Scope of the Annual Report

The Annual Report of the South African Reserve Bank (the SARB or the Bank) and its subsidiaries (the Group) covers the period 1 April 2014 to 31 March 2015.

Previous reports had demonstrated that the Bank was progressively moving towards the implementation of integrated reporting. The Bank remains committed to complying with best practice insofar as it is practical for a central bank, taking into account the overriding legislation and confidentiality requirements.

The report reflects a holistic account of all relevant and material financial and non-financial information, which will enable stakeholders to evaluate the performance and impact of the Bank’s operations and the implementation of its mandate.

Entities

The entities that make up the Group, which are covered in this report, are as follows:

- The Bank, founded in 1921, is the central bank of South Africa. It is established and governed by the South African Reserve Bank Act 90 of 1989, as amended (SARB Act). Its existence, mandate and independence are entrenched in the Constitution of South Africa.

- The two wholly owned currency-producing subsidiaries of the Bank, namely:
  - the South African Mint Company (RF) Proprietary Limited (SA Mint) including its own subsidiary Prestige Bullion (RF) Proprietary Limited; and
  - the South African Bank Note Company (RF) Proprietary Limited (SABN).

- The South African Reserve Bank Captive Insurance Company (RF) Limited (SARBCIC) is a wholly owned subsidiary of the Bank, registered in terms of the Companies Act 73 of 2008 (Companies Act) as a public company to comply with the provisions of section 9(3)(a)(i) of the Short-term Insurance Act 53 of 1998 (STIA).

- The Corporation for Public Deposits (CPD) is a wholly owned subsidiary of the Bank, which operates under its own legislation, the Corporation for Public Deposits Act 46 of 1984 (CPD Act). It accepts call deposits from the public sector, investing these funds in short-term money-market instruments and special Treasury bills.

Guidelines

The Annual Report is compiled in accordance with the King Report on Corporate Governance in South Africa 2009 (King III). Instances where the Bank was unable to apply the King III recommendations, or has decided not to do so, are listed and explained in the King III compliance report on page 57 of this report.

In compiling and presenting its annual financial statements, the Bank has elected to use the International Financial Reporting Standards (IFRSs) as a guide, except where IFRSs guidance conflicts with provisions of the SARB Act; in such instances, the SARB Act has taken precedence. Further details in this regard are contained in the Bank’s summarised Group annual financial statements from pages 64 to 99 of this report.

Assurance

Both the summarised Group annual financial statements contained in this report and the full Group annual financial statements available on the Bank’s website (https://www.resbank.co.za/Publications/Reports/Annual-Reports.aspx) have been independently audited by PricewaterhouseCoopers Inc. (PwC) and SizweNtsalubaGobodo Inc., the Bank’s external auditors.

Feedback

The Bank is grateful for the feedback it has received from its shareholders and stakeholders in respect of the 2013/14 Annual Report.

Your feedback, comments and/or questions can be forwarded to S L (Sheenagh) Reynolds, the Secretary of the Bank, at Sheenagh.Reynolds@resbank.co.za.
Background
The Bank is the oldest central bank in Africa. It opened its doors on 30 June 1921 and issued the first banknotes to the public on 19 April 1922, with all commercial banks in the country instructed to stop issuing or reissuing their own banknotes with effect from 30 June 1922.

When the Bank was established in 1921, most central banks worldwide had private shareholders and a similar structure was introduced in South Africa. The Bank was listed on the JSE Limited (JSE) on 7 April 1922 and delisted on 2 May 2002 due to a change in the Listings Requirements. The Bank still has private shareholders and its shares are traded by way of an over-the-counter share-trading facility maintained by the Bank. An ordinary general meeting of shareholders is held annually at the Bank’s premises in Pretoria.
Regulatory framework
The Bank is the central bank of South Africa. It is established by the SARB Act, read with section 223 of the Constitution of South Africa, Act 108 of 1996 (Constitution). Its primary object and independence are entrenched in the Constitution (sections 224 and 225 of the Constitution).

Mandate and purpose
In terms of its constitutional mandate, the Bank is required to protect the value of the currency in the interest of balanced and sustainable economic growth in South Africa.

Price stability is a critical element of the foundation of an economy, contributing to economic growth, development and employment creation. The achievement of price stability is quantified by government setting an inflation target that serves as a yardstick against which price stability is measured. The achievement of price stability is underpinned by the stability of the entire financial system.

It is expected that the Financial Sector Regulation Bill 2014, once promulgated, will formally include the mandate to maintain, promote and enhance financial stability in South Africa and the establishment of the Prudential Authority, thus expanding the regulatory responsibility of the Bank beyond licensed deposit-taking institutions.

Functions
In pursuit of its mandate, the Bank performs the following key functions:
Vision
The Bank leads in serving the economic well-being of South Africans through maintaining price and financial stability.

Mission
To protect the value of the currency in the interest of balanced and sustainable economic growth in South Africa.

Values
The Bank actively encourages and strives towards the following values:

<table>
<thead>
<tr>
<th>Values</th>
<th>Behavioural indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Respect and trust</td>
<td></td>
</tr>
</tbody>
</table>
  - Treat all people in a fair and consistent manner at all times  
  - Value all people and respect the human dignity of each individual under all circumstances  
  - Build trust and confidence by being reliable  
  - Build trust through honesty in all interactions and refrain from abuse of office and/or position |
| Open communication |  
  - Build trust by encouraging effective and transparent communication and ensuring protection from blame and/or victimisation, irrespective of position or level  
  - Build relationships through frank conversations with colleagues  
  - Actively share necessary and important information, and encourage and participate in productive conversations across all levels in the organisation  
  - Use interactions with colleagues as an opportunity for understanding, which supports initiative and the flow of ideas |
| Integrity |  
  - Be honest and reliable, and behave in a consistent manner, giving credit where credit is due  
  - Do the right thing, even if nobody will know  
  - Act in the best interest of the common good and lead by example at all times to build trust and confidence  
  - Ensure that information provided is accurate and value-adding |
| Accountability |  
  - Engage in courageous conversations, and do not make excuses or blame others  
  - Build trust by being reliable, taking ownership and accepting responsibility  
  - Accept the consequences of your own actions and instructions to others  
  - Admit mistakes and rectify them where possible |
| Excellence |  
  - Perform your duties competently and exercise due care in doing so  
  - Commit to doing your job in an efficient, timely and accurate manner in accordance with the highest professional and ethical standards  
  - Endeavour to constantly enhance your knowledge and skills  
  - Take your job seriously and actively contribute to organisational excellence and the sharing of knowledge |
South African Reserve Bank at a glance (continued)

Strategic focus areas for 2015/16 – 2017/18

The Bank will focus on the following strategic areas in the next three years (2015/16 – 2017/18):

1. Enhance organisational efficiency and effectiveness by:
   - building a high-performing, highly skilled and capable workforce to fulfil the mandate of the Bank;
   - utilising fit-for-purpose technologies to meet the business requirements of the Bank; and
   - optimising the currency value chain for banknotes

2. Promote the safety, soundness and integrity of regulated financial institutions and financial market infrastructures

3. Increase South Africa’s resilience to external shocks

4. Maintain headline inflation within the target range of 3 to 6 per cent

5. Enhance engagement with informed stakeholders, general public and employees

6. Promote financial stability to achieve a safer and sound financial system
The Group’s achievements in the year under review included the following:

- In the context of regulation and supervision, steady progress continued to be made towards the implementation of the Twin Peaks Regulatory Model for regulating the financial sector of the country, including the creation of a fully fledged Financial Stability Department in the Bank and preparations for the promulgation of the Financial Sector Regulation Bill. South Africa’s banking sector continues to be sound and well capitalised.

- Monetary policy is in a gradual normalisation cycle. This policy stance aims at achieving a fine balance between providing monetary accommodation in an economy characterised by persistent weakness, while also anchoring expectations and controlling for a number of risks facing the forecast. During the period under review, the repurchase rate (repo rate) was raised by a quarter of a percentage point in July 2014. Thereafter, falling oil prices suppressed inflation and permitted a pause in the tightening cycle.

A number of initiatives to enhance Group efficiency and further develop the skills and professionalism of the Group’s workforce were undertaken, which included:

- the 2020 People Strategy, which will drive the Bank’s human resources (HR) interventions over the next five years, was adopted;
- a Bank-wide Multiple Career Paths (MCP) Strategy, to enhance the development of all employees, was finalised during the reporting period and implemented on 1 April 2014;
- a framework was created to ensure coordination and harmonisation across the Bank’s departments and across the Group;
- a Bank-wide organisational review, covering all departments, was completed, with the exception of the departments that will be affected by the implementation of the Twin Peaks Regulatory Model; and
- the South African Reserve Bank College (SARB College) was remodelled and launched as the South African Reserve Bank Academy (SARB Academy) with effect from 1 April 2014.

The Bank continued to show leadership and is recognised for its contributions both locally and globally, with the following notable highlights:

- The Bank played a leading role in the negotiations of the BRICS Contingent Reserve Arrangement Treaty signed by South Africa at the BRICS Leaders’ Summit in Fortaleza, Brazil, in July 2014.
- The Bank was awarded the 2015 ‘Reserve Manager of the Year Award’ by the international publication CentralBanking.com. This was in recognition of the measures it had taken to ensure resilience during a challenging year for emerging markets and to address the fundamental change in perceptions of risk and return under which reserves managers operate in a post-crisis environment. This global award also recognised the work being done at the Bank, which ensures that its reserves management operation is in keeping with central banking best practice.
- South Africa was rated as having a high level of compliance with the Basel core principles for effective banking supervision of the Basel Committee on Banking Supervision (BCBS) following a Financial Sector Assessment Programme (FSAP) by the International Monetary Fund (IMF) during 2014.
- Internally, the Bank achieved a number of significant successes in the field of information technology (IT) over the past financial year, including:
  - the adoption of the Bank’s 2020 IT Strategy; and
  - the selection of partners for the successful delivery of the Systems Renewal Project in the Financial Markets Department to improve the automation of processes, system stability, and risk and portfolio management analytics.
- In the year under review, the Bank successfully hosted a biennial economic conference, which was titled “Fourteen years of inflation targeting in South Africa and the challenge of a changing mandate”.
- The Bank hosted supervisory colleges for selected banks that have been established to compile and implement a strategy for compliance with the requirements of anti-money laundering (AML) and combating the financing of terrorism (CFT) and have entered into memorandum of understanding with relevant African supervisors.
- Regional settlement services offered through the SADC Integrated Electronic Settlement System (SIRESS) were extended to participants from non-Common Monetary Area (CMA) SADC countries (i.e. Malawi, Mauritius, Tanzania, Zambia and Zimbabwe) during the period under review and a R1 trillion settlement value mark was reached on 1 April 2015.
Organisational highlights (continued)

Financial highlights

Group financial statements – key highlights

Table 1: Group financial statements

<table>
<thead>
<tr>
<th></th>
<th>Group</th>
<th>Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2015</td>
<td>2014</td>
</tr>
<tr>
<td>Net interest income</td>
<td>4 580</td>
<td>1 715</td>
</tr>
<tr>
<td>Operating costs</td>
<td>4 772</td>
<td>4 685</td>
</tr>
<tr>
<td>Profit/(loss) for the year</td>
<td>627</td>
<td>(1 317)</td>
</tr>
<tr>
<td>Total assets</td>
<td>669 251</td>
<td>600 889</td>
</tr>
<tr>
<td>Total equity</td>
<td>6 627</td>
<td>6 387</td>
</tr>
</tbody>
</table>

SARB

Figure 1: Net interest income/(expense) 2008/09 – 2014/15

Yields fell across all large fixed income markets, the movement of the rand resulted in higher returns on foreign assets and the increase in accommodation to banks contributed to higher net interest income.
Organisational highlights (continued)

Financial highlights (continued)

SARB (continued)

Table 2: Operating costs

<table>
<thead>
<tr>
<th></th>
<th>2015 R’m</th>
<th>2014 R’m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Staff costs</td>
<td>1 902</td>
<td>1 850</td>
</tr>
<tr>
<td>Other operating costs</td>
<td>789</td>
<td>711</td>
</tr>
<tr>
<td>Cost of new currency</td>
<td>1 874</td>
<td>1 667</td>
</tr>
<tr>
<td><strong>Total operating costs</strong></td>
<td><strong>4 565</strong></td>
<td><strong>4 228</strong></td>
</tr>
</tbody>
</table>

Operating costs increased by **R337 million** from R4 228 million in 2014 to R4 565 million in 2015.

- The major contributor to the higher staff costs is the increase in the post-retirement benefits. A higher cost of new currency in comparison to the prior year is driven by the timing of deliveries.

Table 3: Financial review

<table>
<thead>
<tr>
<th></th>
<th>2015 R’m</th>
<th>2014 R’m</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign reserves</td>
<td>564 989</td>
<td>522 732</td>
</tr>
<tr>
<td>Domestic assets</td>
<td>47 583</td>
<td>32 018</td>
</tr>
<tr>
<td>Other assets</td>
<td>5 914</td>
<td>5 983</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td><strong>618 486</strong></td>
<td><strong>560 733</strong></td>
</tr>
<tr>
<td>Liabilities and equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foreign currency loans</td>
<td>94 414</td>
<td>84 354</td>
</tr>
<tr>
<td>Domestic liabilities</td>
<td>187 216</td>
<td>177 640</td>
</tr>
<tr>
<td>GFECRA</td>
<td>203 396</td>
<td>177 913</td>
</tr>
<tr>
<td>Notes and coin in circulation</td>
<td>122 170</td>
<td>107 385</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>6 065</td>
<td>8 292</td>
</tr>
<tr>
<td>Capital and reserves</td>
<td>5 225</td>
<td>5 149</td>
</tr>
<tr>
<td><strong>Total liabilities and equity</strong></td>
<td><strong>618 486</strong></td>
<td><strong>560 733</strong></td>
</tr>
<tr>
<td>US dollar exchange rate</td>
<td>12,18</td>
<td>10,58</td>
</tr>
<tr>
<td>Euro exchange rate</td>
<td>13,12</td>
<td>14,59</td>
</tr>
<tr>
<td>Pound sterling exchange rate</td>
<td>18,03</td>
<td>17,61</td>
</tr>
<tr>
<td>Statutory gold price (per ounce) (R)</td>
<td>14 455</td>
<td>13 687</td>
</tr>
</tbody>
</table>

The year-on-year rise in the foreign reserves and the Gold and Foreign Exchange Contingency Reserve Account (GFECRA) are the key contributors to the overall increase in total assets and liabilities, respectively. The drivers are the movement of the rand as well as an increase in the gold price.
Manufacturing subsidiaries key highlights

South African Bank Note Company (RF) Proprietary Limited

The SABN reported an increase of 43 per cent in revenue to R1 023 million in relation to the prior year of R716 million, attributable to an increase in sales volume – 1 069 million banknotes in the current year compared to the prior year of 862 million. The waste rate has reduced substantially. The number of banknotes produced per employee increased to 2.4 million in relation to 1.8 million of prior year.

The R1.2 billion capital investment project completed in 2014 resulted in an increase in production capacity.

The increase from R75 million in 2014 to R130 million in 2015, in profit before tax is due to an increase in sale volumes, a reduction in banknote waste, lower fixed costs and an increase in interest received.

Revenue for 2015/16 is forecast at R989 million due to a lower sales volume of 1 billion banknotes to be produced.

South African Mint Company (RF) Proprietary Limited

Revenue decreased by 5.5 per cent mainly due to the inclusion of 18 months of revenue for Prestige Bullion in the prior year. Revenue for the 12-month comparative period including the sale of gold bullion increased by 8 per cent.

Profit before tax has increased significantly in the last number of years, mainly attributable to the inclusion of the joint venture, Prestige Bullion and increased profitability in circulation coins. The profit before tax in 2014/15 amounted to R279.9 million of which R218.1 million can be attributable to Prestige Bullion. The 2013/14 results include 18 months of Prestige Bullion. The 12-month comparison resulted in a 140 per cent increase in profit before tax amounting to R279.9 million in the 2014/15 year.

Revenue volumes for 2015/16 are expected to be at the same levels as 2014/15.
Central banking in transition

- Adapting to an ever-changing environment
It gives me great pleasure to present to shareholders and other stakeholders the Annual Report of the Bank for the financial year ended 31 March 2015. In addition to the Group annual financial statements of the Bank and its subsidiaries, this Annual Report contains updates on monetary policy and financial stability as well as an outline of the operations and internal workings of the Group.

The Bank faced yet another challenging domestic and global environment during the year under review. The uneven nature of the global recovery persisted, with the United States (US) and the United Kingdom (UK) leading the way among the advanced economies. While the eurozone outlook remains relatively weak, there appear to be some positive responses to the significant monetary stimulus announced by the European Central Bank in January, amid signs that the banking sector in the region may be recovering.

By contrast, the outlook for emerging markets deteriorated over the past year, with negative growth rates in both Brazil and Russia and a slowdown in China as the economy rebalanced away from domestic investment towards consumption. This moderation has already contributed to the continued decline in commodity prices which began in 2011, with adverse impacts on South Africa’s terms of trade. This deterioration was reversed somewhat with the sharp decline in international oil prices. Although growth in African economies remains generally relatively robust, oil and other commodity producers face a difficult outlook.

Uncertainty over the timing and pace of US policy interest rate normalisation continued to dominate global financial markets and the pattern of global capital flows. The changing outlook regarding domestic US growth, labour market trends and inflation caused a great deal of volatility in financial markets. Normalisation is expected to begin this year, but the exact timing remains uncertain. At the same time, monetary policy in Japan and the eurozone remains highly accommodative.

Changing expectations with respect to monetary policy stances in the advanced economies are likely to keep emerging-market currencies relatively volatile, as capital flows respond to these risks. The rand was particularly vulnerable to these changes in risk perceptions, having depreciated by about 10 per cent on a trade-weighted basis during the financial year under review. However, domestic factors also contributed to this depreciating trend. These included the persistently wide current-account deficit (of around 5 per cent of GDP), the strained labour relations environment, and the weak growth outlook.

The past financial year was particularly difficult for the domestic economy, which had to contend with a protracted strike in the platinum sector followed by a strike by metal
workers. The downward pressure on growth was exacerbated
by the resumption of regular electricity load shedding by
Eskom, which is expected to continue for some time.

The outlook for the economy remains subdued, and the
Bank expects economic growth of between 2.0 and
2.5 per cent in 2015 and 2016 following a growth rate of
1.5 per cent in 2014. Growth in private-sector gross fixed
capital formation remains weak, but it improved somewhat in
the second half of 2014 following a contraction in the first half
of the year, while household consumption expenditure grew
by less than 2 per cent amid low credit extension to the
private sector.

Headline inflation, which had exceeded the target for five
consecutive months during 2014, returned to within the target
range of 3 to 6 per cent in September and has remained within
the range since then. In the wake of the international oil price
decline, inflation then reached a low of 3.9 per cent in February
2015. However, the Bank expects inflation to increase and
temporarily breach the upper end of the target during the first
quarter of 2016, with upside risks and pressures from the
weaker exchange rate as well as food and electricity prices.
Core inflation is expected to remain within the target but
uncomfortably close to the upper end of the range.

Monetary policy had to contend with the continued dilemma
of trying to balance rising risks to the inflation outlook, driven
to a large extent by supply-side shocks and a weak economy.
A tightening monetary policy cycle commenced in January
2014 with a 50 basis point increase, followed by a further
25 basis point increase in July. This move was prompted by
a combination of rising inflation risks and the need to
normalise the policy rate, which had been negative for some
time. The lower oil price also allowed for a pause in this cycle.
The Bank’s Monetary Policy Committee (MPC) emphasised
the moderate nature of the cycle given the wide output gap,
and that further moves would be highly data-dependent.
However, the Bank remains committed to achieving its
primary mandate of price stability.

Progress towards operationalising the financial stability
mandate of the Bank continued in line with the Twin Peaks
Regulatory Model which expands the responsibility of the Bank
for prudential regulation and supervision beyond banking, and
locates the Prudential Authority within the Bank. The Financial
Sector Regulation Bill, which is expected to be tabled in
parliament during 2015, assigns to the Bank the responsibility
to maintain, promote and enhance financial stability. The Bill
gives effect to the policy framework for macroprudential
regulation and supervision, and further provides for interaction
and coordination between the Prudential Authority within the
Bank and other financial sector regulators. Once passed, the
Bank is expected to have significant resource and personnel
implications for the Bank.

In the year under review, the Bank continued to develop its
capacity to oversee and monitor the broader financial sector
with the adoption of a macro-prudential surveillance approach.

At the micro-prudential level, the past year saw the first
significant bank failure in South Africa in over a decade when
African Bank Limited was placed under curatorship. In
cooperation with National Treasury, the Bank adopted
innovative steps to resolve the issue and prevent systemic
spillovers, with the application of bail-in provisions in line with
the key attributes of effective resolution regimes of the
Financial Stability Board, which South Africa has undertaken
to adhere to as a Group of Twenty Finance Ministers and
Central Bank Governors (G-20) member country. African Bank
Limited remains under curatorship and, once it is restructured,
it is anticipated that the resulting ‘good bank’ will be relisted in
the foreseeable future.

As the responsibilities of the Bank have evolved, there has
been recognition of the need for greater emphasis to be placed
on aligning its staff complement and competencies with these
new demands. The Bank has started the process of
segmenting its workforce through a Multiple Career Paths
Strategy which is focused on attracting and retaining skills and
expertise that are required to take the Bank forward as its
mandate and areas of responsibility expand. In support of this
strategy, the Bank is revising its policies to align them with the
requirements for each career path.
Although its headcount has grown over the past five years, the Bank has decreased the number of its unskilled and semi-skilled staff and increased the number of its skilled, professional and management staff who will position the Bank for the longer term. There is a focus on increasing the number of specialists within the core areas in the Bank over the next five years as part of the talent management, succession planning and skills development processes. In addition, the SARB Academy has been aligning its curriculum to support the underlying competencies and skills required for each of the career paths.

I am pleased to report that, having made losses in the previous five financial years, the Bank has returned to profitability. I should emphasise, however, that the Bank does not have a profit-maximising objective and that its operations are conducted in the broader interests of the country, in pursuit of its mandate and responsibilities. The Group recorded an after-tax profit of R0.63 billion compared with the loss of R1.3 billion in the previous financial year. This improvement in the financial position of the Bank was attributable mainly to unrealised profits due to declining global yields and the depreciation of the rand against major currencies, which increased the rand value of the interest earned from investing the country’s foreign-exchange reserves. Operating cost increases were attributable mainly to the higher cost of producing new currency, higher staffing costs, and the change in the actuarial assumptions related to post-retirement benefits.

The Bank operated with a full Board for most of the year under review. The term of office of one Board member, Mr Anthony Chait, expires at the 2015 AGM, and he has indicated that he is not available for re-election. The Panel, established in terms of the SARB Act, has chosen three
names from the list of nominees for the position, and the new Board member will be elected from this shortlist at the upcoming AGM.

The term of office of the previous Governor, Ms Gill Marcus, expired in November 2014, and she informed the President that she was not available for reappointment. I am honoured to have been appointed to succeed her, and it will be a hard act to follow. I am sure I speak for the Bank and for the country in thanking her and acknowledging the contribution she made to the Bank and to the economy during her tenure. She has left a legacy of a strong institution, and I will build on this. She has also left behind a highly capable and professional management team, which has contributed to a seamless transition. We all wish her well in her well-deserved retirement.

The President appointed Mr Kuben Naidoo as a Deputy Governor of the Bank with effect from 1 April 2015, filling the vacant position created by my appointment as Governor. I wish him well in his new appointment.

In conclusion, I would like to extend my appreciation to the non-executive directors, the Deputy Governors and all staff for their support during the transition. I rely on their ongoing commitment to the Bank.

We face a challenging period ahead, but I am confident that the Bank has the capacity to overcome these challenges and contribute to price and financial stability in the interest of all South Africans.

E L (Lesetja) Kganyago
Governor
The changing mandate of central banks
Monetary policy

The objective of monetary policy is to achieve and maintain price stability in the interest of sustainable and balanced economic growth. Price stability provides a favourable environment for growth and employment creation. Low inflation protects the purchasing power of all South Africans, particularly the poor.

Monetary policy in South Africa is conducted in a flexible inflation-targeting framework. The policy target is for the Bank to keep the year-on-year rate of change in the headline consumer price index (CPI) for all urban areas within a range of 3 to 6 per cent on a continuous basis. While government consults the Bank on target setting, the Bank has operational autonomy in the conduct of policy.

Global developments

The global economic environment has been characterised by low inflation and low growth recently. There have been only a few cases of sustained economic momentum, with the US, the UK and India the most prominent examples. Elsewhere, performances have been disappointing. Emerging markets continue to slow down, and potential growth seems to have fallen, indicating that the slowdown has structural and not only cyclical elements.

The US has been a bright spot in the world economy. In 2014 it enjoyed its best year for employment creation since 1999, with non-farm payrolls growing by nearly three million jobs. The unemployment rate has declined markedly, from over 10 per cent at the height of the crisis to just 5.5 per cent in March 2015, close to estimates of full employment. Wage growth has, however, been muted, which points to persistent slack in the labour market. The labour force participation rate remains close to four-decade lows.

The number of people working part time for economic reasons – meaning they would prefer full-time work, were it available – is declining, but it remains elevated. Furthermore, the downward nominal rigidity of wages may have kept remuneration undesirably high during the crisis, forestalling a post-crisis rebound. Accordingly, inflation has been subdued. The CPI briefly slipped into negative territory in January 2015 on low energy prices although underlying inflation was more robust, with core CPI at 1.6 per cent in January 2015. The personal consumption expenditures (PCE) inflation, the US Federal Reserve’s (the Fed) preferred measure, was narrowly positive in January 2015, and core PCE stood at 1.3 per cent.

In the context of strong US economic performance, the Fed began tapering its programme of quantitative easing (QE) in January 2014 and concluded it in October. As the end game for QE became clear, market attention shifted to ‘lift-off’ – the first adjustment of the Fed’s funds rate above the zero lower bound, where it has been pinned since December 2008.
The Federal Open Market Committee (FOMC) statement omitted the word ‘patient’ in March 2015, which removed the last element of explicit forward guidance from US monetary policy, raising the possibility of lift-off in the second half of the year. The Fed’s communications have stressed the forward-looking nature of monetary policy, signifying that the present low inflation is not important for interest rate decisions if inflation is likely to rebound over the medium term. Policymakers have also emphasised that the timing of the initial rate hike is less important than the amount of overall tightening that will occur.

China, the world’s second-largest economy, continues to slow as it rebalances away from export and investment-led growth towards domestic consumption. Its output expanded by 7.4 per cent in 2014, fractionally under the target but well below the double-digit growth rates of recent years. China’s economy has seen a remarkable expansion of debt since the crisis, even as growth has slowed. Total debt to gross domestic product (GDP) has more than doubled since 2007, reaching nearly 220 per cent of GDP in 2014, with especially strong borrowing in the corporate sector. Inflation has, however, been low and falling. Consumer prices rose less than 2 per cent in 2014 against a target of 3.5 per cent. Producer prices have been deflating for more than three years. These changes reflect falling world commodity prices, including energy prices, but also significant overcapacity in many sectors of the economy. Chinese monetary policy has responded with a series of rate cuts as well as lower reserve ratios for banks. Meanwhile, foreign reserves accumulation appears to have peaked and the renminbi has appreciated against most currencies, including the US dollar.

The euro area experienced another year of weak growth in 2014 although output expanded slightly after contracting in 2012 and 2013. Consumer prices have been increasing by less than 2 per cent since February 2013 and entered deflationary territory in December 2014. Accordingly, inflation expectations have declined, dipping below 2 per cent even over long-time horizons. The European Central Bank (ECB) has responded with a range of tools, including negative interest rates and a programme of QE, which will see the central bank accumulate assets at a pace of about €60 billion per month at least until September 2016. Bond yields declined for almost all governments in the euro area, with the most highly rated sovereigns now able to borrow at negative rates for maturities of up to five years. In Greece, however, borrowing costs spiked sharply following the election of a new anti-austerity government. There has been no evidence of contagion from these events to other members of the euro area.

Despite the fall in headline inflation, core inflation – a measure of underlying inflation that omits food and energy prices (including petrol) – has remained elevated. It has in fact drifted steadily upwards since 2011, from near the bottom of the target range to the top, reaching 5.8 per cent in January 2015. Inflation expectations, as measured by the Bureau for Economic Research (BER), are similarly placed, having converged on the upper end of the target range. Although average expectations for 2015 have fallen (to 5.4 per cent), expectations for the next two years are for 5.9 per cent inflation. As usual, the averages conceal variations between the different categories of respondents, with financial analysts expecting lower inflation than business people and union representatives.

Outlook for inflation

Consumer price inflation is expected to average 4.9 per cent in 2015, down from 6.1 per cent in 2014. The fall in oil prices has depressed headline inflation quite sharply, with price increases falling below the midpoint of the target range in January and then slipping further to 3.9 per cent in February. However, the disinflation impact of the oil shock is now expected to be weaker than previously forecast. Brent crude, having fallen below US$50 a barrel in January 2015, has since recovered to nearly US$59 in April. Furthermore, government’s decision to raise fuel levies means a smaller proportion of the oil price decline will feed through to consumer prices. Rand depreciation against the dollar has also moderated the windfall. The February 2015 inflation figure therefore likely marks a trough, with inflation expected to breach the upper end of the target in the first two months of next year due to base effects.

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1 This is the total debt of households, non-financial corporations and government. See McKinsey Global Institute, ‘Debt and (Not Much) Deleveraging’, February 2015.
2 Terms of trade refers to the ratio of the value (in price terms) of exports to the value (in price terms) of imports.
After a short period of balanced risks to the inflation outlook at the end of 2014, inflation risks are once again tilted to the upside. One important risk is the exchange rate. It is not clear to what extent currency markets have already priced in the Fed’s tightening. Fed communication should reduce the likelihood of a market surprise, along the lines of May 2013’s taper tantrum. However, there are some indications that market participants have lower interest rate expectations than policymakers at the Fed. The exchange-rate consequences of Fed normalisation should be mitigated to some extent by policy easing from other major central banks, especially the ECB and the Bank of Japan. For this reason, the nominal effective exchange rate of the rand has been fairly stable this year. The US dollar is nonetheless more important for inflation outcomes in South Africa than its weight in the trade-based exchange rate suggests. Furthermore, South Africa’s persistently large current-account deficit remains an important source of vulnerability.

The inflation forecast also faces other risks. Electricity prices may increase by significantly more than the current National Energy Regulator of South Africa (NERSA)-approved amounts, which are already well above headline inflation at nearly 13 per cent for direct customers and just over 14 per cent for municipalities. Wage settlements in excess of cost-of-living increases and productivity gains will continue to put upward pressure on prices. Finally, food costs pose some risk, with maize prices in particular affected by drought in some parts of the country. Food price inflation has been above headline inflation for more than a year, although the rate of increase has moderated since August 2014.

**Outlook for growth**

Growth in South Africa has slowed markedly since the 2011 post-crisis rebound. In 2014, the economy expanded just 1.5 per cent, an underperformance chiefly attributable to major strikes in the mining and manufacturing sectors. Growth is expected to improve slightly, to 2.2 per cent in 2015 and 2.3 per cent in 2016, well below pre-crisis norms. These levels are nonetheless consistent with revised estimates of potential growth, which may be understood as the pace of expansion which does not raise inflation. This ‘speed limit’ for the South African economy now appears to be between 2.0 and 2.5 per cent, significantly lower than the average of 3.5 per cent estimated for 1998 to 2011.

The most crucial domestic constraint on growth is the supply of electricity. Extensive load shedding has already imposed significant costs on the economy, and electricity shortages are expected to persist over the medium term. The completion of the Medupi and Kusile power stations will not suffice to remove the energy constraint, owing to Eskom’s maintenance backlog and ageing fleet. Although growth remains possible under these conditions, it will require less energy intensity either through efficiency gains or through expansion in less energy-reliant sectors.
There is limited evidence of demand pressure in the
economy. Credit growth has been muted, with bank lending
rising at about 3 per cent, in real terms, in each of the past
three years. Credit to the corporate sector expanded over the
course of 2014, although this was offset by weaker credit
growth to households. (The two categories account for roughly
half of overall bank lending.) Households have achieved some
deleveraging since the crisis, reducing debt-to-income ratios
from 89 per cent at the start of 2008 to 78 per cent in the last
quarter of 2014, and appear to have limited appetites for
additional debt. Retail sales growth has remained tepid, with
real growth of 2.1 per cent in 2014. Business confidence is
subdued and well below pre-crisis levels. Investment has been
correspondingly disappointing. Gross fixed capital formation
declined 0.4 per cent in 2014, with rising investment by the
public sector offset by a fall of 3.4 per cent in the private sector.
In this environment, employment growth has been stagnant.

Policy decisions
Monetary policy commenced a moderate interest rate
normalisation cycle in January 2014, with an increase in the
repo rate from 5.0 to 5.5 per cent. This was followed by an
additional increase in July 2014 to 5.75 per cent. The MPC
then paused the tightening cycle, in the context of an improved
short-term inflation outlook due to the steep decline in oil
prices, and heightened uncertainty over the path of inflation in
the medium term. Lower inflation in the context of weak growth prompted
public speculation about policy easing. In a flexible inflation-
targeting framework, supply shocks do not necessarily require
a policy response, whether they are positive or negative.
Rather, policymakers will seek to look through the first-round
effects and respond only to second-round effects. These
effects are typically wage increases and upward movements
in inflation expectations. The MPC made it clear in its
communications that the bar for additional monetary
accommodation was high. As the effects of the oil price shock
appear to have been temporary, the committee judged that it
could pause, but not reverse, the tightening cycle.

Monetary policy is constrained by the proximity of core
inflation and inflation expectations to the upper end of the
target range. The forecast also faces significant risks which
could result in higher inflation. Large, additional increases
in electricity prices are likely to keep inflation outside the
target range for a longer period of time than is now forecast.
The exchange rate remains an important risk, with the large
current-account deficit making the rand particularly vulnerable
to changes in investor sentiment. High wage settlements
continue to threaten a wage-price spiral, should these spread
throughout the economy. In this environment, the pause in the
tightening cycle is likely to be temporary.

The MPC therefore continues to face the dilemma of
stubbornly high inflation in a context of weak economic growth.
While price stability remains the overriding objective of
monetary policy, the speed and extent of policy adjustment
will remain sensitive to developments in the real economy.
Financial stability

Report on financial stability

Financial stability refers to a financial system that is resilient to systemic shocks, facilitates efficient financial intermediation, and mitigates the macroeconomic costs of disruptions in such a way that confidence in the system is maintained. Financial stability is, however, not an end in itself but, like price stability, is generally regarded as an important precondition for balanced and sustainable economic growth.

Although the Bank has always fulfilled a responsibility for financial stability in an implicit way, the expected passing of the Financial Sector Regulation Bill will make this responsibility explicit. While the price stability mandate of the Bank is clearly defined and measurable, its mandate for financial stability will be much broader and will be a shared responsibility with other regulators and stakeholders.

Historically, the main objective of the Bank has been to pursue price stability, but it has also had the implicit mandate to promote financial stability arising from its roles as lender of last resort and regulator of banks. Following the East-Asian and Mexican financial crises of the late 1990s and the more recent global financial crisis, it became clear that price stability is a necessary but insufficient condition for financial stability. Many countries, including South Africa, have since decided to make financial stability an explicit mandate of their respective central banks. A new approach to monitoring the broader financial system, known as ‘macro-prudential surveillance’, has been developed. The Bank has been developing its capacity to oversee the financial sector since 2001 when a Financial Stability Department was first established. In 2011 the Department was merged with the Bank Supervision Department, mainly for data sharing reasons. In 2014 the Financial Stability Department was re-established since the Bank’s mandate will be expanded to include an explicit responsibility for financial stability with the passing of the Financial Sector Regulation Bill.

The bill is expected to be promulgated during 2015 and will assign to the Bank the responsibility to maintain, promote and enhance financial stability in South Africa. The bill also sets out the requirements to give effect to the Bank’s financial stability mandate. These include the establishment of an advisory committee, called the Financial Stability Oversight Committee (FSOC), chaired by the Governor, with the primary objective of supporting the Bank in performing its functions in relation to financial stability. The committee should also facilitate cooperation and collaboration between financial sector regulators and the Bank on financial stability matters. Membership of the FSOC will include the Financial Sector Conduct Authority and National Treasury.

In terms of the Financial Stability Board’s (FSB) Key attributes of effective resolution regimes issued in October 2011, which South Africa has undertaken to adhere to as a G-20 member country, South Africa is required to have in place recovery and resolution plans for all systemically important financial institutions in order to improve the resolvability of institutions during distress, with minimal use of taxpayer funds. During the reporting period the development of recovery plans was discussed with banks, including details of how a bank’s management would execute such a plan in order to recover from a severe financial crisis. In addition, the Bank, having been designated as the resolution authority, will have the responsibility of developing resolution plans for domestic systemically important banks as soon as the relevant legislative framework is in place. A policy paper, which includes a special resolution framework and proposals for a depositor guarantee scheme, creditor preference, and bail-in, is under development.

Although the Bank’s financial stability mandate is distinct from its price stability mandate, careful consideration should continuously be given to the interaction between the Bank’s monetary policy and financial stability objectives. This coordination is facilitated by a degree of cross-membership between the Bank’s monetary policy and financial stability committee structures.

During the year under review, African Bank Limited was placed under curatorship when shareholders and funders lost confidence in the bank and possible contagion to the rest of the system needed to be prevented. The Bank managed the resolution of African Bank Limited by putting in place a package of measures in line with the Key attributes of effective resolution regimes of the FSB. These measures were aimed at enabling the institution to continue operating and to deal with any contagion effects to the rest of the banking sector and the financial system in general. Although the intervention of the Bank managed to avoid systemic risk materialising and there were no significant adverse effects on the rest of the banking sector, the broader financial markets or the economy, some spill overs did occur, especially to bond markets, money-market funds and pension funds.

The African Bank Limited event has brought to the fore the degree to which the financial sector, and the banking system in particular, is interconnected. From a financial system perspective, interconnectedness increases risk. Part of the Bank’s mandate and responsibility is to protect the financial system against systemic risk. The Bank will continue to strike a suitable balance between protecting the financial system against excessive risk-taking or unhealthy lending practices and promoting financial deepening, integration and inclusion.
The Bank participates in several of the structures of the FSB, whose mandate is to promote global financial stability by coordinating the development of regulatory, supervisory and other financial sector policies. South Africa is a plenary member of the FSB and was recently allocated a second seat at the FSB Plenary table. The Bank and National Treasury represent South Africa and use every opportunity to influence the agenda to focus on the issues that especially impact emerging markets. South Africa is currently the only African jurisdiction with a seat on the FSB Plenary.

The Bank also participates in the various committees of the FSB, as the work of the FSB has far reaching implications for South Africa’s financial system and regulatory framework. The Bank participates (in some cases jointly with National Treasury) in the following high-level committees: FSB Steering Committee, Standing Committee for Supervisory and Regulatory Coordination, Standing Committee on Standards Implementation, Resolution Steering Group, the Analytical Group on Vulnerabilities, which is a sub-committee of the Standing Committee on Assessment of Vulnerabilities, and the Regional Consultative Group for sub-Saharan Africa. Additional activities that the Bank participates in, include working groups on shadow banking, workshops, peer reviews, thematic reviews, surveys and impact assessments of the effects of global financial reforms.

During the year under review, the Bank published two editions of the Financial Stability Review (FSRs). The FSR aims to identify and analyse potential risks to financial stability, to communicate such assessments and to stimulate debate on pertinent financial stability issues. Global and domestic risks that could affect the stability of the financial system in South Africa were identified and analysed in these publications.