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

Introduction

The past year has witnessed the most severe global economic downturn since the 1930s. At the time of the previous annual general meeting, the impact of the financial market crisis was becoming evident in various economies. However, at that stage the extent and depth of the global recession were still to be realised. In response to the slowdown, central banks and governments around the world have taken unprecedented and unconventional steps to protect their banking systems and economies. In South Africa the well-regulated banking system was relatively insulated from the fallout. However, the globalised nature of the downturn meant that the domestic economy was not spared, and the resulting domestic recession required appropriate fiscal and monetary policy responses.

These developments posed a new challenge to monetary policy and resulted in a renewed focus on matters of financial stability. Appropriate supervision and regulation of the domestic banking sector and payment system have ensured an orderly financial market environment. Although inflation was outside the target range, the stance of monetary policy was loosened significantly in the face of an expected moderation in inflation and a weakening economy. Nevertheless, some upside risks to the inflation outlook remained and this constrained the monetary policy response somewhat. Apart from these concerns, the South African Reserve Bank (the Bank) also focused on maintaining and improving its internal operations.

A comprehensive economic report, which is included as part of the *Annual Report 2008/09*, provides an analysis of developments in the domestic and international economy during the year under review. Particular emphasis is placed on those developments that have had implications for the operations of the Bank. As is usually the case, the focus of this address is on the main operational areas of the Bank.

Monetary policy

During the past year, monetary policy has been faced with new challenges. For the first time since the introduction of the inflation-targeting framework in 2000, monetary policy had to be implemented in the context of a domestic recession and against the backdrop of the severe and synchronised downturn in the world economy. At the same time, inflation remained well above the upper end of the inflation target range and, despite the downside pressures, targeted inflation was only moderating at a very slow rate.

At the time of the previous annual general meeting, inflation was significantly outside the target range. The consumer price index excluding mortgage interest cost (CPIX) inflation peaked at 13,6 per cent in August 2008 and declined to 10,3 per cent by December. With the publication in February 2009 of the reweighted and rebased inflation measure, headline consumer price index (CPI) inflation for all urban areas was adopted as the new inflation target measure, with the target range remaining at 3 to 6 per cent. CPI measured 8,1 per cent in January, but increased to 8,6 per cent in February and has been declining gradually since then. By July, CPI inflation had declined to 6,7 per cent. However, the pace of decline has been constrained by substantial increases in some administered prices, particularly electricity prices, and persistently high food price inflation.

As a result of the global turmoil, the outlook for inflation was subject to greater risk and uncertainty than usual, and this complicated monetary policy decision-making. Furthermore, the assessment of risks changed significantly in the course of the year in line with the reversal in the trends of a number of factors impacting on inflation.

The international oil price had been one of the main sources of upside risk to the inflation outlook during 2008. However, in response to the global downturn, the price of North Sea Brent crude oil declined from levels of around US$146 per barrel in August 2008 to around US$34 in December. Domestic petrol prices followed suit and declined from R10,70 per litre in July 2008 to R6,01 per litre in January 2009. However, as global growth prospects improved, the oil price has recently increased to around US$70 per barrel. Nevertheless, as a result of exchange rate developments, the domestic petrol price is still lower than the levels that prevailed in 2008 and has contributed to downward pressure on inflation during the year to date.

The behaviour of the rand exchange rate during the past year has reflected the volatile global environment. In the early stage of the unfolding crisis, the rand came under pressure, along with the currencies of most other emerging-market economies. In November the rand had depreciated to around R11,85 against the US dollar, and at the December meeting of the Monetary Policy Committee (MPC), the exchange rate was identified as the single biggest upside risk to the inflation outlook. However, as risk aversion abated, the rand recovered somewhat over the subsequent months and the risk to the inflation outlook from this source was reduced significantly. The rand has recently been at levels close to those prevailing in the first half of 2008.

Global developments also reduced the risk to the inflation outlook. The synchronised global recession and generally lower commodity prices meant that the threat to world inflation had dissipated substantially. While there are concerns about the possible inflationary consequences of the accommodating monetary policy stance in a number of advanced economies, global inflation is expected to remain contained at low levels.

The widening domestic output gap during the past period also posed a downside risk to the inflation outlook. After a number of years of growth of around 5 per cent, the economy began to slow to rates below potential output growth. The economy grew at an annualised rate of 0,2 per cent in the third quarter of 2008, but the full impact of the slowing world economy on the domestic economy became more evident in subsequent quarters. In the final quarter of 2008 a contraction of 1,8 per cent was recorded. In the first two quarters of 2009 the economy contracted at annualised rates of 6,4 per cent and 3,0 per cent respectively.

Final consumption expenditure by households has been contracting since the third quarter of 2008. The weaker domestic demand was a result of declining real disposable incomes and employment, and negative wealth effects as a consequence of the significant decline in equity and house prices. The negative trend in consumption expenditure was reinforced by a significant deceleration in the growth of credit extension to the private sector. This was in response to both lower demand for, and restricted supply of, credit as banks applied stricter lending criteria in view of the increasing number of impaired loans.

Despite these factors that were generally conducive to a decline in the inflation rate, there were other pressures and risks to the upside. Administered prices continued to exert upward pressure on inflation. The biggest thrust came from the electricity price increase of 27,5 per cent granted to Eskom in 2008, followed by a further increase of 31,3 per cent announced in June 2009. Wage settlements in excess of inflation have also posed a threat to the inflation outlook. These settlements partly reflected the deterioration of inflation expectations over the period.

Food price inflation was the main contributor to overall inflation over the past year. This was despite significant declines in the prices of agricultural commodities, which were reflected at the producer price level with respect to both agricultural products and manufactured food. Nevertheless, food price inflation at the consumer price level has remained stubbornly high. However, there have been recent indications that the pace of moderation in food price inflation may be accelerating.

In response to the downward trend in actual and forecast inflation, the monetary policy stance has been eased progressively by a cumulative 500 basis points since December 2008. The repurchase rate was reduced by 50 basis points at the December 2008 meeting of the MPC and by a further 100 basis points at each of the four subsequent meetings. At the June 2009 meeting the monetary policy stance remained unchanged, but at the August meeting the repurchase rate was reduced by a further 50 basis points as the committee assessed that the risks to the inflation outcome had tilted further to the downside.

The easing in monetary policy was applied despite the fact that inflation was still outside the inflation target range. However, in a forward-looking monetary policy framework the MPC focuses on the expected path of inflation. Although subject to a high degree of variability and uncertainty, the inflation forecast during this past period has consistently indicated that inflation was expected to return to within the inflation target range over a reasonable time horizon. The MPC continued to apply monetary policy within a flexible inflation-targeting framework, cognisant of the economic downturn. Nevertheless, price stability remains the ultimate objective of monetary policy and the Bank remains committed to achieving the target over a reasonable time frame.

Money-market operations

In response to the consequences of the global financial market crisis, many central banks injected large amounts of liquidity into their money markets. However, domestic markets remained characterised by excess liquidity conditions and, therefore, no additional liquidity had to be provided to domestic banking institutions. In order to drain the excess liquidity, the Bank issued South African Reserve Bank (SARB) debentures and conducted reverse repurchase transactions. Liquidity was also drained from the money market through increases in the balances of the accounts held at the Bank by banks and the public sector, and increases in notes and coin in circulation. In the year to the end of August 2009 these factors were jointly responsible for draining a total amount of approximately R6,9 billion from the money market. The excess liquidity is partly associated with the increase in foreign-exchange reserves over the past years.

Foreign-exchange reserves

The pace of accumulating foreign-exchange reserves by the Bank declined considerably as a result of the turmoil in the international financial markets. At the end of August 2009 the official gross gold and foreign-exchange reserves amounted to US$38,0 billion and the international liquidity position amounted to US$36,9 billion. The Bank will continue with its strategy of accumulating reserves when market conditions are favourable.

However, further accumulation is expected to be constrained by the volatility in the foreign-exchange markets, the level of global risk aversion and the cost of sterilisation.

Managing the foreign-exchange reserves poses considerable challenges, particularly in the current uncertain global financial market conditions. As capital preservation represents one of the main pillars of the reserves management policy of the Bank, various steps have been taken to protect South Africa's reserves from the instability and volatility experienced in these markets. Accordingly, counterparty risks, exposure to specific asset classes and the overall duration of the reserves portfolio were reduced, and the Bank's conservative investment guidelines were tightened further. However, the demise of Lehman Brothers, in particular, gave rise to a series of downgrades in the credit ratings of financial institutions and investment instruments, which resulted in mark-to-market declines or unrealised losses in the value of some of the instruments on the balance sheet of the Bank.

A comprehensive review of the external fund management programme was conducted during the year under review. The mandates of three of the existing fund managers will be renewed and three new managers will be appointed in September 2009, bringing the total number of external fund managers to six.

Currency distribution

Currency counterfeiting generally remains a risk to the Bank and the economy. Continuous efforts are being made to combat counterfeiting and to ensure the integrity of currency in circulation. The Bank has initiated a process for the introduction of a new series of banknotes and coin with new themes and improved security features. It is envisaged that the new currency series will be launched by mid-2013.

The national payment system

The Bank, in conjunction with the settlement banks, has been concentrating on the development and implementation of a national payment system information database, and a review of the real-time gross settlement (RTGS) network infrastructure and associated applications. A review of the current RTGS system – the South African Multiple Option Settlement (SAMOS) – indicated that the system was of a world-class standard. Potential enhancements to the SAMOS infrastructure and applications are due to be made in consultation with stakeholders during 2009.

Although volumes and values of payment transactions increased substantially during the financial market volatility in September and October 2008, the operations and liquidity provision of the settlement system and associated foreign-exchange Continuous Linked Settlement (CLS) system performed well and without disruptions. In October 2008 the SAMOS system settled a record aggregate value of R8,5 trillion.

The Bank continued its role as part of the CLS system oversight group chaired by the Federal Reserve Bank of New York. During the year the Bank and other participating central banks signed a CLS oversight protocol arrangement. CLS oversight arrangements and processes were thoroughly and successfully tested during the financial market crisis in September and October 2008.

Financial stability

Financial stability is of vital interest to central banks and, with the evolution of the global financial crisis, renewed attention has been paid to financial stability policy responses. Some central banks have responded by adopting more explicit and broader mandates for financial stability. The crisis also highlighted the need for macroprudential analysis of the financial system as a whole in order to identify and mitigate systemic risks. The Bank continually seeks to identify inherent weaknesses in the financial system and monitors risks that may result in financial system disturbances.

Financial institutions and markets in South Africa were spared the worst of the direct effects of the global financial crisis as they were largely shielded by their limited exposure to risky foreign assets and liabilities. Developments in the domestic financial infrastructure and regulatory environment that are likely to strengthen the resilience of the financial system include new legislative developments to improve competition, consumer protection and corporate governance.

Bank regulation and supervision

As part of its bank supervision function, the Bank maintained its focus on promoting the soundness of the domestic banking system through the effective and efficient application of international regulatory and supervisory standards. The implementation of Basel II on 1 January 2008 and the application of the Core Principles for Effective Banking Supervision issued by the Basel Committee on Banking Supervision remain the cornerstones of the Bank's regulatory and supervisory framework.

The Bank continued to refine its Basel II-revised regulatory and supervisory approach during 2008 and 2009 by attending, *inter alia*, to the Internal Capital Adequacy Assessment Processes implemented by banks; thematic reviews of credit, market and operational risk; and the processing of applications by banks to use the advanced approaches to calculate their minimum capital requirements in respect of credit and operational risk. In line with international developments, the Bank held discussions with the banking industry on the stress-testing frameworks it implemented. In addition, the Bank continued to develop its own internal stress-testing expertise and methodology to facilitate the effective monitoring of the stress-testing frameworks of banks.

The secondary effects of the international financial market turmoil, combined with cyclical economic developments in South Africa, worsened the operating environment of the banking sector during 2008 and the first half of 2009, with a significant decline in the rate of growth in loans and advances. Furthermore, increasing pressure on consumers continues to be clearly evident in the marked increase in impaired advances and rising credit impairments, which impact negatively on the earnings of banks. However, the South African banking system remains stable and banks are adequately capitalised.

In response to the international financial market turmoil, the Bank commissioned an independent review of all securitisation schemes in which domestic banks were participating in order to determine whether such schemes were being managed prudently. Although no material issues were identified, the recommendations in the final report will be used as the basis for further consultation with the banking industry and for possible legislative and/or regulatory framework amendments in future.

International co-operation

The Bank addresses itself to regional and continental programmes that promote future regional integration. The Bank hosts the Secretariat of the Committee of Central Bank Governors (CCBG) in the Southern African Development Community (SADC) and supports the implementation of CCBG projects. The SADC Finance and Investment Protocol (FIP) was ratified by the South African Parliament in 2008 and work has begun in the various committees. Of note is the completion of the drafting of the proposed SADC central bank model law, which will pave the way for the harmonisation of the legal and regulatory frameworks of SADC central banks.

The Bank plays a leading role in the SADC payment system project. During the past year the focus has been on the efficiency of electronic settlement systems and the collection of payment system statistics. Further work is being done on the interlinking of payment systems on a regional basis and the efficiency of remittance payment systems in the region.

The Bank participated in several initiatives to strengthen financial systems in SADC. The Bank hosted or organised a number of regional workshops and conferences for SADC central banks in conjunction with international training institutions. These institutions included the International Monetary Fund Institute, the Bank for International Settlements (BIS) and the Toronto Centre.

Participation in multilateral forums such as the Group of 20 (G-20) and the Financial Stability Board increased in the wake of the global financial and economic crisis. South Africa, as an active member of the G-20, contributed to the formulation of the co-ordinated G-20 response to the global financial crisis. The Bank also continues to foster relations with the BIS, and participates in a number of BIS committees and forums, including the Basel Committee on Banking Supervision.

Internal administration

The *Annual Report 2008/09* of the Bank was distributed to shareholders before this meeting. The total assets of the Bank show an increase from R300 billion at the end of March 2008 to R344 billion at the end of March 2009. The Bank was not unaffected by the turmoil in the world’s financial markets. Low yields on prime investments and the collapse in prices of many traded financial instruments caused a decline in net income after tax from R2,5 billion in the previous financial year to R0,9 billion in the 2008/09 financial year.

Operational expenditure is budgeted to increase by 22 per cent in the current financial year. This increase is due to an increase of 42 per cent in the production cost of currency; stock building of currency for the 2010 FIFA World Cup tournament; delivery of back orders of currency in respect of the previous financial year; and significant repairs and maintenance to Bank premises.

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 have continued to be 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 2008/09*.

The shares of the Bank continued to trade through the over-the-counter trading facility. During the 2008/09 financial year, 40 transactions were concluded, representing 57 980 shares.

The permanent staff complement of the Bank increased by 34 in the year and totalled 1 930 at the end of the financial year. The overall staff turnover for the period was 6,2 per cent; slightly lower than in the previous year. In terms of overall employment equity, the percentage of black employees has increased by 2 percentage points to 60 per cent, compared with a target of 50 per cent for 2009. At management level an increase of 2 percentage points was also achieved. While the Bank has made advances with regard to gender representation generally, female representation at the more senior levels remains a priority area.

The Bank consulted widely on employment equity, resulting in the implementation of a programme to educate and sensitise employees about disability issues. The Bank completed its disability verification process in which employees were given the opportunity to declare their disability status voluntarily.

Performance management had previously been identified as the only remaining barrier to employment equity in the Bank. A task team investigated the Bank's performance management system and made recommendations for improvement. The revised system is being implemented.

As part of the Bank's HIV/AIDS programme, almost 70 employees were trained to serve as peer counsellors. The programme is an ongoing initiative, and the next phase will address voluntary counselling and testing.

The Bank continues to emphasise training and development. In the period under review the Bank received R2,4 million in the form of mandatory grants for complying with the reporting regulations of the Skills Development Act, 1998 (Act No. 97 of 1998). Seven students have completed learnerships and have all been appointed to permanent positions in the Bank. The Bank has also approved a new policy for external bursaries and 25 university students in their second year of study have been granted financial assistance.

Besides the general central banking programmes offered, the Bank organised and hosted a number of specialised courses and seminars. Topics included the flow of funds, advanced econometric and computational methods, financial stability, and currency management.

The Bank strives to promote a research culture in the Bank and a number of joint research projects have been completed under the auspices of the Visiting Research Fellows Programme. In October the Bank hosted its biennial conference with the theme "Challenges for Monetary Policy-makers in Emerging Markets". The conference proceedings were published in book form and on the website of the Bank.

The Bank has initiated work on an integrated workforce plan to ensure that Bank employees have appropriate skills. The plan will address the continuity of skills and ensure the effective transfer of the intellectual knowledge essential for the successful operations of the Bank.

A number of the Bank's branch buildings have been assigned heritage status, which creates challenges for cash-handling requirements, energy efficiency, environmental friendliness, the provision of uninterrupted power supply, fire-detection systems and access for people with disabilities, while preserving the integrity of the buildings. Most of the planned upgrades, additions or alterations to the branches have either been completed, have reached the construction stage or are near this stage pending the successful completion of the planning and tendering processes. The new Bloemfontein branch building is being designed. The existing fire-detection and evacuation communication systems at Head Office and in the Durban branch are being replaced to comply fully with health and safety regulations.

Finally, the Bank has made considerable progress with the implementation of the new enterprise resource planning (ERP) solution, which is expected to enhance the efficiency of internal processes. The ERP will integrate the data and processes from various business units, and should offer numerous benefits to the Bank, including the introduction of proven best practices and the decommissioning of more than 20 legacy systems that have become difficult to maintain. The ERP should be fully implemented before the end of 2009.

Conclusion

Although the worst of the global downturn appears to be behind us, the recovery is expected to be slow and protracted. The domestic economy also appears set to recover somewhat in the coming months, and domestic inflation is expected to continue its moderating trend as a result of downward pressures from weak domestic demand and lower commodity prices. However, the rate of decline is being constrained by high and sustained administered price increases and wage settlements in excess of inflation. The Bank will continue to strive to achieve price stability within a flexible inflation-targeting framework in the interest of sustainable economic growth.

The recent global financial market turmoil has highlighted the need for the Bank to maintain a commitment to financial stability. This includes the monitoring and supervision, where applicable, of the national payment system, the financial markets and the banking system. The domestic financial markets have come through the global banking crisis relatively unscathed. Nevertheless, credit impairments have been increasing, which poses a threat to the profitability of banks, and these trends will be monitored closely.

Internally, the Bank will continue to concentrate on staff development, and to implement measures to retain staff and boost staff morale through more appropriate performance management. Emphasis will also be placed on enhancing the efficiency of the internal processes of the Bank and the introduction of the new ERP solution during the year is expected to contribute to this objective.

Acknowledgements

I wish to thank the Presidency, the Government and Parliament for their continued support. The good working relationship with the National Treasury was maintained, facilitated by the system of bilateral committees. I wish to thank the previous and current Ministers and Deputy Ministers of Finance for their support and co-operation during the past year, as well as the Director-General and staff in the National Treasury.

I also wish to thank the Board of the Bank for the work they have done in ensuring appropriate corporate governance in, and the smooth running of, the Bank. Mr Daniel Mminele joined the Board of the Bank following his appointment as Deputy Governor. I wish to take this opportunity to congratulate him on his appointment.

This is my last annual address to shareholders. I wish to thank the Presidency for the opportunity to serve the country as Governor of the South African Reserve Bank. It has been an honour and a privilege. I can look back on the past ten years with pride at the achievements of the Bank. In this respect, I wish to express my sincere appreciation to the deputy governors, the management and staff of the Bank for their professionalism, support and dedication in assisting to achieve the various objectives of the Bank during the past ten years. I also wish to congratulate Ms Gill Marcus on her appointment as my successor. Ms Marcus is no stranger to the Bank or to the financial sector, and I know that I will be leaving the Bank in extremely capable hands. I wish Ms Marcus, the deputy governors and the staff of the Bank all the best in facing future challenges.