Mr. Stals reports on major economic developments in South Africa over the past twelve months Address by the Governor of the South African Reserve Bank, Dr. C. Stals, at the 77th Ordinary General Meeting of Shareholders of the Bank on 26/8/97.

Introduction

The turbulences in the South African market for foreign exchange from February 1996, and the subsequent destabilisation of the balance of payments, contributed to a weakening of overall economic growth and to an upturn in inflation. The major task for monetary policy over the past year has accordingly been to restore both external equilibrium and domestic financial stability which are important preconditions for sustained investor confidence and economic growth.

The process of restoring external economic equilibrium had to begin at home. Many adverse factors converged to contribute to the sudden exchange rate shock of February 1996. Some were of a non-economic nature while others were rooted in macroeconomic developments over the preceding two years. The problems caused by non-economic factors diminished as concern about the finalisation of the Constitution of the Republic of South Africa, the delay of local authority elections in certain provinces, and the political composition of the Government of National Unity were fortunately allayed during the course of the past year. Equally important has been the fact that the Minister of Finance, newly appointed in April 1996, has stood the test of the markets with acclaim and soon established himself as an effective leader of the country's overall financial policy.

Many of the disturbing economic problems which emerged last year were addressed by appropriate policy responses, while the private sector has on the whole endured the inevitable painful adjustments with much understanding. During both 1994 and 1995, growth in real domestic expenditure by far outpaced growth in real domestic production. This was clearly not a sustainable situation, and growth in domestic demand had to be curtailed to ensure a better balance in the overall economy.

The untenable developments in domestic economic activity created a widening deficit in the current account of the balance of payments which was being financed by an inflow of volatile short-term foreign capital. When these short-term capital inflows switched into outflows after February 1996, however, a downward adjustment in the rate of growth in overall domestic expenditure, and therefore in the growing demand for imports, became imperative.

The divergent rates of expansion in domestic production and expenditure, respectively, were also being financed to an increasing extent with domestic bank credit, or simply the creation of additional money. With insufficient domestic saving and a sudden decline in the inflow of foreign capital after February 1996, the pressure to accelerate the creation of more money increased even further.

Assessed against this background, an untenable macroeconomic disequilibrium was rapidly being perceived to be developing at the then level of the exchange rate of the rand. Large foreign capital inflows in 1995, as well as the early weeks of 1996, exerted upward pressure on the value of the rand. Within a floating exchange rate regime, the rand appreciated in real terms, despite heavy Reserve Bank intervention to absorb part of the excess supply of foreign exchange. The appreciation of the rand at the time was clearly irreconcilable with South Africa's otherwise weak position in a very competitive world economic environment. A stronger rand could not be sustained in the long term. Also instructive in this regard is that similar

experiences by other emerging economies over the past year proved that alternative exchange rate systems, based on fixed or managed floating exchange rates, could also not cope with such divergent economic trends. In some of those countries, even more painful economic adjustments were required to restore financial stability than in the case of South Africa.

The monetary policy approach adopted by the Reserve Bank under the circumstances was to let market forces take their course, with some short-term intervention by the Bank only to support an orderly process of adjustment. The exchange rate was therefore allowed to take its market-determined run while liquidity was drained from the domestic money market, interest rates were guided in a gradual upward path, and the resultant adverse consequences of the adjustment in real economic activity were accepted as essential to avoid even greater disruption later on. Domestic financial stability had to be restored first and must now be maintained in order to raise the production capacity of the economy to higher levels on a sustainable basis.

These developments over the past year again exposed the urgent need for longer-term structural economic reforms. In June 1996, the Government released a Macroeconomic Strategy for Growth, Employment and Redistribution (GEAR). The full implementation of this programme over the next few years will undoubtedly raise the potential of the economy and enable South Africa to meet the vast basic social and economic needs of the people of the country more adequately. It will also provide the economy with better armour to withstand with more vigour similar adverse macroeconomic developments that may recur in future.

In retrospect, the economic policies of the past year contributed significantly towards improving equilibrium when emerging imbalances threatened to frustrate the primary objective of achieving sustainable optimum economic growth and development. Recent improvements in the current account of the balance of payments, the firmer exchange rate of the rand, the increased inflow of foreign capital, and the rise in official foreign exchange reserves, provide sufficient evidence to the effect that the serious danger of a collapse in South Africa's external economic relations a year ago has been successfully averted. Moreover, there are encouraging, although as yet still only tentative, signs, emanating from both the production and the expenditure sides, that the economy recovered slightly during the second quarter of 1997.

This preliminary indication is also confirmed by some hopeful signs that the inflationary pressures which arose from the economic imbalances experienced last year are now subsiding. At the same time, however, the overall financial situation still provides reason for concern, particularly in view of the continued high rates of increase in bank credit extension and in broad money supply. For reasons that will be explained in more detail below, the monetary authorities must persist with their vigil against the threat of overall financial instability that can only lead to stagflation in due course. There are many examples in the world today, both among industrial and emerging economies, where this lesson is again being learnt the hard way after years of reluctance to apply appropriate but unpopular short-term disciplinary monetary policies in a timely fashion.

The Reserve Bank is not prepared to consider any short-term expediencies and implement monetary policies that will in the long term lead to serious disruption of financial stability. The country just cannot afford unsound monetary policies for short-term gain. Such policies would gradually undermine the value of the rand and lead to an eventual collapse of the financial system, with serious adverse implications also for the level of real economic activity.

Recent economic developments

The Reserve Bank's Annual Economic Report released this morning serves as a background to the following brief summary of major economic developments over the past twelve months:

A year of economic consolidation

The pattern of developments in real economic activity over the past twelve months can best be described as the outcome of a necessary process of consolidation after three years of positive growth. The rate of expansion in gross domestic product reached a seasonally adjusted and annualised rate of 3½ per cent in the second half of 1996, but then slowed down to only 1 per cent in the first half of 1997, indicating a lower rate of growth for the full calendar year of 1997 compared with that experienced during any one of the past two years.

During the first quarter of 1997, total gross domestic product actually declined by 1 per cent, setting off alarm bells of a pending recession. During the second quarter, however, there was a distinct recovery when overall economic activity again turned to positive growth, equal to an annualised rate of 2½ per cent. With a continued decline in agricultural production during the second quarter and only moderate growth in mining production, total value added by the primary sectors declined by a further 1 per cent. Against this poor performance, however, production in the rest of the economy was back on track with an expansion equal to 3½ per cent on an annualised basis. With growth of 7 per cent in manufacturing, 6 per cent in electricity, gas and water, and 4½ per cent in transport and communication, together with positive growth in all the other sub-sectors, the fears of a pending recession must at least for now have been allayed.

Gross domestic expenditure, on the other hand, remained fairly depressed. An estimated small decline in total expenditure in the first half of 1997 contributed to the consolidation process of restoring a better balance between total domestic production and effective demand. Further declines in the growth rates of private consumption expenditure and gross domestic fixed investment, coupled with a substantial reduction in total inventories, were partly offset by a continued high level of expansion in general government consumption expenditure, particularly at the level of provincial and local government.

During the second quarter of 1997 there was, however, a noticeable recovery in demand when total gross domestic expenditure expanded again by 2 per cent, after having declined by 1 per cent in the first quarter. Small increases from the first to the second quarter in the rates of growth in private consumption expenditure as well as domestic fixed investment were strongly supported by a further rise at an annualised rate of more than 5½ per cent in general government consumption expenditure. Excluding the effect of a substantial reduction in inventories, total domestic expenditure actually increased by 2½ per cent in the second quarter.

These disparate movements in real economic aggregates between the first and second quarters of 1997 underline the importance of correctly interpreting short-term indicators of current economic developments. The Reserve Bank will conscientiously analyse all economic information that becomes available over the next few months with the necessary sensitivity to the pressing needs of the country.

Better equilibrium in the balance of payments

The salutary effects on the balance of payments of slower growth in total domestic expenditure are clearly reflected in the rapid decline in the deficit of the current account. On a seasonally adjusted and annualised basis, this deficit declined from R13 billion in the second quarter of 1996 to only R3.5 billion in the second quarter of 1997. In unadjusted figures, the negative balance declined from R5.5 billion in the first half of 1996 to R3.0 billion in the second half of last year, and R2.4 billion in the first half of 1997.

Both imports and exports of merchandise responded to the depreciation of the rand last year. In the second quarter of 1997, the level of merchandise exports at current prices was 25 per cent higher than in the second quarter of 1996, whereas the value of imports increased by only 11 per cent. This was, however, not all due to the price effect of the depreciation of the rand. Growth in the volume of imports also slowed down as a result of the decline in gross domestic expenditure. In the case of the value of exports, an increase of 25 per cent was already experienced in the year prior to the depreciation, partly as a result of the removal of international sanctions, which no doubt continued to affect exports in 1996 and the first half of 1997.

The improvement in the current account was supported by a larger net inflow of funds reflected in the capital account of the balance of payments. The pressure on the exchange rate of the rand, which continued from February to October 1996, subsided again after October, almost as suddenly as it had appeared. During the first three quarters of 1996, the net capital inflow amounted to only R585 million, but this was followed by a net inflow of R3.3 billion in the fourth quarter, and by no less than R16.7 billion in the first half of 1997.

After the rand had depreciated by as much as 23.5 per cent in nominal terms between 14 February 1996 and the end of October 1996, it appreciated by 10 per cent over the next five months. From the end of March to the end of July 1997, however, the rand depreciated again by 3.6 per cent to give a net increase of 6.0 per cent in the external value of the currency from November 1996 to the end of July 1997. It should be noted, however, that the average level of the exchange rate of the rand over the first seven months of 1997, compared with its average value over the same period in 1996, showed a depreciation in nominal terms of 8.4 per cent.

Although the initial appreciation after October 1996 was accepted as a partial correction of an over-reaction, the Reserve Bank nevertheless, already in November 1996, started to intervene again in the market as a net buyer of foreign exchange. The country's gross foreign reserves held by the consolidated banking sector indeed increased by R17.2 billion over the past three quarters to reach a level of R31.1 billion at the end of June 1997. This was sufficient to cover about 9½ weeks of imports of goods and services.

Currency depreciation as a means to achieve greater international competitiveness only has a chance to succeed in countries where inflation is not sensitive to depreciation. The events of the past year proved once again that in South Africa inflation reacts with a time lag of only about six months to major changes in the exchange rate. The quarter-to-quarter increase in the seasonally adjusted and annualised rate of change in the production price index for imported goods escalated from 6.0 per cent in the first quarter of 1996 to no less than 18.1 per cent in the fourth quarter, before it declined again to 12.4 per cent in the first quarter of 1997. In the second quarter of 1997, that is approximately six months after the turnaround in the trend of the exchange rate in November 1996, the production price index for imported goods actually declined by 10.7 per cent.

Monetary aggregates slow to respond

Over the past two years, the Reserve Bank has on various occasions advanced reasons why changes in the M3 money supply may have lost some of its usefulness as a reliable anchor for monetary policy. At this juncture, the Bank regards changes in M3 only as one among several important financial indicators. It no longer bases its monetary policy decisions automatically on any rigid formula linking actual changes in M3 to the predetermined money supply guidelines issued by the Bank at the beginning of each year. In 1996, for example, monetary policy was aimed more directly towards the restoration of external financial stability. More recently, the Bank has become more concerned about the excessive increase in domestic bank credit extension, not only because of its influence on the money supply, but also for other reasons. There has, for example, been growing anxiety about the over-extension of the private sector’s indebtedness relative to disposable income, and the increasing vulnerability of the banking sector to adverse developments in a possibly less favourable future macroeconomic environment.

No central bank can, of course, disregard developments in the money supply or in bank credit extension, even if such developments can be explained as temporary distortions caused by major structural economic reforms. Although changes in M3 and its shorter-term components should be interpreted with circumspection in the present South African environment, they cannot be discarded or ignored. The relationship between the money supply and nominal production, or the velocity of circulation of M3, may be changing, but new relationships are being established in the process of transformation. Over the longer term, it remains true that inflation cannot be sustained indefinitely unless it is fuelled by continuous excessive money creation.

Throughout 1996, the annual rate of increase in the M3 money supply fluctuated within a narrow range of between 13.6 and 16.1 per cent. By January 1997 it reached a peak of 16.8 per cent, and then declined gradually to 12.7 per cent in June 1997. As a guideline the Reserve Bank currently regards a rate of increase of not more than 10 per cent per year in the M3 money supply as consistent with the prime objective of reducing inflation gradually to a level that will be more in line with the average rate of inflation in the economies of South Africa’s major trading partners.

The increase in M3 has now consistently exceeded the rate of growth in the nominal value of gross domestic product for more than three years, with the result that the ratio of the total amount of money in circulation to gross domestic product has risen to 58 per cent, which is the highest level since 1980. A lack of availability of money can therefore hardly be advanced as a reason for the slowdown in real economic activity over the past eighteen months.

The relatively high level of the money supply or, inversely, its low level of velocity of circulation, holds a potential danger for future inflation. Although a substantial part of the excess amount of money in circulation may at this stage be confined to the financial sector, possibly contributing to financial asset inflation, the Reserve Bank will have little control over the situation once holders of financial assets decide again to divert their spending to the acquisition of goods and services. Central bank policy must therefore always be forward-looking and attempt to pre-empt the danger of overspending or rising inflation at some future inopportune stage.

Total bank credit extended to the private sector likewise continued to increase at a high rate throughout 1996, and fluctuated between a peak of 18.9 per cent in July and a low of

16.1 per cent in December. During the first six months of 1997, it peaked at 17.4 per cent in April, and then declined only marginally to 16.3 per cent over the twelve months up to June. As in the case of the money supply, the total amount of bank credit outstanding has risen as a percentage of gross domestic product over the past few years. At the end of June 1997, it amounted to 75 per cent of gross domestic product, compared with 67 per cent at the end of 1993.

Bank credit is, of course, not only extended for the purpose of financing purchases of goods and services. Indeed, particularly in recent months, a substantial amount of the additional bank credit created may have been linked to the explosive increases in the volume of transactions in the financial markets, particularly in the equity and bond markets. Nevertheless, all forms of bank credit create money, and the initial reason for which money is created is only of limited significance for monetary policy purposes. Once the money has been created, it becomes part of the amorphous pool of the total money supply and, depending on the strength of the multiplier effect, is available to be used a number of times over, and for many purposes other than its first application.

Many explanations can be offered for the persistently high rates of increase in bank credit extension and in the money supply, despite the slowdown in real economic activity over the past eighteen months. It could partly be linked to a switching of international trade financing from foreign to domestic sources, or partly to the financing of summer crops in the agricultural sector that are being harvested late this year. It is also known that bank credit extended to local authorities increased by no less than R2.7 billion from 31 December 1996 to 30 June 1997. These explanations, however, do not detract from the need for a curtailment of the excessive rates of increase in these important monetary aggregates at this juncture.

In light of the unfavourable experiences of a number of other countries in recent years, ranging from a well-developed country such as Japan to an emerging economy such as Thailand, central bankers elsewhere are increasingly concentrating on restricting the provision of bank credit for investment in financial assets and property. In a bull market, even at high interest rates, borrowers will continue to borrow funds to buy assets that are rapidly appreciating in value; and banks will continue to lend because the value of their collateral is rising. This could easily cause a speculative bubble that, should it burst, can create major difficulties for both lenders and borrowers. In such a situation, it is not unusual for the money supply to continue to rise, in conflict with the objectives of the monetary authorities, and often also in contrast to the slowdown in real economic activity. South Africa is hopefully not yet in such a position. In the implementation of monetary policy more than in anything else, prevention is almost without exception less costly in terms of a possible temporary loss of production and employment that can in any case not be sustained, than the sacrifices that will eventually be required to fight high inflation once it has become entrenched.

In the present situation, the Reserve Bank feels that a cautious monetary policy stance remains justified. This has been the approach throughout the past year and undoubtedly has had a major influence on developments in the money market. The shortage of funds in this market, as reflected by the amount of accommodation required by banking institutions from the Reserve Bank, first increased from a daily average of R4.9 billion in January 1996 to R10.6 billion in March 1997, before it declined to R7.3 billion in July 1997. As the recovery in the balance of payments recently gained momentum, the Reserve Bank has been prepared to allow a natural downward adjustment in the money market shortage, paving the way for a gradual decline in money market interest rates.

The Reserve Bank raised its lending rate to banking institutions, the Bank rate, from 15 per cent at the end of 1995 to 16 per cent in April 1996, and then to 17 per cent in November 1996. The rate on three-month bankers' acceptances first increased sharply from 14.6 per cent at the end of December 1995 to 17.0 per cent a year later, but has since declined gradually to 15.0 per cent in the middle of August 1997.

As the South African financial markets are being integrated more in the global financial system, the comparison between South African and international interest rates takes on greater significance. Too low a level of interest rates locally will eventually be reflected in a weak currency, and lead to a further depreciation of the rand. Too high a level, on the other hand, will attract speculative short-term capital from abroad, and lead to an undesirable appreciation of the currency, and/or an unhealthy expansion of domestic liquidity.

The sharply inverted shape of the yield curve in South Africa makes the comparison of the level of local interest rates with the international markets more difficult. At the long end of the spectrum, the yield on long-term government bonds in South Africa seems to be on the low side in real terms. Short-term interest rates, and particularly bank lending rates at the other end of the yield curve, seem to be high in South Africa, reflecting negative expectations on inflation, high risks involved in more short-term lending to an already overborrowed community, and a relatively high demand for funds.

The conservative monetary policy measures applied by the Reserve Bank over the past eighteen months have paid off by containing the increase in inflation to below 10 per cent, despite the pressures arising from the depreciation of the rand last year. Measured over a period of twelve months, the rate of increase in the overall production price index rose from 5.3 per cent in April 1996 to 9.6 per cent in March 1997, but then declined to 7.5 per cent in June 1997.

Movements in the consumer price index followed a similar path and the increase in consumer prices, measured over twelve months, rose from 5.5 per cent in April 1996 to 9.9 per cent in April 1997, before declining to 8.8 per cent in June 1997. At the time of the depreciation of the rand in 1996, a much higher rate of inflation was predicted on the basis of previous experience.

There is, however, no reason for complacency. As long as the South African rate of inflation remains significantly higher than that in the major countries of the world, the integration of South Africa into the global financial markets will be slow and turbulent. In view of the complex interaction between the level of interest rates, the rate of inflation, and the exchange rate in the process of financial globalisation, disruptive adjustments will be demanded from time to time. This will continue to complicate decisions for investors and cross-border traders. Participation in the process of financial globalisation ultimately requires a high degree of convergence between countries in these basic financial aggregates. The domestic levels for interest and exchange rates can no longer be determined by governments or central banks in isolation. These financial prices will indeed increasingly be driven by international market consensus.

At this stage, the international market imperative requires of South Africa to bring its rate of inflation gradually in line with the rest of the world. Alternatively, the country's drive towards greater participation as an important borrower of funds in the world financial markets will be constrained.

Furthermore, what is even more important is that the existing imbalances of income and wealth in the domestic economy will further deteriorate in an inflationary environment. It is relatively easy for those more fortunate members of society to protect themselves against inflation as they have easy access to credit and can spend more in today's terms, hoping to repay with depreciated money sometime in the future. Less fortunate members of the society find that wage increases do not keep up with inflation, especially run-away rising inflation, and their savings and buying power deteriorate continuously.

Financial market reforms pay dividends

The major reforms in South Africa's financial markets over the past few years paid good dividends in the form of substantial increases in the volume of business done through these various markets. Structural improvements introduced by the Johannesburg Stock Exchange, the Bond Exchange of South Africa, and the South African Futures Exchange (SAFEX), were also boosted by the further relaxation of exchange controls.

The value of bonds traded in the Bond Exchange of South Africa increased by 51 per cent in 1996 to exceed the R3,000 billion level. In the first half of 1997, the total turnover in this market already exceeded R1,700 billion. These higher values included a substantial increase in transactions effected by non-residents in the market.

The value of shares traded in the secondary share market increased from R63 billion in 1995 to R117 billion in 1996, and to R92 billion for the first half of 1997. As in the case of the Bond Exchange, non-residents also made an important contribution to the increase in business transacted through the Johannesburg Stock Exchange. The turnover in options and futures contracts traded through SAFEX performed likewise, showing sharp increases over the past eighteen months.

The importance of the formal capital markets for the economic development of South Africa can be clearly illustrated by two basic statistics. Firstly, over the eighteen months from the beginning of 1996 up to the middle of 1997, the amount of new capital raised through issues on the Stock Exchange and net issues of fixed interest-bearing securities in the primary bond market amounted to approximately R50 billion. Secondly, over the same period, net purchases by non-residents of South African securities listed on the exchanges amounted to about R34 billion.

Supportive fiscal policies

The Minister of Finance applied further disciplines in his Budget proposals for 1997/98 with a commitment to reduce both government dissaving and the deficit before borrowing during the current fiscal year. In the preceding year net dissaving by government was equal to 3.1 per cent, and the budget deficit equal to 5.6 per cent of gross domestic product. The deficit for the current fiscal year is expected to be reduced to 4.0 per cent of gross domestic product.

The Government also made an important contribution to the official foreign reserves of the country by way of two bond issues in international capital markets during June 1997. The total proceeds from these two loans amounted to R3.8 billion.

A few smaller and one major privatisation transaction – the sale of an equity stake of 30 per cent in Telkom – raised more than R6 billion over the past year. Part of these funds

was used to contain total government debt to a level of about 56 per cent of gross domestic product.

The better harmonisation of monetary and fiscal policies over the past year made a major contribution to the success achieved with the objective of restoring overall financial stability after the foreign exchange market disruption of February last year.

Financial co-operation in Southern Africa

The Committee of Governors of the Central Banks of the twelve members of the Southern African Development Community (SADC) met twice during the past twelve months to discuss matters of financial co-operation. The Secretariat of the Committee within the Reserve Bank has made good progress in the compilation of a computerised data base of financial statistics of the region and information on the functions and responsibilities of the twelve participating central banks.

Officials from all the central banks participated in a number of courses presented by the Reserve Bank's Training Institute, and a course was again presented for bank regulators and supervisors in the East and Southern Africa Banking Supervisors Group (ESAF). A special study is being undertaken with the support of the World Bank on the development of national payment and clearing systems with a view to the eventual establishment of a cross-border payment and settlement system for all SADC countries.

Over the next year, the co-ordination of financial co-operation in the region will be extended also to include the activities of commercial (private) banks and stock exchanges.

A need for more flexible monetary policy operations

Developments over the past year revealed a need for greater flexibility in the market for short-term funds. The transformation in the South African financial markets since 1994, and in particular the further integration into the global financial system, will in future require more prompt action and decisive direction for movements in financial asset prices, interest rates and exchange rates.

Part of the explanation for the rigidities in the South African money market lies with the present system used by the Reserve Bank to provide accommodation to banking institutions at the discount window. Banking institutions have unlimited access at the Bank rate to overnight loans from the discount window, provided they have at their disposal acceptable collateral. The Bank accepts Treasury bills, Land Bank bills, South African Reserve Bank paper and Government bonds, all with an outstanding maturity of less than 91 days, as security for such overnight loans. A second-tier facility is also available, but at a penalty rate of 75 percentage points above the Bank rate against similar securities as collateral, but with outstanding maturities of between 91 days and three years.

The Bank rate is, of course, changed from time to time to adapt to changes in underlying financial market conditions. To make the system work effectively, the market must react with sensitivity to changes in underlying demand and supply conditions, and must also emit clear and comprehensible signals to the authorities. For example, a rise in market interest rates for interbank funds, various maturities of negotiable certificates of deposit, or for bankers' acceptances to the Bank rate level or above, will provide a clear indication of a need for an increase in the Bank rate. Alternatively, when a Bank rate increase is regarded as undesirable at

that point in time, the Reserve Bank will have to use other means at its disposal to create more liquidity (money) in order to reduce the pressure on interest rates.

Over the past year, major changes took place in South Africa's underlying money market conditions, but money market interest rates were slow to react to these changes at a time when the Bank was looking for signals from the market, while the market sought guidance from the Bank on the direction of interest rates. It is clearly necessary to find a way out of this uncertain situation and to ensure that greater flexibility will be introduced in the working of the money market. Inflexible markets, be they for goods, services, labour or financing, invariably lead to incorrect pricing, inefficient allocation of resources and, ultimately, unnecessary and costly losses in output and employment.

In March 1998, the Reserve Bank will start introducing a new upgraded electronically-driven National Payment System to provide for a daily automated settlement of outstanding interbank positions. The system is planned to be extended by September 1998 to effect intraday settlements on a gross basis for large transactions. The introduction of the new versatile payment and settlement system will also provide a good opportunity for the Reserve Bank to reconsider the existing accommodation arrangements between the Bank and private banking institutions.

At this stage, the Bank would like to give notice of the proposed introduction of a new, more flexible accommodation facility, to be created in the form of regular repurchase transactions between the Reserve Bank and its banking sector clients. The private banks will be offered the opportunity to tender on a regular basis for central bank funds through the repurchase facility, and accordingly be given more scope to manage their own liquidity positions better.

Furthermore, the purpose of the minimum cash reserve accounts that banks must maintain with the Reserve Bank will be extended to serve also as operational accounts for the regular settlement of clearing account balances. An averaging principle will be introduced, in terms of which each bank will have to ensure that the average daily balance in its account over a monthly period will comply with the prescribed minimum cash reserve requirements. This should enable the banks, during the course of the month, to use their minimum reserve balances for settlement purposes.

The present discount window facility will still be retained to provide banks with a further source of funds for the management of their liquidity positions. It is envisaged, however, that the Bank rate for such loans will be at a substantial premium to the fluctuating effective interest rate as established in the regular repurchase transactions.

The Department of Finance is planning to implement new arrangements for the primary issue of, and the secondary market-making in, Government bonds through appointed private market securities dealers. The transfer of these functions from the Reserve Bank to securities dealers will strengthen the Reserve Bank's ability to pursue open-market operations more vigorously for monetary policy purposes.

The Bank is now in the process of preparing a discussion document on the proposed new accommodation procedures. This document will be distributed to the banking community and to other interested parties before the end of October for comments and participation in the preparation of the new system.

It must not be expected, however, that the introduction of the new system will lead to a permanently lower level of interest rates. The Reserve Bank may well in future use interest rates more frequently and extensively to pursue its overriding objective of protecting the value of the currency. The Bank will nevertheless have to ensure that interest rates will be maintained at a level that will be consistent with all the other objectives of monetary policy, and with developments in other economic aggregates.

Internal administration of the Bank

With the appointment of Mr. James Cross as Deputy Governor from 1 January 1997, all vacancies in the top management of the Bank have now been filled again for the first time since July 1995. The total staff complement of the Bank varied around 1,800 during the year ended 31 March 1997. At the same time, further progress was made with the Bank's transformation process when more than 70 per cent of the 136 new appointments to the Bank was drawn from previously under-represented groups.

The Bank's international activities were affected to an important extent by the currency turmoils of last year. The International Banking Department, in particular, was frustrated by these developments, which temporarily disrupted the longer-term programme of increasing the country's foreign reserves and reducing the role of the Bank in the forward foreign exchange market. These programmes are, however, now back on course, and the recent successful conclusion of a syndicated loan facility for a total amount of US$ 1.75 billion served to strengthen the Bank's foreign liquidity position further.

Good progress was made by the Information Technology Department to prepare the way for the introduction of a new real-time gross settlement system within the banking sector. The substructures for this ambitious new programme are now in place, and, as already indicated, the first phase will go live in March next year. Precautions were also taken to ensure that all the Bank's electronic data processing systems will be able to cope with the technical "Year 2000" problem with the change-over to the next millennium.

The Economics Department is likewise involved in guiding the Bank into the fast-expanding, worldwide electronic-communication system. South Africa was one of the first countries to subscribe to the Special Data Dissemination Standard (SDDS) of the International Monetary Fund (IMF) in August 1996, and is now one of only eight countries that provide electronic links (hyperlinks) from the IMF's SDDS to the more comprehensive sites of important South African economic data and information. In March 1997, the Quarterly Bulletin of the Reserve Bank was released for the first time in its entirety with text, graphs and statistical tables on the Internet.

The Exchange Control Department is continuing with the task of gradually phasing out all the remaining exchange controls. The concessions made to private individuals to invest limited amounts abroad as from 1 July 1997, and all the other exchange control relaxations over the past year, were implemented smoothly and efficiently. Subject to the approval of the Minister of Finance, the phasing out of the remaining exchange controls will continue in an orderly manner.

During the year, the former Management Services and Administration Departments were merged into a new Corporate Services Department as part of an internal rationalisation programme. A new Organisation Development Department was created to give

more specialised attention to the Bank's transformation programme, human resource development, and the co-ordination of strategic planning and development.

With the rapid increase in the number of foreign banks operating in South Africa, and with the establishment in many other countries of branches, subsidiaries and representative offices of South African banks, the resources of the Bank Supervision Department came under pressure. The Office of the Registrar nevertheless also gave special attention to specific problem areas such as illegal deposit-taking operations, micro-lending activities, deposit insurance schemes and regional co-operation in Southern Africa.

Other administrative functions of the Bank, such as note and coin distribution, protective services and the branch network are being taxed by the ever-increasing need for greater vigilance against fraud, burglaries and violent criminal attacks.

The Bank relies heavily on its Internal Audit Department for the early detection of any possible irregular activities, as well as for sound risk management. A major contribution is made in this area by the Audit Subcommittee of the Board, and also by the external auditors.

In retrospect, the Bank can be grateful for the quality of its staff, and for their loyalty to the task of the Bank as demonstrated again by the excellence of services rendered during the past year.

Concluding remarks

In its Macroeconomic Strategy for Growth, Employment and Redistribution, the Government defined the role of monetary policy as follows:

"The main objective of monetary policy will continue to be the maintenance of financial stability and the reduction of the inflation rate. Positive real interest rates are a minimum condition for overall financial stability. Low inflation is an important requirement for higher economic growth, the creation of employment opportunities and a more equitable distribution of income."

Looking back, the past year was particularly challenging for macroeconomic management. The Reserve Bank can be satisfied that it has been relatively successful in making its specialised contribution to the attainment of the Government's overall economic objectives as set out in GEAR. After major disturbances in the market for foreign exchange early in 1996, stability has been restored. The rate of inflation, which accelerated to nearly 10 per cent by April 1997, is now abating. To achieve these results required a consistent restrictive monetary policy with relatively high interest rates. As the monetary policy objectives are being consolidated and other programmes of GEAR, for example to increase total saving in the economy, are being implemented with greater effect, the way will be paved for lower interest rates on a more durable basis.

The contribution that monetary policy can make towards the attainment of maximum economic development and the creation of more employment opportunities is, after all, limited to the intermediate goal of maintaining a stable financial environment. Attempts to use monetary policy for wider purposes or, more directly, to solve problems in the real economic sphere are bound to lead to an inflationary dead end. However sincere intentions might be, the inevitable result will eventually be lower growth and even less employment.

The policy of persisting with essential monetary disciplines in South Africa at this difficult stage of general transformation is understandably being opposed in some circles, due to adjustment fatigue and frustrated expectations. It is imperative, however, for the sake of attaining higher economic growth of a more durable nature, to ensure overall financial stability that will also make access to the world financial markets easier for South African borrowers. This task demands the continuous implementation of monetary policies that will create a financial environment with low inflation, a sound banking system, and well-functioning financial markets.

I wish to place on record my appreciation to Minister Trevor Manuel, Deputy Minister Gill Marcus, Ms. Maria Ramos, Director-General of Finance, and also all the officials in the Department of Finance, for their continued support and close co-operation over the past year. I thank my colleagues on the Board of the Bank for their undivided loyalty during difficult times. Finally, thanks are also due to the three Deputy Governors and staff of the Bank for keeping the many activities of the South African Reserve Bank at a level where the Bank has come to be respected as one of the most efficient institutions of its kind in the world today.