T T Mboweni: Recent financial and economic developments in South Africa

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the eighty-second ordinary general meeting of shareholders, 27 August 2002.

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Introduction

The South African Reserve Bank was again confronted by many challenges during the past year. I am, however, glad to say that, as on previous occasions, the Bank coped well. Although some ground was lost in containing inflation owing to the exogenous shocks that affected the economy, remedial action has been taken to bring the inflation rate down towards the targeted levels. A period of consolidation in the banking sector was handled in an effective manner so as to ensure continued domestic financial stability. Attention was given to the regulatory structure of the banking sector to continue protecting the funds of depositors and to ensure that the intermediation of savings runs smoothly. The efficiency and effectiveness of internal administrative procedures were improved further and considerable progress was made with transforming the composition of the Bank's staff to better reflect the demographics of the country.

Recent economic developments

The South African economy also did well in a rapidly changing political and economic world. A comprehensive review of recent economic developments in South Africa is contained in the Reserve Bank's Annual Economic Report, which was released this morning. In my address I therefore wish to highlight only the following developments:

South Africa, like most other emerging-market economies, was affected considerably by the attacks on the United States of America in September 2001, the uncertainties that this created politically as well as in the business world, the continued relatively high levels of oil prices and the strong downturn in world economic activity. The resulting decline in the volume of our exports in the second half of 2001 affected domestic economic growth. In addition, greater risk aversion to investment in developing countries had a marked impact on capital flows to South Africa. In response to the weakness in world economic activity, monetary policy in most countries became more accommodative and interest rates were brought down significantly. In some countries, fiscal measures were also taken to stimulate activity. These measures now seem to be bearing fruit and a world economic recovery should be of significant benefit to South Africa.

The most important effect of world political and economic developments on South Africa was that they contributed materially to the volatility in the external value of the rand during the past year. After the value of the rand had been relatively stable in the first six months of 2001, it depreciated steeply in the second half of the year. As a result, the nominal effective exchange rate of the rand decreased by about 34 per cent in the second half of the year. Towards the end of 2001 the external value of the rand began to recover and the weighted exchange rate recouped about 20 per cent of its losses up to the end of May 2002.

In the following two months the rand fluctuated around this new level but, on balance, declined by just more than 7 per cent. This brought the nominal effective exchange rate of the rand back to about 27 per cent below its level at the beginning of 2001.

A number of factors contributed to the depreciation in the value of the rand during 2001. These included a weak export performance and a strong increase in imports and dividend payments to non-residents. The resultant deficit on the current account of the balance of payments was accompanied by a net outflow of portfolio capital. This outflow stemmed from the perceived higher risk of investing in emerging-market economies, the problems experienced in Argentina and later Brazil, instability in Zimbabwe, and unfounded expectations of imminent exchange-control relaxations in South Africa. Eventually, international investors began to regard the external value of the rand as a one-way bet, exporters delayed repatriating their foreign-earned currency and importers switched financing from foreign to domestic sources. In other words, there was a typical speculative bandwagon effect.

After the authorities had reminded the market about the sound economic fundamentals in South Africa in a statement on 20 December 2001, and it became clear that the exchange rate of the rand had over-reacted, this whole process was reversed. Exporters stopped delaying the transfer of their proceeds, importers shifted back to foreign financing for purchases and international investors were again willing to invest large sums in domestic shares and bonds. International conditions calmed down somewhat and the world economy began to recover. At the same time the current account of South Africa's balance of payments moved into surplus, mainly owing to a decline in dividend payments to the rest of the world and a rise in exports.

The depreciated external value of the rand has undoubtedly strengthened the price competitiveness of domestic producers and could lead to a strong export performance. Substituting domestically produced goods for imported goods should further promote economic growth. The South African economy also proved to be quite resilient to the world economic slowdown in the period under review. Despite a synchronised decline in the growth of most of our major trading partners, the growth rate in real gross domestic product only declined moderately from 3,4 per cent in 2000 to 2,2 per cent in 2001 and 2,3 per cent in the first half of 2002.

The positive production growth in generally depressed world economic conditions could be attributed to continued strong domestic demand for goods and services. Final consumption expenditure by households and general government contributed to the pick-up in spending, but the largest contribution came from investment, especially fixed investment by the private sector. After declining in the second half of 2001, the volume of exports also began to rise in the first half of 2002.

As could be expected with the strong domestic final demand for goods and services, the saving performance of the South African economy remained at a low level. In the past five years, gross saving as a ratio of gross domestic product has continued to fluctuate between about 15 and 16 per cent, which is too low to finance the growth performance the country needs for creating enough employment opportunities. The consistently low saving ratio has persisted despite a substantial improvement in government saving. After being a large dissaver a few years ago, government has made a positive contribution to saving since 2001. Corporate saving, which still represents the mainstay of the domestic saving effort, has weakened considerably over the past five years, while household saving remained at low levels.

The steady growth performance in South Africa was accompanied by substantially higher labour productivity. The real output per worker in the non-agricultural sectors had increased by only about 1 per cent per year in the period from 1985 to 1995, but rose at an average annual rate of nearly 41/2 per cent from 1995 to the first half of 2002. Higher labour productivity was the combined result of an increase in output and a reduction in formal-sector employment. Producers preferred to employ capital rather than labour. Economising on the utilisation of labour resources was in part the result of a decline in the user cost of capital. But it was also brought about by factors such as a declining gold price and the opening up of the economy to international competition, which made the use of cost-saving production methods more urgent.

Concerted efforts by government to reduce the public-sector deficit contributed further to a decline in formal non-agricultural employment. More than one million employment opportunities have therefore been lost since the peak of the employment cycle in 1989. Employment growth has occurred largely in the informal sectors of the economy and in other forms of self-employment. Unemployment in South Africa nevertheless remains a major problem, with nearly 30 per cent of the economically active population out of work.

On the monetary front, the broadly defined money supply grew vigorously during 2001 and the first half of 2002, and reached a year-on-year level of 18,1 per cent in June 2002. Most of this growth was in the form of increased short and medium-term deposits by corporates. This could imply that companies are uncertain about the outlook for the economy and that investors are restructuring their portfolios. It may, however, also be an indication that depositors are positioning themselves for future spending. The risk for monetary policy is that in the long run, there is a close correlation between the rates of increase in the money supply and the general level of prices.

The growth in total bank credit extension measured over twelve months moved into the double-digit range towards the end of 2001, but slowed down again to 9,6 per cent in June 2002, compared with 6,9 per cent in June 2001. This increase occurred mainly in the demand of the private sector for funds and arose largely from increases in trade finance, mortgage borrowing by households, instalment sale credit and leasing financing.

In the financial markets the private corporate bond market expanded significantly in the past year as the government financed most of its borrowing requirements on international capital markets. From the beginning of 2002, part of the companies' needs for capital was financed in the primary share market when the prices of shares improved considerably. New record turnover levels in the secondary bond and share markets were attained in the year ended June 2002. The decline that has been discernible in bond yields from the second half of 1998 was related to a dwindling supply of public-sector fixed-interest securities and lower inflation expectations that came to an abrupt end in the last quarter of 2001. The depreciation of the rand and resulting inflation fears drove bond yields sharply higher, but the mood in the bond market seems to have turned more positive from the beginning of April 2002.

Monetary policy continued to be supported by fiscal policy in securing financial stability. In the fiscal year 2001/02 the public-sector borrowing requirement amounted to only 0,6 per cent of gross domestic product. In fiscal 1996/97 it had still been as high as 5,6 per cent. This substantial improvement in the finances of the fiscus was achieved by more efficient tax collection methods and disciplined expenditure programmes. As a result, the rise in public debt relative to gross domestic product was stopped and the interest burden of government eased considerably. This afforded government the opportunity to grant significant tax relief and to expand infrastructural development.

Monetary policy

After pursuing a relatively neutral monetary policy stance during 2000 and the first half of 2001, the Reserve Bank relaxed monetary policy from the middle of 2001. The neutral monetary policy stance was maintained in a period of low expected future rates of inflation and a slowdown in economic activity. However, the twelve-month growth rate in the consumer price index excluding mortgage interest cost (CPIX) continued to rise steadily from 6,5 per cent in October 1999 to 8,1 per cent in September 2000. This rise in consumer prices was largely related to international developments, such as rising oil prices, general upward pressure on international commodity prices and a depreciation in the external value of the rand.

Although these exogenous factors became a threat to monetary stability, most domestic factors remained positive for the containment of inflation. Greater stability in domestic interest rates also seemed warranted to counter the heightened volatility in many financial markets.

This policy stance was highly effective as there were few signs of the secondary effects of the weaker currency. In fact, inflationary expectations declined, nominal unit labour cost increased only moderately and growth in the money supply slowed down. Internationally the oil price declined, world economic activity began to slow down and interest rates were reduced aggressively. The twelve-month growth rate of the CPIX was turned around and declined to 6,5 per cent in May 2001 and to 5,8 per cent in September.

Taking all these developments into consideration, the Monetary Policy Committee decided to relax monetary policy. The repurchase rate was first reduced by 100 basis points on 15 June 2001 and by a further 50 basis points on 20 September 2001. This brought the repurchase rate down to a level of 9,5 per cent, compared with its peak of 21,85 per cent in early October 1998. However, towards the end of 2001 it became clear that the favourable environment for inflation had changed.

Subsequently, two important develop-ments led the Reserve Bank to reconsider its monetary policy stance. Firstly, the inflation targets for the three years after 2002 were announced by the Minister of Finance. The target for 2003 was kept unchanged at an annual average rate of increase in the CPIX of between 3 and 6 per cent, but this range was lowered to an average of 3 to 5 per cent for the next two years. This clearly reflected government's commitment to the adjustment of policies to bring the inflation rate down to lower levels.

Secondly, the external value of the rand began to depreciate sharply in September. The pass-through from the depreciated exchange rate to inflation had been surprisingly muted in 2000, but the sharp downward movement of the rand in the last quarter of 2001 inevitably had a significant impact on inflation. Before this change the challenge to monetary policy had been how to deal with external shocks that had not been putting undue pressure on domestic inflation. The new challenges were how to deal with external shocks that were now beginning to have a significant impact on current and expected inflation, and to avoid an inflation spiral.

Inflationary pressures began to pick up during the last quarter of 2001. Food prices were initially the main factor contributing to the acceleration in inflation. These food price increases were partly related to the depreciated value of the rand as domestic prices approximated those determined internationally since the deregulation of agriculture. In particular, maize prices were significantly affected by the depreciation in the value of the rand. The maize price has wide economic significance in South Africa. White maize is a staple food for many South Africans and 90 per cent of yellow maize is used as feed in the meat, dairy, poultry and egg industries. Apart from the depreciation of the value of the rand, supply and demand factors also contributed to the more than doubling of the spot prices of both white and yellow maize between June 2001 and January 2002.

Later the increase in consumer prices became more broadly based, in line with the sharp depreciation of the currency. Rising expectations of price increases became an important factor in the inflationary process, as was clearly reflected by the pre-emptive buying of durable goods by households in the fourth quarter of 2001.

As the depreciated rand pushed prices higher, the twelve-month rate of increase in the CPIX started moving upwards from the psychologically important level of below 6 per cent in September 2001 to 9,9 per cent in July 2002. The quarter-to-quarter rate of increase in CPIX inflation was even more pronounced, rising from a seasonally adjusted and annualised level of 6,8 per cent in the fourth quarter of 2001 to 11,6 per cent in the first quarter of 2002 and 12,1 per cent in the second quarter. The twelve-month rate of increase in the all-goods production price index accelerated from 7,8 per cent in September 2001 to the even more alarming level of 14,4 per cent in June 2002.

These developments soon indicated that the inflation target for 2002 could be in jeopardy. Moreover, given the lags between the implementation of monetary policy and its impact on inflation, estimated at between 12 to 24 months, there was very little that monetary policy could do to rectify this. However, the Bank remains committed to the objective of price stability and policy became focused on the targets for 2003 and 2004.

The first response of the Bank to the rising inflationary pressures was to convene an unscheduled meeting of the Monetary Policy Committee early in January 2002. Although the exact feed-through of the depreciated value of the rand to inflation was still unclear at that stage, a number of developments indicated that it might be prudent to adopt a more restrictive monetary policy stance. These developments included a reversal of the downward trend in oil prices, indications that higher inflation expectations were becoming entrenched, higher wage demands, a more rapid rate of increase in unit labour cost and large increases in money supply and bank credit extension. In view of these developments the Monetary Policy Committee decided to raise the repurchase rate by 100 basis points in order to prevent an inflation spiral.

Monetary policy was tightened further at the March and June meetings of the Monetary Policy Committee. In both cases the repurchase rate was increased by 100 basis points, bringing the rate to 12,5 per cent on 14 June 2002. By March it was clear that inflation expectations had been adversely affected by the depreciation of the rand. In addition there was concern about the continued high rate of growth of money-supply aggregates and bank credit extension, the state of the balance of payments and the rising trend in unit labour cost. It was argued that a tighter monetary policy at that stage could avoid more drastic interest rate increases in future if the stricter stance was successful in dampening inflationary pressures.

By June, it was apparent that the upward trends of inflation and inflation expectations had maintained their momentum, and that growth in unit labour cost and money supply developments remained unfavourable. The Monetary Policy Committee, however, also identified some positive developments that could reduce the pressure on inflation. These developments included the partial recovery of the rand, the appearance of a surplus on both the current and financial accounts of the balance of payments, the continued low level of capacity utilisation and the maintenance of fiscal discipline.

The latest forecasts of the Bank show that, given this tightened stance of monetary policy and barring any unforeseen negative shocks, the inflation target for 2003 could be met. However, the average annual rate of increase in the CPIX will probably be close to the upper end of the target range and the risks to the forecast are on the upside. As such, it seems unlikely that monetary policy will be relaxed in the foreseeable future.

Although the current stance of monetary policy may be perceived as negative for short-term growth and employment creation, such a view must be compared with the alternative of even higher future interest rate levels, if inflation is not brought under control. Furthermore, the tax concessions granted in the last budget should benefit consumption, and the significant depreciation in the external value of the rand should promote production, particularly of exported goods.

Exchange rate policy

As outlined earlier, the external value of the rand came under severe pressure during the second half of 2001. The currency then stabilised in early 2002 and strengthened slowly but consistently until the end of May. Since the beginning of June the exchange rate of the rand has fluctuated widely around its newly established levels.

The rand has continued to be negatively affected by developments in emerging markets, and events in 2002 in Argentina and Brazil, for example, could hamper the short-term outlook for the rand. For this reason the Reserve Bank strongly supports the government's policy that the remaining exchange control regulations should be very gradually relaxed.

Despite the relatively volatile movements in the exchange rate of the rand and even when it became apparent that the depreciation of the rand towards the end of 2001 was based largely on speculative transactions unrelated to underlying conditions, the thrust of exchange rate policy remained unchanged. The exchange rate of the rand is therefore essentially determined by the supply and demand conditions in the market for foreign exchange.

At the same time, it remains a stated objective of the Bank to gradually close down the net oversold open foreign reserve position. The existence of this net oversold open position has been perceived as a source of weakness for the rand, and has contributed to negative sentiment towards the currency. However, it is also recognised that if the net open foreign reserve position is reduced too quickly, it could contribute to rand weakness. The Bank therefore announced in a statement on 14 October 2001 that we would in future not intervene by purchasing foreign exchange directly from the market to reduce this position. The net open foreign reserve position would instead be expunged from the cash flows derived from the proceeds of privatisation and the government's off-shore borrowing. This does not imply that all the proceeds from these sources will always be used to achieve this objective. For example, part of the proceeds from the sale of Transnet's interest in M-Cell was not used to reduce the Bank's open position.

In accordance with this objective, the Bank reduced the net open foreign reserve position from US$23,2 billion at the end of September 1998 to US$11,5 billion at the end of January 2000, i.e. during a period of overall strength in the balance of payments. When the overall balance of payments then began to deteriorate, the open position was brought down far more slowly to US$9,0 billion at the end of April 2001. The net open position was reduced to US$4,8 billion at the end of July 2001 with the proceeds obtained from the restructuring of the Anglo American Corporation and the De Beers mining company, and from foreign borrowing by government.

The net open foreign reserve position was reduced further to US$1,8 billion at the end of July 2002 following the stated approach that the Bank adopted in October 2001. This reduction was basically the result of three major sources, namely the transfer of a syndicated loan liability of US$1,5 billion from the Reserve Bank to the National Treasury; the reopening of an existing dollar bond by the South African government which raised US$274 million for delivery against the oversold forward book; and the issuing of a new US$1 billion bond by the National Treasury for delivery against the forward book. While the Bank remains committed to eliminating the net open foreign reserve position, at its current level of US$1,8 billion this position should no longer be perceived as a source of vulnerability.

Financial stability

International developments also affected domestic financial stability during the past year. The attacks on the United States of America on 11 September 2001 illustrated an enormous systemic risk to financial systems worldwide as well as the key role that central banks must play in such circumstances. The increase in the international linkages among financial institutions adds to the risk in such events. The weakening position of Japanese banks also continues to be a source of vulnerability for inter-national financial markets. Furthermore, corporate governance standards and structures, as well as the credibility of the accounting profession, are being questioned after revelations about the corruption in and resultant failure of a number of large and well-known corporations in the United States of America. The corporate failures in the United States have impacted significantly on markets worldwide, with many stock exchanges shedding considerable value. This again demonstrates the importance of restructuring the financial architecture. Closer to home, trade and financial links expose South Africa to the contagion effects of recent adverse developments in Zimbabwe, which are closely monitored.

Domestically the South African banking sector was characterised by a process of consolidation triggered by the difficulties of some small banks. This trend intensified after the announcement that Saambou Bank Limited, the seventh-largest bank in South Africa, would be placed under curatorship from 9 February 2002. As a result, there were significant withdrawals of deposits from some smaller banks in general and BoE Bank Limited in particular. This spurred the Reserve Bank to take a proactive and leading role in co-ordinating the actions of all key players in the banking sector, which led to an agreement between the private and public sectors on the management of liquidity by recycling cash flows and handling the orderly exit of Saambou Bank from the banking sector. The withdrawal of deposits from some banks prompted the joint action by the Bank and the National Treasury to restore the confidence of depositors, by guaranteeing all the deposits of BoE Bank Limited. BoE also accelerated the planned sale of its mortgage book to FirstRand Bank to manage its liquidity position.

The activities of Saambou Bank and BoE were merged with those of some of the big four banks in South Africa. The liquidity problems of some of the smaller banks induced them to cancel their banking registrations and to carry on with niche operations. Other smaller banks are redesigning their ownership structures and in some cases downsizing their balance sheets.

Despite these developments over the past year, South Africa's banking system remains sound. Domestic banks are well-managed and have sophisticated risk management as well as corporate governance structures in place. Banks are well-capitalised, with an average risk-weighted capital adequacy ratio of 12,1 per cent at the end of June 2002. This can be compared with the new and higher required capital adequacy ratio of 10 per cent introduced in October 2001.

Total bank funding grew by 22,4 per cent during the year up to the end of June 2002. The growth in total assets of 18,8 per cent over the same period to a level of R1 065 billion was mainly the result of an increase of 21,4 per cent in total loans and advances. The assets of the four big banks as a ratio of the total assets of the banking sector rose from 68,8 per cent on 30 June 2001 to 70,5 per cent on 30 June 2002. At the latter date the foreign banks operating in South Africa held 8,4 per cent of the total banking assets, compared with 6 per cent the previous year.

Despite the difficulties encountered over the past year, the liquidity of the banking sector is generally adequate. The average daily amount of liquid assets held in June 2002 exceeded the prescribed prudential minimum by about 9 per cent. However, the reported profitability of the banking sector has continued to decline as margins on earnings decreased and operating expenses increased.

Non-performing loans amounted to R26 billion in June 2002. This represents only about 3 per cent of total loans and advances, which compares well with international standards. The provisions made by banks for non-performing loans were adequate, even in terms of international best practice standards. The debt-servicing capacities of households also showed no signs of fragility. The ratios of household debt to disposable income and of household debt to financial assets both decreased over the past year.

The single regulator

The problems encountered in the banking sector earlier this year illustrated in the most definite manner that it is important that banking supervision in South Africa should remain part of the functions of the Reserve Bank. The blurring of boundaries between the financial services provided by banks, insurers and securities traders has prompted certain developed countries around the world to consolidate the different supervisory agencies under one roof. It is commonly recognised that the potential benefits of assessing the risk management functions of financial conglomerates on a holistic basis are very attractive for developed countries with integrated financial markets and ample regulatory resources.

In South Africa the banking supervision function was transferred to the central bank in 1987 because it was regarded as the institution most suited to carrying out this function. Since then, even in the face of many abnormal circumstances, banking supervision has been carried out to the highest international best practice. Over this period, experience has shown that banking supervision is closely aligned with the other functions of the Reserve Bank. With the recent liquidity problems of some small banks, it was again evident that a least-cost resolution of a banking crisis would always depend on a special collegial interaction between the Registrar of Banks and at least four other departments in the Bank. The policy formulation, decision making, co-ordination and rapid execution of the many interventions that were necessary would have been almost inconceivable in a situation where the supervision of banks was not part of the Bank.

Stability in the banking sector is so integral to the monetary policy transmission mechanism, that a central bank must always be involved in banking supervision. Unlike other financial institutions, banks potentially pose a systemic risk because of the nature of their contracts. Their assets are typically long term and uncertain in value, whereas their liabilities are generally short term and certain in value.

The banking sector is therefore prone to contagion as soon as confidence in any bank is undermined. These characteristics give rise to the commonly accepted approach of regulating banks in a discretionary manner. A rules-based approach to banking regulation would be inappropriate because every case of distress in the system is unique. Supervision consequently has to be risk-based and proactive.

The banking supervision function in the Reserve Bank has caused many problems and frustrations, and the temptation to pass the responsibility on to another agency is great. However, the capacity to perform effective banking supervision is crucial to price and financial stability. After careful consideration of the issue, I am therefore convinced that it is in the best interests of the South African economy that banking supervision should remain in the Bank.

At the same time, I also realise that close co-operation should exist between the different regulatory authorities to address the need for consolidated supervision. Co-operative working arrangements between regulators are essential to address the ever-increasing demands of sound regulation, the hallmark of which consists of decisiveness, timely action and proactive intervention when required.

Regulating the banking sector

The different approaches adopted to handling the liquidity problem of banks in the past year have created considerable uncertainty about the principles applied in regulating the banking sector. This again emphasises that the execution of this function should be made as transparent and business-like as possible.

The objective of bank supervision is to ensure stability, efficiency and depositor protection in banking. A stable financial environment is essential for the working of the economy and the attainment of price stability. A sound banking system contributes to the effectiveness of intermediation, maturity transformation, payment facilitation, credit allocation and financial discipline. Moreover, banks play an important role in collecting savings, allocating resources and providing liquidity.

The registration of banks is the first step to achieve stability in the banking system. Stability is promoted by preventing applicants with potentially destabilising weaknesses, such as unqualified or unscrupulous manage-ment or insufficient capital, from entering the system. Unfortunately, there is no reliable formula to determine whether a bank will fail or succeed. The regulator can only apply international regulatory and supervisory norms to the supervision of banks. The South African authorities have adopted the 25 principles contained in the Core Principles for Effective Banking Supervision of the Basel Committee for Banking Supervision, to construct an effective supervisory structure in the country.

In deciding on whether a banking licence will be granted to an applicant, an assessment is made of the institution's business plan, shareholding structure, capital base, directors and senior management, internal controls and projected financial conditions. This evaluation of an application is not a mechanical process, but is in a sense abstract and subjective. Every application is regarded as unique.

Once a bank has been established it must be monitored continuously to ensure that it remains fundamentally healthy. This monitoring process involves a quantitative and qualitative assessment of a bank's soundness. The quantitative assessment entails an analysis and evaluation of defined risk-based data received from banks on a monthly basis, to determine whether they are within prescribed prudential limits and whether their financial positions fall within acceptable norms. The qualitative assessment consists of the examination and evaluation of whether risks are being managed properly. This assessment is done within a framework of corporate governance structures.

Despite every effort by the supervisors to ensure a healthy banking system, they cannot guarantee the safety and soundness of individual banks at all times. Where a bank encounters difficulties, special contingency measures are applied. The general approach followed in providing financial assistance is that the bank in distress is experiencing only temporary liquidity problems. By contrast, an insolvent bank or one with ongoing liquidity problems is required to exit from the banking system in an orderly, efficient manner with minimum losses to depositors and the least harm to the public's confidence in the banking system as a whole.

Special action is taken in a case where a temporary liquidity problem is identified. As every case is different, these actions may vary from one case to another. A broad framework for the contingency procedures has nevertheless been developed. A plan for remedial action is normally drawn up, in close co-operation with the bank concerned. Possible solutions may range from new capital injections by shareholders to measures designed to attract and retain large deposits. In addition, the relevant bank may be allowed to obtain liquidity by discounting liquid assets and by utilising its minimum cash reserves to cover cash outflows.

If none of these measures can solve the liquidity problem of the bank in distress, the Reserve Bank may, as lender of last resort, be approached for special assistance in certain circumstances. This special assistance is granted only against collateral of acceptable assets pledged by the bank or a government guarantee because the Reserve Bank is prohibited by statute from making unsecured loans.

The Bank's policy and practice of solving liquidity problems have recently received considerable attention. Two reports were published in the past year. One was on the failure of Regal Treasury Private Bank Limited. The other report was on the financial assistance package to Bankorp (and later to Absa) in the late 1980s and early 1990s. The panel of experts, known as the Davis Panel, found in the latter report that the assistance had averted a systemic crisis. The panel members also concluded that the procedure for dealing with banks in distress had been refined and now conformed to current international best practice.

In reviewing the support provided recently to Saambou Bank and the repayment of all the depositors' money, three of the members of the Davis Panel found that all the actions taken complied with the Reserve Bank's established procedures. Contrary to possible public perceptions, the authorities did not give any special positive or negative treatment to Saambou Bank's depositors or shareholders.

To create a safety net for depositors, the Policy Board for Financial Services and Regulation has formulated a proposal on designing a deposit-insurance scheme for South Africa. The main purpose of the scheme is to protect small depositors from losses if a bank fails. Membership will be compulsory for all registered banks and separate funds could be established for non-bank financial institutions. The level of coverage still has to be determined, but it would be low enough to avoid creating a moral hazard, yet high enough to inspire confidence.

The relationship between auditors and the regulator has always been regarded as extremely important. Recent international events involving the auditing profession have again illustrated the critical role that auditors should play in ensuring that the accounts of institutions are a fair reflection of their financial position. For this reason, a decision was taken to establish an Auditor-Regulator College to create a structure for regular interaction with and compliance training for the auditing profession. The college will play a major role in training and strengthening the banking supervisory process in South Africa.

Procedures have also been implemented to introduce banking legislation which will, for the first time, effectively deal with management deficiencies in banks. The proposed legislation will, among other things, provide for the removal by the regulator of directors and managers of banks who are not considered to be fit and proper to perform such appointments.

These improvements to the regulation of banking are being undertaken to safeguard the funds of depositors and to ensure that South Africa maintains a recognised, stable banking system. However, the Bank is also aware of the need to broaden the access of individuals and small and medium-sized enterprises to basic banking services and funding. To this end, the approach in the past was to encourage registered banks to provide such services and to exempt certain approved non-bank financial institutions, such as stokvels, credit unions and village financial services co-operatives, from the requirements of the Banks Act provided that these institutions comply with certain specified conditions. Work is now in progress to reform the Mutual Banks Act by making provision for different classes of banks. This would create a more appropriate regulatory framework and give broader access to finance. The Bank also supports all initiatives aimed at finding a balance between facilitating socially responsible behaviour by banks and protecting the stability of the banking sector.

Internal administration

In view of the importance of maintaining an overall stable financial environment, a Financial Stability Department was established in the Reserve Bank. The primary aim of this department is to assess and promote the stability of the banking and financial system in South Africa. The main functions of the new department are to identify, analyse and research any potential threats to and weaknesses in the financial system, and to make policy proposals on and encourage changes that will support the stability and effectiveness of the financial system.

Another administrative change arose from the majority decision by shareholders to delist the Bank from the JSE Securities Exchange SA, with effect from 2 May 2002. The new listing requirements of the JSE Securities Exchange SA as well as the unique role and structure conferred on the South African Reserve Bank in terms of its Act, made it evident that the Bank would no longer be able to trade its shares on this exchange. The shareholders' decision led to the establishment of an Over-the-Counter Share Transfer Facility on 3 June 2002, to provide for trading in the Bank's shares. This facility operates as a closed auction and is administered by the Bank.

Satisfactory progress has been made with a process of Bank-wide business continuity planning to ensure that the Bank can continue functioning and meeting its obligations in the event of any interruption or disaster. All the Bank's departments, branches and subsidiaries are participating in preparing the best possible response to a threat to normal operations.

In the field of information and communication technology, several initiatives resulted in lower costs, greater efficiency and new interactive ways of doing the Bank's business. These included the establishment of a generic facility for receiving data electronically from external associates, enhancing the balance-of-payments system to enable the direct reporting of all cross-border transactions, collecting data online for economic research and creating a new Internet website for the Bank.

The Bank's new cash management strategy (Project Imali) was successfully implemented during the past financial year. The branches of the Bank now provide a full and comprehensive bulk cash-handling service to the private banks. This service has been extended to the Mpumalanga and Limpopo provinces on a contractual basis.

Project Bataki, the project aimed at revising the banknote series, has made good progress. Consultations with all stakeholders on developing the preferred technical and security features for the current banknotes will commence in the near future. The problems with dye-stained notes arising from ineffective dye-staining devices have been successfully addressed. With the co-operation of the manufacturers and users of such systems, a new industry standard has been developed and implemented. This will make these notes unusable, which should discourage robbery and theft.

Major progress was also made with the reduction of settlement risk in the payment system when agreements were concluded with the payment clearing houses. After intensive consultation with the banking industry, same-day settlement now generally takes place. Real Time Line settlement is effected directly via the SAMOS system and batch settlements forwarded from Bankserv are settled before the following day. Only interbank borrowing and lending, and the final square-off between banks, are done the next day. These changes have aligned South African payment practices to the principles of internationally accepted payment systems.

The Committee of Central Bank Governors in the Southern African Development Community made satisfactory advances supporting regional economic integration. In particular, notable progress was made in the fields of payment, clearing and settlement systems, information and communication technology, legal and operational frameworks for central banks and exchange-control policies. The Reserve Bank has also engaged in technical co-operation and advice to a number of central banks in Southern Africa as well as in other African countries, such as Rwanda. In addition, the Bank was actively involved in initiatives to establish closer monetary and economic co-operation in Africa through participation in the Association of African Central Banks.

In keeping with the objective of transforming the composition of the Bank's staff to reflect the demographics of the country, an important milestone was reached in the past financial year when the total black staff complement exceeded the white staff complement for the first time since the inception of the Bank in 1921. This confirms the Bank's commitment to achieving its objectives for staff transformation by 2005, in accordance with the plan submitted to the Department of Labour in terms of the Employment Equity Act, No. 55 of 1998. Despite this progress, further efforts will be made to achieve gender and race representivity at all seniority levels. We want the Bank's staff to reflect the diversity and unity of South Africa.

Extensions to the Bank's head office building, which started in 2001, are progressing satisfactorily and will be completed in 2003. Once completed, the building will meet the Bank's requirements for additional office space and for parking and conference facilities. The conference facilities will also be made available for use by the public, which should contribute to the improvement of activity in the Pretoria central business district.

Acknowledgements

All these changes to ensure the efficient functioning of the Reserve Bank could not have been accomplished without the help of a number of people and institutions. In conclusion, I therefore wish to express my appreciation to everyone who contributed to the success of the Reserve Bank in overcoming the challenges of the past year. I wish to thank the Presidency in particular, the government in general and Parliament for supporting the work of the Reserve Bank.

In addition, I wish to express my appreciation to the Board of Directors of the Reserve Bank, including the deputy governors, for their commitment and undivided loyalty. Mr J H Cross, Senior Deputy Governor, left the service of the Bank at the end of his term for health reasons and Mr I J Moolman retired. Both of them made valuable contributions to the work of the Bank and the Board, for which we are deeply grateful. Finally, I wish to thank the staff of the Reserve Bank for their professionalism, excellent performance and continued loyal support.