T T Mboweni: Review of the South African Reserve Bank and its activities - 1998-2003, a preliminary assessment

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Cape Town Press Club, Cape Town, 29 September 2003.

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1. Introduction

Ladies and gentlemen. I thank you for this invitation to interact with you once again. We certainly live in interesting times and much has changed in the world over the past five years. These changes have also affected the South African Reserve Bank as much as any other institution which has a domestic and international focus. We constantly face new challenges and new circumstances in which to conduct our work. The fact that the SARB has risen to meet these challenges says much about the fact that it is an international institution par excellence.

2. International developments

There has been two key developments over the last five years that have brought wide-ranging changes to the global social, economic and financial order. The first was the introduction of a single European currency. After decades of preparation, the Euro was introduced as a single currency on 1 January 1999 and Euro banknotes and coin were introduced on 1 January 2002. This currency change-over in Europe firmly established the European Central Bank (ECB) as the single monetary policy authority for participating countries of the European Union.

The introduction of the Euro was an eventful episode in the history of Europe. Firstly, the United Kingdom, Sweden and Denmark elected not to adopt the Euro as their national currency on 1 January 2002, although they are member countries of the European Union. Secondly, the Euro/US dollar exchange rate has shown large swings since January 1999. After reaching a high of just over €1 = US$1,18 some four days after its introduction in January 1999, the exchange rate of the Euro subsequently dropped by nearly 30 per cent to just below €1 = US$0,83 by October 2000.

The second major event was the attacks on the United States on 11 September 2001. These attacks highlighted a potential systemic risk to financial institutions worldwide in the event of a prolonged disruption of their operations. Multi-lateral co-ordination to ensure business continuity in the financial industry has received considerable attention since these attacks, and South Africa and the SARB are glad to be involved in these initiatives. The Bank has played an active role in the establishment of a Financial Sector Contingency Forum, which is responsible for the identification and management of potential crisis events that might threaten the stability of the South African financial sector.

The Bank has also made satisfactory progress with its own business continuity planning to ensure that the head office and branch activities would continue functioning in the event of any disruption.

The attacks of 11 September 2001 have also contributed to increased international economic uncertainty, which has in turn resulted in lower economic growth in developed economies. The monetary policy focus in developed economies shifted from containing inflation to avoiding unnecessarily and undesirably low inflation. This has brought new terminology to the vocabulary of central bankers and economists.

3. Domestic developments

Although 1998 is a mere five years ago, so much has changed in South Africa in the interim that a brief reflection on that year is called for. By 1998, our democracy was only four years old and South Africa was still re-integrating into the international arena. However, it was already obvious then that the country's sound macro-economic policies were delivering the desired results.

After a period of double-digit inflation covering the largest part of the 1970s and 1980s, inflation was in single-digits in 1995. It has averaged around 7,8 per cent per annum over the last decade. The national government was also achieving success with its sound approach to fiscal policy. While the deficit before borrowing reached a high turning point of 7,3 per cent of the gross domestic product

(GDP) in the 1992/93 fiscal year, it equaled 3,7 per cent of GDP for the 1997/98 fiscal year and declined further to 2,8 per cent of GDP in the 1998/99 fiscal year. Owing to the reduction in its deficit before borrowing, it was clear by 1998 that the national government had managed to slow down the growth in government debt to sustainable levels. Not only had government proven by 1998 that it could avoid a debt trap, but it had also successfully reprioritised expenditure and consolidated the fiscus.

The introduction on 9 March 1998 of the repurchase system of accommodation and liquidity provision to banks marked a significant change in the country's accommodation system with the repo rate replacing the previous Bank rate. In the five years since its introduction, changes have been made to the repo system to improve the transmission mechanism of monetary policy. The most important of these changes was introduced with effect from 5 September 2001, the date from which the SARB introduced a fixed repo rate to eliminate any ambiguity from monetary policy signals, which might have arisen under the previous flexible repurchase rate system.

In 1998 we also experienced the downside of international economic and financial integration: financial turbulence in a number of south-east Asian economies. Although South Africa could not escape at the time the negative consequences of such financial turmoil, it became obvious during that period that sound policies, rather than crisis management, yield the best results in the long run. This has been a guiding principle for the SARB in the implementation of policy over the past five years.

South Africa barely managed to record an average growth rate of 2,0 per cent per annum during the 1980s, but this has since accelerated to around 3 per cent per annum since 1994. Despite the recent slowdown in the international economy and the short-lived global recovery, South Africa's growth performance of 3 per cent in 2002 was relatively sound. After peaking in the first half of 2002, South Africa's real GDP then slowed down to an annualised 1,5 percent in the first half of 2003.

4. Policy issues

A number of policy issues have occupied the attention of the SARB over the past five years in dealing with these economic and financial developments. The most important of these are the adoption of an inflation target as the anchor for monetary policy; the reconsideration of the Bank's role in the foreign exchange market; the elimination of the oversold net open foreign currency position (NOFP); and the handling of distressed banks by our bank supervision department.

Although the functions of the SARB have changed and expanded over time, the formulation and implementation of monetary policy has remained the centrepiece of our activities. The Bank has used different monetary policy frameworks over time, such as credit ceilings and credit controls in the 1960s and 1970s, money supply growth targets from the middle of the 1980s, money supply growth guidelines by the early 1990s, an eclectic monetary policy from the middle 1990s and inflation targeting since 2000.

Successive mission statements of the Bank confirm a fundamental commitment to low inflation. The initial mission statement, published in 1990, entrusted the protection of the internal and external value of the rand to the Bank. This was changed by the middle 1990s to the protection of the value of the rand. In 1999 the mission was reformulated as the achievement and maintenance of financial stability.

In February 2000, an inflation target set by the government was introduced as the anchor of monetary policy. This entrusted a single ultimate monetary policy objective to the Bank: price stability. For targeting purposes inflation is measured as CPIX (CPI excluding interest on mortgages) and the first target range (for 2002) was set at 3 to 6 per cent. The same target range applies to now.

Achieving an inflation target through the use of monetary policy became the overriding objective. The objective is clearly set as low inflation, and the short-term interest rate (the repo rate), the instrument used for monetary policy, is adjusted exclusively for the achievement of this objective. It follows that interest rates should and will be adjusted once it becomes clear that inflation will be outside the target range in the period ahead if left unchanged.

Movements in interest rates over the period under review confirms this approach. In 1998 the prime overdraft rate of the banks started the year at 19,25 per cent. In March it was lowered to 18,25 per cent. However, as the emerging-markets crisis made itself felt, prime rose to a maximum of 25,5 per cent in August and September 1998 as one of the policy measures used to contain the decline in the exchange rate of the rand during that period, before starting to decline during October. For the year as a whole it averaged 21,8 per cent.

The exchange rate also depreciated strongly in the second half of 2001. Interest rates were also increased early in 2002, but with a different objective. This increase was caused by the need to contain the negative inflationary side effects of the lower rand, rather than to support the exchange rate at any given level.

The medicine worked, bringing inflation and expected inflation down. This made policy relaxation possible. At the beginning of 2003 the prime overdraft rate was 17 per cent, before being lowered gradually to 13,5 per cent at present, giving an average rate of 16,3 per cent for the first eight months of the year.

An important development since 1998, coinciding with the adoption of inflation targeting, was the establishment of a Monetary Policy Committee with responsibility for deciding on the monetary policy stance. The establishment of this Committee has contributed significantly to the removal of the myth that monetary policy decisions and reasons for such decisions are clouded in secrecy, taken by an invisible decision-maker not accountable to anybody. The Committee deliberates on recent economic and financial developments and members reach consensus on the appropriate policy stance to be adopted. The Committee's consensus decision is communicated by means of a detailed policy statement delivered at a media conference. This approach should enhance the public understanding of and transparency in the monetary policy process. The media has an important role in communicating with the general public. If the public does not understand that interest rates are adjusted with the achievement of the inflation target (and, therefore, price stability) in mind, the actions of the central bank will be clouded in mystery and the public is unlikely to support the Central Bank.

Since 1998 the SARB has also played its part in the improvement of the communication of monetary policy decisions and progress towards the successful achievement of the inflation target. The Bank's Monetary Policy Forums in the nine provinces are now well-established and facilitate open discussions on monetary policy and general economic developments. The Bank's regular reporting to Parliament on recent economic and financial developments is also a well-established part of its accountability to the citizens of South Africa. In addition, since March 2001 the Bank publishes a bi-annual Monetary Policy Review, which includes a fan chart of the Bank's inflation forecast.

Since 1998 the Bank has been remarkably successful in containing inflation despite exchange rate instability and the international financial turmoil of 1998 referred to earlier. CPIX inflation averaged 7,1 per cent for 1998 and only rose from a twelve-month rate of 6,5 per cent in February to 7,6 per cent in October 1998 before starting to decelerate again. During that period, tight monetary policy helped to contain inflation.

The gradual waning of inflation in 2000 and 2001 was interrupted when inflationary pressures mounted in the wake of the sharp depreciation of the rand towards the end of 2001. Essentially driven higher by the cost-raising effects of the depreciated exchange value of the rand, CPIX inflation rose from year-on-year rates of approximately 6 per cent during the second half of 2001 to 11,3 per cent in October and November 2002. Initially, CPIX inflation accelerated mainly on account of the sharp increases in the prices of food products which were largely related to the depreciation of the rand. In subsequent months, the rise in CPIX inflation became more broadly based. The rise in non-food CPIX inflation resulted from higher rates of increase in the prices of housing services, furniture and equipment, medical care and health expenses, new and used vehicles, and transport running costs. The inflationary momentum which had built up in the course of 2002, was moderated by a more conservative monetary policy stance and the recovery of the exchange value of the rand since about the middle of 2002.

Inflationary pressures therefore waned in the final months of 2002 and the first half of 2003. By January 2003 CPIX inflation has already declined to 10,0 per cent and receded to 6,3 per cent in August 2003. CPIX is expected to recede to within the target range in the immediate (before December 2003) future.

The exchange rate of the rand has shown large swings over the past five years. In 1998 the exchange rate of the rand averaged R5,53 to the US dollar. On 28 August 1998 (with the Russian default on their debt signalling what was probably one of the worst moments in the emerging-markets crisis) it reached its weakest point during that year of R6,67 per dollar. After a period of relative stability in 1999 and 2000, a sharp depreciation in the exchange rate of the rand occurred during the second half of 2001. During that period the nominal effective exchange rate of rand depreciated by 34 per cent, before recovering early in 2002. Subsequently the rand has been remarkably steady, and for the eight months January to August 2003 the average exchange rate of the rand amounts to R7,90 per US dollar.

The elimination of the oversold NOFP was the Bank's third major policy challenge over the past five years. The Bank's latest Annual Economic Report mentions that "a milestone was reached on 16 May 2003 when the NOFP of the Reserve Bank recorded its first-ever positive balance, having been in an oversold dollar position of more than US$23 billion as recently as 1998". This remarkable achievement has received surprising little media coverage, but allows the Bank a shift in focus to the reduction of its oversold forward book and increasing the official foreign exchange reserves position.

The fourth policy issue, namely the responsibility for banking supervision, has also seen a number of developments. With the performance of this function come also a number of responsibilities. This was evidenced by events early in 2002, when satisfactory solutions had to be found for the financial difficulties experienced by a number of smaller banks and two relatively large ones (Saambou Bank and BoE Bank). In the event the SARB acted in accordance with international best practice and successfully avoided systemic risk and panic about the soundness of the South African banking sector.

Commercial banks have an extremely important role to play in maintaining financial stability in any economy. Financial stability is extremely fickle, and unfortunately often more easily lost than restored. No central bank can maintain or restore the public's trust in the financial system without the cooperation of commercial banks and the public.

It should always be remembered that the central bank has at heart the best interests of the financial system as a whole. No country, bank or financial system can afford a systemic banking crisis.

5. Internal management issues

The SARB has had a clear commitment to the transformation of its staff complement and work processes over the past five years. I announced in my first address as Governor at the ordinary general meeting of the Bank held on 24 August 1999 that "… 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". A year later shareholders were informed that the Bank's transformation plan "endeavours to achieve a staff complement comprising a minimum of 50 per cent Black people and 33 per cent females by 2005". Last year shareholders were informed that "in keeping with the objective of transforming the composition of the Bank's staff to reflect the demographics of the country, an important milestone was reached in the past financial year when the total black staff complement exceeded the white staff complement for the first time since the inception of the Bank in 1921". As in many other areas of responsibility, the Bank is also proud of the progress made with the transformation of its staff complement over the past five years.

6. Conclusion

Indeed over the past five years, many challenges were faced head-on by the Bank. Important milestones were achieved and the stage is now set for further improvements in our work. Of immediate importance is the achievement of the inflation target, maintaining banking stability and transforming our staff complement further.

There are many more challenges ahead.

Thank you.