T T Mboweni: Overview of the South African economy

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the 87th ordinary general meeting of shareholders, Pretoria, 20 September 2007.

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Introduction

The primary goal of the South African Reserve Bank (the Bank) is the achievement and maintenance of price stability. However, the role of the Bank in the economy goes beyond a narrow monetary policy focus. Low and stable inflation provides an important framework for economic growth, but regulation and supervision of parts of the financial sector, as well as the oversight of the payment system ensure that the wheels of the economy continue to turn efficiently. In the past year we have had to execute our mandate in an increasingly difficult and uncertain environment. The South African financial markets have not been spared the effects of the recent volatility in the financial markets and we have to be increasingly vigilant of the risks posed to the domestic economic landscape. At the same time we have to ensure good governance with respect to the internal workings of the Bank. It is against the backdrop of this volatile economic environment that I report to you today.

Today we also release our *Annual Economic Report* which covers developments in the domestic and international economy over the past year. In particular, we highlight the main economic developments which have affected our operations and policy implementation. The focus of this address is on the main operational areas of the Bank including monetary policy and its implementation, gold and foreign-exchange reserves management, financial stability issues, the national payment system, banking regulation and supervision, international co-operation and internal administration.

Monetary policy

This past year has been a challenging one for monetary policy. As I reported in August last year, from the middle of 2006 pressures on inflation emerged, and have since intensified. By December 2006, year-on-year CPIX inflation measured 5,0 per cent compared to 3,7 per cent in April of that year. Inflation remained within the target range until April 2007 when it increased to 6,3 per cent from 5,5 per cent in the previous month. Since then it has remained outside the target range. Initially the main drivers of this adverse trend were food and petrol, but more recently there has been evidence of a more generalised upward trend in inflation, including that of services prices.

The Monetary Policy Committee (MPC) responded to these developments by raising the repurchase rate by 50 basis points in June 2006, the first increase since 2002. This was followed by successive increases of 50 basis points at each of the subsequent three meetings of the MPC in 2006. By December the repurchase rate had increased to 9,0 per cent per annum.

The pressures on inflation emanated from both international and domestic sources. At the global level, the world economy continued its strong performance which contributed to sustained upward pressure on oil and food prices which, in turn, had a direct impact on domestic food and petrol prices. These items were the major contributors to the upward inflation trends during 2006.

In August last year international oil prices peaked at levels just below US$80 per barrel. Prices were influenced by strong global demand, supply disruptions in a number of countries and geopolitical uncertainties. Food price pressures have also had a global dimension. Drought conditions in a number of countries as well as the increased diversion of agricultural products, particularly wheat, maize and sugar, to bio-fuels production have contributed to this trend. South Africa was not immune to these developments which, in conjunction with the impact of drought conditions in a number of regions, resulted in an acceleration of food price inflation, in particular meat prices and to a lesser extent maize prices. In October and November 2006 meat prices increased at year-on-year rates of almost 20 per cent, while grain product prices increased by around 6 per cent.

Although world inflation remained under control, the pressures emanating from these developments have dictated that monetary policy remains restrictive in many countries.

Domestically, the MPC had to contend with the combined threats of high rates of growth of consumption expenditure and credit extension. In the second half of 2006, domestic household consumption demand growth also continued at a robust pace of around 7 per cent per annum, while the various consumer confidence indices indicated sustained optimism on the part of consumers despite the tightening stance of monetary policy. Towards the end of the year, motor vehicle sales, particularly passenger vehicles, showed some signs of moderation. Underpinning this consumer exuberance were strong rates of growth of credit extension, despite an increase in securitisation transactions.

Following the 15-per-cent depreciation of the effective exchange rate from May to July 2006, the exchange rate of the rand had an impact on the inflation outlook. However, it then remained in a fairly tight trading range, despite the continued widening of the deficit on the current account of the balance of payments, which continued to be adequately financed by capital inflows.

Not all the determinants of the inflation rate posed a threat to the outlook. Nominal unit labour costs were well contained, fiscal policy continued to be supportive of monetary policy and although the economy was growing at a robust pace, it was not deemed to be growing at a rate significantly above potential. Inflation expectations were also anchored within the inflation target range.

In the first two months of 2007 international oil prices declined significantly, with the price of North Sea Brent crude oil reaching a low of US$51 per barrel in January. These developments contributed to a general downward revision of oil price and inflation forecasts. At the same time, there were tentative signs of some moderation in household consumption expenditure, particularly with respect to passenger vehicle sales. The MPC was also mindful of the fact that interest rate adjustments take time to impact fully on demand. Although the inflation risks were still perceived to be on the upside, the continued stability of the exchange rate, sustained fiscal restraint and the improved inflation expectations resulted in the committee keeping interest rates on hold at the February and April meetings of the MPC.

By the June 2007 meeting of the MPC, the outlook had deteriorated further. Despite the previous adjustments to the monetary policy stance, available data at the time suggested that real household consumption expenditure and credit extension remained strong, growing at year-on-year rates of around 7 per cent and 26 per cent, respectively. International oil prices resumed their upward trend, eventually peaking at around US$78 per barrel in July. The overall impact of the adverse oil-price trend on domestic inflation was moderated somewhat by the relative stability of the rand exchange rate.

However, following the breach of the upper end of the inflation target, there were some worrying signs of a deterioration in inflation expectations. Furthermore, partly in response to the higher inflation outcomes, nominal wage settlements began to trend higher, posing a further risk to the inflation outlook. In response to these pressures and the less favourable outlook, the repurchase rate was increased at both the June and August 2007 meetings of the MPC. At the time of the August meeting, the turmoil in the world financial markets had begun. At that stage it was unclear to the MPC whether these developments would be confined to the financial markets, or if they would impact significantly on the growth prospects domestically and abroad. The committee decided that it was appropriate to remain focused on the inflation target, and react to financial market developments insofar as they affected the inflation outlook.

The breach of the target can be seen as a setback for monetary policy. Nevertheless, it should be noted that the main cause of inflation exceeding the upper end of the inflation target range was factors beyond the direct influence of monetary policy. We are mindful, however, of the impact of these developments on inflation expectations and the need to act against the emerging broader inflation pressures. The most recent inflation forecasts of the Bank suggest that inflation may return to within the inflation target range during the second half of next year, and the MPC will continue to act accordingly to ensure that this outcome is achieved.

Money-market operations

To ensure that the implementation of monetary policy was in line with the stance determined by the MPC, the Bank managed the daily liquidity requirement in the money market in a range roughly between R10 billion and R15 billion. The Bank also broadened the list of securities that qualify as eligible collateral in its refinancing operations. With effect from 23 May 2007, two categories of collateral are now accepted. Category 1 securities comprise Government bonds, Land Bank bills, STRIPS, SARB debentures and Treasury bills. The new Category 2 securities comprise all non-bank, non-government securities that are included in the All Bond Index of the Bond Exchange of South Africa. Borrowers using this category have to provide more collateral.

In co-operation with various market participants the Bank addressed shortcomings that had been identified in the South African Overnight Interbank Average (Saonia) rate. The Saonia rate was replaced by the South African Benchmark Overnight Rate on deposits (Sabor), which is a more representative and reliable pricing benchmark than its predecessor.

Reserves accumulation and management

The Bank has continued to increase its level of official reserves. Gross gold and foreign exchange reserves increased from US$23 billion at the end of March 2006 to US$29,8 billion at the end of August 2007. The international liquidity position, which was positively affected by the prepayment by the Bank of the US$1 billion syndicated loan that was raised in 2004, increased from US$19,5 billion to US$27,4 billion over the same period. The prepayment resulted in some cost savings for the Bank, and conveyed a positive signal to counterparties of the Bank and the market. With the recent buy-back of foreign currency-denominated debt by the National Treasury, the prepayment also contributed to the effort to reduce the external vulnerability of the country.

A key focus area remained the refinement of the reserves management capabilities of the Bank. In this regard, the Bank worked closely with the World Bank under the auspices of the latter's Reserves Asset Management Programme for central banks. Capacity building is central to these efforts, and the Bank continued to invest in training and systems for staff involved in the areas of reserves and risk management. In addition, the investment policy of the Bank was reviewed and the governance structure was enhanced by the establishment of a Reserves Management Committee.

The Bank and the National Treasury further strengthened their co-operation in the areas of reserves accumulation and liquidity management. The National Treasury assisted in draining a large portion of the liquidity created by the foreign-exchange purchases of the Bank. At the end of July 2007, the special deposit account of the National Treasury with the Bank, which was created for this purpose, totalled R54,5 billion including accrued interest. Agreement has been reached on the settlement of outstanding balances on the Gold and Foreign Exchange Contingency Reserve Account (GFECRA). The Bank and the National Treasury have agreed that, in future, only realised profit or loss positions that have an influence on money-market liquidity would be settled on a regular basis. This arrangement should reduce the amount of funds flowing between the Bank and the National Treasury and moderate the impact on money-market liquidity. Under this new arrangement, the Bank transferred an amount of R319,3 million (including interest) to the National Treasury for settling the outstanding GFECRA balance as at 31 March 2006.

Currency distribution

Efforts are continuing to combat the counterfeiting of banknotes and to ensure that only banknotes and coin of acceptable quality are in circulation. Minimum standards for the reissue of banknotes have been prescribed.

In collaboration with the commercial banks the primary phase of the implementation of the Integrated Cash Management System has been completed. This system has the potential to improve the efficiency and effectiveness of the National Cash Management System in the cash value chain, thereby reducing the cost of cash to the public.

The developmental phase of the interactive Cash Risk Identification and Mitigation programme developed by the Bank and the South African Banking Risk Information Centre with the participation of the commercial banks, the cash-in-transit industry and the South African Police Service has been completed. This programme defines the minimum security standards for the cash management industry to reduce incidents of cash-in-transit heists and banking crimes, and is now being consulted on with unions and employee representatives. The minimum standards will also be promulgated into regulations by the Minister of Safety and Security.

The national payment system

The value of total settlement in the South African Multiple Option Settlement (SAMOS) system amounted to an all-time high of R5,6 trillion in July 2007, which is approximately R280 billion per day. This settlement figure also includes transactions stemming from the equity and bond markets. In 2006 and 2007, approximately 90 per cent of settlement through the SAMOS system was effected on a real-time basis during the day. The remainder, which emanated from the retail environment, was settled in the evening.

Directives for conduct in the payment system for system operators and third-party service providers will become effective during 2007. In May 2007 the Bank also commenced with the detailed oversight of non-bank participants in the national payment system. Specific focus is being placed on the operational soundness of payment clearing house operators.

Following the promulgation of the National Credit Act, 2007, amendments were made to the National Payment System Act, 1998. These amendments outlawed any non-statutory preferential treatment of a payment instruction in any given payment system and paved the way for the implementation of a specific payment stream to process payment instructions randomly.

Financial stability

In support of its objective to achieve and maintain price stability, the Bank also seeks to identify inherent weaknesses in the financial system and monitor risks that may result in financial system disturbances. On the basis of an analysis of various financial soundness indicators the financial system was appraised as sound.

The Bank also assessed the financial regulatory system in South Africa to be inherently robust in terms of the twelve key financial soundness standards identified by the Financial Stability Forum of the Bank for International Settlements (BIS). Some financial regulatory challenges remain. These include the implications of the recently introduced National Credit Act, the possible introduction of an explicit deposit insurance scheme, the review of South

Africa's membership of the Financial Action Task Force, initiatives to bring the hedge fund industry within the scope of current regulation, and the implementation of a new capital framework (Basel II) for banks on 1 January 2008.

In co-operation with other stakeholders in financial stability, the Bank furthered its efforts to prepare and maintain suitable contingency plans and crisis management strategies to respond to systemic distress. In the year under review, a programme of financial sector continuity testing was initiated to help hone the responses of financial sector authorities to systemic threats. The Bank also participated in the Coordinated Compilation Exercise of the International Monetary Fund (IMF), aimed at developing capacities of countries to compile financial soundness indicators for the surveillance of financial systems.

Banking regulation and supervision

The Bank has the responsibility to ensure that the domestic banking regulatory environment stays abreast of international best practice. A key focus area remains the preparation for the implementation of Basel II. The implementation programme aims to effect the requisite amendments to the legal framework and ensures the successful implementation of Basel II on 1 January 2008.

The migration to Basel II has necessitated intensified interaction with the banks. Interaction has included on-site visits by staff of the Bank, requests for and the processing of specific information to assess the impact of Basel II on the capital adequacy of banks, as well as readiness assessment meetings with banks.

In accordance with the latest industry requirements and market developments, and with the prescriptions of Basel II in mind, a finalised draft Banks Amendment Bill was approved by the Standing Committee for the Revision of the Banks Act in November 2006. Parliamentary hearings on the draft Bill were held in mid-June 2007. The Bill is expected to be promulgated later this year, with implementation effective from 1 January 2008. The Regulations relating to banks (the Regulations) have been reviewed in totality to comply with the prescriptions of Basel II and to provide banks in South Africa with all the options and approaches offered under Basel II.

A compliance assessment with the revised 25 Core Principles for Effective Banking Supervision of the Basel Committee on Banking Supervision was completed in October 2006. Based on this assessment, a gap analysis was completed and supervisors are implementing plans to improve the supervisory process with immediate effect where possible. Where necessary, amendments will be made to the Banks Act, 1990, and Regulations to ensure effective supervision.

During the review period the level of compliance of the banking industry with the application of anti-money laundering and the combating of terrorist-financing legislation remained a focus area. About 40 suspect business or investment schemes, which gave the impression of being engaged in banking activity, are under investigation.

International co-operation

South Africa assumed the chair of the G-20 for 2007 and the Bank and the National Treasury have been jointly co-ordinating activities. The G-20 comprises systemically important developed and emerging-market economies. Two G-20 Deputies meetings, one in Pretoria and the other in Durban, and two African Policy Seminars, which were held on the fringes of the G-20 Deputies meetings, were hosted.

Our term as host will culminate in the G-20 Summit of Finance Ministers and Central Bank Governors, which will be held in the Western Cape on 17 and 18 November 2007. Policy topics that will be considered include the reform of the Bretton Woods Institutions, commodity cycles and financial stability, and fiscal elements of growth and development. These topics were also the focus of G-20 seminars hosted in Brazil, the United States and Turkey earlier this year.

The international relations of the Bank remain focused on strengthening co-operation with central banks and multilateral organisations. Special attention has been given to the African continent and the Southern African Development Community (SADC) region in particular, where efforts are geared towards the achievement of regional integration. The Bank continues to take a strong leadership role in the Committee of Central Bank Governors (CCBG) in SADC.

In its role as leader of the SADC Payment System Project and under the auspices of the CCBG, the Bank has continued to facilitate the modernisation and harmonisation of the SADC regional payment, clearing and settlement systems. To date, the project has focused on the implementation of Real Time Gross Settlement systems, automated clearing and payment system oversight. Significant progress has been achieved in this regard and the current focus of the project is on areas such as remittances, retail payment system risk reduction, the securities settlement project and capacity building for payment system oversight. Further assistance will be provided to the Democratic Republic of the Congo and Madagascar in terms of the planning of their payment system development.

The Bank continues to be an active participant in the activities of the BIS. The participation of the Bank in and its contribution to the Foreign Exchange Settlement Risk Subgroup of the BIS Committee on Payment and Settlement Systems ensured that the Bank keeps abreast of international developments in this area and promotes best practice.

Closer bilateral relations with other central banks have resulted in the signing of Memoranda of Understanding with the central banks of China and Peru in the past year. In addition, the Bank has received numerous visits from other central banks which have allowed for more exchange of information.

The Bank has maintained close relations with multilateral organisations. Our collaboration with the IMF and the World Bank has resulted in a number of joint seminars and courses being presented by the South African Reserve Bank College (College) in 2007. These are open to participants from central banks and finance ministries from the African continent.

Internal administration

The *Annual Report* of the Bank was distributed to shareholders before this meeting. The total balance sheet of the Bank shows an increase from R168 billion at the end of March 2006 to R220 billion at the end of March 2007. The increase was mainly the result of the accumulation of official gold and foreign-exchange reserves and was financed in the main by an increase in government deposits, an increase in currency in circulation and the effect of valuation adjustments to the net reserves as a result of exchange rate movements. These adjustments are reflected in the increase in the GFECRA.

The profit before taxation of the Bank increased from R1 038 million for the previous financial year to R2 907 million for the financial year ending 31 March 2007. Budgeted expenditure of the Bank for the current financial year amounts to R1 879 million, compared to actual expenditure of R1 658 million in the financial year to 31 March 2007. This represents an increase of 13,3 per cent in budgeted expenditure compared to actual expenditure for the previous financial year. This increase is largely a result of the increased volume and cost of producing new currency.

The four subsidiary companies of the Bank 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 these companies are managed in accordance with their objectives and best corporate governance practice. The results of the subsidiaries are reported on a consolidated basis with those of the Bank in the financial statements. The Bank continued to operate an over-the-counter market for the trading of its shares. During the financial year ending 31 March 2007, 24 transactions in respect of 94 700 shares of the Bank were concluded at an average price of R1,60 per share. On 31 March 2007, the Bank had 612 registered shareholders and by 31 August this number had increased to 630.

The Bank views risk management as an essential element of good corporate governance and has therefore established a Risk Management Committee (RMC) to oversee the risk management process in the Bank. The RMC is chaired by a Deputy Governor and the four executive general managers of the Bank also serve as members.

Business continuity planning for the Bank has been completed and extensive adequacy testing is currently being conducted. A consolidated information and communication technology disaster recovery facility was established to enable the successful recovery and continuation of critical business processes in the event of a disaster or serious disruption at the Head Office building.

The sourcing of an enterprise resource planning solution for the Bank was approved and a suitable solution selected. This system will replace many of the old and ageing central services software systems in the Bank and also integrate data from disparate information systems into one unified system.

The Bank continues to maintain and improve existing buildings and additions not only to enhance the value of its properties, but also to preserve the cultural heritage of the country and support country-wide inner-city development initiatives where possible. Major renovations and refurbishment are being undertaken at Head Office and the branches in Pretoria North, Johannesburg and Cape Town. A new branch is being planned for Bloemfontein and plans are under way to renovate the branches in East London and Port Elizabeth, while preserving the historical character of these buildings.

Corporate art collections play a critical role in nurturing artistic talent. In the more than 53 years that the Bank's art collection has existed, it has supported a wide range of emerging and established artists. A book depicting a selection of the more than 600 works of art, dispersed throughout Head Office, the seven branches and the College was published earlier this month and it is believed that this book will make a valuable contribution to the appreciation of art.

The Bank continues to pay close attention to its human resources. The staff complement decreased to 1 934 at the end of March 2007, compared to 1 956 a year earlier. The overall staff turnover for the period was 6,8 per cent. The profile of new appointees was 84 per cent black, with 77 per cent of the management appointees black, and 45 per cent female. The profile of new appointees since 1 April 2007 until the end of July 2007 is 88 per cent black and 40 per cent female, with 80 per cent of the management appointees black, and 60 per cent female.

The modernisation process pertaining to the revised *Staff Policies* was concluded and the policies implemented. The outstanding policies pertaining to outside occupations and directorships, as well as to ethics are being consulted with staff.

An emphasis on wellness management continues, with the focus on physical and mental health. Disability management and HIV and Aids prevention continue to receive attention. Other measures taken include the provision of medical and psychological wellness services.

The Bank continues to place an emphasis on developing its staff. In addition to students who have recently completed their degrees, the Cadet Graduate Programme will be expanded to also cater for staff members of the Bank. This will double the number of cadets to twenty in 2008. In an effort to guarantee future accreditation for its learnerships, the College has completed a process to ensure that all its learning programmes adhere to the principles of outcomes-based education.

To stimulate research in the Bank, a research fellows programme has been introduced in terms of which senior researchers from other central banks and academia are invited to spend time at the Bank and engage in collaborative research. Three research fellows, two of whom are from abroad, have already spent time at the Bank in 2007, and a fourth is expected later in the year. Applications have been invited for the 2008 programme.

To contribute further to the economic research effort in the country, a conference on macroeconomic policy challenges for South Africa was organised by the College in 2006. It included papers presented by leading academics from local and international universities, as well as other local economists.

Conclusion

From a monetary policy perspective this past year has been particularly challenging for the Bank. The international environment has been uncertain, and the recent turmoil in international markets means that further challenges and uncertainties lie ahead. Nevertheless, the Bank will continue to focus on achieving its mandate and will strive to bring inflation to within the target range. Low and stable inflation remains the best contribution the Bank can make to economic growth and development in South Africa.

The Bank will continue to make a contribution to financial stability in the country. Apart from oversight and regulation of the national payment system, future challenges are likely to come from the introduction of Basel II at the beginning of next year, the possible implications of the National Credit Act, and the impact of higher interest rates on a highly indebted population.

We will not lose sight of the need to give attention to the internal management of the Bank. The Bank remains committed to the training and development of staff in the broader context of its Employment Equity Plan.

Acknowledgements

I want to thank the Presidency, the Government and Parliament for their continued support. Through the system of bilateral committees, the Bank has maintained a good working relationship with the National Treasury. I wish to thank the Minister and Deputy Minister of Finance, and the Director-General of the National Treasury and his staff for their ongoing support and co-operation.

I also wish to express my thanks to the members of the Board for their commitment to the Bank. Their efforts are important in ensuring effective corporate governance and strategic direction for the Bank. Last but by no means least, I wish to thank the deputy governors, management and staff of the Bank for their support and contributions to the successful running of the Bank. An organisation such as ours is only as good as the quality and commitment of its personnel. We are indeed fortunate to be able to attract an excellent group of employees.