South African Reserve Bank

An address by Lesetja Kganyago,
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This past year was, to some extent, one of contrasting halves. The second half of 2017 saw a generally constructive global backdrop for South Africa and other emerging markets. The recovery in the advanced economies continued at a steady pace, with most showing signs of sustained growth. In the United States (US), growth was above the estimated potential, and unemployment continued to decline. Economic activity in the euro area surprised on the upside after a protracted period of sluggish growth. A notable exception to this trend was the United Kingdom, where growth prospects were adversely affected by the uncertainty arising from the decision to leave the European Union.

There were also indications that, while the withdrawal of monetary policy stimulus was likely to continue in the advanced economies, the policy tightening cycle was expected to be moderate. These settings remained supportive of strong capital flows to emerging markets. Stronger demand underpinned higher commodity prices, reinforced by strong growth in China.

This favourable setting did not last long into the first half of 2018. Expectations of a faster pace of monetary tightening than previously expected began to emerge as the strong US growth was sustained. The US unemployment rate reached levels below the estimated natural rate, while fiscal policy became more expansionary. This put upward pressure on long-term US Treasury yields, which exceeded 3% for the first time since July 2011. Surprisingly, US inflation remained stubbornly below the target of 2% in the absence of significant wage growth. The recent communications of the Federal Open Market Committee appear to have reinforced the likelihood of a tighter stance, which in turn has sustained US dollar strength.

By contrast, growth in the euro area and Japan slowed, leading to a reassessment of expectations of early withdrawal of monetary policy accommodation in these regions. In addition, the strong dollar effect dominated global markets, which saw a reversal of capital flows from emerging markets, reminiscent of the so-called taper tantrum in 2013. While most emerging markets are assessed to be more resilient to these developments than was the case at that time, their exchange rates and bond yields have come under pressure, although experiences have differed widely.

Two other developments overshadowed the global environment in the first half of 2018. First, while most commodity prices declined during the first half of this year, the international oil price continued what seemed to be an inexorable ascent. This was driven to a large degree by the successful implementation of the agreement to restrict output by the Organization of Petroleum Exporting Countries (OPEC) and some non-OPEC countries. The result was a steady increase in the price of Brent crude oil, from US$50 per barrel in July last year to around US$80 by June this year. Although some moderation has been evident recently, the outlook remains uncertain, with mixed views by analysts in this regard. To date, the impact on domestic petrol prices and on inflation has been significant.

The second development was a marked escalation in the changes to US trade policy. Initially, tariff increases were focused primarily on China, but have subsequently been broadened to encompass some traditional allies of the US as well. It is still unclear whether these actions and countervailing reactions will evolve into a full-blown trade war. However, the rise in protectionism has already had a moderating impact on the optimism for global growth, and has also already contributed to risk-off scenarios in global financial markets. Of concern is that the sharp contraction in world trade that was recorded in April would be protracted. This was the worst performance in world trade since May 2015.

The net result of all of these recent global developments has been a generally deteriorating environment for emerging markets.

During the second half of last year, the domestic economic outlook was overshadowed by heightened political uncertainty in the lead-up to the African National Congress (ANC) elective conference. Business and consumer confidence were at extremely low levels. Although the 1.3% growth rate for the year exceeded the post-crisis low of 0.6% recorded in 2016, it was in stark contrast to the average emerging market growth rate of 4.7%. The low growth and deteriorating fiscal position exacerbated the risk of rating agencies' downgrades that could have seen South African bonds falling out of some of the major global bond indices. In response to these developments and risks, the rand remained under pressure for much of that period and reached its weakest level of R14.47 against the US dollar during November.

Renewed optimism following the outcome of the ANC's elective conference set in during the early part of 2018. Consumer confidence reached a record high in the first quarter of the year and remained high, although slightly lower in the second quarter. Business confidence also improved significantly in the first quarter, but fell back again in the second quarter. The rand exchange rate appreciated to R11.55 in late February, a level last seen in mid-2015. At the same time, there was a positive response to the 2018 government budget, which reconfirmed the commitment to fiscal consolidation and maintaining the expenditure ceiling. This also helped to avoid a downgrade of South African domestic government debt to sub-investment grade.

Unfortunately, the boost to confidence did not translate into a short-term boost to actual growth. Following an upside surprise growth rate of 3.1% in the final quarter of 2017, the economy contracted by 2.2% in the first quarter of this year. At this stage, the high-frequency data for the second quarter indicate that a modest improvement is likely in the quarter, and the South African Reserve Bank (SARB) does not expect a second consecutive quarter of contraction. Nevertheless, a reassessment of the growth outlook has resulted in a downward revision to the SARB's gross domestic product (GDP) growth forecast for 2018, from 1.7% to 1.2%. Growth of 1.9% is expected in 2019, while the forecast for 2020 remains unchanged at 2.0%. At these growth levels, we cannot expect to make appreciable inroads into the unemployment problem of the country.

During the past year, monetary policy has been able to achieve its objective of keeping inflation within the target range of 3-6%. Consumer price index (CPI) inflation has been continuously within the target range since April 2017, and is expected to remain within the target range for the rest of the forecast period, ending in 2020. Inflation averaged 4.7% during the past financial year, and reached a recent low of 3.8% in March of this year, the lowest level recorded since 2010. The favourable outcome was due, in part, to lower food price increases following the end of the drought in most parts of the country, as well as subdued domestic demand. However, the low point of the inflation cycle appears to be behind us, as the impact of the value-added tax (VAT) increase and higher petrol prices, and more recently the depreciated exchange rate, is being felt.

The improved inflation outlook and below-potential growth afforded some space for monetary policy to be more accommodative. This was particularly in the context of a moderation in inflation expectations during the first half of this year. For some time, these expectations had been stubbornly anchored at the upper end of the target range. In July 2017 and March 2018, the SARB's Monetary Policy Committee (MPC) reduced the repurchase rate by 25 basis points on each occasion, to its current level of 6.5%.

The MPC still assesses the monetary policy stance to be accommodative, and appropriate in the context of the current state of the economy. But there is a limit to what monetary policy can do to stimulate growth. At best, monetary policy can provide some support over the cycle, and can provide a stable environment for growth. As the MPC has emphasised on numerous occasions, a firm commitment by government to credible structural policy initiatives and implementation is required to make an appreciable impact on employment and potential output.

At the March MPC meeting, we warned that the global risks in particular could upset the improved inflation outlook. Unfortunately, these risks, which I have highlighted earlier, have taken centre stage. Since April, the rand has depreciated, alongside other emerging market currencies. Together with the higher international oil prices, the depreciation of local currency has resulted in domestic petrol prices reaching record highs in nominal terms. Furthermore, risks from higher electricity prices have also emerged.

At the recent meeting of the MPC, the repurchase rate was kept unchanged, although concern was expressed regarding the possibility of upside risks to the inflation outlook materialising. At this stage, inflation is still expected to remain within the target range for the forecast period, but at higher average levels than previously thought.

The most recent forecast suggests that inflation will average 4.8% this year, but is then expected to rise to 5.6% and 5.4% respectively in the coming two years. This upward drift will not help in our quest to get inflation and inflation expectations anchored closer to the midpoint of the target range. However, because the deteriorating outlook is driven mainly by supply-side factors, the MPC will look through the first-round effects. The MPC will maintain its vigilance and will react should there be second-round effects that take inflation significantly away from the midpoint of the target range.

Protecting and enhancing financial stability is now an explicit statutory mandate of the SARB. After a protracted process, the Financial Sector Regulation Act was enacted in August last year, and the Prudential Authority was officially established within the SARB on 1 April 2018. This involved the transfer of a number of employees from the former Financial Services Board, particularly those tasked with the regulation of the insurance industry. This responsibility now resides in the SARB and adds to the long-standing role that the SARB has played in regulating and supervising the banking sector. The amalgamation facilitates the SARB’s role in maintaining, promoting and enhancing financial stability in the country, at both the macro- and the microprudential levels.

In general, the banking system remains sound and well capitalised and there were no significant financial stability risks during the past year. Nevertheless, there were a number of highly publicised events that were not assessed to be systemic in nature, but which do hold important lessons for all of us. In particular, they have underlined the importance of having a strong and ethical auditing profession as an integral component of maintaining financial stability.

In March 2018, having observed signs of a severe liquidity crisis, the SARB placed VBS Mutual Bank under curatorship with the aim of protecting the interests of depositors. Subsequent to this step, the SARB instituted a forensic investigation into possible fraud and/or material misstatements. Financial statements are currently being restated, and until they are, we will not know the full extent of the problem. Any evidence of wrongdoing will be handed over to the relevant law enforcement agencies.

Given the size of VBS Mutual Bank and its limited interconnectedness with the rest of the financial sector, it is not assessed to pose a systemic risk. Nevertheless, it did create hardship and anxiety for the thousands of retail depositors who stood to lose their life savings. Fortunately, most of these deposits are now guaranteed by the National Treasury, although the corporate and municipal deposits are not. On 9 July, the SARB announced a mechanism to repay retail depositors up to R100 000 of their deposits in the troubled bank.

Some criticism has been levelled at the SARB for not picking up evidence of fraud and/or wrongdoing at VBS Mutual Bank earlier. It is not the role of the regulator to run the bank. The regulator's role is to protect the depositors of the bank, not the shareholders, and to ensure that the bank adheres to its prescribed prudential requirements.

The governance of the bank is the responsibility of its board, and its operations are in the hands of management. It goes without saying that proper control systems and governance structures are of paramount importance. As regulators, we have to rely on the accounts given to us by the bank as the basis for our risk assessment, and these will have been signed off by both the internal and the external auditors. The auditors, in turn, rely on the information provided to them and cannot be held responsible if they are misled by fraudulent activities. However, if they are complicit in the misstatements or irregularities in the running of the bank, they will be held accountable.

Regulators cannot prevent banks from failing if bad or illegal business decisions are made. Our role is to ensure that bank failures do not put the entire banking and financial system at risk.

The issue of the integrity of company audits was also in the spotlight with another potential financial stability risk. The collapse of the share price of Steinhoff International Holding NV, following the announcement of an investigation into alleged accounting irregularities, raised concerns about the exposure of South African banks to the company. Fortunately, the company's debt is mainly concentrated in foreign banks, and the impact of a potential default on loans on the domestic banking system appears to be limited.

During the past year we also had to deal with the potential risks posed by a questionable report on Capitec Bank and the subsequent short-selling of the bank's shares, which caused some volatility in its share price. The SARB's view is that Capitec Bank is well capitalised and has sufficient liquidity. The share price has since clawed back most of its losses, and there was no run on the bank.

At the previous AGM, I reported on our challenge to the Public Protector's ruling on the legality of the SARB's assistance to Bankorp over 30 years ago as well as her finding that Absa, as the purchasing bank, was liable to repay the facility. We were particularly concerned about the binding remedial instruction to Parliament to set in motion a process to change the constitutional mandate of the SARB away from price stability. We challenged this remedial action, as well as the Public Protector's other findings. The judgement, as you may know, went in our favour. The entire report was set aside, and we have finality on these issues. Our mandate, to protect the value of the currency in the interest of balanced and sustainable economic growth in the country, remains unchanged and enshrined in the Constitution. We will continue to vigorously defend challenges to our independence and mandate.

The issue of the mandate of the SARB is often confused with the proposed nationalisation of the SARB. Some proponents of nationalisation believe, erroneously, that such a move would facilitate a change in our mandate. This view is partly based on the premise that the SARB operates in the interest of private shareholders. This is definitely not the case. We act in the interest of the economy as a whole, guided by our mandates, and we do not favour any particular interest group or groups.

Given that this issue remains very much part of current debates, it may be instructive to explain again the role that SARB shareholders play and the SARB's view on this matter. The rights of our shareholders are extremely constrained, limited to voting for some Board members at the SARB's AGM. In fact, government appoints 8 of the 15 Board members, but it plays no role in the broader policy or regulatory decisions of the SARB. These decisions are the responsibility of the Governor and the Deputy Governors, who are themselves appointed by government. Private shareholders and Board members they elect have no influence whatsoever on monetary policy, financial stability or banking regulation. There is also no mechanism through which the shareholders, or indeed even the Board, can influence these policies.

Furthermore, the South African Reserve Bank Act 90 of 1989 caps shareholder dividends at 10 cents per share per annum. With two million shares on issue, and a limit of 10 000 shares per shareholder and associates, the total dividend payment by the SARB to its shareholders is R200 000 per year, and a maximum of R1 000 per shareholder per year. In addition, any surplus remaining at the end of the SARB's financial year, after provisioning for bad debts; depreciation of assets, pension benefits for employees and the payment of the dividend to shareholders, one tenth (10%) is allocated to the reserves of the Bank and 90% to government.

Private shareholders do, however, represent an additional layer in the governance framework of the SARB. This helps to strengthen accountability and transparency. Shareholder-elected Board members add valuable expertise and inputs to the internal operations of the SARB. Getting rid of private shareholders would not necessarily improve governance. The South African experience has taught us that boards appointed by government are no guarantee of good governance, nor are they a guarantee that decisions will be taken in the interest of the broader economy.

Private shareholding in central banks is an historical legacy, and is no longer common. Admittedly, there is no strong argument, in principle, in favour of retaining private shareholders. However, we are concerned that the process could be expensive, as the shares trade for far less than what some existing shareholders are prepared to sell their shares for. Indeed, it is the case that a group of shareholders is agitating for the SARB's nationalisation as they believe that they are entitled to a share of the assets of the SARB and see this as an opportunity to make enormous profits at the expense of taxpayers. This could turn out to be a protracted legal process and a very expensive exercise for what would, at best, be a cosmetic gain. To reiterate: whatever the shareholding structure, the primary mandate of the SARB will remain unchanged.

This past year leading up to this AGM has been challenging, but we have ended it on a positive note. As you are all no doubt aware, this year marks the centenary celebrations of former President Mandela's birth. The SARB played its role in these celebrations by issuing a commemorative banknote series and a commemorative R5 circulation coin in Tata Madiba's honour earlier this month. This was the first time in the SARB's nearly 100-year history that commemorative banknotes were issued. The full range of banknotes, as well as the commemorative circulation coin, depict the history of Madiba's long walk to freedom.

At the same time as the commemorative notes, we launched a mobile app as a platform to create greater public awareness of the security, technical and design features of our bank notes. The app also features interesting details on the life and times of Madiba – aligned with the commemorative banknotes. I encourage you all to download the mobile app from any of the mainstream app stores to learn interesting facts and details about our currency.

It is our responsibility to ensure that the integrity of Madiba is reflected in the integrity and value of our currency. This we will do not only by constantly upgrading the security features of our notes, but also through protecting the value of the currency by striving for price stability. This is, after all, the primary mandate of the SARB, and we will continue to pursue prudent monetary policy in the interest of balanced and sustainable economic growth in our country.

Thank you.