T T Mboweni: A broadbrush picture of recent financial and economic developments in South Africa

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the 18th Ordinary General Meeting of shareholders, held on 29 August 2000.

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Introduction

The South African Reserve Bank has once again met the many challenges posed by the changing domestic and international environment with great success during the past year. The Bank's resilience was proven without any doubt in coping with such changes as the implementation of an inflation-targeting monetary policy framework, the information technology and other problems arising with the new millennium, and maintaining financial stability during very volatile conditions. The Bank also succeeded in improving the efficiency and effectiveness of internal administrative procedures and completed a plan to effect employment equity in all occupational categories.

The domestic economy also adapted very well to volatile international financial markets and reversals in capital flows. Developments in the rest of the world had both positive and negative effects on South Africa. On the one hand, the economic recovery in many parts of the world, together with continued low inflation, led to higher international commodity prices and an increased demand for South Africa's exports. On the other hand, certain inherent weaknesses in the world economy had a negative impact on domestic financial markets and, eventually, also on the recovery in domestic production.

The external imbalances in the world caused a realignment of currencies, with the dollar becoming notably stronger against the euro. Risks of sudden changes in market sentiment were exacerbated by increases in share and property prices. Furthermore, international oil prices rose steeply when the Organisation of Petroleum Exporting Countries (OPEC) and several other oil producers began to curb production. Prices rose from about US$ 10 per barrel at the beginning of 1999 to levels in excess of US$ 30 per barrel in the first half of 2000. This had a material impact on the import bill and prices in South Africa. Despite these developments, South Africa's balance of payments remained inherently healthy, and the foreign reserves of the country increased substantially.

Developments in some parts of sub-Saharan Africa unfortunately had an adverse influence on international perceptions of South Africa. Socio-political conditions in a number of countries remained unstable, and conflicts continued in parts of the continent. Events in Zimbabwe preceding the general election affected the sentiment of many investors towards the region, and unjustifiably raised questions regarding South Africa's economic prospects. The understanding by non-residents of the underlying strength of the South African economy was further clouded by perceived structural weaknesses in Africa, the slow pace of skills development, inadequate health facilities, the prevalence of virulent diseases (including HIV/AIDS), and growing poverty and debt. These perceptions disrupted domestic financial markets and real economic activity in South Africa during the first half of 2000.

A fundamentally sound balance of payments

The regional events, a shift of funds away from commodity-based countries to high-technology and manufacturing-oriented economies, a rearrangement of portfolios as a result of the surging energy prices, and higher international interest rates led to large net sales of domestic securities by non-residents. After being net investors in South African bonds to the amount of R16.5 billion from the beginning of 1999 until the end of January 2000, non-residents became net sellers of bonds totalling R15.3 billion in the next six months up to the end of July 2000. Moreover, the net purchase of

shares by non-residents on the Johannesburg Stock Exchange fell from R40.6 billion in 1999 to only R6.8 billion in the first seven months of 2000.

At first an inflow of other capital was able to offset the net sales of domestic bonds by non-residents. In 1999 the net inflow of capital, including errors and unrecorded transactions, amounted to R27.1 billion, and in the first quarter of 2000 to a still satisfactory R3.1 billion. However, in the second quarter of 2000 a net outflow of capital was recorded, totalling R5.9 billion. The more permanent inflow of capital in the form of direct investment by non-residents in South Africa remained positive, but was offset by portfolio and trade-related outflows and a further accumulation of foreign assets by residents. Non-resident direct investment in South Africa amounted to R13.3 billion in the eighteen months until June 2000. These direct investment flows, as in other emerging-market economies, can be boosted by large one-off privatisations.

Although the current account of the balance of payments moved into a deficit from the second quarter of 1999, the deficit remained relatively small. Throughout 1999 and the first half of 2000 the deficit did not exceed ½% of gross domestic product, and in the second quarter of 2000 a surplus of R5.7 billion at a seasonally adjusted and annualised rate was recorded. This surplus was a remarkable achievement taking into account the substantial increase in the country's oil import bill as well as sharp increases in the volume of imports from the second half of 1999. The strong performance of the current account can largely be attributed to the growth in merchandise exports. The favourable global economic conditions, a rise in international commodity prices and a competitive exchange rate level in South Africa, led to a considerable increase in both the value and volume of merchandise exports.

As a consequence of these developments on the current and financial accounts of the balance of payments, total net gold and other foreign reserves increased by nearly R28 billion from the end of 1998 to March 2000, before declining by R4.4 billion in the next three months. At the end of June 2000 the gross gold and other foreign reserves of the country nevertheless stood at R69.8 billion, which is the equivalent of the value of approximately 15 weeks' imports of goods and services. Moreover, the utilisation of foreign credit facilities to boost gross foreign reserves was reduced by about R0.3 billion over the eighteen-month period until June 2000.

As could be expected, this fundamentally sound balance of payments situation at first resulted in relatively stable conditions in the foreign exchange market. The nominal effective exchange rate of the rand in fact increased by 0.6% from the end of 1998 to the end of 1999. At the beginning of 2000, the external value of the rand began to depreciate in an environment of uncertainty in financial markets arising from the strength of the United States dollar, increases in oil prices and concerns about socio-political developments in sub-Saharan Africa. The weighted value of the rand declined by about 8½% from the end of 1999 up to 30 May 2000.

Towards the end of May the behaviour of non-residents in the secondary bond market started to change and the United States dollar weakened somewhat on international foreign exchange markets. Net sales of South African bonds by non-residents of R17.3 billion in the four months ended May 2000 changed to net purchases of R1.6 billion up to 22 August 2000. The nominal effective exchange rate of the rand accordingly, on balance, increased again to a level on 23 August 2000 that was about 5% lower than at the beginning of the year.

Buoyant but volatile financial markets

The depreciation of the rand was one of the factors contributing to a temporary reversal in the downward movement of long-term interest rates and yields in South Africa during 2000. The monthly average yield on long-term government bonds fell from 18.3% in September 1998 to a daily average of 13.3% in mid-February 2000, influenced by the strength of the rand during that period, low inflation, fiscal discipline and a positive assessment by international rating agencies of South Africa as an investment destination.

Subsequently, bond yields reacted hesitantly to perceived changes in financial markets. In March market sentiment deteriorated markedly owing to the weakness in the external value of the rand, rising official interest rates in major financial centres and higher risk premiums on South African assets. The

daily average yield on long-term bonds shifted upwards to reach a peak of 15.2% on 10 May 2000, before the return to more stable financial conditions reduced it to 13.7% on 22 August 2000. The monthly average inflation-adjusted yield on long-term government bonds amounted to 5.5% in July 2000, compared with 10% in September 1998.

Trading activity in the secondary bond market was boosted by the uncertainty in international markets. A record annual turnover of R8.8 trillion was recorded on the Bond Exchange of South Africa in 1999, followed by R6.2 trillion in the first seven months of 2000, which was about one-quarter more than in the corresponding period of the preceding year. In the primary bond market more active borrowing by private-sector companies compensated for a decline in the net borrowing of the public sector.

The share market entered a long and difficult recovery phase after the financial crisis in 1998. The daily average index of all classes of share prices fell by no less than 40% from the end of April 1998 to the end of August 1998, and then rose gradually to a new all-time high on 17 January 2000 of 10% above its previous peak in April 1998. Rising interest rates, the depreciation of the rand and corrections on major international bourses resulted in a decline in the daily average index of share prices of 28% until 17 April 2000, when it began to recover again. On 22 August 2000 the daily average index of all classes of share prices was nevertheless still 9% below its peak on 17 January 2000.

The strong recovery of share prices throughout 1999 supported trading activity on the Johannesburg Stock Exchange. The value of shares traded in the secondary share market rose to R448 billion in 1999, which was 40% more than in 1998. Volatility in share prices fuelled trading activity further during 2000. The value of shares traded in the first seven months of this year was 25% higher than in the corresponding period of 1999.

In contrast to the unstable conditions in the bond and share markets, interest rates in the money market declined sharply during 1999 and remained largely unchanged during the first seven months of 2000. For example, the call rate on interbank funds declined from 17.75% at the end of 1998 to 9.5% on 31 January 2000 and remained at that level in the ensuing period. Similarly the three-month bankers' acceptance rate moved down from 17.53% at the end of 1998 to 9.95% on 21 January 2000 and then fluctuated in a narrow range of between 9.83% and 10.25% up to the end of July 2000. The stability in the money market during the first seven months of 2000 can mainly be ascribed to the monetary policy stance pursued by the Reserve Bank.

As a result of the changes in long-term and short-term interest rates, the relatively flat yield curve at the beginning of 1999 assumed a steep positive slope over the next eighteen months. This reflected an easing of the monetary policy stance and, in the first five months of 2000, higher long-term yields and interest rates. From the end of May 2000 the differential between long-term and short-term yields began to decline again.

A slowdown in economic recovery

The South African economy showed clear signs of a vigorous economic recovery during 1999. The annualised quarter-to-quarter growth in the seasonally adjusted real gross domestic product accelerated from 1% in the first quarter of 1999 to 3½% in the fourth quarter. Moreover, the expansion in economic activity became far more widespread in the course of the year. Whereas the agricultural and tertiary sectors had been mainly responsible for the initial rally in production, increases in manufacturing and other secondary sectors made a major contribution to output growth in the second half of 1999.

Contrary to general expectations, the rate of expansion in the economy slowed down in the first half of 2000. Growth in real gross domestic product fell to 1% in the first quarter of 2000 and 1½% in the second quarter. To a large extent this was due to a decline in the output of the primary sectors, reflecting poor climatic conditions and an over-supply of coal on international markets. Manufacturing output was also affected by negative business sentiment related to the depreciation of the rand, the withdrawal of portfolio capital by non-residents and socio-political developments in some sub-Saharan African countries.

As a result of these developments, the inventory accumulation moderated in the second quarter of 2000. Domestic final demand continued to increase at relatively modest rates of between 1 and 2½% in the four quarters until June 2000. Over this period the government reduced its final consumption expenditure significantly as part of its efforts to maintain fiscal discipline. Public-sector fixed capital formation also declined throughout 1999 and the first half of 2000. This decrease, together with a reduction in private-sector investment, reduced total real gross fixed capital formation by 7% in 1999. However, the rate of decline in total investment levelled off towards the end of the year. Fixed capital formation increased at an annualised rate of 1½% in the first half of 2000 when private companies apparently started to increase capital spending in anticipation of stronger growth in domestic and export demand.

In sharp contrast to the developments in other expenditure aggregates, real household consumption expenditure rose steeply over the twelve months up to June 2000. Consumer confidence was high owing to increases in personal disposable income, a fall in bank lending rates and a lowering of effective income-tax rates. Despite this optimism, consumers avoided the use of excessive debt accumulation in financing consumption. Household debt as a ratio of disposable income declined from nearly 60% in the first quarter of 1999 to 57% in the second quarter of 2000. The reluctance of consumers to incur debt stems mainly from the volatility in real interest rates over the past two years.

The modest economic growth over the past eighteen months did not lead to meaningful employment creation. Further reductions were recorded in employment in the non-agricultural private sector as well as in the public sector, which were neutralised by increases in the informal sector. At the same time, the growth in nominal unit labour costs slowed down significantly because of lower increases in the labour remuneration per worker and a rise in productivity. The rate of increase in nominal unit labour costs declined from 8.9% in 1998 to 3.2% in 1999 and only 0.5% in the first quarter of 2000, compared with the same period in the preceding year.

Discipline in fiscal policy

Disciplined fiscal policies and efficient public administration procedures brought the public-sector borrowing requirement down from R25.6 billion in fiscal 1998/99 to R10.9 billion in fiscal 1999/2000. Over the past five years the public-sector borrowing requirement has been reduced from 5.8% of gross domestic product in fiscal 1994/95 to only 1.3% in fiscal 1999/2000. The further decline in the borrowing requirement of the public sector in the past fiscal year can be attributed to substantial improvements in the financial position of the national government, provincial governments and the non-financial public enterprises and corporations.

A decline in investment spending by public enterprises and corporations was responsible for approximately 25% of the reduction in the public-sector borrowing requirement. The remaining 75% saving in the borrowing requirement was largely due to the considerable restraint with expenditure allocations exercised by the national government and more efficient procedures for collecting income and other taxes.

It is important to note, however, that part of the curtailment in expenditure over the past five years may have been achieved at the cost of the development and maintenance of the economic and social infrastructure of the country. There is a delicate balance between containing expenditure and maintaining the infrastructure required for economic development.

Greater price stability

The effective fiscal, monetary and other policy measures pursued by the authorities, in conjunction with lower international inflation, succeeded in creating greater price stability in South Africa. In 1998 and 1999 the rate of increase in the consumer price index excluding mortgage interest costs (CPIX) averaged 7% per year. This rate of increase can be compared with inflation rates fluctuating around 15% in the 1980s and early 1990s.

During 1999 the twelve-month growth rate in the CPIX slowed down from 7.3% in March 1999 to 6.5% in October, but then accelerated to 8.0% in July 2000. The rise in inflation was largely due to shocks such as higher international oil prices, floods and volatile financial markets. When the effects of the price rise in petrol, diesel and food are omitted from the CPIX, the rate of increase over twelve months in other consumer prices fell from 6.8% in October 1999 to 6.7% in July 2000.

The year-on-year increase in the all-goods production price index accelerated from a low rate of 2.3% in March 1998 to 10.1% in April 2000. This rate of increase, which normally precedes changes in consumer prices, slowed down to 8.6% in July 2000 in line with the appreciation in the external value of the rand.

Recent developments in monetary aggregates bode well for the inflationary outlook, provided that the direct impact of external shocks wears off and that the secondary effects of the increase in oil prices can be contained. The level of the broadly defined money supply (M3) at the end of June 2000 was virtually the same as at the end of 1999, whereas M3 had increased at an annualised rate of nearly 19% in the second half of 1999. Moreover, the decline in money supply growth was largely concentrated in cheque and transmission deposits and coin and banknotes, ie in that part of M3 reflecting the transaction demand for money.

Growth in bank credit extension, which had moved to single-digit levels in the second half of 1999, remained below 10% in the first half of 2000. The demand for overdraft facilities was buoyant in the first six months of 2000. Most of the overdrafts were utilised by the corporate sector to finance working capital. Mortgage advances, instalment sale credit and leasing finance also picked up with the revival in the real-estate market and in expenditure on durable goods.

Monetary policy in a volatile environment

The volatility in financial markets had a significant influence on monetary policy during the past year. At first, evidence that the emerging-market crisis of 1997/98 was abating made it possible to relax a very stringent monetary policy stance. The repurchase rate of the Reserve Bank was allowed to decline from a peak of 21.85% in early October 1998 to approximately 12% on 24 November 1999. The Monetary Policy Committee then announced that the repurchase rate would be fixed at this level temporarily because of possible disruptions in liquidity relating to the computer problems expected to arise at the year-end date change. The marginal lending rate of the Bank, ie the rate on a standby facility to bridge the unforeseen liquidity needs of banks, was also reduced from 15 to 5 percentage points above the repurchase rate.

In addition to these measures, the Reserve Bank deliberately eased liquidity conditions in the money market during the last four months of 1999 to allay fears about the millennium change. When it became apparent that no serious Y2K problems would be experienced, the Reserve Bank reinforced the reserve dependency of banks on central bank funding. Bank liquidity was drained by increasing reverse-repurchase transactions, issuing Reserve Bank debentures and by concluding foreign exchange swaps with banks. From 14 January 2000 the Bank began to resume a variable-rate auction in accordance with the agreed signalling procedures with banks, and indicated that changes in short-term interest rates at that stage warranted an immediate reduction in the repurchase rate by a further 25 basis points.

From the middle of January 2000 the Monetary Policy Committee indicated that the repurchase rate should remain at or around a level of 11.75%. The interpretation of this announcement by the banks was that the Reserve Bank wished to keep the repo rate fixed at this level. They accordingly tendered at the daily auctions at exactly this rate. While the Reserve Bank's objective was to achieve stable money-market interest rates in volatile financial conditions, this did not preclude moderate variations in the repo rate around the 11.75% level.

Stable money-market interest rates were regarded as desirable to restrain volatility. In the circumstances, a rise in rates would have failed to counter the effects of the supply-side shocks on domestic prices. Moreover, a number of other factors indicated that the upside risks for inflation would probably be short-lived. Developments such as modest increases in nominal unit labour costs,

fiscal discipline, excess production capacity, low growth in money supply and bank credit extension and a prudent monetary policy stance, pointed to a favourable long-term inflation outlook.

In a further attempt to create greater certainty about the ultimate objective of monetary policy, an inflation-targeting monetary policy framework was formally adopted in South Africa as part of overall economic policy. This was announced in the Budget Speech by the Minister of Finance on 23 February 2000, with an annual average inflation target range of 3 to 6% for the year 2002 being set. The new framework provides an anchor for the ultimate objective of monetary policy. It helps to focus monetary policy, increases transparency and leads to a clear accountability of the Reserve Bank to the citizens of the country. The successful application of inflation targeting, however, will depend on a concerted, cooperative effort by the key stakeholders, such as government, labour and business.

The inflation target was specified as a range to allow the Bank some discretion in taking decisions on the monetary policy stance. The target is calculated as the average annual increase in the overall consumer price index excluding mortgage interest costs in metropolitan and other urban areas for the year 2002. A variant of the headline inflation rate was used, because the overall consumer price index is affected directly by changes in the Reserve Bank's repurchase rate. By including price changes in metropolitan as well as other urban areas, the most comprehensive price index available in South Africa has been targeted. The year 2002 was selected because of the long lags of between 18 and 24 months before changes in short-term interest rates have an impact on inflation.

The adoption of an inflation-targeting monetary policy framework for South Africa has certain important implications. Firstly, the numerical inflation target becomes the overriding objective of monetary policy. Monetary policy operational procedures are concerned overwhelmingly with the attainment of this objective. The objective of the framework is, after all, to achieve the target. However, this does not mean that the central bank is left without any discretion. A rigorously applied rule would deprive the central bank of its ability to deal with unusual or unforeseen circumstances.

Secondly, the pursuit of inflation targets does not mean that the Reserve Bank is not concerned about the achievement of sustained high economic growth and employment creation. Monetary policy cannot contribute directly to sustainable economic growth and employment creation. However, by creating a stable financial environment, monetary policy fulfils an important precondition for the attainment of economic development. Empirical evidence has shown that high and variable inflation is bad for economic growth and that price stability is beneficial to a country's performance.

Thirdly, to be successful, inflation targeting requires nominal exchange rate flexibility. Trying to maintain an inappropriate exchange rate may be costly in terms of domestic economic activity. Unrealistically valued currencies may lead to large international capital flows with serious disruptive effects on the domestic economy. In an inflation-targeting monetary policy framework, exchange rates should essentially reflect the domestic monetary and fiscal policies of the authorities and be determined by the supply of and demand for currency in foreign exchange markets. This will result in fluctuations in the exchange rate of the rand, but should at the same time promote domestic economic stability. The Reserve Bank nevertheless takes cognisance of the second-round impact of exchange rate movements on the inflation rate.

Fourthly, inflation targeting is a forward-looking approach. Monetary policy is based on the likely path of inflation. In any monetary policy framework a central bank has to decide how its current policy stance will affect future price movements. The difference between inflation targeting and other frameworks is that inflation targeting makes forecasting explicit and more transparent.

For this purpose econometric models are applied and changes in economic circumstances are carefully analysed to determine the inflation outlook. With the assistance of a number of other central banks, considerable effort has been made to improve the forecasting capacity of the Reserve Bank. A number of small and simplified models have been developed to forecast inflation. In addition, the Bank has initiated an inflation expectations survey to determine the expected level of inflation.

Econometric modelling is only one of the tools used to determine the monetary policy stance. However, the real world cannot be encapsulated adequately by an integrated system of mathematical equations. Econometric models over-simplify actual economic relations. Determining monetary policy

requires a much more detailed analysis of factors that may have an impact on inflation. Value judgements are unavoidable. The determination of monetary policy in an inflation-targeting framework therefore remains an art and does not become an exact science.

Finally, inflation targeting increases the transparency and accountability of monetary policy because the objective of price stability is expressed as a numerical target to be achieved over a specific period. The public announcement of explicit targets enhances the understanding of the policy objectives. Good governance calls for the Bank to be accountable, particularly in view of its operational independence in achieving the targets.

In order to further facilitate an understanding of monetary policy, the policy stance is explained in a statement issued after every meeting of the Monetary Policy Committee, at Monetary Policy Forums in major regional centres, in various publications of the Bank and in speeches and presentations to the public and the Parliamentary Portfolio Committee on Finance. The Reserve Bank also intends to publish a six-monthly Monetary Policy Review to describe in greater detail the policies pursued and instruments applied.

However, the Reserve Bank does not intend to publish the minutes of meetings of the Monetary Policy Committee. The statement published after every meeting provides a good reflection of considerations taken into account at the meeting. The Bank also does not intend to publish the structure of its econometric models at this stage because the functioning of these models needs to be evaluated over a long period of time. Disclosure of the models could create uncertainty about policy decisions. Once the models have been validated, the Bank will consider publishing them.

At present it is also the objective of the Bank to reduce its net oversold position in foreign currency whenever circumstances allow. The foreign currency exposure of the Reserve Bank adversely affected market sentiment and has increased the volatility in the exchange rate of the rand and in other financial aggregates. Recognising this, a policy of gradually reducing the net open position in foreign currency has been followed. By buying dollars in the market, the net open position in foreign currency of the Bank was reduced from US$ 23.2 billion at the end of September 1998 to US$ 9.9 billion at the end of July 2000. The reduction of the net open position in foreign currency to zero will remove one of the risk factors in the economy.

The reduction in the net open foreign position has had the added advantage of reducing the foreign currency exposure of the national government as a ratio of government debt from nearly 43% at the end of September 1998 to approximately 24% at the end of July 2000. The comparable ratio for South Africa's peer group was some 46% at the end of December 1999. Were the Bank to succeed in reducing the net open foreign position to zero, the foreign currency exposure of the government as a ratio of government debt, at current levels, would amount to only 6%. This low currency exposure makes it easier to borrow funds abroad.

Maintaining stability in the financial sector

A stable financial environment requires not only low inflation, but also a sound financial sector. This involves stability in the financial markets where transactions can take place at prices reflecting demand and supply forces, and with healthy financial institutions capable of meeting contractual obligations without interruption or outside assistance.

Stability in the financial sector and price stability are inextricably interrelated. Failure to maintain one form of stability creates an uncertain operating environment for the other, with causality running in both directions. A lack of price stability could lead to rapid growth in credit extension and higher interest rates, with the danger that borrowers could default on loan commitments. Bank failures may potentially be contagious, which would render monetary instruments ineffective and cause higher inflation. By contrast, stability in the financial sector enhances financial intermediation, improves the allocation of real resources and provides an environment conducive to the implementation of monetary policy.

South Africa is fortunate to have a well-developed and sound financial system. Moreover, the domestic banking sector proved remarkably resilient during the global financial turmoil of 1997/98. In the mature South African financial market with a moderate level of private indebtedness and a good regulatory and legal framework, the major banks were able to cope efficiently with the effects of high interest rates and exchange rate volatility.

In the past financial year, thorough preparations to avoid the possible impact of the transition to the year 2000 ensured that normal operations were maintained. Some of the smaller banks experienced temporary liquidity problems which were largely solved by allowing the affected banks to discount their cash reserves and statutory liquid-asset portfolios. The funding and other corrective measures enabled the affected banks to restore liquidity positions during the first quarter of 2000.

South African banks are well run with sophisticated risk-management systems and corporate-governance structures. They are also well capitalised and had an average risk-weighted capital-adequacy ratio of 12.5% at the end of June 2000, compared with the required minimum ratio of 8% stipulated in the Basel Capital Accord. More than 60% of the banks had a capital-adequacy ratio of at least 15% at the end of June 2000.

Although non-performing loans have increased since the international financial crisis, South African banks have made greater provision for bad and doubtful debts. As a ratio of total loans and advances, gross overdues in the banking sector came to only 4.6% in the second quarter of 2000. Provision for doubtful debts amounted to about 60% of total overdues in the same period, which is far more conservative than the international norm of 40%. However, there are signs that the profitability of the banking sector is declining somewhat. Lower income combined with higher operating expenses resulted in marginally lower returns on assets and equity in the first half of 2000.

The excess of short-term liabilities over short-term assets for banks stood at 16% of their total funding requirements in June 2000. In view of the robust capital adequacy position of the banks and efficient management procedures, this is not a cause for concern. South African banks in any event maintain adequate levels of liquidity, with liquid assets exceeding the regulatory minimum by nearly 9% in June 2000.

The Reserve Bank strives to ensure that effective and efficient banking supervision is in place. A recent assessment undertaken by the International Monetary Fund (IMF) and the World Bank in terms of a Financial Sector Assessment Programme found that South Africa complies with almost all the Basel Core Principles for Effective Banking Supervision. Where some requirements do fall short, proactive steps have already been taken to address them. The imminent promulgation of amendments to the Banks Act and revised Regulations thereunder should further enhance the country's status in the regulatory environment.

In view of the complexity of the financial system and the linkages of banks with other financial activity in the country, a Financial Stability Unit was established in the Reserve Bank in July 2000. This unit will research and analyse ways of promoting and maintaining a stable financial system. The aim is to focus on overall financial stability so as to enhance confidence in the domestic financial system, increase South Africa's attractiveness as a regional financial centre and attract foreign investment. Considerable attention will be given to strengthening the non-regulatory aspects of the financial regime such as incentive structures, market discipline and corporate governance. A priority will be to help establish a deposit-insurance scheme for South Africa.

One of the most important functions of the regulator of banks is to authorise the establishment of new banks. The power to grant licences provides the mechanism for preventing the entry of banks whose presence might be prejudicial to the interests of depositors and the soundness of the banking system. In South Africa our approach is to grant licences to all applicants that comply with a stringent set of entry criteria. These criteria are that the establishment of a bank should be in the public interest; no single shareholder should be able to dictate the bank's direction without due regard to the interests of its depositors; the bank should be governed and managed by directors and managers with proven ability and integrity to pursue the interests of the owners without harming the interests of depositors; the bank should establish operational and control systems commensurate with the complexity of the

risks and exposures it takes; and the bank should be established with sufficient financial strength to ensure adequate capital and sustainable profitability.

Banks are monitored continuously to ensure that they remain fundamentally healthy. This has mainly been done through quantitative and qualitative off-site assessments. In 1999 the Bank began the preparatory work for on-site reviews of credit-risk management systems and evaluations of asset quality. The process is expected to become fully operational in the second half of 2000. Substantial progress has also been made with the development of consolidated supervision, ie in reviewing both banking and non-banking activities conducted by a banking group domestically and internationally.

Despite all these procedures, it is not possible to guarantee that banks will not experience some difficulties from time to time. In such cases, the policy of the Reserve Bank is to assist only banks which have a temporary liquidity problem, whereas insolvent banks are allowed to exit from the system in an orderly manner which does the least harm to the banking system and depositors. In all cases of bank failure, the bank's management is replaced and the individuals involved would normally not be permitted to hold influential positions in banks again.

When a bank experiences funding difficulties on a short-term basis, lender-of-last-resort assistance is provided to it. Lender-of-last-resort assistance is a recognised responsibility and practice of central banks. The objective of such assistance is to enable the bank concerned to implement corrective measures and to prevent the contagion effect of a run on the bank. The liquidity under the lender-of-last-resort function is provided on a short-term basis only and has to meet certain important preconditions. These preconditions include that the institution has to be solvent; sufficient collateral is available; the institution has sought other reasonably available sources before seeking assistance from the Reserve Bank; the shareholders of the bank have made a reasonable effort to support it; there is no prima facie evidence that the management is not fit and proper, or that the liquidity problem is due to fraud; and the institution has developed and is committed to the implementation of a viable plan of appropriate remedial action to deal with its liquidity problems.

In an integrated world economy, it is essential to have close cooperation and that information is shared internationally. This is becoming even more important with the increased foreign participation in the South African banking sector. The Bank continues to develop relations with other banking supervisors to meet the challenges posed by globalisation. At a regional level, the Bank participates actively in the initiatives of the East and Southern Africa Banking Supervisors Group to harmonise the banking legislation and banking supervisory practices of member states and to share information on matters relating to banking supervision.

In addition to the banking supervision function, stability in the financial sector depends on the availability of currency in circulation and the maintenance of an efficient national payment, clearing and settlement system. The Bank incurs considerable expense annually to ensure the availability of high-quality currency in circulation in various denominations as a means to execute transactions. As a precaution against possible Y2K problems and an increased demand for currency near the year-end, a large number of additional banknotes were printed during 1999. No difficulties were therefore experienced in meeting the higher demand in the last few weeks of the year.

Considerable progress was made with the planning and preparations to take over the provision of bulk cash services to banks from SBV Services (Pty) Ltd. A new currency management strategy was adopted by the Board of the Reserve Bank in February 2000 to deal with this matter. As a consequence, the infrastructure of the Reserve Bank's branches will be adapted to provide for the increased level of currency-handling activity.

Further advances have also been made in the national payment, clearing and settlement system to achieve same-day settlement. At present approximately 76% of all payments in the South African Multiple Option Settlement (SAMOS) system are already made on a same-day basis. In terms of the principles of international best practice, a start was made with introducing further risk-reduction measures in the Payment Clearing House (PCH) batches. PCH agreements are being drafted which will assist the industry to remove high-value payments from inappropriate payment streams and, in time, will enable all payments in the SAMOS system to be settled on a same-day basis.

Another important challenge is the financing of small, medium and micro enterprises (SMMEs) which do not have securities or other assets as collateral for needed funds. Because banks lend out money that they receive from depositors, rigorous credit requirements have to be maintained under all circumstances. At the same time SMMEs are expected to make a major contribution to employment creation and economic development. To achieve this, they will obviously require outside finance. The Reserve Bank believes that the development of a microlending industry is essential for this purpose. Microlenders are well placed to provide such finance to SMMEs as they normally have an intimate knowledge of potential customers. Efficient credit-risk management requires an understanding of a customer's business and the risks associated with loan financing.

The Reserve Bank wants to actively promote the microlending industry by fostering community banking and exempting common-bond savings groups and village financial services cooperatives from compliance with the Banks Act, under certain conditions. The establishment of the Micro Finance Regulatory Council (MFRC) should further boost the already rapid growth in microlending. Only microlenders that are affiliated to the MFRC will be allowed to fund themselves by means of deposits in South Africa and conduct their business within a self-regulatory framework.

Broadening of external relations

Following the normalisation of South Africa's relations with the rest of the world, senior officials of the Reserve Bank have become more involved with multilateral financial institutions, other central banks and international private financial institutions. A number of meetings were attended at the IMF and the Bank for International Settlements in the past year where discussions were held with other central bankers on current economic and policy developments. The Reserve Bank took an active part in the discussions about the new international financial architecture. Further headway was made with the enhancement of cooperation among the central banks of the Southern African Development Community (SADC). The Committee of Central Bank Governors in the SADC, chaired by the South African Reserve Bank and assisted by a secretariat in the Bank, is implementing projects aimed at facilitating monetary and financial cooperation in the region. These projects include the convergence of payment, clearing and settlement systems in the region; the maintenance of a common monetary and financial database; the development of a common legal framework for central banks; the harmonisation of listing requirements on stock exchanges; and the development of norms for good banking practice in the SADC. Close cooperation in sharing experiences and skills was also achieved in banking supervision, information technology, protective services and human resources development and training.

As custodian of South Africa's foreign reserves, the Bank continues to manage foreign reserve portfolios and foreign credit facilities. In order to increase the efficiency of reserve management, some of the international reserves were handed over to external fund managers to manage on behalf of the Reserve Bank. In this way the Bank expects to benefit in the form of training and technology transfers. In June 2000 syndicated loan facilities amounting to US$ 1.5 billion were successfully finalised to replace a similar loan that had matured.

Changes to internal administration

In the internal administration of the Reserve Bank a focus area during the past year was the establishment of a Budget Committee which is responsible for preparing and managing the Bank's operational and capital budgets. This committee gave considerable attention to the budgetary process and procedures followed in the Bank and established definite rules. Roles for the Governors' Committee, the Budget Committee, the Remuneration Committee and the Procurement Committee were clarified. The budget schedule was revised to synchronise with the strategic plans of departments and to allow more time for the preparation of departmental budgets and the approval of proposals by the Budget Committee.

The Year 2000 project, which had started in July 1996 and culminated in the transition to the new millennium, was completed successfully. This was replaced by a number of new projects to ensure the

most efficient, cost-effective information technology systems, including the dissemination of economic data and the upgrading of foreign exchange information. Treasury bills were immobilised and assistance was provided to the Strate system for its equity dematerialisation, clearing and settlement system.

A paradigm shift in exchange control is under investigation. In the new planned philosophy most transactions will be permitted, except for certain specified exclusions. Emphasis will be placed on the accurate reporting of cross-border transactions. The completion of this study should improve the compilation of the balance of payments and provide more details of transactions in services with non-residents. The first stage of the implementation of this reporting system is envisaged for 2001. Briefing sessions in this regard have already been held with authorised dealers in foreign exchange and the other members of the Common Monetary Area.

Like many other central banks, the Reserve Bank is seeking to enhance its effectiveness and efficiency by focusing on its core activities. To this end, considerable emphasis has been placed on the strategic management process. Strategic reviews are undertaken more frequently by the governors, and participation in the process was extended by involving advisers, all heads of departments, branch managers and the managing directors of the subsidiaries. Feedback on the results of these discussions was given to the Board in the form of a strategic framework document which provides general guidelines to departments on aligning departmental strategies and operational plans.

In addition, the Bank has embarked on the development of a long-term vision which will serve as the framework for future planning. As part of this Vision 2010 a comprehensive human resources plan has been developed that forms the basis for effecting employment equity. The formulation and implementation of the plan underscore the Bank’s commitment to transforming the institution, eliminating past employment imbalances and making the staff more representative of the population of the country in terms of race, gender and people with disabilities. By the same token, the Bank is cognisant of the need to retain the necessary corporate memory and skills within a transforming environment.

The plan endeavours to achieve a staff complement comprising a minimum of 50% Black people and 33% females across all occupational levels by 2005. The achievement of these targets will be complemented by a number of action programmes, which include a special drive to recruit people from the designated groups, accelerated management development and promotions, dedicated training and development, early retirement and redundancy procedures, organisational restructuring, wellness and disability management, and affirmative procurement.

The Bank continues to regard the development of the skills and knowledge of its staff as a major responsibility. Emphasis is placed not only on the proficiencies required in its daily activities, but also on human resources development in such diverse fields as adult basic education, languages, business presentations, the conduct of meetings, the power of positive imaging, the personal and professional growth of women, financial and labour relations matters, management and preparing for retirement. The South African Reserve Bank College concentrates on upgrading the central banking skills of individuals to the highest level. The college plays an active role in the SADC Training and Development Forum and presents courses to staff of the Bank, private-sector and tertiary education institutions in South Africa and to individuals nominated by central banks in the SADC region.

Concluding remarks and acknowledgements

Events during the past year again illustrate how interwoven South Africa has become in the integrated world economy. Globalisation has many benefits for emerging-market economies. Capital movements facilitate the efficient allocation of saving, channel resources into productive uses and promote the financing of international trade and investment. In this way globalisation creates opportunities to increase international trade, economic growth, employment creation and welfare.

Unfortunately, like all good things in life, globalisation also has certain disadvantages. In particular, the integration of South Africa into the world economy has made the country more vulnerable to external shocks. These can take the form of supply, demand and financial shocks. In such an uncertain

environment the pursuit of financial stability has become even more imperative. Although stability does not provide unconditional protection against reversals in international capital flows, it does forestall uncertainties on the monetary front and can counter excessive volatility. The Reserve Bank therefore remains determined to maintain financial stability in South Africa.

In conclusion, I wish to thank the President and Deputy President of the Republic of South Africa, and the Reverend Frank Chikane, Director General of the Presidency, for their support for the work of the South African Reserve Bank. In particular, I wish to express my heartfelt gratitude for their support for the independence of the South African Reserve Bank. I also want to place on record my appreciation to Mr Trevor Manuel, Minister of Finance, Mr Mandisi Mphahlwa, Deputy Minister of Finance, Ms Maria Ramos, Director General of National Treasury, and the staff of the National Treasury for their cooperation with the Bank over the past year. A word of appreciation is also appropriate to Mr Alec Erwin, Minister of Trade and Industry, Dr Alistair Ruiters, Director General, and the staff of the Department of Trade and Industry who have become important collaborators of the Reserve Bank. Informative meetings were held with the Parliamentary Portfolio Committee on Finance, which we found very helpful. I thank my colleagues on the Board, including the deputy governors, for their commitment and undivided loyalty to the Bank. Finally, a word of thanks is also due to the staff of the Reserve Bank for their work during the past year and for their loyal support.