South African Reserve Bank

An address by Lesetja Kganyago,
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to the Ninety-Seventh Annual Ordinary General Meeting
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This past year has been extremely eventful, from both an economic and a political perspective. This has been the case both globally and domestically.

A number of themes dominated the global backdrop. First, there were major shifts in the political settings. Surprise outcomes in the UK[1] referendum regarding its continued membership of the European Union and in the US[2] presidential election coincided with increased concerns about the rise of political populism in a number of regions, a backlash against rising inequality blamed on globalisation, and a rise in nationalistic tendencies. The French political landscape changed dramatically, given the decimation of traditional parties, but a strong move to the extreme right did not transpire as feared.

Second, these developments threatened the sustainability of the global economic recovery which had shown signs of resilience after a few years of disappointing outcomes and false starts. But despite these uncertainties, there appear to be definite signs that most regions are on a path of sustained recovery from the most recent global economic crisis. It has taken almost 10 years to reach this point, which is indicative of how long it takes to recover from economic slowdowns following a financial crisis. Nevertheless, expectations are for a lower growth trend than in the pre-crisis period.

[1] United Kingdom
[2] United States

Third, most of the advanced economies saw a decline in unemployment rates, although they remain relatively high in the euro area on average. Despite tightening labour market conditions, wage growth in these economies has remained minimal. While some ascribe this trend in part to low productivity growth or the impact of technological change, the full explanation remains a subject of much debate. But this trend could contribute to the persistence in rising inequality and political instability.

The fourth global theme relates to inflation. Earlier concerns about deflation have abated. Inflation generally remains benign and below target in most of the advanced economies despite the improved growth outlook and lower unemployment. The volatility that was observed was driven primarily by oil price fluctuations. A notable exception is the UK where the inflation target has been exceeded following the Brexit-induced depreciation of the sterling. The subdued global inflation environment is ascribed in part to low wage growth.

Fifth, despite the absence of inflation pressures, monetary policies in the advanced economies have begun a slow retreat from their highly accommodative stances. The US Fed[3] has led the way with three Fed Funds rate increases of 25 basis points each in the past year. The Fed has also communicated its intention to begin slowly shrinking its balance sheet – which was expanded significantly during the global financial crisis – this year. The ECB[4] and the Bank of England have also recently signalled a possible end to their extremely accommodative monetary policy stances later this year, but rates are expected to remain low in Japan.

Sixth, capital flows to emerging markets have remained relatively robust but sensitive to changes in advanced economy policy signals. While changing expectations regarding ECB and US monetary policy in particular have impacted on a number of emerging market currencies and bond yields, the reaction has been relatively muted. Those economies that were most sensitive to the 2013 ‘taper tantrum’ episode have

[3] US Federal Reserve
[4] European Central Bank

much-improved macroeconomic balances, and their currencies are less vulnerable to possible spillover effects from US monetary tightening.

Finally, international oil prices have also been fairly volatile. Attempts by OPEC[5] and other producers to underpin falling prices through output restrictions were effective in the short run, with oil prices rising to around US$58 per barrel in December 2016 from earlier levels of around US$45-50, after they had fallen to below US$30 per barrel in early 2016. Since April we have seen this strategy being undermined by increased output from shale gas producers in the US in particular, and by non-compliance by parties to the agreement.

Turning closer to home: while global growth prospects have generally improved, South Africa is unfortunately an outlier. This past year has seen the worst domestic growth performance since the recession during the global financial crisis. The economy grew at a paltry 0.3% in 2016, and recently recorded two consecutive quarters of negative growth. The SARB[6] had expected the fourth quarter of 2016 to be the low point in the cycle, but growth in the first quarter of this year surprised significantly on the downside at -0.7%. This contraction was broad-based, with only the primary sector recording positive growth.

Despite this, we believe that the worst is behind us – and that growth in the second quarter of this year will be positive. However, the SARB's growth forecast was revised down significantly, as communicated at the recent meeting of the MPC[7]. Growth of just 0.5% is now forecast for this year, rising to 1.3% and 1.5% respectively in the next two years. This is clearly too low to make any meaningful inroads on unemployment.

For most of the past year, headline inflation was above the upper end of the target range of 3-6%, at an average of 6.3% and a peak of 6.8% in December. In the early months of 2017, inflation moderated considerably and returned to within the inflation target range in April.

[5] Organization of the Petroleum Exporting Countries
[6] South African Reserve Bank
[7] Monetary Policy Committee

The inflation forecast presented to the MPC at its most recent meeting showed a marked improvement. While previous forecasts had suggested that the longer-term inflation trajectory would be uncomfortably close to the upper end of the target range over the forecast period, the new forecast showed a more benign path. Inflation is now expected to average 5.3% in 2017 and 4.9% and 5.2% respectively in the coming two years, with a low point of 4.6% in early 2018. The core inflation forecast is just below 5.0% for all three forecast years.

The drivers of these improved inflation outcomes over the past few months include:

- lower food price inflation, as the effects of the drought recede;
- lower international oil prices;
- lower electricity tariff increases;
- a more resilient exchange rate than had previously been expected, coupled with muted exchange rate pass-through; and
- weak domestic demand.

More recently, there have also been indications of some wage moderation.

Despite the improved outlook, the MPC is still concerned that inflation expectations remain sticky at the upper end of the target range. As indicated in our post-MPC statement, we would prefer expectations to be anchored closer to the midpoint of the range. Furthermore, we are aware that the inflation outlook can change quickly in the event of supply-side shocks. At this point, however, we view the risks to the inflation outlook to be broadly balanced.

The main risk to the inflation outlook has, for some time, been the exchange rate. During the past year, while volatile, the rand has been relatively resilient, considering the adverse shocks it has had to face. At current levels, it is still stronger than it was at this time last year. The local currency has been supported by the significant improvement of the current account of the balance of payments, favourable terms of trade, and the generally positive capital flow environment for emerging markets. The rand has been adversely affected by low growth, political and policy uncertainty, and the credit ratings downgrades. These factors, along with the possibility of advanced economy monetary tightening, continue to weigh on the rand.

For much of the past year, monetary policy has had to deal with the increasingly difficult scenario of accelerating inflation in the context of slowing domestic economic growth. With inflation expectations anchored at levels of around 6.0%, the monetary policy challenges were significant. Furthermore, most of the pressures on inflation emanated from the supply side, in particular food prices, and were not driven by excess demand.

Faced with this policy dilemma, the MPC accommodated the temporary breach of the upper end of the inflation target band and maintained an unchanged monetary policy stance since the 25 basis point increase of the repo rate[8] to 7.0% in March 2016. In both March and May of this year, as the inflation outlook improved, the MPC indicated that the tightening cycle was likely to have ended but that a further improvement in the inflation outlook would be required before the policy rate could be reduced. At its most recent meeting, following the improved inflation forecast and deteriorating growth outlook, the MPC reduced the repo rate by 25 basis points, to 6.75% per annum. The MPC also noted that future policy decisions would be dependent on data outcomes and the assessment of the balance of risks. The MPC will remain vigilant and will not hesitate to reverse this decision should the inflation outlook and risks deteriorate.

The most recent global financial crisis saw increased financial stability responsibilities being given to central banks around the world. Although the SARB has had a role in ensuring financial stability for some time, our responsibilities in this area have expanded. The SARB's role in maintaining, promoting, and enhancing financial stability is formally mandated in the Financial Sector Regulation Bill (FSR Bill). Unfortunately, the parliamentary processes to promulgate the FSR Bill took longer than expected. This has delayed the establishment of the proposed Prudential Authority, which will expand the SARB's regulatory responsibilities in the financial sector. I am, however, pleased to be able to report that the FSR Bill has now been

[8] repurchase rate

passed, and is awaiting the signature of the President. Implementation planning is nonetheless well advanced.

The delay in the promulgation of the FSR Bill has not detracted from our focus on those areas of responsibility that we currently have, both at macroprudential and at microprudential levels. As I alluded to earlier, the recovery in the advanced economies from the global financial crisis has taken 10 years and is still not completely assured. This underlines the importance of financial crisis prevention. We therefore need to ensure the stability of the banking sector through appropriate regulation and supervision, and to monitor the broader economy for excesses that could undermine financial stability.

As you are all no doubt aware, the SARB has been in the spotlight for the past few weeks, mainly for the wrong reasons. It is appropriate for me to make a few brief comments about some of these issues. The first relates to the remedial instruction by the Public Protector to Parliament to set in motion a process to change the constitutional mandate of the SARB. We have challenged this remedial action in the High Court on a number of grounds, and the matter will be heard in court next week, even though the Public Protector has chosen not to oppose our submissions. Apart from the issue of whether the Public Protector has overstepped her legal powers in this regard, or the issue that the remedial actions proposed were unrelated to the original complaint under investigation, these developments have opened the door to a debate about the appropriateness of our mandate and of the inflation-targeting mandate specifically.

Price stability, or the protection of the value of the currency, is a core function of central banks. I know of no central bank that does not have this mandate. These institutions are best equipped to carry out this function, and stripping them of this mandate would raise the question as to where the responsibility for price stability should lie. Our Constitution is very clear: this is, correctly, a SARB function, and we should protect the value of the currency in the interest of balanced and sustainable growth in the South African economy.

There is no virtue to high inflation, which ravages the incomes and savings of the poor in particular, but which has also wiped out the savings of the middle classes in a number of countries. We need not look further than our northern border to see the impact. The wealthy are more able to protect themselves through various hedging mechanisms, and in this respect inflation has a negative distributive effect. Low inflation, by contrast, protects the purchasing power of incomes and social pensions and savings, and provides a more conducive environment for investment and job creation by reducing uncertainty about future prices.

Any mandate given to a central bank should focus on what it can do and not on what we would like it to do. A socio-economic objective such as protecting the buying power of the money in the pockets of South African citizens is an important and attainable objective, and in the area of our core competency.

Apart from this objective, we also:

- ensure the availability of good-quality banknotes and coin;
- ensure the effective functioning of the national payment system;
- prudently manage the official gold and foreign exchange reserves of the country;
- strive for a stable financial system; and
- regulate and supervise the banking system.

As we have seen from the global financial crisis, such crises have a devastating effect on the economy – and it takes many years to recover. It would be counterproductive to divert the SARB’s policies away from these important socio-economic objectives in order to try and achieve outcomes over which the SARB has little or no influence.

The fact that we do not have an explicit employment or growth mandate does not imply that we have a narrow focus on inflation to the exclusion of these considerations. However, we must be clear about what a growth mandate means for central banks. Monetary policy cannot determine the longer-run growth potential of the economy. This is the domain of other policies, as potential growth is determined by structural policies (e.g. on education, infrastructure, and technology). South Africa’s high unemployment rate is largely structural. The contribution that monetary policy can make to long-run growth is through ensuring price stability, which is more conducive to longer-term investment and expenditure decisions. The higher and more volatile inflation is, the higher the riskiness of investment.

Monetary policy can, however, impact on the real economy over the economic cycle, i.e. on the extent to which growth fluctuates around potential output. The extremely moderate nature of the tightening cycle since 2014 is an illustration of our concerns for cyclical growth. While it is true that excessively tight monetary policy conditions can undermine growth and employment, the low and at times negative policy rate prevailing in South Africa in recent years is indicative of an accommodative monetary policy stance.

The bottom line is this: we cannot solve a structural growth problem with monetary policy, irrespective of our monetary policy framework. Keeping interest rates artificially low may have short-term benefits, but it will result in higher inflation in the long run. We cannot ‘buy’ higher growth and employment through high inflation. In fact, high inflation inhibits growth. Low inflation, by contrast, allows for lower interest rates and higher growth.

Whether we operate in an inflation-targeting framework or not, our objective will still be the protection of the value of the currency. Inflation targeting is a framework within which to achieve this target. It makes our objective transparent and helps to anchor inflation expectations. We would not behave differently in the absence of an explicit target. Inflation targeting has been successfully adopted by many other emerging markets as well, and more recently by a number of developing economies, including Ghana and Uganda.

The issue of private shareholding in the SARB also needs addressing, particularly in this forum. Private shareholding in central banks is an historical legacy, as originally central banks were in fact privately owned. This changed over time, particularly since the 1930s. Apart from the SARB, there are nine other central banks that have some form of private shareholding. These include the US Federal Reserve System as well as the central banks of Belgium, Greece, Italy, Japan, and Switzerland.

The critical issue is the role that private shareholders play and the potential for conflicts of interest. In the SARB, private shareholding does not impart the same rights and benefits that shareholders in private companies have. The notion of a central bank as a public policy institution, with the main goal of promoting monetary and financial stability in the interests of the general public, is remote from the traditional concept of a commercial company with a profit motive. The SARB is an independent legal person, a public institution that has no profit motive and is not owned by its shareholders or anyone else.

Accordingly, shareholders in the SARB:

- have very limited rights;
- have no role whatsoever in the setting of, or influencing, the key mandates of the SARB, i.e. monetary policy and financial stability policy;
- have no sway over the day-to-day management of the SARB;
- are restricted to a maximum of 10 000 shares per shareholder out of 2 million issued shares (including those of their associates);
- receive a fixed return on their shares of 10 cents per share from profits made (This amounts to an overall divided payment by the SARB of R200 000 per year. In fact, 90% of the SARB's profits are transferred to government, and the remaining 10% are allocated to the SARB's reserves.);
- do not have any claim on the foreign exchange reserves of the SARB; and
- are unable, by means of a resolution or otherwise, to amend or change the SARB's affairs by deviating from the prescriptions of the SARB Act[9].

In terms of the SARB Act, the most effective powers of the shareholders are:

- the approval of the appointment of auditors for the SARB and their remuneration; and

[9] South African Reserve Bank Act 90 of 1989

- the election, from a vetted list, of seven non-executive directors to the Board. (The other eight members are appointed by the President. These include the Governor and the three Deputy Governors.)

Furthermore, the Board itself is a corporate governance board, and has no input or say in policies related to the SARB’s mandates and primary functions. The Board’s functions are limited to corporate governance issues, internal controls (including auditing), staff policies, and staff remuneration.

The management of the business of the SARB, including the setting of monetary policy, vests in the Governor and Deputy Governors, who are appointed by the President after consultations with the Minister of Finance and the SARB Board. The Governor and Deputy Governors are clothed with decentralised original powers of management.

Private shareholding represents an additional layer in the governance framework, to strengthen accountability and transparency, and complements the mechanism of how we are accountable to South Africans through their representatives in Parliament.

While international experience does not suggest that the shareholding structure of a central bank meaningfully affects its performance, there is equally no obvious case for changing this structure at present. Any move towards ‘nationalisation’ would be largely symbolic and would have no impact whatsoever on the SARB’s mandate. The view that the SARB is owned and run in the interest of the private sector is incorrect. Our independence and mandate are enshrined in the Constitution. Whether the SARB has private shareholders or whether all its shares are owned by government, its primary mandate remains.

A considerable number of legal considerations would have to be taken into account if private shareholding were to be removed. The potential purchase of all the SARB shares by government would require the introduction of suitable legislative measures, since the SARB Act does not currently provide for this. This legislation would also have to provide for measures such as the determination of the value of the shares, as determined by the Legislature.

On private shareholding, it should also be noted that the SARB embarked on a process of regularising its shareholder structure, which culminated in a judgement obtained from the Gauteng division of the High Court in November 2016. In terms of said court order, a total of 149 200 SARB shares held by 15 shareholders were disposed of, which resulted in 57 new shareholders spread across the general public. The interest in SARB shares is currently exceptionally high, with standing buy offers from 28 buyers wishing to purchase 90 109 shares.

Conclusion

The economy has been in recession but is expected to recover in the latter part of this year. Understandably, in times like these questions arise about the role of central banks and their contribution to economic growth. Our Constitution is very clear: the core mandate of the SARB is to protect the value of the currency in the interest of balanced and sustainable growth in the South African economy. However, monetary policy cannot determine the longer-run growth potential of the economy. Our Constitution is clear on this, too: in carrying out its mandate, the SARB must not bow to any pressure, be it political or from the private sector.

Despite the challenging environment in which we operate, the SARB as an institution remains strong; it is staffed by people who are committed to the promotion of the economic well-being of all South Africans.

Thank you.