the bi-metal commemorative R5 coin bearing the image of the former president. These coins were distributed to all provinces prior to 18 July 2008, thereby attempting to ensure that they were available nationally on President Mandela's birthday.

The national payment system

In March 2008 the Bank celebrated the 10th anniversary of the implementation of the South African Multiple Option Settlement (SAMOS) system. During 2008 an upgrade of the SAMOS system was initiated to facilitate the implementation of delivery-versus-payment in the settlement of money-market securities.

The Bank continued to develop the oversight of the national payment system (NPS). This included the issuing of directives relating to the conduct of system operators and third-party service providers in the payment system. The Bank also participated in the Continuous Linked Settlement system oversight and served on the foreign-exchange settlement subgroup of the Bank for International Settlements.

The Bank, in its role as overseer of the NPS, established the National Payment System Advisory Body which is representative of all the regulated stakeholders within the NPS. Regulated bank and non-bank participants may establish associations that can represent the interests of their members in this forum.

International co-operation

The African continent and the Southern African Development Community (SADC) region remain one of the focal points of the Bank's international relations efforts as programmes to achieve regional integration gain momentum. The Bank currently hosts the Secretariat of the Committee of Central Bank Governors (CCBG) in SADC and continues to support the implementation of CCBG projects. The Governor of the South African Reserve Bank is the chairperson of the CCBG. In our relations with multilateral institutions our efforts have been concentrated on increased participation in key forums such as the G-20. The chair of the G-20 passed from South Africa to Brazil at the beginning of this year.

The South African Reserve Bank is an active participant in the programmes of the Bank for International Settlements, the International Monetary Fund as well as various initiatives of sister central banks.

The Bank, through the SARB College (the College) continued to contribute towards the training initiatives in Africa by co-operating with international training institutions and other central banks. The College hosted a number of courses in conjunction with the IMF Institute and the World Bank Institute.

Internal administration

The *Annual Report* of the Bank was distributed to shareholders before this meeting. The total assets of the Bank increased from R220 billion at the end of March 2007 to R300 billion at the end of March 2008.

The profit before taxation of the Bank increased from R2,9 billion for the previous financial year to R3,5 billion for the financial year ending 31 March 2008. The budgeted expenditure of the Bank for the financial year under review amounts to R1,9 billion.

The four subsidiary companies of the Bank, namely the South African Mint Company, the South African Bank Note Company, the South African Reserve Bank Captive Insurance Company and the Corporation for Public Deposits achieved their objectives during the financial year. The Bank is satisfied that the subsidiaries are managed in accordance with their mandates, objectives and best corporate governance practices.

Human resources remain an important focus area of the Bank. As at the end of March 2008 the Bank employed 1 896 permanent and 48 contract staff members. The staff turnover rate was about 7 per cent, which is significantly lower than the banking-sector average of about 11 per cent. The Bank has surpassed its employment target of 50 per cent black employees, while 47 per cent of employees are female. The Bank aims to have 50 per cent female employees at all levels of employment by 2011.

Performance management received special attention during the past year. A special task team was commissioned to research, investigate and benchmark best practice relating to performance management. The report was finalised and approved by the Remuneration Committee of the Bank.

At the Bank we consider the wellness of employees as one of our primary human capital objectives. In this regard, we have updated and modernised clinic facilities that will cater for the well-being of employees. In the area of HIV/AIDS management, we have completed prevalence testing, and are in the process of implementing Bank-wide peer counsellor and educator training.

The Bank has always considered training and development to be of paramount importance. In the past financial year the Bank spent an amount of about R33 million on training, development, study aid, bursaries, skills development levies and educational grants. The College formed a strategic alliance with the University of South Africa and the Institute of Bankers in South Africa to offer the nationally recognised Advanced Diploma in Central Banking, which is also prescribed for the Cadet Graduate Programme of the Bank.

Conclusion

Global and domestic developments are expected to continue to pose challenges for the Bank in the coming year. The Bank will continue to focus on bringing the inflation rate down to within the inflation target range. The objective of the Bank remains to achieve and maintain low inflation in the interest of sustainable economic growth and development.

During times of global financial market instability, it is even more important to maintain vigilance over the payment system, domestic financial markets and the banking system in particular. After the successful implementation of Basel II, the Bank will continue to monitor closely the domestic banking sector.

Staff development will remain one of our strategic objectives. There will be a continued focus on training and development. Appropriate training is a benefit not only to the individual, but more generally to the Bank and the wider economy.

Acknowledgements

I wish to thank the Presidency, the Government and Parliament for their continued support of the Bank. The Bank maintained good working relationships with the Ministry of Finance and the National Treasury through the system of bilateral committees. Furthermore, I wish to thank the Minister and Deputy Minister of Finance, and the Director-General of the National Treasury and his staff for their ongoing support and co-operation.

Sincere thanks are also due to the members of the Board of the Bank for their efforts in ensuring appropriate corporate governance in the Bank. I welcome Mr Elias Masilela who has been appointed to the Board as a government representative. He takes the place of Professor Vishnu Padayachee whose term of office expired last year. I wish to take this opportunity to thank Professor Padayachee for his invaluable contribution to the Bank over the past years.

The successes achieved in dealing with the challenges of the past year are due to the continued dedication and commitment of the deputy governors, executive general managers, management and staff of the Bank. I wish to thank them all for their contributions and I am confident that their efforts will ensure that the coming year is even more successful.

Thank you very much indeed.