## CHAPTER 2:

## The South African Reserve Bank

# Textbook Questions

### Review questions

*The following questions appear in the textbook on page 58.*

*Answer the following questions.*

**Explain the role of the SARB in the financial system.**

**The achievement of price stability is dependent, inter alia, on financial stability. It is therefore important that the Bank encourages and supports the development of sound, well-managed banking institutions. This is done firstly by monitoring the financial risks that banks undertake. The *Bank Supervision* Department is responsible for ensuring prudential soundness of the banking system. Secondly, *lender-of-last-resort assistance* is provided to banks to safeguard the system from systemic risks. This assistance is only applied in cases where a bank is encountering liquidity shortages and where its failure would pose a serious threat to the financial system as a whole.**

**Efficiently functioning financial markets are a prerequisite for the achievement of financial stability. In this regard it is important to have sufficient banknotes and coin in circulation so as not to obstruct trade and financial transactions. Without a system for the clearance and settlement of bank claims, payments for transactions would be encumbered. In addition, the Bank must have a vested interest in the development and functioning of the money, capital and foreign exchange markets if it wants to maintain financial stability.**

**Describe the inflation-targeting framework.**

**In February 2000 it was announced that formal inflation targeting would be adopted in South Africa as the monetary policy framework. Before this announcement, “informal inflation targeting” was already being applied by the SARB.**

**Inflation targeting is a monetary policy strategy that embraces five elements:**

* **The public announcement of medium-term numerical targets for inflation. The target range is set at 3 to 6 per cent, which must be obtained continuously in every month measured over a 12-month period in the coming years.**
* **An institutional commitment to price stability as the primary goal of monetary policy, to which other goals are subordinated**
* **An information-inclusive strategy in which many variables, and not just monetary aggregates or the exchange rate, are used for deciding the setting of policy instruments**
* **Increased transparency of the monetary policy strategy through communication with the public and markets about the plans, objectives and decisions of the monetary authorities**
* **Increased accountability of the central bank for attaining its inflation objectives**

**Inflation targeting therefore entails more than the announcement of a numerical target over a specific time horizon. From January 2009 the consumer price index (CPI) was used as the target variable in the inflation-targeting framework.**

**The specification of the target does not mean that monetary policy must necessarily react if the inflation rate moves outside the target. If it is expected that the inflation rate will again move into the target range within a short period of time, no reaction of monetary policy is required. However, if the inflation rate is expected to remain out of the target for an extended time period, then monetary policy will have to be adjusted. It is not the current rate of inflation that is important in making policy decisions, but the expected future trend in inflation.**

**The inflation-targeting framework makes allowance for the influence of exogenous shocks by means of an “explanation clause”. The Bank is expected to fully inform the public of the nature of any exogenous shock, its anticipated impact on inflation, the monetary policy response that will be taken to ensure that inflation returns to the target range, and the time horizon over which this is expected to happen.**

**Describe open-market operations as a monetary policy tool. Refer in your discussion to five types of open-market operation used by SARB.**

**The objective of open-market operations is to manage the banks’ liquidity requirements around the level of the structural shortage. However, due to certain limitations of the CRR, it has become necessary for the Bank to use some of these instruments to actually increase the size of the structural shortage in order to make the application of its policy more effective.**

**The Bank mainly conducts four types of open-market operations to drain any excess liquidity. The first method used by the Bank is the issuing of its own *debentures*. These are issued for 28 or 56 days on an auction basis, while the interest rate at which these securities are issued is capped at the level of the prevailing policy (repo) rate. At maturity, the SARB pays each bank the nominal amount plus interest. These securities are explained in more detail in Chapter 10 of *Understanding South African financial markets*, 4th edition.**

**A second instrument that the Bank uses for draining liquidity from the market is longer-term *reverse repos*. Bonds in the monetary policy portfolio are utilised in 28- or 56-day reverse repo transactions in order to drain excess liquidity. The instruments are issued through an auction process and the interest is also capped at the level of the repo rate. The amount of reverse repo transactions that the Bank can conduct is limited to the size of its bond portfolio.**

**Thirdly, the Bank engages in regular *foreign exchange swap* operations in order to reduce surplus rand liquidity in the market. These swaps imply that the Bank sells dollars (against rand) to its counterparties (the banks) on a spot basis while simultaneously buying these dollars back on a forward basis. For the duration of the forward leg of these swaps, the rand amounts received by the Bank are regarded as “sterilised” rand. Obviously when the forward contracts mature, the Bank then buys the dollars back from the banks and delivers rand against it. The process is then repeated or rolled over for another period. Foreign exchange swaps used by the central bank are discussed in Chapter 14 of *Understanding South African financial markets*, 4th edition.**

**The surplus rand liquidity which has to be removed or sterilised from the market is created by virtue of the normal cyclical cash flows between the banks and the Reserve Bank on the one hand, as well as a result of Reserve Bank foreign exchange purchases not funded by the government. The latter is part of the Bank’s longer-term accumulation of official foreign exchange reserves. Note also that, in contrast to foreign exchange swap transactions executed by the Bank in the early 2000s, these swaps are carried “across month-ends” – that is, they have longer maturities.**

**Fourthly, the transfer of deposits in the Corporation for Public Deposits (CPD) between the Bank and the market has become a liquidity management instrument at the disposal of the Bank.**

**Fifthly, the Bank can potentially also engage in outright sales of bonds from its monetary policy portfolio to drain excess liquidity permanently from the market. However, it is limited to the relatively small size of the portfolio.**

**The National Treasury Sterilisation Deposit Account (NTSDA) is a special account kept by National Treasury with the Bank. It reflects the rand equivalent of a substantial portion of foreign exchange reserve purchases which was funded by the National Treasury. Prior to January 2010 this implied that any particular foreign exchange purchase by the Bank (and funded by the government) would be reflected as an increase in rand balances of the government held with the banking system. Such an increase would then be sterilised by moving an equivalent amount of rand from the government’s tax and loan accounts at the banks to the NTSDA at the Bank. The return on these balances is based on the returns recorded on the official foreign reserves of the Bank and is therefore not a direct cost for the Bank. Since January 2010, however, the proceeds of foreign exchange purchases funded by the National Treasury have been deposited directly into a foreign exchange account held with the Bank and, as such, disclosed as a “Foreign currency deposit receipt” on the Bank’s monthly statement of official gold and foreign exchange reserves.**

**Note that *open-market purchases* of securities by the central bank are made for the express purpose of supplying cash reserves to the domestic banking system. Likewise, *open-market sales* of securities are aimed at creating a shortage of cash reserves in the banking system, which forces the banks to make use of the SARB’s refinancing system.**

**Open-market operations (OMOs) are flexible monetary policy instruments, and the involvement of individual institutions is on a voluntary rather than a compulsory basis. OMOs can be performed frequently and in any quantity. They are, therefore, a technique suited to fostering financial competition and market development. OMOs can be performed in both the primary market – through new issues of short-term government or central bank debentures – and in secondary markets.**

**The theory of OMOs is that purchases or sales of securities by the central bank tend to directly and immediately increase or decrease the quantity of money in circulation and the cash reserves of the commercial banks. Such an increase or decrease therefore affects the credit-creating capacity of the commercial banks. This in turn tends to further increase or decrease the quantity of money, changes in credit conditions and interest rates, which ultimately affect the level of overall economic activity in an economy.**

**OMOs therefore represent a direct and comprehensive instrument for liquidity management, provided that there are broad and active markets in those short- and long-term securities in which the central bank wishes to deal, and that such securities constitute a sufficiently sensitive and decisive part of the whole credit structure.**

**Describe the methods of prudential supervision of banks and the financial system.**

**The SARB, through its Bank Supervision Department (BSD) is responsible for *macroprudential supervision* (a sound financial system) on the one hand and *microprudential supervision* (sound financial institutions) on the other. The microprudential approach, however, stretches much more deeply in the sense that it consists of two important legs – *microprudential* and *microprudential regulation*.**

**Discuss the government banking accounts managed by the SARB.**

**The accounts which have been retained by the government at the SARB are the following:**

***Exchequer and Paymaster General accounts***

**The accounts of the National Treasury with the Bank are by far the most important, having originally been transferred to the Bank in 1927. They principally comprise the Exchequer and Paymaster General accounts, which are held at the head office of the Bank in Pretoria. The Exchequer accounts are used mainly for inflows of government funds, while the Paymaster General accounts are employed to meet expenses.**

***Administration costs***

**Generally speaking, many a central bank is, under its charter or statute, or under a private agreement with the government, obliged to maintain its national government’s accounts free of charge. This is the position of the SARB to a large extent. In other words, save for the NTSDA (the Treasury’s foreign exchange sterilisation account), the SARB does not pay interest on any balances kept with it by the government. This obligation on the part of the central bank is normally associated with its enjoyment of the right to issue notes, and any other privileges which may have been conferred by legislation, including that of acting as a custodian of the cash reserves of commercial banks.**

***Privatisation of government accounts – tax and loan accounts***

**In May 1993, legislation was introduced in parliament that allowed a portion of government funds to be placed with the four main commercial banks. Since 1 February 2004 these accounts have provided for tax and loan receipts to be deposited directly into the so-called tax and loan accounts at these clearing banks, and held in the respective accounts until the money is required by government. The flow of funds between the private sector and the SARB, which in the period before 2004 at times considerably disrupted the money market, has since been eliminated. This simplified money market management, and contributed to better cash flow management within the government sector which, in turn, reduced their net financing cost. Another advantage of the system was that the government was now able to earn interest on its deposits with banks.**

***Customs and Excise account***

**The Bank still maintains the Customs and Excise account on behalf of all the member countries of the Southern African Customs Union. In terms of this arrangement, no quantitative restrictions or duties are levied on goods originating within the common customs area, while provision is made for a common external customs duty and for uniform excise duties within member countries. A common revenue pool account exists at the Bank into which the revenue is pooled, which is distributed among member countries according to a specific formula.**

**Discuss the subsidiaries of the SARB and their role in the economy.**

**The SARB established itself as the central bank of South Africa during the 1920s by performing most of the duties and functions with which central banks are customarily entrusted. After residing in the old government library in Church Street (currently Helen Joseph street), Pretoria for about 10 years, the Bank moved into its first properly (Sir Herbert Baker) designed official head office building in July 1931. It was situated on the well-known Church Square, and gold bullion was stored in the Bank’s vaults for the first time in August 1934. The first Reserve Bank branch was situated in Harrison Street in Johannesburg and commenced business on 1 July 1925. Branches in Cape Town, Durban, Port Elizabeth and East London were established between 1925 and 1926. The Pretoria branch became operational in July 1933 but was closed in June 1995, while the Bloemfontein branch opened for business in March 1939. The opening of branches enabled the Bank to extend its direct dealings with the public and to establish closer contact with the financial markets of the country, including those in the various regions. The Bank finally moved to its current Church Street premises in Pretoria in 1988.**

**Currently, the main function of the SARB branches is to ensure that there is an adequate supply of new notes and coin available to meet the demand by the banks and to replace unfit notes, which are destroyed by the branches. In order to satisfy their requirements for banknotes, the Bank has ensured that there is sufficient storage capacity in branch vaults to meet the normal demand, as well as a "buffer" amount to meet exceptional or seasonal demands. The branches all have electronic note-processing machines to sort the notes deposited with them. In this way, the Bank ensures that good-quality banknotes remain in circulation. The branches of the Bank are responsible for the quality of banknotes in circulation in their respective regions.**

**Over time, it became more challenging for the Bank to operate in the fast-developing South African economy and its financial markets. In order to deal with these challenges, it established four subsidiary companies, namely the Corporation for Public Deposits (CPD), the South African Mint Company, the South African Banknote Company and the South African Reserve Bank Captive Insurance Company Limited.**

***The Corporation for Public Deposits***

**The CPD is a wholly-owned subsidiary of the Bank. In terms of the Corporation for Public Deposits Act 46 of 1984, the corporation accepts call deposits from the public sector and invests the funds in short-term money market instruments, special Treasury bills and with the SARB. With the permission of the Minister of Finance, the corporation also accepts call deposits from other depositors.**

**The cash flows of the CPD have a direct impact on money market liquidity. Therefore, as part of its daily money market liquidity management operations, the Bank manages both the deposits (liabilities) and investments (assets) of the CPD. The CPD was established in 1984 in order to rationalise the investment of short-term funds of the public sector and to enable the monetary authorities to control the investment of these funds more efficiently. The CPD accepts short-term deposits from entities in the public sector and funds from other institutions approved by the Minister of Finance, and repays them on demand, with interest.**

**The board of the CPD has approved investment guidelines for the Corporation. Since the largest portion of the CPD’s funds may be withdrawn at short notice, it is a prerequisite that investments are made mainly in short-term assets. The business operations of the CPD are controlled by a board of directors consisting of members appointed by the Minister of Finance, and senior officials of the Bank and National Treasury. The CPD is managed and administered by officials of the Bank. In terms of the CPD Act, any surplus generated by the CPD, after providing for dividends and transfers to reserves, must be transferred to the government. The CPD is exempt from taxation.**

***The South African Mint***

**The South African history of coins is linked to that of the four provinces of the Union of South Africa. The first official government mint was established in Pretoria in 1890. After the unification of South Africa in 1910, the country used British coin as well as coin of the *Zuid-Afrikaansche Republiek*. The latter remained legal tender until 1938, while the British coin remained legal tender until 1961.**

**The South African Mint was established in 1923 and functioned as a division of the central government. On 1 September 1988 the Mint was privatised as a full subsidiary of the SARB. Historically, coins had to contain their face value in their metal content. However, the international trend is to choose a composite material rather than a pure metal for coinage.**

**The South African Mint is considered to be one of the most modern in the world, and can produce more than six million coins per day. In terms of the production capacity, about 80 per cent is used to produce South Africa coinage. The remaining capacity is used to produce coins for expert purposes.**

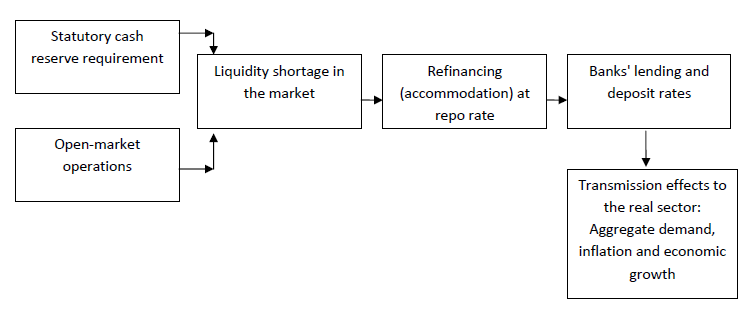
***The South African Bank Note Company***

**The South African Bank Note Company (Pty) Ltd (SABN) was established on 21 May 1958 by the SARB in partnership with Bradbury Wilkinson, a British company which provided the necessary technical expertise. The first locally produced South African banknotes appeared in 1963. In 1969 the SABN became a wholly-owned subsidiary of the SARB. Today the company has grown to become one of the most technically advanced banknote security printers on the African continent, and competes with the best in the world. The SABN now also prints currency for a number of countries other than the Republic of South Africa.**

**What is the Financial Stability Committee?**

**For purposes of achieving the financial stability objective of the Bank, a committee of the Bank, known as the Financial Stability Committee (FSC) was established, and first convened on 15 October 2010. The objective of the FSC is to complement the price stability objective of the Bank through the formulation and implementation of appropriate macroprudential policy measures to limit the cost of system-wide distress in the financial system.**

**Explain the monetary policy framework of the SARB. Use an appropriate diagram to illustrate your discussion.**

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**The liquidity requirement or money market shortage affects the banks’ ability to adjust their balance sheets in two ways. Firstly, it determines the availability and cost of their marginal funding requirements – that is, the funding needed for additional asset growth (e.g. creating new loans) on a daily basis. This is the asset growth that cannot be funded by the available amount of liquidity in the market and consequently has to be funded by new liquidity obtained from the central bank. This marginal cost of funding should eventually have an effect on the required return on marginal asset growth, including credit extension, thus making the repo rate more effective. Secondly, banks have to hold relatively low-yielding securities to use as collateral in the Bank’s refinancing operations. Funding that is locked into acquiring these assets also restricts the commercial banks’ ability to extend credit.**

**The Bank’s main liquidity-providing facility is the weekly seven-day repo conducted against suitable collateral of assets. In addition to the main repo, the Bank also provides for daily square-off facilities available to banks – that is, to facilitate the daily balancing (squaring off) of their settlement accounts with the Bank. These auctions are announced towards the end of the settlement cycle if some unexpected developments cause a large shift in liquidity conditions in the market. The auctions can be in the form of a liquidity-providing repurchase transaction or a reverse repurchase transaction where surplus liquidity is drained from the market. Supplementary square-off auctions are conducted on an overnight basis at the prevailing repo rate.**

**In addition, standing facilities are available in the form of a repo or reverse repo transaction maturing on the following business day. These transactions are conducted at the prevailing repo rate or at a spread of 100 basis points above or below the policy rate respectively. Should a particular bank, for example, be short of funds, it could borrow money from the Bank at a penalty rate of 100 basis points above the repo rate. Likewise, a bank with an excess balance could deposit such additional funds with the SARB at 100 basis points below the repo rate. The Bank may change the spread from the repo rate at any time at its discretion.**

**Note that banks are allowed to “average” their required cash reserve balances. This means that they do not have to comply with the statutory cash reserve requirements on a daily basis but rather on an average basis over the maintenance period. Accordingly, banks have access to their own cash reserve balances at the Bank and/or the standing facilities on a daily basis.**

**The operations of a central bank in the money market to influence liquidity (i.e. its monetary operations) can be divided between liquidity-providing (i.e. refinancing operations) and liquidity-draining open-market operations. *Open-market operations* (OMOs) are the central bank’s transactions with counterparts in the financial markets through which it aims to either inject or withdraw liquidity.**

**What is the difference between macroprudential and microprudential supervision?**

**Macroprudential supervision = sound financial system**

* **Maintenance of financial stability**

**Microprudential supervision = sound financial institutions = soundness of banking system**

* **Microprudential supervision**
* **Microprudential regulation**

**What is the SAMOS system?**

**In 1998, the Bank introduced a sophisticated real-time gross settlement (RTGS) system called the South African Multiple Option Settlement (SAMOS) system. The system was designed for high-value interbank transactions and provides the facilities to banks to settle obligations on a real-time basis. A settlement system participant typically would have an account at the Bank from which interbank settlement obligations are settled. Accordingly the settlement system, participants need to lodge prescribed collateral at the Bank. These requirements are necessary to provide sufficient liquidity and to ensure the smooth functioning of the system.**

**The SAMOS system settles on a pre-funded (credit push) basis. If a bank has insufficient funds available in its settlement account, the SAMOS system will automatically grant a loan to the bank against acceptable collateral. The amount of such a loan is limited to the collateral reserved and registered at the Bank for this purpose. SAMOS is also used to settle the repurchase agreement (repo) transactions that are conducted for monetary policy purposes. Banks can obtain central bank funds via repos. In addition, SAMOS significantly reduces risk in the payment system environment.**