# Mr Mboweni's address on the occasion of the seventy-ninth ordinary general meeting of shareholders of the South African Reserve Bank

Address of Mr T T Mboweni, Governor, at the South African Reserve Bank's seventy-ninth ordinary general meeting of shareholders on 24 August 1999.

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## Introduction

The South African economy has recovered remarkably from the contagion effect of the financial turbulence in Asia and Russia. After being seriously affected by the volatility in global financial markets during the four months from May to August, tentative signs of a return to financial stability already began to appear during the last few months of 1998. The recovery of the financial sector was, however, attained at the cost of lower economic growth because of the restrictive measures that the authorities were forced to apply, the impact of a slowdown in international economic activity in many parts of the world and a slump in international commodity prices. Currently the economy seems to be poised for higher growth in production, provided that it is not again affected by setbacks in other countries.

At the beginning of the financial turmoil the thinking was that it would only have a limited impact on domestic economic conditions through a lower demand for South African exports from the Asian region. Later it became apparent that the crisis would not only be restricted to certain countries in Asia, but would affect many countries around the world. The international financial system was dealt a further blow when Russia de facto devalued the rouble, imposed a moratorium on foreign credit repayments and unilaterally restructured public debt in August 1998.

As a result of these circumstances, international investors lost confidence in emerging markets and withdrew investments from developing countries to higher quality, but lower yielding, financial assets of industrialised countries. Interest rates rose to high levels, equity and bond prices fell sharply and the currencies of many economies depreciated considerably. Many banks and other financial institutions suffered losses, especially on highly leveraged investment positions, which induced systemic risks in the financial sectors of some emerging-market economies. The financial turmoil spilled over to real economic activity, with serious consequences for growth in world production and trade.

All these developments once again demonstrated that in a globalised financial system the mobility of capital has serious consequences for financial stability. In a closely integrated financial world it has become even more important for monetary policy to be focused primarily on financial stability. The lack of a credible commitment to that objective by the monetary authorities could intensify the risk of market overreaction and systemic instability. Such a policy approach does not, of course, provide unconditional protection against speculative capital outflows. Decisions by international investors to withdraw capital from a country, based on developments in other emerging-market economies, are beyond the control of any central bank. The best approach that the South African Reserve Bank can follow is to pursue financial stability in a transparent way so that it can forestall uncertainties.

Monetary policy will be more successful in avoiding imbalances and disruptive capital flows if measures are in place to address structural weaknesses in the economy. Crisis prevention requires close coordination between the various spheres of macroeconomic management to ensure market confidence. In addition, domestic financial systems should be closely monitored and made more transparent and thus more robust.

While it is essential for South Africa to maintain these disciplines, the recent crisis has illustrated the need to adapt the international financial system to the realities of global markets to reduce the frequency and size of crisis situations. International organisations have made considerable progress with the improvement of the financial architecture. Standards or codes of good practice have been or are being developed in many financial disciplines to allow market participants to compare the practices of countries with internationally agreed benchmarks. The Reserve Bank regards this work as essential for the creation of more stable conditions and is accordingly willing, wherever possible, to participate in these endeavours.

If a financial crisis does occur despite the efforts of the monetary authorities to prevent it, monetary policy has to accommodate the market. Intervention in financial markets can assist in smoothing the adjustment process, but should not oppose market trends. The authorities have to allow interest rates and the exchange rate of the currency to move to new levels. Such adjustments increase the cost of speculation, reduce inflationary pressures and contribute to an improvement in the balance of payments position of a country.

Unfortunately, the adjustments required in a crisis also adversely affect real economic activity. However, experience in many of the emerging-market economies during the recent financial crisis has shown that where monetary policy had not been tightened quickly and sufficiently, instability persisted with an even greater negative impact on those economies. Pursuing a tighter monetary policy led to a quicker return to currency stability and market confidence. This, in turn, provided room for a lowering of interest rates which helped to mitigate the negative results of the earlier tighter measures.

The efforts of individual governments and the international financial community to re-establish financial stability are proving successful. The implementation of flexible exchange rate regimes and other structural adjustments in emerging-market economies seemed to have stabilised financial markets during the first seven months of 1999, and are also improving the prospect of a gradual economic recovery. Interest rate cuts by central banks in virtually all major industrialised countries are helping to improve liquidity and to rebuild investor confidence. Although there are still risks and uncertainties in the world economy, conditions are far better now than they were during 1998.

**The contagion effects of the international financial crisis on South Africa**

The effects of the international financial crisis spilled over into the South African economy in May 1998 when foreign fund managers began withdrawing portfolio investments. The well-developed capital markets and the relatively free convertibility of capital in the country provided an easy source of liquidity for fund managers who wished to reduce their exposures to emerging markets. From May to December 1998 non-residents reduced their holdings of South African bonds by R26 billion. In the first four months of the year they were net buyers on the South African Bond Exchange to the amount of R16 billion.

This reversal of portfolio investments in bonds by non-residents was difficult for the South African economy to absorb because it occurred at a time when South Africans were also making direct and portfolio investments in other countries following a relaxation of exchange controls. Moreover, the reversal created leads and lags in other foreign payments and receipts related to an expected depreciation of the rand. However, non-residents continued to invest large sums in the equity capital of South African enterprises, with the result that the net outflow of capital not related to reserves amounted only to R0.4 billion in the second half of 1998, compared with an inflow of R8.3 billion in the first half of the year.

The international developments also affected the current account of South Africa’s balance of payments because they brought about a substantial drop in international commodity prices and depressed world trade. The volume of merchandise exports declined in the second half of 1998, while higher rand proceeds for exports mainly reflected a depreciation of the currency. In addition, the gold price in terms of United States dollars declined further and the value of imports rose steeply because of infrastructural investments by public corporations. These developments led to an increase in the deficit on the current account of the balance of payments and a marked decrease in the gold and

foreign exchange reserves of the country. As could be expected under these circumstances, the exchange rate of the rand depreciated to a level at the end of 1998 that was nearly 20% lower than its weighted value at the end of 1997.

The volatility in international financial markets generated substantial increases in the turnovers of financial markets in South Africa, including the markets in foreign exchange, shares, bonds and derivatives. The large outflow of foreign funds on the Bond Exchange contributed to an increase in the daily average yield on long-term government bonds from a low of 12.67% on 17 April 1998 – its lowest level since May 1994 – to 20.09% on 28 August 1998. So much liquidity was drained from the South African banking sector that the banks had to borrow large amounts from the Reserve Bank on a daily basis. The liquidity shortage in the market pushed up short-term interest rates by about 7 percentage points, forcing the banks to raise their prime overdraft and mortgage lending rates to more or less the same extent. These higher lending rates had a dampening effect on real-estate transactions. Share prices also dropped sharply, even though the market was supported by a strong demand from foreign investors.

The high turnovers in the financial markets and a desire for precautionary money balances resulted in an exceptionally strong growth in the money supply. The growth over twelve months in the broadly defined money supply (M3) reached 19.4% in June 1998 and declined only fractionally to 18.9% in August 1998. These high rates of increase were recorded despite a slowdown in the growth of nominal gross domestic product and apparently formed part of the rise in the nominal value of financial asset portfolios. This latter factor, together with an increased demand for working capital by the corporate sector and some borrowing by companies to tide them over a period of slack demand in the economy, were prominent forces behind a continued steep rise in total bank credit extension. The increase in the demand for bank credit was reinforced by speculative opportunities in a period of heightened volatility in the securities markets.

The international financial turmoil halted the downward movement in the rate of increase in both production and consumer prices from the beginning of 1997. Over the six months to September 1998, growth in production prices accelerated considerably as the rand depreciated. The consumer price index, in turn, was strongly influenced by a sharp rise in the prices of consumer services, notably the rise in mortgage lending rates. Core inflation, which excludes certain food prices, interest costs, value-added tax and municipal rates, was far more subdued, rising from 6.9% in March 1998 to only 7.7% in September 1998.

In comparison to other emerging-market economies, the South African banking sector proved remarkably resilient during the global financial turmoil. Banks were able to weather this storm better than some of their counterparts in other countries because of good management, strict legislative requirements, low international credit exposures and diligent risk management. The level of the net external liabilities of banks is low, in other words their exposures to exchange rate risks are minimal. In addition, our banks eased the increased burden of high interest rates on borrowers by extending the repayment period.

The non-performing loans of banks nevertheless increased by more than R8.2 billion over one year to R27.4 billion at the end of June 1999, but the gross overdues of banks as a percentage of total loans and advances amounted to only 4.7% on this date; a level which is still low enough not to be of concern. Many of the banks have in any case also increased their provisions for bad and doubtful debts, which amounted to 2.7% of loans and advances at the end of June 1999.

The banks in South Africa are well capitalised. The average risk-weighted capital-adequacy ratio for the system as a whole reached 11.6% at the end of June 1999, compared with the required minimum ratio of 8% stipulated by the Basel core principles. Moreover, more than half of the banks had a capital-adequacy ratio of 15% or better. The disruptions internationally did not materially affect the profitability of banks, and their return on equity reached approximately 15% at the end of June 1999. Cost control and an expansion of the business of banks into new areas helped to sustain profit levels. Banks have successfully developed alternative non-interest-bearing sources of income, and transaction-based fee income and investment income now represent nearly half of their net revenues.

### The return to financial stability

The way in which the banking sector coped with the international financial crisis, together with a prudent monetary policy approach, were important factors that contributed to a relatively quick return to financial stability in South Africa. By the fourth quarter of 1998 there were signs that the storm was abating. The strain on the South African situation slackened so much in the last part of 1998 that the exchange rate of the rand against the United States dollar eased from about R6.66 on 28 August 1998 to R5.70 early in January 1999. Domestic interest rates declined by about 3 percentage points over the same period.

Although problems in Brazil temporarily created new pressures in the South African market for foreign exchange in January 1999 and interrupted the decline in interest rates, the nervousness in the financial markets gradually evaporated when it became apparent that the contagion effects of Brazil's problems would be limited. Non-residents again became net buyers of South African bonds, while they continued to invest large amounts in shares listed on the Johannesburg Stock Exchange. In the first seven months of 1999 the portfolio investments of non-residents in South Africa amounted to no less than R33.8 billion, compared with disinvestments of R3.2 billion in the last eight months of 1998.

Direct investment by foreigners in domestic enterprises came to R3.7 billion in the first half of 1999. These investments were neutralised to some extent by South African investments in other countries, with the result that the net inflow of capital not related to reserves, or the surplus on financial transactions with the rest of the world, totalled R7.4 billion. At the same time, a lower level of final demand, significant further reductions in inventories and an increase in the cost of imported goods, depressed the value of imports. By contrast, exports rose strongly as the Asian economies began to recover, the decline in international commodity prices levelled out and domestic producers began expanding into other markets. Expressed in terms of seasonally adjusted and annualised rates, the current account of the balance of payments accordingly turned around from a deficit of R19.1 billion in the last half of 1998 to a surplus of R0.6 billion in the first half of 1999.

The improvement in South Africa's overall transactions with the rest of the world led to a sizable increase in the international reserves of the country. The total gross gold and other foreign reserves improved steadily from a lower turning point of R40.9 billion at the end of November 1998 to R47.2 billion at the end of June 1999. The nominal effective exchange rate of the rand nevertheless decreased somewhat in the first seven months of 1999. At the end of July 1999 the weighted average level of the exchange rate of the rand was no less than 38.4% below its level at the end of 1995, clearly indicating a marked strengthening of the international price competitiveness of domestic producers.

The greater stability in the exchange rate of the rand and the containment of domestic cost increases relieved inflationary pressures. As a consequence, a slowdown in inflation in consumer prices was observed from the end of 1998. However, higher oil prices contributed to a rise in production prices from the very low levels reached in the first half of 1998, while core inflation increased from 7.1% in April 1998 to 8.2% in July 1999.

The surplus balance on South Africa's transactions with the rest of the world eased the total liquidity requirement of banking institutions and prompted a steady decline in money market rates in the first seven months of 1999. Sentiment in the market for fixed-interest securities became more positive in view of the slowdown in the inflation of consumer prices, an easing in money market conditions and declining short-term interest rates, a conservative fiscal policy which reduced government's funding requirement for the fiscal year ending 31 March 2000 and positive credit assessments by international rating agencies. Consequently, the yield on long-term government bonds declined from 20.09% on 28 August 1998 to 15.18% at the end of July 1999.

As normality returned to financial markets and the turnovers on these markets came down from the exceptionally high levels that they had reached during the international financial turbulence, growth in the monetary aggregates finally started to decline after four years of high rates. The general downturn in economic activity, lower inflation and a decline in liquidity preference, were other factors that caused the growth in M3 to move within the guideline growth range of between 6% and 10% from February 1999. The growth in total domestic credit extension by banks also slowed down significantly in the first half of 1999. Despite these favourable developments, it is important that monetary policy

takes into account that the ratio of the money supply to gross domestic product was still very high at 53.5% in the second quarter of 1999.

All in all, the financial markets have rallied remarkably during 1999. Internationally, the turbulence prevailing during 1997 and 1998 seems to have calmed down. Provided that there are no serious setbacks in the international economy, we are confident that real economic activity in South Africa should begin to recover.

**Adverse financial conditions depressed economic growth and employment**

At the beginning of 1998 it was expected that the downswing in economic activity experienced during the preceding year would come to an end and that the economy would turn around before moving into a recession. However, the measures that the authorities were forced to take to stabilise financial conditions led to sharp declines in the components of domestic demand that are sensitive to interest-rate costs, such as inventories, consumption expenditure on durable goods and private-sector fixed investment. Domestic production was also harmed by a lower demand for exports, with the result that real gross domestic product contracted sharply in the third quarter of 1998. Fortunately, this setback was short-lived and aggregate output began to increase again, albeit at low rates.

The downturn during the middle of 1998 spread to most of the economic sectors, with the notable exception of financial services which benefited from price volatility and high turnovers in financial markets. From the fourth quarter of 1998 the secondary sectors and some of the other tertiary sectors started to record small positive growth, but the value added by agriculture and mining continued to contract. Gold production, in particular, decreased sharply in reaction to the effect that increased gold sales by some central banks had on the price of gold.

The gold mines have had to contend with rising costs of production and a generally depressed market price since the mid-1980s. This has not only had serious consequences for the domestic economy, but also affected developments in neighbouring countries through the loss of employment opportunities. From the beginning of the 1980s the number of people employed on the gold mines has been reduced by almost 250,000 because of mine closures and the introduction of cost-saving production methods. The substitution of capital for labour in other sectors of the economy further contributed to high unemployment in South Africa and other negative social effects. The low production growth in the past year aggravated this problem as employment was slashed further.

The decline in employment was accompanied by a marked increase in labour productivity. At first the growth in output per worker could not contain an acceleration in the rate of increase in nominal unit labour costs. From the beginning of 1999 the growth in unit labour costs has slowed down significantly, which could help to curtail inflation because labour is still the single most important component of overall production cost in the economy.

Unlike the decline in production, the domestic demand for goods and services continued to expand in 1998, but the rate of increase in aggregate expenditure slowed down. The main reason for the expansion in final demand was the solid growth in fixed capital formation, largely owing to investment expenditure in telecommunication and transport activities by public corporations. Contrary to these developments, the rates of increase in the consumption expenditure of both the public sector and households slowed down considerably during 1998, while private-sector real fixed investment declined sharply. Inventory levels were reduced significantly in response to the slowdown in domestic economic activity and the high costs of carrying stock.

In the first half of 1999 the real domestic final demand for goods and services declined markedly when the capital spending of public corporations contracted. In addition, a decline in interest-rate sensitive household expenditure on durable goods and the strict discipline applied to government expenditure resulted in a decrease in consumption expenditure, while private-sector fixed investment continued to move to lower levels. Real gross domestic expenditure contracted even more sharply than final demand, due to a reduction in inventory levels as businesses economised further on inventory holdings.

The reduction in consumption expenditure and efforts of households to bring down high debt levels led to a marginal improvement in the savings ratio of households in the first half of 1999. Moreover, the resolve by government to adhere to sound fiscal policies was reflected in a decline in the net dissaving by general government as a ratio of gross domestic product from 5% in 1997 to 3% in the first half of 1999. The corporate sector succeeded in lifting retained earnings by more than the growth in production over the same period. As a consequence, the ratio of gross saving to gross domestic product rose somewhat from a low of 13% in the fourth quarter of 1998 to 15% in the first half of 1999. Although this is a welcome change in the declining trend of the savings ratio, it is still well below the levels needed for sustained higher economic growth. Serious attention will have to be given in economic policy deliberations to promoting saving and inward direct investments in order to create job opportunities.

**Prudent public finance**

The government persisted with a well-managed conservative fiscal policy stance. The public-sector borrowing requirement, i.e. the deficit before borrowing of the central government, provincial governments, local authorities, non-financial public enterprises and public corporations, has been brought down systematically from an upper turning point of 9.3% of gross domestic product in the fiscal year 1993/94 to a ratio of 3.4% in the fiscal year 1998/99.

In the past fiscal year there was a decline in the absolute value of the public-sector borrowing requirement. What made this an even more remarkable achievement was the fact that the revenue of the government increased at a lower rate than in the preceding year. Total expenditure by general government, however, rose at a rate of only 5.3% in the fiscal year 1998/99, i.e. significantly below the inflation rate. General government successfully contained growth in expenditure mainly through a decisive slowdown in current spending on goods and services.

**The financial turbulence and monetary policy**

The conservative fiscal policy stance assisted in countering the contagion effect of the international financial turbulence during 1998. However, the brunt of the adjustment process fell on monetary policy, as it takes a long time to make changes in fiscal and other policy measures. The strains that developed in the foreign exchange market in 1998 caused the exchange rate of the rand and domestic interest rates to adjust automatically to the changed supply of and demand for foreign exchange and the impact of these developments on bank liquidity. In these volatile and uncertain circumstances, the monetary authorities could only influence the speed of the adjustments required by the market.

The Reserve Bank's response was to underprovide in the liquidity requirement of the banks and to intervene in the foreign exchange market so that financial stability could be restored at the least cost in terms of inflation and economic growth. As a result, the repo rate moved sharply upwards by about 7 percentage points from the beginning of May to 21.85% on 28 August 1998. The accommodation system was made more effective to cope with the crisis by phasing in a wider spread from 1 to 20 percentage points between the repo rate and the marginal lending rate. These measures led to corresponding steep increases in other short-term interest rates, which eased the adjustment in the exchange rate of the rand.

In tandem with the rise in interest rates, the Reserve Bank at first intervened heavily in the foreign exchange market in May and June 1998 in an attempt to create some order in a market that had become extremely sensitive to any negative news or rumours. The intervention consisted mainly of swaps in the forward market, which increased the Bank's net open foreign currency position from US$ 12.8 billion at the end of March 1998 to US$ 23.2 billion at the end of September 1998. The Bank returned this foreign exchange liquidity to the market which had been obtained previously from large inflows of portfolio investments.

In view of the large risks and potential costs associated with a net open exposure, the Reserve Bank stopped using this intervention technique when it became apparent that the contagion impact of the

emerging-markets' crisis would be more severe and longer lasting than originally expected and when the purchases of foreign exchange preceding the crisis had been fully reversed. This decision was validated when it became known that highly leveraged funds had built up speculative positions against the rand through forward foreign exchange transactions. Later, when these leveraged funds incurred losses in emerging markets and were forced to buy back their short rand positions, these transactions contributed to the retracing of some of the rand's earlier losses.

As indicated, financial conditions became more stable from the fourth quarter of 1998. General nervousness continued to prevail among international investors, and they withdrew funds from emerging-market economies whenever there were signs of any pressure on exchange rates. In these circumstances, the Reserve Bank deemed it prudent to guide the repo and other money market interest rates gradually down to lower levels. With brief interruptions, the repo rate then moved lower from its upper turning point of 21.85% on 28 August 1998 to 13.65% on 31 July 1999. Over the same period, the net open foreign currency position of the Reserve Bank was reduced by US$ 5.6 billion to US$ 17.5 billion at the end of July 1999.

Despite the initial wide fluctuations in the repo rate, the repo-based accommodation system that the Reserve Bank had introduced in March 1998 is proving of considerable value in general and during periods of instability in financial markets in particular. Most of the difficulties encountered shortly after the implementation of the system were due to general nervousness in the market and teething problems. The system was flexible enough to be adjusted easily to solve these problems. Changes to enhance the efficiency of the repo system included the shortening of maturities, the introduction of "square-off auctions" at the end of the daily settlement period, administrative adjustments to the management of cash reserves and a refinement of the signalling procedures of the Reserve Bank. After these changes had been made, short-term interest rates became more flexible without being too volatile or too slow in reacting to signals.

## The way forward

The liberalisation and international integration of financial services make it imperative for South Africa to bring domestic inflation in step with that of the rest of the world and to maintain sound and efficient financial institutions and markets. If these goals are not achieved, the economy could be subjected to sudden reversals in international capital flows, exchange rate instability and volatile interest rates. The thrust of monetary policy in these circumstances should therefore be to establish and maintain financial stability, i.e. stability of prices, financial institutions and financial markets.

This does not mean that monetary policy ignores other objectives of economic policy, such as economic growth, employment creation and improved social conditions in the country. On the contrary, we regard financial stability as a precondition for balanced and sustainable economic growth and improved living conditions, because it improves the efficiency of the pricing system and economic decision-making; enhances the efficiency of financial intermediation; minimises the inflation risk premium in long-term interest rates; reduces the incentive to hedge against inflation; promotes a more equitable distribution of wealth and income; and facilitates investment decision-making. A monetary policy that maintains financial stability in a credible and lasting way will accordingly make the best overall contribution to improving economic growth, employment and living standards.

A market-oriented strategy will be followed to achieve this overriding goal of monetary policy because financial institutions and markets function best in the national interest if they are competitive, active and liquid, and if interest rates and exchange rates are flexible. The Reserve Bank will accordingly continue to discuss with government the relaxation of exchange controls when underlying conditions are conducive to taking such steps. The eventual removal of exchange control restrictions should contribute towards dismantling the oversold forward book and reducing the net open foreign currency position. Once residents have accumulated large amounts of foreign assets, they could use these assets to counterbalance short-term currency volatility if they perceive this to be an opportunity to profit from a temporary undervaluation of the exchange rate.

In pursuit of the primary objective of price stability it is essential, as stated in the Constitution, that the Reserve Bank performs its functions independently and without fear, favour or prejudice. The Bank will maintain an attitude of economic-professional objectivity, but will, of course, at the same time be accountable to Parliament and the general public for its actions. Transparency in the interpretation of economic data and the monetary policy stance will be promoted further. Regular reporting on economic conditions and Reserve Bank operations to Parliament and the general public will receive high priority.

Although the Bank will strive to achieve closer cooperation and coordination with the authorities responsible for policy decisions in other macroeconomic and microeconomic fields, the autonomy of the Bank will be preserved. There are structural deficiencies in the economy which impair saving, investment, production growth and employment creation and increase the level of real interest rates. A number of initiatives announced by the President at the opening of Parliament are aimed at easing these supply-side constraints. The implementation of these structural changes could create further scope for lower nominal and real interest rates. Closer cooperation and coordination between the Reserve Bank and other national official bodies may expedite this process.

The Southern African Development Community (SADC) provides an opportunity for member states to face jointly the challenges of global financial integration. Considerable progress has been made over almost four years in promoting interaction in Southern Africa through the Committee of Central Bank Governors of the SADC. This committee has enhanced cooperation among central banks; forged close ties between bank regulators and supervisors in member countries, promoted the expansion of training facilities for employees of central banks, enhanced the payment, clearing and settlement systems of member countries, established closer consultation between private banking institutions and stock exchanges operating in the region, analysed exchange control restrictions in Southern African countries with the aim of gradually removing or harmonising these restrictions and collected and disseminated macroeconomic statistics.

The South African Reserve Bank will continue to promote the effective cooperation and integration of the financial systems and markets of Southern Africa. Where needed, banking institutions and financial markets should be established in conjunction with effective payment, clearing and settlement arrangements within and between countries in the region. For the time being this will be done informally before attempting to achieve officially sanctioned harmonisation and integration of financial arrangements.

In applying monetary policy in South Africa it is advisable to move away from the “eclectic” or informal inflation-targeting framework to formal inflation targeting. The eclectic monetary policy approach has been a useful framework for containing inflation, but at times it created uncertainties about Reserve Bank decisions and actions which were perceived as being in conflict with intermediate objectives. The guidelines on the growth in money supply and bank credit extension have constantly been breached in recent years as a result of financial deepening. To the extent that a formal or explicit inflation-targeting framework would be more transparent than the previous framework, it ought to allay some of these uncertainties.

With the adoption of inflation targeting, it will become clear that the containment of inflation is not solely a Reserve Bank responsibility. Inflation targets should be set jointly by the Reserve Bank and government. Inflation targeting will be more effective when economic policies are well coordinated. Before inflation targeting is introduced, this coordination should be clearly spelled out and all stakeholders must be consulted, including business and the trade union movement. We are convinced that the government will ensure that the policy measures are properly coordinated.

Our considered view is that a policy target agreement should be drawn up that would be signed by the Minister of Finance and the Governor of the Reserve Bank to define precisely the coordinated effort needed to contain inflation in pursuit of the broader economic objectives of sustainable high economic growth and employment creation. In this agreement the instrumental independence of the Reserve Bank must be guaranteed. This stipulation and the rest of the agreement will, of course, have to be ratified by Parliament.

Inflation targeting is a complicated monetary policy framework that requires careful preparations before an announcement is made to apply it in practice. To facilitate the implementation of inflation targeting, the Bank is currently revising and reorganising the functions of the Economics Department, now renamed the Research Department. As the new name implies, the activities of the department will concentrate on research, i.e. analysing monetary issues and coordinating research in the Bank. Although an important part of the Research Department's work will still be devoted to the compilation of economic statistics that can be used in economic analysis, greater attention will henceforth be given to monetary policy assessment, econometric modelling, international economic developments, international relations and labour and social research.

The Research Department is developing the technical support systems that are essential for the implementation of an inflation-targeting framework, namely the development of additional and more sophisticated inflation-forecasting models, the investigation of the transmission mechanism between changes in policy instruments and inflation and the design and implementation of a survey-based assessment of inflation expectations.

Although these steps are necessary for the implementation of inflation targeting, this new framework should not in any significant way affect the conduct of monetary policy. Policy actions will still be guided by a medium-term inflation outlook, albeit in a more transparent manner. In order to arrive at an inflation outlook, the Bank will continue to monitor a wide range of economic indicators, including developments in money supply and bank credit extension. In this new framework the Bank's main operational instrument will continue to be the repo mechanism. The same fine-tuning and structural operational instruments will be used to influence interest rates and the level of the exchange rate of the rand will be determined primarily by the impact of these actions on the supply of and demand for foreign exchange.

Price stability depends not only on monetary operational procedures, but also on stability in the financial sector or the degree of confidence in the ability of financial institutions and markets to meet contractual obligations without interruption or outside assistance. Any signs of weakness in the financial system could disrupt price stability. Conversely, stability in the financial sector could be seriously disturbed by sharply rising inflation and interest rates, and a resultant increase in non-performing loans and a fall in asset prices and collateral values. An appropriate balance between risk and reward in the financial system is a major challenge to any central bank.

In view of these considerations, the Reserve Bank will continue to monitor financial conditions carefully as part of its objective to maintain financial stability. Where unavoidable pressures do arise in the financial system, the Bank may have to carefully contain them directly as "lender of last resort". The lender-of-last-resort facility will not, however, automatically be made available to all banks in distress, but only in cases where the failure of a bank would pose a serious threat to the financial system as a whole. Criteria will be established to specify the exit strategy of the Reserve Bank. A deposit-insurance scheme is being developed to cover retail depositors. This scheme could provide more latitude in deciding whether to close an ailing bank, without the concern that depositors in financially healthy banks may lose confidence in the banking system as a whole.

Sound financial supervision is a prerequisite for financial stability and warranted the debate during the past year on the feasibility of establishing a single financial regulatory authority in South Africa. Most countries have securities commissions responsible for the regulation of investment services and in many countries there is still a separation of banking and insurance supervision. Current opinion in South Africa is influenced strongly by recent developments in the United Kingdom and Australia where banking supervision has been moved out of the central bank into a single financial regulator.

There are convincing arguments both for and against a single financial regulator. Arguments for such a single regulator include issues such as the blurring of functional dividing lines between different institutions, the development of financial conglomerates, the exploitation of gaps in financial regulation and the achievement of economies of scale and a uniform style of regulation. Arguments for the retention of bank supervision as a Reserve Bank function are based on the characteristics of banking, the special relationships between the Bank and the banking sector, the high systemic risks in banking, the importance of a healthy banking system for effective monetary policy and the Bank's

ability to compete for scarce human resources. It is important that all these arguments be carefully considered by government to find an appropriate approach to this issue that can continue to assist in the execution of monetary policy.

A well-organised decision-making process is another important factor in the conduct of monetary policy. All monetary policy decisions are currently made by the Governors' Committee (consisting of the Governor and deputy governors), while the Monetary Policy Implementation Committee (MPIC) is responsible for carrying out monetary policy. Although this decision-making process works well, monetary policy issues demand more attention. It has therefore been decided to create a Monetary Policy Committee (MPC) for the formulation of monetary policy. The MPC will consist of the Governor and deputy governors as voting members and senior officials of the Bank as non-voting members.

The MPC will consider and evaluate the state of the economy, the current stance of monetary policy and the operational procedures in the conduct of monetary policy and formulate the changes deemed necessary in monetary policy and operational procedures. The final decision-making power on monetary policy matters will nevertheless still vest in the Governors' Committee.

In order to provide opportunities for public involvement in the monetary policy decision-making process, it has also been decided to create a Monetary Policy Forum (MPF). The Governor of the Reserve Bank will chair the MPF, and representatives of private business enterprises, labour and other interested institutions and organisations will be invited to participate in the meetings of the MPF. The MPF will meet twice a year to discuss macroeconomic developments and monetary policy issues.

**Internal administration of the Bank**

The internal decision-making process of the Reserve Bank will be changed in the coming year. In addition to the existing Currency, Payment and Financial Systems Committee and the Management Committee, a Budget Committee will be formed. The Budget Committee will have the authority to compile and monitor the implementation of the Bank's annual budget. Through a Subcommittee on Procurement, the Budget Committee will also be responsible for the procurement, management and control of supplies, services and assets of the Bank.

In a further attempt to achieve greater transparency, the Bank has decided to establish a fully fledged Media Office. This office will be primarily responsible for focusing external communication, thus assisting the media, national and provincial legislative structures and the general public to gain a better understanding of the Bank's policies, decisions and activities.

During the past year, considerable progress has been made with a number of other administrative projects in the Reserve Bank. These projects included the certification of year 2000 compliance of the banking system's information technology infrastructure and applications, as well as the South African Multiple Options Settlement (SAMOS) system. Operational contingency plans have been prepared to handle any problems that may arise over the year-end, including plans for the provision of additional cash, the management of liquidity and for continued clearing, payment and settlement through the SAMOS system. Simulations of the clearing arrangements were conducted on the public holiday on 9 August 1999 and the results were successful. Moreover, the Registrar of Banks has issued a number of regulations to ensure that the banking sector is year 2000 compliant and, in collaboration with the Financial Services Board, has prepared a booklet to inform the public of the preparations to overcome the year 2000 problem.

Further progress was made in enhancing various national payment system principles, practices and arrangements in preparation for same-day settlement by June 2000. These enhancements included the introduction of settlement risk-reduction measures, the adoption of a legal framework and the development of a risk and research database.

The Reserve Bank and the banking industry have also agreed to collaborate in improving the national notes and coin management system. The wholesale cash processing services performed by SBV

Services (Pty) Ltd. will revert to the Reserve Bank. A study is currently being done on ways of improving the infrastructure of the branches of the Bank to cater for these changes.

The Bank completed comprehensive recalculations of national accounts and balance of payments statistics during the past year. The estimates follow the conventions and guidelines of the latest System of National Accounts 1993 and the Balance of Payments Manual, prescribed by the United Nations Organisation and the International Monetary Fund (IMF), thus complying with the IMF's requirements for the Special Data Dissemination Standard.

Human resource development is regarded as an important element of the Reserve Bank's responsibilities because the Bank's staff is its major asset. Considerable effort has accordingly been made in the past financial year to develop the skills of the Bank's staff. In addition, several courses were presented to trainees from other African central banks at the Reserve Bank's Training Institute. The Institute, and the Bank of Tanzania Training Institute also jointly compiled a report on the coordination of training and development in the SADC region. In a further attempt to promote training, the Reserve Bank established a task force to review the training currently provided to staff and to make recommendations on ways of optimising the existing training facilities.

In the past financial year, a beginning has been made in drawing up a human resources plan which will deal with progressive employment equity in the workplace by promoting equal opportunities and fair treatment. The plan will propose the implementation of affirmative action measures to redress the disadvantages of designated groups to ensure their equitable representation in all occupational categories and levels of the workforce. A renewed focus will be placed on recruiting from the target group and enhancing the skills profile through development and monitoring. This plan will, however, be put into effect in a manner that will ensure that the institutional memory does not drop below the critical level required for national and international excellence. To achieve these goals, a Subcommittee on Human Resources will be established under the auspices of the Management Committee to oversee the execution of the human resources plan.

## Concluding remarks

Events over the past year illustrate that the thrust of monetary policy in an integrated financial world should clearly be to pursue financial stability. Although such a policy stance does not provide unconditional protection against volatile international capital movements, it improves the country's ability to withstand international financial turbulence. When international financial disruptions affect the South African economy, adjustments will inevitably have to be made to the exchange rate of the rand, domestic liquidity and interest rates. The objective of the monetary authorities should not be to resist such changes, but rather to ease the adjustment process by pursuing consistent and transparent policy measures. Financial stability is a precondition for sustained economic growth and employment creation.

The changes to the monetary policy framework and the monetary policy decision-making process that are proposed in this address should assist the authorities in this difficult task. Inflation targeting is no panacea, but it should help to anchor inflation expectations and minimise the inevitable, but short-term, social and economic cost of achieving price stability. A more transparent decision-making process will further assist in reaching this goal.

The financial crisis over the past two years showed that globalised financial markets and volatile capital movements create new challenges for supervisors to maintain stability in the financial sector. Various incidents revealed the extent to which participants took advantage of a wide variety of leverage methods to enhance returns on investments in emerging-market economies. The extensive use of derivatives and short sales of securities compounded losses and increased the need for liquidity when asset prices declined. In view of such developments, credit risk management becomes extremely important because of the dangers of default and large bad debts in the banking sector. In the recent crisis South Africa was fortunate to have had efficient and well-run banking institutions. Continued attention will have to be given in the coming years to sound risk management and to devoting even more resources to the maintenance of stability in the financial sector.

In conclusion, I wish to thank the President and Deputy President of the Republic for their support and appreciation with regard to the functions of the South African Reserve Bank and its governors. I further wish to thank Mr Trevor Manuel, Minister of Finance, Ms Maria Ramos, the Director-General of Finance and the staff of the Department of Finance for their support of the Reserve Bank over the past year. I should like to thank the directors of the Reserve Bank, including the deputy governors, for their undivided loyalty to the Bank. On this occasion, it is also fitting to pay further tribute to Dr Chris Stals for his term of ten years as Governor, and just more than 44 years in the service of the Bank. Dr Stals made numerous valuable contributions to the work of the Bank and for the benefit of South Africa during his career, for which we are deeply grateful. Dr Chris de Swardt, Deputy Governor for almost ten years, also retired recently after a distinguished career of nearly 44½ years in the Bank. We wish both Dr Stals and Dr de Swardt, as well as their wives, a happy retirement and fulfilling years ahead. Finally, I wish to thank the staff of the Reserve Bank for the professional manner in which they performed their duties in the past year. I am confident that with their continued loyal support, the Bank will meet the challenges that lie ahead.