Ian Plenderleith: Always something normal from South Africa

Speech by Mr Ian Plenderleith, Deputy Governor of the South African Reserve Bank, to the Association of Collective Investments Conference, Cape Town, 17 August 2004.

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It is not very often that a central banker gets to comment on his country's economy in Latin. As someone whose undergraduate studies were ancient Greek and Latin, I am delighted to seize the chance.

The Latin I have in mind is Pliny's often-quoted phrase, "ex Africa semper aliquid novi" - always something new out of Africa, by which I think Pliny meant that Africa could always be relied on to spring surprises, by astonishing the world with some bizarre new novelty.

I want today to suggest some reasons why, if Pliny were with us now looking back on the remarkable progress South Africa has made over the past ten years, he would say the opposite. Much of the effort that has been applied to leading South Africa forward over the past decade has been directed to achieving what might be called "normalisation" - the steady process of building the stable political and social and economic structures that are normal for a modern, well-governed country in the 21st century. This is true of our political system, as was evident to all the world earlier this year as, with pride and style, we celebrated 10 years of democracy and held standard normal democratic elections, which were conducted with exemplary calm and good order. It is true, too, of the immense progress that has been in building a genuinely open multi-racial society and progressively alleviating the legacy of social neglect in areas such as education, health and basic living standards. It is true also, very visibly, in the economic sphere, in the huge strides that have been made in bringing South Africa into the frame as a normal, modern, open, competitive, market-based economy.

It is this commitment to normalisation that has won the admiration of the world. I think it would win Pliny's admiration, too, and that he would see that it is not frivolous novelty, but stable and sensible normality that is South Africa's great achievement. So I think he would re-write his quotable phrase, to suggest that the key ingredient in the immense progress we have made in the past ten years has been, not "semper aliquid novi", but "semper aliquid normalis" - always something *normal* out of South Africa.

In the economic sphere, the extent to which the country has been put on the track of normalcy, running as a standard, normal, modern economy, is something of which everyone can be immensely proud. It is a priceless gain, achieved by hard work, dedication and intelligent policy-making. But it is not just something to look back on with satisfaction. It is even more important to look forward, to recognise that the stable framework for a normal, well-run economy that has been achieved to date provides the foundation for improved economic performance in the years ahead. That means the prospect, if we stick to the task, of faster sustainable growth, better public services, higher living standards for all our citizens and growing and competitive businesses that will generate lasting jobs for the future.

But we need to recognise, too, that it is only now, after some years of laying the foundations, that we are beginning to see these benefits come through in substantive, concrete form. Sensible policies, aimed at generating benefits that are sustainable over the long term, take time to deliver dividends. But commitment to good government, in the economics sphere as elsewhere, really does produce results, and I want to highlight three areas where I believe we are now seeing the benefits come through strongly.

First, South Africa has for ten years steadily pursued a stable, disciplined macroeconomic framework. The rewards for macroeconomic discipline, however, build up over time and it is important to recognise where we are now beginning to see the real benefits come through.

On the fiscal side, the National Treasury's commitment to maintaining budgetary control and strengthening the public finances is now providing the base for significantly increased expenditure on key public services without in anyway jeopardising fiscal discipline. On the monetary side, the inflation-targeting framework and the independent responsibility given the South African Reserve Bank for managing monetary policy has enabled us to bring down inflation to within the target range of 3 - 6 percent and, in the process, reduce interest rates very substantially during the past year or so. With the exchange rate recovering from its temporary and irrational plunge in 2001, increased public confidence in the inflation targeting framework has delivered a steady decline in inflation expectations.

The benefits of this steady commitment to a stable macroeconomic framework have now begun to come through in a quickening in economic growth over the past year, with every prospect that the economy can continue to pick up speed in the year ahead and beyond helped by the recovery in the global economy. The economy has in fact achieved the remarkable record of registering continuous positive growth every quarter for the past 22 quarters. With inflation remaining under control, we are set to extend that record, as can be seen just last week by the further step we were able to take in reducing interest rates.

A second feature of particular relevance has been the strengthening of the micro structure of financial markets in South Africa, again designed to ensure that our markets meet normal established international standards. The well-constructed framework the National Treasury has pursued in its debt management activities, the quality of the markets administered by the JSE Securities Exchange, the Bond Exchange of South Africa and the clearing and settlement agencies, and the oversight exercised by the regulatory authorities have all greatly improved the quality and liquidity of our markets and generated substantial international interest and participation in South African financial instruments. Well-functioning markets encourage savings and, by matching savings with productive investment opportunities, help to bring down the cost of capital. We have seen the evidence of this in the diversification of issuers in the bond markets: alongside the Government's bond issues, corporate issues are growing rapidly, securitization is increasing and recently the municipal bond market has returned to life.

This process undoubtedly has further to go and will help to provide the efficient structure of financial markets that are an essential support as our economy continues to grow. A notable further step in strengthening our financial infrastructure was implemented only last week, when our real-time wholesale payment system - SAMOS - moved to same-day final settlement. This is an excellent example of how the steady and persistent commitment to normalising the structure and functioning of our economy can produce real gains that are often overlooked or under-recognised. SAMOS, our real-time payments system, lies deep in the plumbing of our financial system. Its functioning is a fascinating piece of advanced IT engineering - at least for central bankers like myself and my colleagues at the National Payment System Department at the South African Reserve Bank, though I have to confess we have noticed that other people's eyes tend to glaze over when we wax lyrical about the elegance of the system! What this seemingly technical step does is to remove a significant element of overnight risk for the financial system as a whole: we can go to bed, however late, knowing that all the day's millions of individual payments have definitively been delivered and that all the resultant inter-bank olbigations have been settled finally and irrevocably. As importantly, that step in turn paves the way for South Africa later this year to join the international CLS system providing for real-time settlement of foreign exchange transactions between the rand and other currencies. In all these ways, the structure of our markets has steadily been strengthened so that they meet international standards.

A third area I want to highlight where normalisation is now bringing real benefits is in the South African Reserve Bank's own financial operations. There are two aspects here - external and domestic.

In our external operations, in foreign exchange, a particular feature of the South African economy that has often attracted attention as an area of weakness has been our relatively low foreign exchange reserves position. Here too, normalisation has been pursued - to build up the official foreign exchange reserves towards a level normal for countries at our stage of development.

At worst, in September 1998, we had a *negative* foreign exchange reserves position of $23 billion - the legacy of accumulated losses on foreign exchange operations in earlier years. The progressive closing-out of this negative net open foreign currency position has been a major challenge in the recent years. The negative position was finally closed out only last year, in May 2003. We then set to the task of squaring-off the negative forward book which had been financing part of our gross reserves. This in turn was achieved in February this year. Since then our reserves have continued to rise, to a level currently of gross reserves of $11.8 billion and net reserves (net of the Reserve Bank's use of committed medium-term facilities) of $8.4 billion. This means that the structure of our foreign exchange reserves now looks, and is, normal by international standards. We shall continue to build the reserves gradually over time, as opportunity presents, but the positive reserves levels we now enjoy should make a material contribution to lessening rand volatility and strengthening our credit standing. Indeed, that is already evident, in the ratings upgrades South Africa has received in recent years and in the substantial narrowing in the spreads on South African international bonds. This in turn helps to reduce the cost of international borrowing by South African companies across the spectrum.

This increase in official foreign exchange reserves is a very positive development, and has been widely welcomed as such. But as we have moved steadily forward, the markets, rather like spectators at the Olympics now underway, have begun to enter into the spirit of the occasion and cheer us on to yet more heroic efforts. Some urge us to run faster and faster and, if not exactly go for gold, at least aim for seriously higher levels of foreign exchange reserves. Others argue that we should run in more than one event, pursuing not only higher reserves but also more active management of the exchange rate. So it is worth being clear exactly what we can hope to achieve in this area of our operations, and equally what we cannot.

We can, and will, continue gradually to build up our official foreign exchange reserves to a respectable level in an orderly fashion in accordance with our balance sheet whenever circumstances allow us to do this. This will bring benefits, as I have indicated, in terms of lessening rand volatility and strengthening our international credit standing. The scale of our operations is, in fact, cumulatively more substantial than is sometimes recognised: over the six years I have described above, we have acquired, directly by purchases in the market, or indirectly, of the order of $30 billion. Around $10 billion of this has been acquired in the past eighteen months. These are not negligible sums, particularly in relation to the size of foreign exchange activity in the rand.

In the process, our operations have undoubtedly provided some moderation to the rise of the rand we have experienced over the period. This has in degree helped to alleviate some of the strains exporters and our manufacturers have faced from the rise of the rand. We fully recognise the difficulty businesses face in adjusting to those strains, and it is useful that our operations can help in this way.

But our operations have to remain focused on rebuilding our reserves. It would not be sensible for us to switch to a different focus, of seeking more actively to manage the exchange rate, principally for two reasons. First, neither we nor anyone can claim with any confidence to know what would be an appropriate equilibrium exchange rate. It is much more sensible for us to pursue a stable monetary framework aimed at delivering low inflation and thereby help the market find a stable trading range for the rand - as indeed it has managed to do for extended periods over the past year. Secondly, endeavouring to manage the exchange rate would jeopardise our success in delivering low inflation: countless episodes in the past around the world demonstrate that attempting to switch focus to the exchange rate means that the central bank loses control of inflation, with seriously damaging results to the prospects for sustaining growth in the economy on a continuing basis.

So we can, through our continuing operations designed to rebuild the reserves, help in the process to moderate the pace of adjustments in the exchange rate. That we are doing and it is entirely consistent with our inflation targeting framework. But a more activist approach to try to manage the exchange rate would risk undermining the inflation target.

In our domestic market operations, in the rand money markets, we have also achieved over the past two years a major streamlining of our activities aimed, here too, essentially at normalisation - to bring our operations back within the frame of normal central bank management of money market liquidity.

We were out of this frame because the accumulated foreign exchange losses, described earlier, had two major distorting effects in our domestic markets. First, the losses accumulated on an account - the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) - which falls to be settled by the National Treasury, but in the meantime stands as a claim on the assets side of the SARB balance sheet. We needed to find a way to fund that asset. Secondly, the losses generated as their counterpart a large structural surplus of rand liquidity in the market. These two distortions - the asset on our balance sheet that needed funding and the excess liquidity held by the market - are essentially two sides of the same coin. We had to bring the two sides together, so to speak, by draining the surplus, in order to ensure that short-term money market rates remained in line with the policy repo rate set by the Monetary Policy Committee; and in doing so, we obtained temporary funding for the GFECRA asset.

At peak, in August 2002, the structural surplus we had to drain amounted to the huge sum of close to R70 billion. We drained this by the use of variety of instruments - some normal in character, e.g. bond repos, but some innovative or unusual, such as the sale of SARB debentures and, on a very large scale, so-called special money market swaps with deposits, which were foreign exchange swaps with the foreign exchange we gave on the swap redeposited with us. Rolling over this diverse funding operation was a technically demanding task and I would like to pay tribute to my colleagues at the SARB who, long before my arrival, handled this task with skill, expertise and high professionalism.

This was clearly not a sustainable situation. Not only did it impair the central bank's balance sheet, but it also had seriously distorting effects on the domestic money markets, hampering their development; and at times it risked undermining the implementation of monetary policy. We have therefore over the past two years set ourselves to find ways of draining this liquidity on a permanent basis.

The key to doing so was the steps taken by the National Treasury, starting in September 2002, to pay off the balance on the GFECRA, principally by issuing the SARB with bonds. We were then able to sell these bonds, either directly or by switching into forthcoming maturing issues, and so drain the excess liquidity on a permanent basis. At the same time, other factors helped us along the way - notably, the steady increase in notes and coins in circulation, and the recovery in the rand, which enabled us to start generating profits on our oversold forward book. The result is that, by the end of last year, we were able to pension off the use of special money market swaps with deposits - which had amounted to over R50 billion at peak - and had effectively completed the task of draining the liquidity surplus on a permanent basis. This episode is a fascinating story of bringing liquidity management back from a distorted position to normalcy.

Thus here, too, there has been a steady process of bringing our structures and process back to normalcy. The process of normalisation is a feature of many areas of our efforts over recent years. I hope I have been able to show that it has been worth the effort, for the benefits it brings in terms of better and more sustainable economic performance for the country as a whole. I hope I have also been able to show that these benefits are now beginning to come through in substantive form, but that there is much more yet to be gained from the heavy lifting that has been done in recent years. That is why we will stick to the task.