Q&A

ABOUT PRICE AND FINANCIAL STABILITY

The SARB serves ordinary South Africans by containing inflation, which erodes the value of the money in their pockets. It also guards against systemic disruptions that may threaten the financial system and the functioning of the economy.

Why price stability matters

Q What is inflation and how is it measured?

A Inflation is the general rise in prices of typical goods and services that erodes the purchasing power of money. Lower long-term inflation is important for protecting purchasing power, containing the costs of living and of doing business, and supporting South Africa's global competitiveness. The standard measure of inflation is the consumer price index (CPI), which is compiled by Statistics South Africa (Stats SA). The CPI is calculated using a basket of goods and services purchased by a typical consumer. Inflation is calculated by tracking the prices of these items over time.

Q How does the SARB work to achieve price stability?

A The government, in consultation with the SARB, has set an inflation target of 3–6% to measure price stability. To protect the value of the currency and the purchasing power of South Africans, the SARB strives to keep inflation within the target range, preferably close to the midpoint of 4.5%.

Q What are the advantages of an inflation target?

A A credible inflation target range reduces the uncertainty regarding the future level of inflation in the economy and helps manage expectations. Households and firms can calculate the purchasing power of their income and make better decisions about consumption and investments, knowing that inflation is likely to be between 3% and 6%. This certainty supports economic growth.

Q What does the SARB consider when making interest rate decisions?

A When determining interest rates, the main factor that the Monetary Policy Committee (MPC) considers is the future path of inflation. The MPC also considers domestic and global economic conditions as well as how its policy decisions will impact economic growth and employment. Interest rate changes affect the economy with a lag of around 12 to 24 months, so the MPC's decisions are forward-looking and aimed at keeping inflation within the target range over the medium term.

Q How does higher inflation affect South Africans?

A **Inflation erodes the purchasing power of money:** R100 left under a mattress for 10 years will not buy you the same goods and services today that it would have bought you a decade ago. Savings and pension plans also lose value if the interest earned is not enough to compensate for inflation.

Inflation can raise inequality: The purchasing power of fixed incomes declines over time. The wealthy are mostly able to protect themselves against inflation by investing in assets such as shares or property that increase in value during periods of inflation. The poor and those living on fixed incomes such as pensioners or grant recipients, are hit harder when prices of living essentials such as food, transport and fuel go up.

Confusing price signals: Higher and more volatile inflation creates uncertainty regarding the future purchasing power of income, interest rates and the real profitability of firms. It makes purchasing decisions such as buying a house, or investment decisions such as expanding a business, more difficult, which can slow down economic growth.

Higher interest rates: When lenders expect higher inflation, they require compensation, which means interest rates are higher. This also reduces fiscal resources to provide services such as education and health, as the government must pay higher costs to borrow and service its debt. By contrast, when lenders expect inflation to decline, interest rates can come down.

Negative impact on the rand: If the inflation rate is consistently higher than that of the country's major trading partners or competitors, South African producers will lose their competitive edge and consumers might be tempted to import cheaper goods instead of buying local products. As the demand for South Africa's exports falls and the demand for imports rises, the need for foreign currency to pay for imports will increase, making it relatively scarce and more expensive, and the rand will lose value against other currencies.

To reduce these adverse impacts, central banks in most emerging markets have lowered their inflation targets to around 3%,* compared to the inflation targeting midpoint of 4.5% in South Africa. A lower inflation target will align South Africa's inflation rate with those of our major competitors and provide significant benefits to firms and households.

Q What is the Gold and Foreign Exchange Contingency Reserve Account and why did the SARB change how it is treated?

A The Gold and Foreign Exchange Contingency Reserve Account (GFECRA) is an account that sits on the SARB's balance sheet. It could be a liability of the SARB and an asset of National Treasury depending on the movement in prices of underlying assets. The account reflects the losses and profits from changes on the value of gold and foreign currency reserves. The credit balance on the account has grown substantially over the past two decades to around R500 billion. Instead of selling foreign currency to realise the rand value of the underlying assets, the SARB has agreed to credit National Treasury's accounts with commercial banks. As these funds are drawn and used by the government, the SARB will pay interest on commercial banks' deposits at the central bank. To cover these interest costs, the SARB will also receive a portion of the GFECRA funds to protect its policy solvency.

Q What are the advantages of this change?

A An immediate benefit is that National Treasury can reduce its own borrowing in the near term and save on interest costs. The new, rules-based framework for GFECRA distributions is also aimed at creating objective, prudent standards for payouts over the longer term. The framework aims to mitigate against the account turning negative in the future, which limits potential capital transfers from National Treasury to the SARB. It also provides the SARB with a claim on GFECRA funds to protect its equity position. Any additional funds are distributed to National Treasury.

* M Ehrmann, 'Point targets, tolerance bands, or target ranges? Inflation target types and the anchoring of inflation expectations', *European Central Bank Working Paper Series No. 2562,* May 2021.

Ensuring a stable financial system

Why is the stability of the financial system important?

Financial stability refers to a financial system that continues to provide efficient financial intermediation and other services when the system is hit by either a financial or non-financial shock, for example, a sudden stop in capital flows or the collapse of a bank.

The financial system enables households and businesses to save, borrow, invest and transact, and facilitates local and international trade. In the absence of financial stability, economic activity declines as firms and households are no longer able to transact efficiently or effectively.

How does the SARB ensure the stability of the financial system?

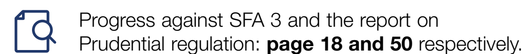
The SARB's financial stability mandate is to ensure that the financial system functions even under stress. This is a responsibility led by the SARB and supported by other financial sector regulators and National Treasury.

The SARB monitors global and domestic developments as well as how specific financial institutions operate to identify potential risks and vulnerabilities that may threaten the whole financial system. It recommends policy actions using a macroprudential policy framework to protect against the build-up of vulnerabilities. It also conducts stress tests of financial institutions to assess their resilience against defined adverse scenarios.

Progress against SFA 2 and the report on Financial stability: **page 17 and 45** respectively.

Why is South Africa's financial system considered safe and sound?

Local financial institutions are well capitalised, they can meet their obligations to depositors and policyholders, and perform well against a set of financial stability and microprudential indicators. These include the SARB Risk and Vulnerability Matrix (RVM), net stable funding ratio, losses linked to specific components of their balance sheets and the profitability of institutions. The resilience of the financial system is illustrated by its ability to provide financial services during large economic and financial shocks such as the coronavirus disease 2019 (COVID-19) crisis.



Progress against SFA 3 and the report on Prudential regulation: **page 18 and 50** respectively.