SOUTH AFRICAN RESERVE BANK

An address by Lesetja Kganyago,
Governor of the South African Reserve Bank (SARB),
at the 102nd annual Ordinary General Meeting of the SARB shareholders

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Introduction

Good morning, ladies and gentlemen.

We convene our annual Ordinary General Meeting (AGM) virtually for the third time in a row – and hopefully for the last time in this format.

We have managed our way through the severe and tragic global calamity of Covid19. Mobility and activity restrictions, public health, fiscal and monetary efforts, in South Africa and abroad, have been unprecedented. In the early days of the pandemic, the South African Reserve Bank (SARB) cut the repurchase (repo) rate to an all-time low of 3.5%, pulling the prime rate down to a 54-year low of 7.0%.

The successful vaccine roll-out, the repeal of COVID-19 protocols and the opening of borders have propelled the economic recovery forward, recreating jobs, and raising output back to above pre-pandemic levels.

Given the size of the pandemic shocks to our economies, with hindsight, it should not surprise us that the aftermath has been tumultuous. Recovery has not progressed in a neat, linear way, but rather has been slowed by unforeseen constraints. The reconnection of global supply chains has been halting and subject to shifting policies and priorities, contributing to high prices for many goods and commodities.

Political surprises have also emerged in the form of heightened geopolitical risks that, together with the ever-present threat of new COVID-19 variants, casts a pall over the rosy recovery of much of the past year.

During the year under review, even as our domestic recovery progressed, a range of setbacks occurred, contributing to economic and financial market volatility, weaker than expected growth outcomes and higher inflation.

As we cross the mid-point of 2022, the International Monetary Fund warns of further downside expectations for economic growth. Fiscal authorities, having extended policy aggressively during the crisis to support their economies, face strictly limited policy space caused by high debt levels and rising debt service costs. And central banks around the world focus more intently on the need to return inflation to much lower rates.

Our response to the inflation threat has been measured, taking into account the moderate inflation of the past year and the acceleration of inflation that we see now. The repo rate was raised gradually from November 2021. In the May and July meetings, larger repo rate steps were taken to ensure that we prevent inflation expectations from becoming unanchored, and generating much higher future inflation. South Africans must be protected from the threat to living standards and jobs that inflation causes. This is, after all, our constitutional mandate.

Let me now reflect on recent economic developments.

Global conditions: from recovery to stagflation

The global economy largely weathered the COVID-19 pandemic, making a good recovery in 2021 and into 2022. The initial recovery phase was underpinned by supportive fiscal and monetary policies as well as widespread vaccination. Advanced economies experienced the strongest growth over the past year, while the recovery in emerging markets has been more mixed.

At a global level, fully extended fiscal and monetary policies pushed recovery forward, with expansionary policies extended through 2021 and into this year. In tandem with a build-up of savings, aggregate demand expanded aggressively, eventually adding fuel to the fire of supply shortages, and giving fresh impetus to the inflation shock that currently besets the world economy.

The fiscal expansions and accommodative monetary policies that underpinned the 2021 recovery boosted demand for goods at a time when supply chains remained constrained due to COVID-19-related lockdowns. The pandemic-induced mobility restrictions meant that demand shifted from services to goods, exacerbating the demand-supply imbalance in the goods markets. Together with the strong recovery in oil and food prices, as well as tightening labour markets, this created a perfect storm for global inflation, which rose sharply during the second half of 2021 and into 2022.

Inflationary pressures were spurred further by the renewed lockdowns in China as well as the Russia-Ukraine war, which not only heightened uncertainty, but also exacerbated supply bottlenecks and disrupted food and energy markets. Oil prices rose sharply in response to the invasion, touching above US$130 per barrel in early March before subsiding somewhat. As a result, inflation has risen to levels last seen in the 1980s in some of the advanced economies.

The combination of these adverse shocks is expected to markedly slow global growth. Prospects are worsened by the expected high global interest rates as central banks respond to keep inflation expectations anchored. Although the International Monetary Fund's (IMF) July 2022 *World Economic Outlook (WEO)* expects the global economy to have registered robust growth of 6.1% in 2021, the IMF has adjusted its forecasts for global growth lower: to 3.2% in 2022 and 2.9% in 2023. This is 0.4 and 0.7 percentage points lower for 2022 and 2023 respectively than was projected in the April 2022 *WEO*.

With inflation more persistent, the United States (US) Federal Reserve (Fed) has moved to tighten monetary policy. After raising rates by 25 basis points in March, the Fed ramped up the pace, increasing the Fed funds rate by 50 basis points in May and by 75 basis points in both June and July. It also began quantitative tightening in June.

Fed communication points to further large rate hikes this year. The market now expects the Fed funds rate to peak around 3.4% early in 2023. The pace of monetary policy normalisation is much faster than was expected last year.

Inflation dynamics have been somewhat different in the European Union (EU). Inflation in the EU has been largely supply-driven. The war in Ukraine and the resulting economic sanctions on Russia have led to an energy crisis in Europe, where gas prices have soared more than 400%. The European Central Bank (ECB) raised its policy rate by 50 basis points for the first time in over a decade at its July meeting as it works to contain inflation of 8.6% – well above its 2% target rate.

Emerging economies, including sub-Saharan Africa (SSA) economies, will be impacted by these global developments on multiple fronts. First, higher food and oil prices pose risks to inflation and social stability. Second, slower global growth softens demand and the prices of export commodities from the region, and emerging markets (EM) in general, with adverse impacts on growth. Third, faster policy normalisation in the advanced economies influences capital flows and puts pressure on EM exchange rates, and thus inflation.

Domestic conditions

On the domestic front through 2021 and into 2022, South Africa's economic recovery was underpinned by buoyant consumption spending, robust terms of trade gains from high global commodity prices and a return to positive private investment growth. The domestic economy grew by 4.9% in 2021 – its fastest pace of growth since 2007 – after the sharp contraction of 6.4% in 2020.

An even better growth outcome for the year might have been achieved however, had local shocks not obstructed growth in July of last year and through much of April, May and June of this year.

Social and political unrest in July 2021 in Gauteng and KwaZulu Natal, as well as the subsequent catastrophic floods in KwaZulu-Natal this year, caused immeasurable damage and added to the plight of communities in the hardest-hit areas. These weather-related events also impacted on insurers and brought to the fore the challenges that the financial sector faces in relation to climate change. In recent months, loadshedding became more extensive and intensive, imposing high costs on economic activity levels.

Fiscal and monetary policy throughout the year supported economic activity through positive real spending and rising credit demand. Spending by households also benefitted from a rebound in wages, a recovery in net wealth and increased social transfers.

The sharp increase in private savings occasioned by the drop in consumption during the hard lockdown helped drive the current account into surplus, and together with revenue windfalls, provided relatively cheap financing to public spending. The country's current account, which reached 3.7% of GDP in 2021, supported the rand, and contributed to less inflationary pressure than had been expected when the crisis first unfolded.

Despite borrowing requirements remaining high, South Africa's fiscal ratios improved markedly, underpinned by revenue overperformance. Commodity export prices and a strong terms of trade have played a critical role in the economy's adjustment to the pandemic and recovery.

As a result of these developments, domestic output has now recovered to pre-pandemic levels, surpassing the 2019 gross domestic product (GDP) level in the first quarter of 2022, on the back of strong growth during the quarter. Our economy grew by 1.9% of the quarter-on-quarter seasonally adjusted rate (sar) in the first quarter of 2022. This followed an upwardly revised 1.4% growth (previously 1.2%) in the fourth quarter.

The first-quarter growth was broad-based, underpinned by manufacturing, trade and the finance sector. The broad-based growth reflects the easing of lockdown restrictions during the period as well as improving domestic demand. Nonetheless, important sectors of the economy – construction, tourism, and hospitality – remain well below 2019 levels of output, with major consequences for employment levels. These sectors will recover, but it will take time, and some of their recovery depends on further weakening of the economic costs of the pandemic.

Continuing with our sectoral view of the economy, we have also seen ongoing volatility in output in mining, construction, and manufacturing, reflecting loadshedding, logistical bottlenecks and blockages, and other shocks. From a production point of view, South Africa has struggled to capitalise on sharply higher export commodity prices.

Unfortunately, the growth momentum from the first quarter is not expected to carry through to the second quarter. The flooding in KwaZulu-Natal in April heavily impeded economic activity and loadshedding has intensified.

Additional headwinds to growth include a sharp correction in commodity prices, rising inflation and increased strike activity. South Africa's commodity export price basket has moderated in recent weeks as metals prices have declined. Despite the implied weakening of the terms of trade, we still expect the current account surplus to extend into 2023 as import demand continues to recover slowly.

A critical determinant of South Africa's economic fortunes in recent years has been an ongoing weakening in investment spending, across the private and public sectors. Gross fixed capital formation in the past year reached 14% of GDP. For this reason, it is encouraging that private investment has strengthened by more than expected in the rebound from the pandemic. Increasing the potential growth rate of the economy, however, requires a sustained further improvement in all forms of investment. Recent moves to open the energy sector to investment by private firms are to be encouraged, accelerated, and hopefully replicated in other network industries.

GDP is projected to contract by 1.1% in the second quarter but to expand again by 0.7% in the third quarter. Though growth for 2022 has been revised higher to 2.0%, up from 1.7%, the Bank's expectations for economic growth in 2023 and 2024 have been revised down to 1.3% and 1.5% respectively as these adverse supply side effects take their toll.

Total employment has continued to recover, although at a slower pace than GDP. The official unemployment rate fell by nearly a full percentage point to 34.5% in the first quarter of 2022 as total employment increased (by 370 000) while unemployment declined (by 60 000). As noted earlier, some labour-intensive sectors have been slow to recover from the pandemic as they depend critically on high levels of human mobility, such as international travel, among other factors.

Household spending has been a key driver of the recovery, growing by about 2.5% in real terms in 2021 on the back of rising disposable income. With rising inflation, however, consumption by households is likely to come under increasing pressure.

Inflation breached the upper limit of the target range in May, accelerating to 6.5%. Early impetus came from food and fuel, but inflation pressures have since broadened. Goods inflation has risen sharply over the past few months, reflecting high global inflation, rising production and distribution costs, and a weaker rand exchange rate. Services price inflation still remains moderate, but has about doubled in recent months and poses a risk to the inflation outlook.

After several years of subdued pass-through of intermediate costs to consumer prices, margin pressure appears to be reversing. Alongside stronger economic growth than expected, these developments raise the prospect that higher import prices feed through more directly to consumer prices. Wage settlements during the first half of this year have come in above inflation[1], further squeezing margins of firms and raising the prospect of more entrenched wage inflation.

The SARB's Monetary Policy Committee (MPC) has moved to normalise rates, raising the repo rate by a cumulative 200 basis points since November 2021. The hiking cycle began gradually with a 25 basis point adjustment at the November MPC meeting, but has since accelerated to include a 50 basis point increase in May, and a 75 basis point increase in July, as inflationary pressures intensified. The path for the repo rate however remains supportive of credit demand in the near term, even as rates rise in

[1] The average level of settlement in Q1 was 6.3% for all sectors bar utilities in which no agreements had been reached by the end of Q1. Notable agreements concluded in Q2 included Eskom (7%), Implats (6.5%) and Sibanye Stillwater (5.1%).

line with the current view of inflation risks. When adjusting for inflation, real interest rates relative to real productivity and income growth remain low.

Monetary policy needs to be forward-looking to maximise its effectiveness. For that reason, policy needs to respond to future expectations of inflation held by economic agents and the inflation forecast served to the MPC by Bank staff. The MPC will continue to monitor inflation developments closely and will respond appropriately to ensure that inflation expectations remain anchored.

Let me now focus on the SARB's other mandate and operational matters.

Securing financial stability

Besides ensuring price stability, the SARB is also tasked with maintaining stability in the financial system. Despite the shock of the COVID-19 pandemic, South Africa's financial sector remains resilient.

During the year under review, a few financial stability risks and vulnerabilities emerged. These included the low growth environment, rising inflation, the cost implications of the July 2021 unrest for the financial sector, climate-related risks, and the geopolitical tensions between Russia and Ukraine.

Work towards crisis preparedness and resolution is continuing. The Financial Sector Laws Amendment Act 23 of 2021 (FSL Amendment Act) was enacted earlier this year. The FSL Amendment Act gives the SARB the powers to act as a resolution authority and establishes the Corporation for Deposit Insurance (CODI). The establishment of a deposit insurance scheme will contribute to improving confidence in banking institutions. This will also put South Africa on par with its international peers and further align its financial sector to the principles of international standard-setting bodies.

Operational matters

The national payment system forms a core part of the financial intermediation infrastructure that enables financial institutions, businesses and consumers to make payments and settle their obligations seamlessly. The review of the applicable legislation and the modernisation of payment system infrastructure has been in the pipeline and forms part of the payment system's *Vision 2025*.

The evolution of payment technologies over the last few years has made the modernisation of both retail and wholesale system infrastructures a key priority. A number of initiatives are currently underway, including a review of the National Payment System Act 78 of 1998 and the payment system modernisation initiative. This initiative encompasses the payment settlement system renewal programme and the retail payment system reforms that include the rapid payments programme.

The launch of the real-time gross settlement (RTGS) system renewal programme aims to reform and modernise both domestic and regional payment settlement services. The programme will facilitate wider access to the payments system, improve efficiency by leveraging new technology, and address the security risks posed by cyber-threats. It will also enhance payment services provision and address the challenges of access, speed, cost and transparency of payments for both payment service providers and consumers.

Financial technology (fintech) has advanced significantly, and we are seeing a wave of innovation in the provision of financial services that in many instances falls outside of the purview of regulatory agencies. Responding to these developments is a fine balancing act. While continuing to focus on their monetary policy and financial stability mandates, central banks also need to respond to market developments that can potentially introduce risk into the broader financial system.

In a quest to embrace innovation in the fintech space, the SARB is working on several collaborative efforts under the auspices of the Intergovernmental Fintech Working Group (IFWG). Initiatives include participation in exploratory work on 'open finance', collaboration with innovators in the 'regulatory sandbox', and work on multiple central bank digital currencies (CBDCs) for international settlement through Project Dunbar.

The SARB is also committed to bringing crypto-assets into the regulatory ambit given the growth and proliferation of these assets and the resulting risks they pose in the form of illicit financial flows, among others. In June 2021 the IFWG released a position paper on the need to regulate crypto assets in a phased and structure manner. As a member of the Financial Stability Board, we have been participating in discussions for the need to coordinate these efforts globally.

In April 2022, the Project Khokha 2 (PK2) report was released- the culmination of work involving experimentation with distributed ledger technology (DLT).
It explores the impact of tokenisation of financial assets through the issuance of a SARB debenture – or debt security - on DLT, and highlights a number of legal, regulatory and policy implications when applying this technology in financial markets.

Climate change

Climate change has emerged as a key threat to economic and financial stability and a lived reality for millions of people, domestically and globally. The floods that wreaked havoc in KwaZulu-Natal in January of this year and again in April represent a tiny fraction of the climate-related destruction visited on the global economy in the year under review.[2] Greater rainfall in the eastern parts of South Africa and less in the west are clear developments that our economy will need to adjust to. Catastrophic weather events occur more frequently, and with greater damage.

Important projects on climate change are taking place within the SARB. These projects are being implemented through various policy and support areas. The Economic Research Department is assessing the implications of climate related shocks for monetary policy execution and implementation. Climate change and the transition to a greener economy have the potential to generate larger, longer and often more frequent economic and financial shocks, with disruptive effects for economic activity and high inflation.

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[2] During 2021 extreme weather events including a deep winter freeze, floods, severe thunderstorms, and heatwaves, contributed to annual insured losses from natural catastrophes of an estimated US$105 billion, the fourth highest since 1970, according to global reinsurer Swiss Re. The World Economic Forum's 2022 Global Risks Report has identified extreme weather and climate action failure among the risks that have worsened the most since the start of the COVID-19 crisis.

Financial institutions play an important role in climate change adaptation and mitigation through the provision of funding. The work of the Prudential Authority and the Financial Stability Department is focussed on improving the resilience of the financial sector to climate related risks and on incorporating climate related information in funding and insurance decisions. Climate change indicators, disclosure and taxonomy rules will become part of the prudential framework.
During 2021, an inaugural sensitivity stress test was conducted of the insurance sector. The results of the stress test were encouraging – an indication that large insurers would have sufficient financial resources in the event of an adverse scenario.

Staff matters

The hybrid way of working that the SARB initiated during the pandemic will stand us in good stead as we kick-start the renovation of the Head Office building in Pretoria.

The renovations are necessary to overhaul ageing infrastructure and perform a much-needed upgrade of our facilities. With the planned addition of a museum, the expanded precinct is intended to enhance public accessibility and become a place of knowledge-sharing and a window onto our country’s economic and financial history.

The Bank has started with these renovations, and has appointed a contractor for the redevelopment and secured temporary office space. It is envisaged that the temporary office space will be ready for occupation by 1 October 2022.

A project of this nature does not come without hurdles. With key project and stakeholder management processes in place however, we anticipate project completion of the Head Office precinct by the end of 2024.

Our vaccination programme has yielded some positive results, with a total of 61% of SARB Group staff (including the currency producing subsidiaries and three cash centres) having received the primary dose of the available vaccines. A total of 11% of staff are considered to be fully vaccinated under the new definition, which includes the primary dose and a booster shot.

In a quest to create a workplace that is more representative of the public we serve, we embarked on a Diversity and Inclusion (D&I) journey in September 2020. Fostering a more inclusive workplace allows people from all walks of life to thrive, for diverse views to flourish and builds a more resilient organisation, founded on a richer set of skills and expertise.

Conclusion

Our staff are the ‘engine room’ of this institution, and employee well-being is of utmost importance. Since the pandemic, we have put in place interventions to assist those impacted by the disruption caused by the pandemic and working from home.

I would like to express my sincere gratitude to all the staff members in the SARB Group. They have soldiered-on under difficult conditions, and their agility and resolve in continuing to deliver high-quality outputs through virtual platforms and supporting each other while discovering new ways to collaborate is testament to living the SARB values of integrity, accountability, open communication and excellence daily.

Despite the challenges we have faced in the past year, the achievements have been heartening. We are now in year three of our strategy, and although we have achieved our strategic objectives for the year, we cannot rest on our laurels. Central banks are faced with new challenges which require us to be proactive and responsive.

We remain committed to serving the economic well-being of South Africans by delivering on our mandates of price stability and financial stability. We have made great strides in engaging our stakeholders through investor sessions, monetary policy and financial stability forums, economic roundtables and publications.

Our monetary policy stance is shifting to better confront the challenges of higher inflation and to guide inflation back to the mid-point of the target band. Monetary policy alone is not capable of solving the deep-seated constraints to economic growth, but it can create an enabling environment and the stability needed for other policies to have a greater impact.

We remain acutely aware that our role in rebuilding this economy is but part of a broader agenda that is supported by other government institutions as well as the private sector. We remain resolute in delivering on our mandates without fear or favour in the interest of the citizens of South Africa.

As we continue on our purposeful journey, it is incumbent on each one of us to remain hopeful. We have pulled through the most severe pandemic since the early 1900s. We will ultimately recover and rebuild from the current storm in which we find ourselves.

Thank you.