TT Mboweni: Empowerment and the South African economy

Speech by Mr TT Mboweni, Governor of the South African Reserve Bank, at the City Press/ Peoples Bank Success Club Forum, Johannesburg, 6 August 2003.

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1. Introduction

Ladies and Gentlemen. Thank you for inviting me to speak at this forum. I am told that this platform often provides for robust debate and I am always pleased to participate in such debates. My remarks today will, however, probably not add as much fuel to the fire as you might have hoped. Nevertheless I am pleased to be here this evening to make a contribution to what should be an ongoing general discussion about the economy of South Africa.

2. Domestic output and expenditure

South Africa's growth performance of 3 per cent in 2002 was relatively sound given the continued underlying weaknesses in the international economy. However, the quarterly GDP growth rate which decreased to 1,5 per cent in the first quarter of this year from 2,4 per cent in the fourth quarter of last year confirmed a slowdown in domestic economic activity. Although manufacturing production grew by 2,7 per cent between the first quarter of 2002 and the first quarter of 2003, on a quarter-on-quarter basis it fell at an annualised rate of 0,3 per cent in the first quarter of 2003. Other indicators also point to a slight slowdown in activity in certain sectors.

But there are indications that domestic final demand in both the government and consumer sectors remains fairly robust. A promising aspect of this is the increase in domestic capital formation in recent quarters. Gross fixed capital formation increased by 8,3 per cent in the first quarter of 2003, after reaching 11,6 per cent in the fourth quarter of 2002. Indications are that because the capital expenditure of all spheres of government is improving, there is greater capacity for delivery, and much-needed infrastructural expenditure is now also taking place.

On the whole, both domestic and global improvements in growth seem to be on the horizon.

3. Inflation developments

The depreciation of the rand during the last quarter of 2001 resulted in a surge in inflation which prevented the Bank from realising the inflation target for 2002. Fortunately CPIX inflation peaked in November last year at 11,3 per cent and there has been a significant decline ever since, with the latest rate for June down to 6,4 per cent. Although still above the target range of 3 to 6 per cent, the Bank's forecasts indicate that inflation should be within the range in the third quarter of this year and remain comfortably within the band in 2004.

There are a number of factors that support the outlook for a sustained reduction in inflation. Firstly, the quarter-on-quarter figures, which give a better indication of short-term trends, show that on an annualised basis CPIX decelerated from 12 per cent in the fourth quarter of 2002 to 2 per cent in the second quarter of 2003. What was particularly significant was that the main driver of inflation in 2002, food price inflation, fell steeply from an annualised rate of 17,7 per cent to only 1 per cent over the same period.

Secondly, producer price inflation, which tends to lead consumer price inflation, has fallen from a peak of 15,4 per cent in August 2002, to 2,3 per cent. The imported component of the PPI in June was down to minus 3,4 per cent, and the domestic component was down to 4,4 per cent.

Thirdly, weak global growth and inflation developments mean that South Africa remains in a low inflation international environment, which will help to contain inflation domestically. Finally, the improved inflation outlook is supported by other factors such as the relatively low levels of capacity utilisation, a responsible fiscal policy, lower money supply growth and the continued recovery of the rand. The improvement in the inflation outlook enabled the Monetary Policy Committee to reduce interest rates by 150 basis points at its last meeting in June.

The major threat seen to the inflation target is the trend in unit labour cost, which plays an important role in the inflation process in South Africa. During 2002, wage settlements trended higher as inflation rose. According to the Survey of Average Monthly Earnings by Statistics South Africa, nominal remuneration per worker increased by 10,6 per cent in 2002 and by 10,0 per cent in the year to February 2003. The slowdown in economy-wide productivity growth and rising nominal wage growth resulted in non-agricultural unit labour cost accelerating from a year-to-year rate of 4,1 per cent in 2001 to 7,0 per cent in 2002.

Our concern is that wage settlements tend to be backward-looking, particularly in the case of multi-year agreements. Wage increases that are consistently above the actual inflation rate constrain the downward movement of inflation and interest rates. The Bank would like to see wages and prices being set in a forward-looking manner, on the basis of the inflation rate that is expected to prevail over the period for which wages are being set. This will not only ensure a faster decline in inflation, but also a lower cost in terms of output and employment.

On balance, the inflation outlook is indeed promising.

4. Balance of payments

The current slowdown observed in the manufacturing sector is not simply a question of a recovering exchange rate, but more significantly the weak state of global demand. South African exporters will have to focus even more on improving competitiveness through productivity enhancements. The slowdown in exports, combined with a relatively buoyant import demand due to increased investment expenditure, resulted in a current account deficit of R6,8 billion (approximately 0,6 per cent of GDP) in the first quarter of 2003. This followed a surplus of R4,3 billion in the fourth quarter of 2002. The most recent trade figures, however, suggest that although the current account deficit is likely to persist in the second quarter, it is not a major cause for concern.

The financial account also recorded a deficit of R4,2 billion in the first quarter which reflected in part activities of non-residents in the share and bond markets. During the first quarter of this year, non-residents' total net sales of shares and bonds amounted to R7,6 billion. In the second quarter however, non-residents were net purchasers of shares and bonds amounting to R10.9 billion.

5. Reserves management

The South African Reserve Bank is responsible for managing the country's foreign reserves outside of the reserves held by private sector banks. The role of foreign reserves held by a central bank has changed considerably since the early 1970s. Under the Bretton Woods system of fixed exchange rates, which was in place until the early 1970s, countries had to accumulate reserves in order to maintain fixed exchange rates. Later on, many countries, including South Africa, adopted floating or flexible exchange rate regimes where reserves were used to smooth temporary fluctuations in the exchange rate.

With the adoption of an inflation-targeting monetary policy framework in 2001, South Africa has abandoned the almost archaic practice of aggressive intervention in the foreign exchange market with the purpose of influencing the level of the rand's exchange rate. In addition, the Bank and the National Treasury made a concerted effort to eliminate the negative net open foreign currency position (NOFP) from a high of –$23,2 billion in September 1998. This goal was achieved in May 2003 and opened the way towards steadily increasing the Bank's reserves. At the same time, the Bank also streamlined its reserve management structures and processes.

As at 30 June 2003, the gross foreign exchange reserves of the Bank amounted to US$7,7 billion. Of this, US$6,5 billion consisted of foreign exchange, mainly US dollar, and US$1,2 billion consisted of gold. The Bank's borrowed reserves (foreign loans) amounted to US$2,9 billion. The net reserves therefore amounted to US$4,8 billion. Given the level of reserves and an oversold forward foreign exchange book to the amount of US$3,7 billion as at 30 June 2003, the positive NOFP of the Bank amounted to US$1,1 billion, with the negative position having been expunged during May 2003.

In managing its reserves, the Bank strives to balance three main objectives. The most important objective is to preserve the capital value of the reserves. The level of the Bank's reserves is closely monitored by the international financial community and contributes to South Africa's overall rating as a stable and safe investment destination. Therefore, any erosion of the capital value of reserves will not only dent the general perception of the Bank's ability to manage its reserves, but will also harm perceptions about South Africa as a country. The second objective is to have adequate liquidity to enable the Bank to meet its day-to-day foreign exchange commitments without incurring significant penalties arising from liquidating investments. The Bank needs foreign exchange on a daily basis for its own transactions and commitments to its correspondent banks, to provide to its clients, such as the National Treasury, and to manage liquidity within the domestic money market as part of its implementation of monetary policy. The third objective is to earn a market related return on the Bank's gold and foreign exchange reserves within a framework of acceptable risks. Although the main objective of a central bank is not to maximise profits, it should still generate sufficient income to cover its operational costs and to facilitate the implementation monetary policy.

In order to balance the Bank's objectives of having adequate liquidity for its daily foreign exchange commitments and earning an acceptable return on the investment of its reserves, the foreign exchange part of the reserves was divided into two broad tranches, namely a liquidity tranche and an investment tranche. The main purpose of having a liquidity tranche is to have sufficient foreign exchange available for the Bank's daily foreign exchange transactions. The size of the liquidity tranche has to be sufficient to provide for all operational requirements of the Bank, and also to enable the financing of unpredictable cash flows.

The stable portion of the Bank's reserves over time, that is the portion that is not required for day-to-day cash needs, was allocated to the investment tranche of the reserves. This tranche is used to increase the return on the Bank's reserves. A portion of the investment tranche is managed by a number of external fund managers and another portion is managed internally. Investments are subject to conservative investment guidelines in order to limit fund managers' risk exposures, and the results are measured against pre-defined benchmarks at regular intervals.

A risk-management section within the Financial Markets Department continuously monitors the returns and risk exposures of both the internally and externally managed portfolios and promptly follows up any negative deviations.

6. Exchange rate developments

The behaviour of the rand continues to perplex many observers. Following the 26 per cent recovery of the nominal effective exchange rate during 2002 as a whole, the rand continued on its recovery path, albeit characterised by periodic volatility. In recent weeks the rand has remained relatively stable, and as of this morning the trade-weighted appreciation of the rand since the beginning of the year was 13,3 per cent.

The behaviour of the rand has continued to confound many pessimists who argue that there is insufficient evidence which supports the recent value of the rand. The depreciation of the rand in 2001 was clearly overdone. Prior to that, there was not a general view that the rand was overvalued. If anything, the current fundamentals are now in better shape than they were at that time, so it should not be a surprise that the rand is making such a significant recovery.

Although there can be no doubt that interest rate differentials have played a role in the recent recovery of the rand, even market analysts are sharply divided as to the extent of this effect. Although many argue that if interest rates come down lower in South Africa, the rand will retrace its value to significantly lower levels, others point to the fundamentals, and in particular commodity price developments, and argue that the rand is around 'fair value' levels. It is perhaps significant that even though the recent decline in the repo rate exceeded market expectations, the rand in fact strengthened following the announcement of the rate cut.

The focus of the South African Reserve Bank, however, is on the inflation target. The Bank does not have a view on the appropriate value of the rand. Obviously from an inflation perspective, a stronger rand is preferable than a weaker one, as we have emphasised on numerous occasions.

7. Progress with employment equity at the Bank

Turning to empowerment and equity issues, the Bill of Rights, as detailed in the Constitution of the Republic of South Africa, has served as an incentive for transformation in all aspects of South African society. And the Bank has been sensitive to developments concerning transformation issues since the advent of democracy in 1994.

By the time the Employment Equity Act was promulgated in 1998, the Bank had already begun to plan the interventions necessary to achieve employment equity. The Reserve Bank as an employer of more than 300 people is required to comply with the requirements of the Employment Equity Act, (No. 55 of 1998). The Bank has prepared its employment equity plan.

The objectives of the employment equity plan reflect a balance in the Bank's approach between achieving compliance with the requirements of the Act and achieving enhanced performance through embracing the spirit of equity. According to the plan by 2005 the Bank intends to have at least 50 percent black employees and 33 percent female in all categories. The Bank has already attained an overall representation of 50 percent black in its workforce and has exceeded its target for female representation.

A special unit, the Vulindlela Unit, was formed in 2000 to oversee the employment equity process. At this time there were only three black people in general management. Today the number stands at 41 - this represents a 25 percent increase in the number of blacks in general management in less than five years. The Bank has also made serious strides in the employment of female managers in the past five years. When the process of transformation was started in 1998, there were only two females in general management - now there are 19 women in general management constituting 30 percent of total managers.

The Bank has developed more than twenty new staff policies over the last three years to ensure the Bank keeps abreast with the pace of transformation. This refers not only to transformation in terms of race and gender, but also to the transformation of processes and systems and the way in which issues are approached in the Bank. Existing policies have also been extensively audited to rid them of discrimination.

But the journey has only just begun. There are many miles ahead and we cannot afford to rest.

8. The South African Reserve Bank's procurement approach

The Bank is likewise committed to furthering the necessary objective of affirmative procurement and has made significant strides in affording previously disadvantaged individuals (PDIs) greater opportunities for involvement in contract work for the Bank. The Bank applies a targeted procurement policy which is effected through a supplier database which is maintained on the Bank's website. All interested companies were invited in the year 2000 to register on the database and this registration process is ongoing. You can register your company online through the Bank's website www.reservebank.co.za. Registration allows the Bank to pre-qualify companies before a request for a quotation (RFQ), a request for a proposal (RFP) or a tendering process is initiated. The Procurement Committee, which is the custodian of the Procurement Policy, is mandated to ensure that every purchase, where applicable, takes into account the imperative of affirmative procurement.

In pre-qualifying suppliers, the Bank has certain selection criteria, which seek to highlight the composition of the companies' Board of Directors, shareholders and the management structures. In particular, the focus is on the involvement of previously disadvantaged individuals, notably women, black people, and people with disabilities. Price, ability to deliver and quality of service, are also major components of our adjudication and selection processes. Large companies that operate in the broad business sector but do not have an adequate black empowerment component, are encouraged to form joint ventures with emerging black companies in order to comply with the Bank's requirements.

One of the Bank's recent experiences in the procurement process has been the newly completed extensions to its head office building. This project has amounted to R250m. Among the criteria taken into account for the selection of the contractors were financial considerations; the companies' transformation strategy and commitment to transformation; capability and composition of the organisation and supervisory staff. I am happy to announce that the project was completed timeously and the outcome is a state-of-the-art office block and conference centre.

9. The banking sector and transformation

The broader transformation issues affecting South Africa have touched the financial sector too. The banking sector started a process towards developing a Transformation Charter on 20 August 2002 at the Nedlac Financial Sector Summit. Discussions have been extended to cover the entire financial sector and organisations currently involved include the banks, life officers, short-term insurers, retirement fund managers, the securities exchange, the unit trust funds, the fund managers and representatives of black interests in the sector.

The broad principles for transformation have been agreed on, and targets are currently being considered for various categories of transformation. These include ownership transfer, employment equity, procurement, access to financial services, low-income housing finance, SME finance, agricultural finance and infrastructure finance.

Of critical importance for the South African Reserve Bank is that the Charter should assist rather than hamper the stability of South Africa's banking and financial sector which is one of the important responsibilities of the Reserve Bank. The Bank Supervision Department at the Bank uses a risk-based approach to supervision and is of the opinion that the Transformation Charter should contribute to these risk management principles.

The critical challenges for black business in the financial sector are to ensure equitable empowerment within the context of a stable and growing sector, that maintains and solidifies its international standing. A critical category within this is that of ownership transfer. This is currently being considered very carefully and will encompass both direct and indirect ownership of financial institutions by black people.

Another issue in the transformation arena is the involvement of black auditing firms in the auditing of banks. Because of the importance of banks in the financial system, several requirements are placed on audit firms before they may engage in the audit of a bank. These requirements are necessary and onerous because of the highly specialised nature of banking activities and include issues such as experience and resources, and these are seen to be preventing black audit firms from participating in the audits of banks. The Bank Supervision Department and the Financial Services Board have embarked on a project to investigate possible options on how to engage smaller black audit firms in the audits of banks and other financial institutions. Options being considered include the sub-contracting of parts of an audit to smaller empowerment firms so that they are able to gain the appropriate experience required to audit banks and financial institutions. The South African Reserve Bank is leading by example in this regard. Our Bank is now audited by PriceWaterhouseCoopers, Deloitte and Touche and SizweNtsaluba VSP Inc, the latter being a black auditing firm.

10. Conclusion

Indeed it has been my pleasure to participate in this forum. I hope I have shed some light on the issues that are currently occupying the efforts of the South African Reserve Bank. It is correct to say that ultimately the functions of the Reserve Bank are to make a contribution towards an environment which would see the growth and prospering of a black business class; the improvement in economic and social conditions of the majority of our people; and the maintenance of macro-economic stability for growth and employment creation.

Thank you.