Mr Mboweni: The role of the South African Reserve Bank in the economy

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Pretoria Council for Businesswomen, Pretoria, held on 14 March 2000.

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1. The establishment of the Reserve Bank

The South African Reserve Bank was established in 1921 as the central bank of South Africa in terms of a special act of Parliament. The founding of the Reserve Bank was the direct result of disruptions caused by the First World War and formed part of a more comprehensive set of measures meant to deal with unsatisfactory monetary and financial conditions. At that time, the existence of central banks was still not common, and the South African Reserve Bank was only the fourth central bank founded outside Europe. The other three central banks were established in the United States of America, Japan and Java.

The Reserve Bank was mainly set up because of the need to issue uniform banknotes and to prevent the over-issue of banknotes. Before the Bank was established an assortment of banknotes were in circulation in South Africa which were issued in terms of the laws of the various provinces. With the formation of the Reserve Bank, it obtained the sole right to issue banknotes in South Africa. The Bank’s first notes were issued to the public in April 1922. At the end of that year the banknotes in circulation amounted to R20 million. At the end of February 2000 the notes and coin in circulation totalled R27,4 billion.

The Reserve Bank’s size and operations were at first hampered by various statutory restrictions on its lending and investing. Some expansions to the Bank’s powers to grant credit were brought about by amendments to the Currency and Banking Act in 1923 and 1930. A more comprehensive revision of the Bank’s powers was affected in 1944. Subsequently, many changes were also made to strengthen the bank’s hand in carrying out its functions. These changes reflected a recognition of the Bank’s need for greater freedom of action in its day-to-day operations and an awareness of the need for sufficient policy instruments in conducting monetary policy.

Today, the Reserve Bank virtually performs the full range of functions and duties that are customarily carried out by central banks. In addition, the Reserve Bank is actively involved in the marketing of South Africa’s gold production. The main functions of the Reserve Bank are:

- the issuing of banknotes and coin;
- acting as banker to the government;
- acting as a bank to other banks;
- providing facilities for the clearing and settlement of claims between banks;
- acting as custodian of the country’s gold and other foreign reserves;
- acting as “bank of rediscount” and “lender of last resort”;
- engaging in public debt management and open-market operations;
- collecting, processing and interpreting economic statistics and other information, and
- formulating and implementing monetary policy.

2. Legal framework of the Bank

The existence, management, powers and functions of the Bank are currently governed by the Reserve Bank Act No 90 of 1989, which came into operation on 1 August 1989. However, the Reserve Bank has also been identified as the central bank of South Africa in the Constitution of the Republic of South Africa. As the Bank is a statutory institution, it is only allowed to perform functions expressly or by implication assigned to or conferred upon it by these two legislative enactments.

Since its establishment, the Reserve Bank has always been privately owned. Today, the Bank has more than 700 shareholders. The shares of the Bank are listed on the Johannesburg Stock Exchange and no individual shareholder is allowed to hold more than one-half per cent of the capital of the Bank. The Bank may never pay a dividend of more than 10% per annum on the nominal value of its capital.

The Bank is managed by a Board of 14 Directors, seven of whom are elected by the shareholder's to represent them on the Board. Without holding any shares in the Bank, the Government has the right to appoint the other seven Board members. The seven members appointed by the President includes the Governor and three Deputy Governors, who are full-time executive members, plus three part-time Directors.

The Governor and the Deputy Governors are appointed for five years, while all other directors serve for periods of three years. All directors are eligible for reappointment or re-election after the expiration of their terms of office.

The Reserve Bank Act provides further that of the seven directors elected by the shareholders, four shall be persons who are or have been actively and primarily engaged in commerce or finance, one shall be a person who is or has been engaged in agriculture and two shall be persons who are or have been engaged in industrial pursuits. Members of Parliament, directors, officers or employees of banks or mutual banks and persons who are not South African citizens resident in the country are disqualified from being appointed or elected as a director of the Bank.

The Board of the Reserve Bank has been given an important degree of autonomy for the execution of its duties. In terms of the Constitution: The South African Reserve Bank, in pursuit of its primary objective, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters".

As a creation of government, the Reserve Bank is, of course, accountable to Parliament and the Government has an important say in the activities of the Bank. In terms of section 31 of the Reserve Bank Act the Governor of the Bank must submit a report annually to the Minister of Finance relating to the implementation of monetary policy. Moreover, in terms of section 32 of this Act the Bank must on a monthly basis submit a statement of its assets and liabilities and annually its annual financial statements to the Department of Finance. These reports are then tabled in Parliament by the Minister of Finance.

The Governor of the Reserve Bank is also summoned to appear before the Portfolio Committee on Finance from time to time. In these meetings he usually explains the monetary policy stance to committee members and answers questions on the Bank's views on financial and economic developments.

Section 37 of the Reserve Bank Act provides further that if at any time the Minister of Finance is of the opinion that the Bank has failed to comply with any provision of the Act or of a regulation made thereunder, he may by notice in writing require the Board of the Bank to make good or remedy the default within a specified time. If the Board fails to comply with such a notice, the Minister may apply to the Supreme Court for an order compelling the Board to make good or remedy the default, and the Court may make such order thereon as it thinks fit.

3. Primary objective of the Bank

In all these endeavours, the primary or strategic objective of the Reserve Bank is to achieve and maintain stable financial conditions in the country. This objective is spelled out in both the Constitution of the Republic and in the South African Reserve Bank Act. In these acts it is recognised that only by protecting the currency can balanced and sustainable economic growth be achieved. It is believed in the Bank, and indeed in most countries of the world, that the potential growth rate of an economy and the optimum creation of employment opportunities can only be attained under stable financial conditions. By fulfilling this primary objective, the Reserve Bank will make its contribution to sustainable higher economic growth in South Africa.

The question may be asked what is meant by the term financial stability? In a broad sense financial stability can be defined to include price stability as well as stable conditions in the financial sector as a whole. Price stability is achieved when changes in the general price level do not materially affect the economic decision-making process. Although relative price movements will still have an impact on production, consumption and investment, the rate of inflation or deflation is not an important factor in the decisions taken by producers, consumers and the authorities under stable price conditions.

The stability of key institutions and markets in the financial system is achieved when there is a high degree of confidence that the financial infrastructure of the economy is able to meet the requirements of market participants. However, it is important to realise that financial stability does not exclude the failure of individual banks or financial institutions. A financial institution can go bankrupt in stable financial conditions. It is only where systemic risks arise, i.e. where the financial sector as a whole may be influenced by an incident, that the situation can be described as financially unstable.

The two elements of financial stability, i.e. price stability and stability of the financial sector, are closely related. Failure to maintain one of these elements provides a very uncertain operating environment for the other, with causality running in both directions. For example, high inflation can lead to tighter monetary policy, higher interest rates, an increase in the non-performing loans of banks and a fall in asset and collateral values, which can cause bank and other failures in the financial sector. Conversely, disruptions in the financial system will make the transmission mechanism of monetary policy less effective and can materially affect changes in the general price level.

4. Monetary policy framework

In its objective to establish and maintain financial stability it is therefore important that the Reserve Bank encourages and supports the development of sound and well-managed banking institutions. This is done, firstly, by monitoring the financial risks that banks undertake. The Bank Supervision Department is charged with the responsibility to ensure prudential soundness in the banking system. Secondly, lender-of-last-resort assistance is provided to banks to safeguard the system from systemic risks. This assistance is never provided automatically to any bank that encounters difficulties, but it is only applied in cases where a bank is encountering liquidity shortages and where its failure would pose a serious threat to the financial system as a whole.

Financial stability also requires well-developed and efficient functioning financial markets. In this regard it is important to have sufficient banknotes and coin in circulation, so as not to hamper trade and financial transactions. Without a system for the clearance and settlement of bank claims, the payments for transactions would be encumbered. In addition, the Reserve Bank has a vested interest in the development and functioning of the money, capital and foreign exchange markets if it wants to maintain financial stability.

In order to achieve price stability, the Minister of Finance announced in his Budget Speech on 23 February 2000 that the government has decided to adopt an inflation-targeting monetary policy framework in South Africa. This means that the authorities are now targeting the rate of inflation directly, instead of setting guidelines for intermediative objectives such as money supply and bank credit extension to bring inflation down to lower levels. The inflation target has been expressed as an average annual rate of increase of between 3 and 6% in the consumer price index excluding the effect of changes in mortgage rates for the year 2002.

With the announcement of this new framework the inflation target becomes the overriding objective of monetary policy. The objective of monetary policy is now to hit the target. Missing the target consistently with wide margins will lead to lost prestige and credibility for the central bank. Such a framework for monetary policy can only be successful if the public is certain that the central bank is serious about containing inflation.

This new framework has been adopted in South Africa to remove any uncertainties about the monetary policy stance that is adopted by the authorities. Inflation targeting makes policy transparent in the sense that it makes the central bank's intentions clear in a way that should improve the planning of the private sector. Inflation targeting should also provide an anchor for inflation expectations, lead to greater stability in interest rates if it brings about better coordination of policy measures and clearly defines the accountability of the Reserve Bank.

In this new monetary policy framework the operational procedures of the Reserve Bank will basically remain unchanged. The Bank will accordingly continue to influence the total monetary demand in the economy to achieve price stability. The Reserve Bank controls the supply of money through its operations in providing liquidity to the banking sector and by affecting the total demand for money that emanates from the private and public sector. Its operational variable in this process is the level of short-term interest rates. The level of interest rates is determined primarily by total saving in the economy, the inflow of capital, and by the demand for funds from government, businesses and private individuals. The central bank affects the cost of short-term funds through the impact of its actions on the repo rate, i.e. the interest rate at which it provides in the liquidity needs of the banks. In such a framework there is no target for the exchange rate of the rand. The external value of the rand forms part of the results obtained in the economy.

5. Decision-making process

In view of the growing complexity of functional relationships between the various economic and financial variables, a detailed and careful analysis has to be made of the underlying economic conditions. A large number of economic indicators are therefore monitored by the Bank to arrive at its monetary policy stance, such as developments in price indices, the level of interest rates, the shape of the yield curve, changes in nominal salaries and wages, nominal unit labour costs, the gap between potential and actual domestic output, money market conditions, the overall balance of payments position, the net open position in foreign exchange and the public sector borrowing requirement.

To evaluate the results of such an analysis of the economy a Monetary Policy Committee was created in the Reserve Bank. The Monetary Policy Committee consists of the Governor and Deputy Governors as voting members and senior officials of the Bank as non-voting members. The first meeting of the Monetary Policy Committee was already held in October 1999. At the meetings of this Committee an evaluation is made over a two-day period of international and domestic economic conditions, the expected behaviour of the inflation rate and the current stance of monetary policy.

Although the governors of the Bank are the only members with voting rights on the Committee, consensus decisions are normally made. The final decision-making power on monetary policy matters nevertheless is still vested in the Governor's Committee, i.e. a subcommittee of the Board comprising the Governor and three Deputy Governors.

After the completion of every meeting of the Monetary Policy Committee a statement is issued to the public. This statement summarises the more important aspects that were discussed at the meeting and the conclusions that were made. In this statement the monetary policy stance of the Reserve Bank is also formulated. For example, in the last monetary policy statement of 2 March 2000 it was concluded that after taking cognisance of the current economic circumstances and consistent with the inflation target set by the authorities, the Monetary Policy Committee is of the opinion that the current level of the repo rate is appropriate. In accordance with the decision taken at the previous meeting, the Reserve Bank will therefore continue to manage the banks' daily liquidity requirement in a way that will result in a repo rate at or around 11.75%".

6. Conclusion

As already indicated, this decision was taken after lengthy deliberations and a detailed analysis of the underlying economic conditions in the country by senior staff of the Reserve Bank. More in particular, the latest decision of the Monetary Policy Committee took note of the following economic developments:

- Favourable global growth prospects with some signs of an acceleration of inflation in industrial countries and a concomitant rise in their interest rates.
- South Arican recovery in domestic economic activity that gathered momentum during the course of 1999. The growth from quarter to quarter in real gross domestic product increased from 2% in the fourth quarter of 1998 to no less than 32% in the fourth quarter of 1999.
- With the increase in economic activity, gross domestic expenditure began to pick up and increased at a seasonally adjusted and annualised rate of 42% in the fourth quarter of 1999. This high growth can be ascribed to a rise in consumption expenditure, an increase in the fixed investment of private organisations and a strong accumulation of inventories.
- Conditions in the labour market remained depressed with further job losses of about 80 000 being recorded in the first nine months of 1999.
- The current account of the balance of payments showed a deficit of 2% of gross domestic product in the fourth quarter of 1999. This deficit did not present any problems to the domestic economy and was wiped out by a net inflow of capital of no less than R14 billion. Moreover, the balance of payments is basically very healthy, which makes it difficult to understand why the external value of the rand recently came under some pressure.
- Clear signs of increased inflationary pressures have become apparent in the South African economy. This has been reflected in a rise in the year-on-year rate of the production price index from 5.7% in September 1999 to 8.2% in January 2000. This acceleration in inflation was mainly due to increases in the prices of petrol and diesel, transport equipment and more recently food products. The recent floods experienced in the country, a further increase in international oil prices and the more rapid rise in money supply growth could also cause rising inflation over the short term.
- Over the medium to longer term, inflation in South Africa is expected to subside again because of the application of fiscal and monetary discipline, a projected low growth in nominal unit labour costs, international competition and the excess production capacity in the economy.

All in all the economic conditions in South Africa are at present much more favourable than at the beginning of the preceding year. With the further improvement in the production structure of the country envisaged in the President’s State of the Nation Address on 4 February 2000, the outlook for the South African economy indeed looks very promising.