



South African Reserve Bank

Governor's Address

by Mr T T Mboweni at the eighty-eighth annual general meeting of shareholders on 18 September 2008

Introduction

The past year has been a difficult one for both the global and domestic economies. At the time of the previous annual general meeting of the South African Reserve Bank (the Bank), the sub-prime mortgage crisis in the United States (US) was in an early phase, and at that stage the full implications were yet to be seen. A year later we are witnessing the repercussions in terms of pressure on the international financial markets and a slowing global economy. Compounding these developments were sustained increases in the prices of a number of commodities, particularly food and oil, which have fuelled domestic and global inflation. 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 system, which contributed to an orderly financial market environment.

At the same time, monetary policy has faced particular challenges as relative price movements and strong domestic demand caused inflation to exceed the inflation target range. In carrying out its mandate of achieving and maintaining price stability, the Bank has tightened the stance of monetary policy over the past year. However, the Bank has retained its focus on maintaining the efficient internal workings of the Bank. It is in this context that I report to you today.

This year a comprehensive economic report is included as part of the *Annual Report*. In previous years this economic report was published as a separate *Annual Economic Report*. The economic report provides an analysis of developments in the domestic and international economy during the year under review, with particular emphasis on developments that have had implications for the operations and policy implementation of the Bank. The focus of this address is on the main operational areas of the Bank.

Monetary policy

The challenges facing monetary policy intensified during the year. Inflation was impacted initially 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 target range of 3 to 6 per cent and it has risen persistently since then. In July 2008 CPIX inflation had 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 or first-round effects of exogenous relative price changes on domestic inflation. Monetary policy needs to focus on preventing these first-round effects from feeding through to a generalised or broad-based increase in inflation. Central to this is the management of inflation expectations. If monetary policy fails to act appropriately, inflation expectations will become less anchored, with implications for price and wage setting. Whereas initially much of the pressure on inflation came from exogenous sources, more recently it has become evident that second-round effects have become more prominent. During the year under review underlying inflation has increased consistently: in July 2007 CPIX inflation excluding food and petrol measured 5,0 per cent, whereas by July 2008 it had increased to 7,4 per cent.

There was also some deterioration in inflation expectations. During the second half of 2007 expectations, as reflected in the inflation expectations survey conducted on behalf of the Bank by the Bureau for Economic Research at Stellenbosch University, remained within the target range, although there was a moderate upward drift. This was despite the unfavourable inflation outcomes. However, the picture changed in 2008 when expectations 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 on inflation and that influenced monetary policy decisions. These included endogenous and exogenous factors.

The international oil price continued to put pressure on domestic inflation. Oil prices were affected by strong global demand, particularly from fast-growing emerging-market economies, most notably in Asia. Numerous oil-supply disruptions, mainly a result of geopolitical developments and adverse weather conditions, also affected the oil market. As a result, the price of North Sea Brent crude oil increased from

just over US\$50 per barrel in January 2007 to reach a high of over US\$145 per barrel in July 2008, 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 R2,75 per litre since September 2007.

Despite an improved domestic maize harvest and relatively benign weather conditions, food prices also continued to place upward pressure on inflation. Factors sustaining pressure on international food prices include drought conditions in some regions, export restrictions in a number of countries, the diversion of food crops to biofuels production, and increased global demand fuelled by strong growth and higher incomes in emerging markets in particular. Domestically, between August 2007 and July 2008, food prices contributed on average 4,1 percentage points to average CPIX inflation of 9,3 per cent.

Pressures from food and oil prices have also impacted on global inflation. Despite a general downturn in most of the advanced economies, monetary policy in numerous countries has been tightened in recent months in response to heightened inflation pressures.

Since early 2008, the exchange rate has also begun to pose a threat to the inflation outlook. The exchange rate reacted to a number of developments including the widening deficit on the current account of the balance of payments, electricity supply constraints, bouts of global risk aversion and movements in the US dollar against other currencies. More recently, the rand exchange rate has appreciated somewhat from its earlier lows. The trend of wage settlements has also become an increasing risk to the inflation outlook. Nominal wage settlements have been increasing over the past year, although they are still on average below the inflation rate, particularly once productivity changes are adjusted for.

Most other domestic determinants of inflation remained well contained and have either been neutral or helpful to inflation developments. After a long lag, household consumption expenditure showed a definite response to the tightened monetary policy stance, despite only a moderate slowdown in bank credit extension to households. Demand for durable goods has been particularly responsive to higher nominal interest rates. 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 has measured around 5 per cent per annum during the past four years, showed signs of moderating and the economy appears to be growing somewhat below 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 has been 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. In January 2008 interest rates were kept on hold despite a mildly deteriorated inflation forecast. At that time, the risks to the outlook were more or less the same, but the MPC assessed that the extent of these risks had moderated somewhat. However, by the next meeting this assessment had changed in the light of new developments, including the risk posed to the outlook by Eskom's application for a significant further increase in the price of electricity.

At its most recent meeting in August 2008 the MPC decided to keep the monetary policy stance unchanged. The committee decided that although upside risks to the inflation outlook remained, 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 deviation from the target in the event of exogenous shocks, which are beyond the control of the monetary

authorities. Our framework also allows for deviations from the target in such instances, to avoid an excessive impact on output variability. However, to prevent second-round effects, it is important that expectations remain well anchored. Failure to respond will 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 in a reasonable time frame.

Money-market operations

The Bank manages the daily liquidity requirement in the money market so as to ensure that the implementation of monetary policy is consistent with the stance determined by the MPC. During the past year the daily liquidity requirement has been kept within a range of between R6,6 billion and R14,7 billion. The purchases of foreign exchange from the local foreign-exchange market create rand liquidity that has to be drained in order to maintain a liquidity shortage in the money market. Liquidity was drained in a number of ways, including the issuing of SARB debentures, conducting longer-term reverse repurchase transactions and increasing deposits in the sterilisation account that the National Treasury holds with the Bank. In addition, increases in notes and coin in circulation, and in the statutory cash reserves of commercial banks also drained liquidity.

Accumulation and management of reserves

The Bank continued to increase the level of official gross gold and foreign-exchange reserves, 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. In addition to accumulating foreign-exchange reserves, the Bank reduced the level of its borrowed reserves from around US\$3,2 billion at the end of August 2007 to US\$896 million at the end of August 2008. Borrowed reserves were reduced with the repayment of the outstanding portion of the syndicated loan entered into in 2005.

South Africa is one of a number of emerging-market countries that have a relatively high current-account deficit, which underlines the need for a healthy level of reserves. The current level of reserves puts South Africa more or less in line with many of its peers in the emerging-market community and it meets the generally accepted reserve-adequacy measures. However, the Bank does not regard the current level as excessive and is likely to 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. This improvement continued during the past year. The primary focus during the period under review was the formulation and partial implementation of a strategic asset allocation, which involved the quantification of risk tolerance in the form of a target duration per currency and a risk budget to facilitate the active management of reserves. In line with these developments, the roll-out of the internally managed portfolios 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 depicting the former president. Arrangements were made to distribute this special commemorative coin to all provinces prior to 18 July 2008, thereby ensuring that they were available nationally on Mr 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. Another project was initiated to review the South African settlement system infrastructure and applications, and

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to benchmark them against those of other central banks. Business continuity management also received special attention during 2008. Interbank clearing and settlement are of systemic importance and the Bank co-operated with stakeholders to minimise potential disruptions in this domain.

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, which became effective in December 2007. The measures contained in these directives are aimed at ensuring the safety and efficiency of the NPS. 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 (NPSAB), which is representative of all the regulated stakeholders within the NPS. This body allows for regulated bank and non-bank participants to establish associations that can represent the interests of their members at the NPSAB.

Financial stability

The resilience of financial markets globally has been severely tested during the past year following the widespread impact of negative developments in the US housing and sub-prime mortgage markets. As a result of the securitisation of sub-prime loans, the effect turned out to be more widespread than anticipated originally. Emerging-market economies, in general, and South Africa, in particular, have proven to be remarkably resilient in the midst of this financial market turmoil. The impact on South Africa has been indirect, mainly through financial market volatility and the resultant economic slowdown in the US and other major industrialised countries.

The Bank, in recognising the importance of a stable financial system to support its primary objective, seeks to identify inherent weaknesses in the financial system and monitor risks that may result in financial system disturbances. The domestic financial system was assessed as sound, based on a quantitative analysis of a standard set of financial soundness indicators. The Bank's qualitative assessment of the inherent robustness of the financial system environment against the 12 key financial soundness standards of the Financial Stability Forum shows a high level of general compliance with international standards and best practice.

Bank regulation and supervision

As part of its bank supervision function, the Bank focused on the impact of international financial market developments on the 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 and specific events in some international banking institutions, the Bank deemed it important to embark on a process to evaluate the appropriateness of South African banks' incentive schemes during 2008.

A major change to the South African banking regulatory and supervisory framework occurred as a result of the implementation of Basel II on 1 January 2008. The process followed in implementing Basel II was characterised by its broad consultative approach; several quantitative impact studies and field tests; amendments to the regulatory and supervisory frameworks; and regular interaction with all South African banking institutions. 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 combating the financing of terrorism. Furthermore, in August 2008 the Bank participated in the Financial Action Task Force's mutual evaluation of South Africa's anti-money laundering and counter-terrorism financing system.

International co-operation

The African continent and the Southern African Development Community (SADC) region remain 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. Significant progress has been made in the committees dealing with payment systems, information technology, macroeconomics, banking supervision and legal issues. This progress has been shared with the finance committees in Parliament where the ratification of the Finance

and Investment Protocol, a key instrument to advance regional economic integration in SADC, has been sought.

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 on to Brazil from South Africa at the beginning of this year. South Africa remains an active participant in this forum of systemically important advanced and emerging-market economies. The focus of the forum this year includes competition in the financial sector, fiscal space for social inclusion and clean energy. In addition, with the active involvement of the forum, progress was made this year with the reform of the Bretton Woods institutions, particularly in relation to quota reform and the finances of the International Monetary Fund (IMF).

The Bank, through the SARB College (the College) continued to contribute to training in Africa by co-operating with international training institutions and central banks. The College hosted the residential segment of the IMF Financial Programming and Policies course, and a course for African countries on external vulnerabilities. The College also co-hosted a high-level seminar on capital flight in sub-Saharan Africa with 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 show an increase from R220 billion at the end of March 2007 to R300 billion at the end of March 2008. 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 issuing of SARB debentures, an increase in currency in circulation, and the effect of valuation adjustments to the net reserves as a result of exchange rate and gold price movements. These adjustments are reflected in the increase in the Gold and Foreign Exchange Contingency Reserve Account.

The Bank's profit before taxation increased from R2 907 million for the previous financial year to R3 475 million for the financial year ended 31 March 2008. Budgeted expenditure of the Bank for the current financial year 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. After a review of reports by their Boards of Directors and internal and external auditors, the Bank is satisfied that the subsidiaries 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 in the *Annual Report*.

The shares of the Bank continued to trade through the over-the-counter trading facility, implemented on 1 October 2005. During the period 1 April 2007 to 31 March 2008, 42 transactions were successfully concluded, representing 69 516 shares.

Human resources remain an important focus 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. In terms of overall racial employment equity, the Bank progressed from 43 per cent black employees in 2000 to 58 per cent in 2008. Accordingly, the Bank's overall target of 50 per cent black employees has been realised and surpassed. At managerial level, 44 per cent of the positions are filled by black employees compared with 18 per cent in 2000. Overall gender equity improved from 42 per cent female employees in 2000 to 47 per cent in 2008. 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. This issue was identified in the Bank's *Seventh Annual Report on the Employment Equity Plan to the Department of Labour* as the only remaining barrier to employment equity. 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 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, conducted industrial theatres to sensitise staff, and are 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 Cadet Graduate Programme of the Bank increased its intake from 10 in the previous year to 17 in 2008. The College formed a strategic alliance with the University of South Africa and the Institute of Bankers in

South Africa to offer a nationally recognised qualification, namely the Advanced Diploma in Central Banking, which is also prescribed for the Cadet Graduate Programme.

A number of high-level workshops and seminars were organised by the College for specific niche markets. The second biennial conference on Challenges for Monetary Policy-makers in Emerging Markets is being organised and is scheduled to take place in October 2008.

Business continuity plans have been developed and successfully tested for all critical business processes. The Bank further continues to contribute towards the establishment and maintenance of a resilient business continuity capability within the broader financial sector, including the cash management industry.

The upgrading of the back-up uninterrupted power supply for Head Office is in progress. This is being done to prevent interruptions in Bank operations as a result of unplanned power disruptions. The Bank has also embarked on a project to investigate the energy efficiency and environmental friendliness of its buildings. This project should result in a reduction in the consumption of electricity and fuel.

Planning is in progress for several projects at the various branches around the country to ensure the efficient distribution of currency. The design for the proposed new Bloemfontein Branch has commenced, and tenders are awaited for extensive additions and alterations to the East London Branch. The new cafeteria at the Pretoria North Branch has been completed. Furthermore, the Cape Town Tower Block will be upgraded and the Johannesburg Branch will undergo major repairs. At Head Office large projects aimed at enhancing the existing infrastructure have been completed. These include the replacement of carpets, modernisation of lifts and maintenance of the air-conditioning system. The upgrading of the fire protection and evacuation systems, and the project to improve accessibility for people with disabilities are under way.

Conclusion

Global and domestic developments are expected to continue to pose a challenge to monetary policy in the coming year. In the international markets heightened volatility is expected to persist and growth in industrialised countries is expected to moderate further. The outlook for commodity prices is therefore uncertain and this makes for a difficult monetary policy environment. The Bank will continue to focus on bringing inflation 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.

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 banks not only with respect to the possible impact of global developments, but also to the impact of tighter credit conditions on indebted households and firms.

Staff development will remain one of our strategic objectives. There will be a continued focus on training and development within the context of our Employment Equity Plan. 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. The Bank maintained a good working relationship with 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 tireless 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 Prof. Vishnu Padayachee whose term of office expired last year. I wish to take this opportunity to thank Prof. Padayachee for his valuable contributions 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, management and staff of the Bank. I wish to thank them all for their contributions and I am confident that these efforts will ensure that the coming year is even more successful.