South African Reserve Bank

GOVERNOR'S ADDRESS

Ninety-Second Ordinary General Meeting (AGM) of shareholders held on Friday, 27 July 2012 at 10:00

GOVERNOR'S ADDRESS

Dear Shareholders,
Members of the Board,
Deputy Governors,
Ladies and Gentlemen

It has become almost customary to begin the Governor's Address with the words "this past year has been extremely challenging". This year is no different: it has indeed been a challenging year in a highly turbulent global environment. In my address to the Annual General Meeting last year, I reported on the precarious state of the global economy. There was cautious optimism that the global slowdown being experienced was a "soft patch" and that the positive growth trend that had been observed earlier in the year would resume soon. The domestic economy was also showing tentative signs of a sustained recovery. Unfortunately, things have not progressed as hoped, and the global economy is possibly in a worse position now than was the case this time last year. The global financial crisis is now in its fifth year and there seems to be no end in sight. Indeed, Mervyn King, Governor of the Bank of England, recently expressed the view that we are only halfway through the global crisis. If he is correct, it means we have a protracted period of turbulence ahead of us, and the challenges will intensify. Moreover, the further away the recovery is, the steeper the climb out of the crisis is likely to be.

During the past year there have been significant swings in sentiment in financial markets, particularly related to the outlook for the euro area. The sovereign debt and banking crisis in the region continues, despite a number of official interventions. Two rounds of significant liquidity injections from the European Central Bank helped to avoid a liquidity crisis in the banking sector, and more recently a bail-out of the Spanish banking sector was required. Other initiatives, including a Greek debt restructuring, have also bought some time regarding a possible exit by Greece from the Eurozone, an event which could unleash further destabilising contagion effects on some of the larger Eurozone economies. Borrowing costs for both Spain and Italy have risen to unsustainable levels and it is clear that the crisis has moved beyond the periphery of Europe.

The financial markets remain unconvinced about the adequacy of the firewalls erected to prevent the crisis from spreading as well as the political will of governments to resolve the crisis. The changing sentiment in this regard has resulted in a high degree of volatility in global financial markets, and this has spilled over to emerging markets, including South Africa, impacting on capital flows, exchange rates and commodity prices.

The global growth environment also deteriorated over this past financial year. Initially it appeared that the recovery in the advanced economies was gaining momentum, but during the second half of 2011 growth slowed down in the euro area with almost half the members experiencing negative growth by first quarter of 2012. The growth slowdown has been reinforced by continued fiscal austerity and bank deleveraging, while unemployment - which varies considerably between different member countries - continues to reach new Eurozone-era highs. As this negative spiral intensifies, it is likely to become less economically and politically sustainable.

More recently weak growth has spread beyond the Eurozone. The United Kingdom remains in recession and the outlook for the United States has also deteriorated as growth slowed in the second quarter of this year. The so-called fiscal cliff is already beginning to impact negatively on consumption and investment decisions in that country. It is estimated that failure to resolve this issue could lead to a fiscal contraction of around 4 percentage points of GDP, with negative consequences for growth.

Some of the large systemically important emerging markets, including China, India and Brazil, have also slowed markedly this year. Commodity prices have declined as a result, reversing the strong upward trend seen in the second half of last year. International oil and food prices have moderated in the first half of this year, contributing to a more benign global inflation environment. However, there are risks to the global inflation outlook posed by the recent drought-induced increases in grain prices in the United States.

Policy responses to these developments have been constrained in many countries by unsustainable sovereign debt positions. The lack of fiscal space to respond to the current phase of the crisis has resulted in increased, and in some instances unrealistic, expectations being placed on central banks. Unfortunately central banks are limited in what they can do, and it is important that central banks, the South African Reserve Bank included, focuses on what it can do and not what some would like us to do.

In many cases implicit mandates, particularly with respect to financial stability, have now been made more explicit. The extension of the Bank’s mandate to include responsibility for financial stability should be seen in this context. During the past year the Bank has remained focused on carrying out its various mandates: to achieve its primary mandate of price stability in support of sustainable growth; to contribute to a stable financial system at a macroprudential level; and to ensure the stability of the banking system.

The domestic growth outlook has also deteriorated largely due to the global uncertainties. These linkages are mainly through the trade channel and lower commodity prices. The Bank’s growth forecasts have been revised down, with growth still below potential, and downside risks to the outlook. At the time of the previous AGM, the Bank was forecasting a growth rate of 3,9 per cent for 2012 and 4,4 per cent for 2013. The most recent forecasts now show forecasts of 2,7 per cent and 3,8 per cent for these two years, and the MPC viewed the risks to these forecasts to be on the downside. The deteriorating outlook has been reflected in declining business and consumer confidence and most of the forward looking indicators are negative. Household consumption expenditure, which had been the main driver of growth in 2011, has moderated. But of greater concern is the anaemic growth of 1,8 per cent in private sector gross fixed capital formation in the first quarter of 2012. The manufacturing sector is also slowing, with the mining and construction sectors remaining under severe stress.

Monetary policy was faced with the challenge of dealing with increased inflation pressures in this subdued domestic economic growth environment. Headline inflation moved above the 6 per cent upper end of the target range in November 2011, driven by exogenous factors, mainly food, electricity and petrol. International oil prices were impacted by stronger global growth and geopolitical factors, although this trend was reversed in April and food price inflation also moderated. Initially it was anticipated that the rate of inflation would remain outside the target range during the whole of 2012, but it now appears that inflation may have peaked at 6,3 per cent in January 2012. Year-on-year inflation measured 5,5 per cent in June and is expected to remain within the target range on a sustained basis over the forecast period, averaging around 5 per cent in both 2013 and 2014

Given the subdued domestic economy, the risks to the inflation outlook are mainly of a cost-push nature. At its most recent meeting in July, the Monetary Policy Committee (MPC), indentified food prices as being an upside risk to inflation, a result of US grain price developments, which have already impacted on domestic maize and wheat prices. The exchange rate, while volatile, has been relatively resilient, particularly in the face of strong inflows to the domestic government bond market, which year-to-date have totaled around R62.5 billion. However, we are seeing significant daily swings in both directions. Overall the MPC assessed the risks to the inflation outlook to be fairly evenly balanced.

Given the lack of domestic demand pressures on inflation as reflected in well-contained core inflation measures, and the persistently negative output gap, the monetary policy stance has remained accommodative. The repurchase rate had been unchanged at 5,5 per cent per annum since November 2010. However at the July meeting, the MPC felt that in the light of the relatively benign inflation environment, and the downside risks to the growth outlook, further accommodation would be appropriate and would not undermine the Bank’s primary objective of price stability. Accordingly the repurchase rate was reduced to 5,0 per cent per annum.

There has been much speculation as to whether this was a beginning of a renewed interest rate easing cycle. This interest rate reduction should, however, be seen as part of the continued monetary policy response to the crisis that began in 2008. Previously we had thought that we were at the bottom of the interest rate cycle, although we had indicated that the monetary policy stance was likely to be unchanged for some time. However, as the global and domestic environment failed to recover in line with expectations, and as the outlook has deteriorated, a further response was seen to be appropriate to ease the strains in some sectors of the economy. Further monetary easing is not automatic and will be highly dependent on global and domestic developments.

The Bank's financial stability mandate has been a strategic focus during the past year. Progress has been made in moving towards a twin peaks model of financial regulation, which will see the consolidation and strengthening of all prudential regulation of financial institutions within the Bank, while market conduct regulation of the financial sector will be consolidated and strengthened within the Financial Services Board. A steering committee comprising senior officials from the Bank, the National Treasury and Financial Services Board has been working to give effect to implementing the new regulatory architecture. This broadened mandate has already resulted in a reconstitution of the Bank's Financial Stability Committee as a policy-making body, but will also ultimately have significant personnel and cost implications. On the microprudential front, the banking system has remained stable, with minimal exposure to the peripheral Eurozone economies. The Bank has continued its active participation in the deliberations on banking regulatory reform in the Basel Committee on Banking Supervision (Basel Committee). Amended regulations relating to Banks were implemented in January and progress has been made with respect to the planned phasing in of the Basel III regulatory framework at the beginning of 2013.

The South African banks remain well capitalised, and their required capital ratios are in excess of those required by the revised regulations. The challenges relating to the liquidity requirements have been alleviated somewhat by the Bank clearly stating its intention to make available a committed liquidity facility to assist banks in meeting the liquidity coverage ratio (LCR). This facility covers up to 40 per cent of the LCR which should enable the banks to meet their liquidity requirements while at the same time reduce their vulnerability to possible shocks. The introduction of the Net Stable Funding Ratio (NSFR) in 2019 is expected to be more of a challenge, but the details of these requirements are currently subject to negotiation and are still to be finalised.

The Bank continued with its policy of building its stock of foreign exchange reserves. In the 2011/12 financial year the Bank, in conjunction with the National Treasury, purchased approximately US$4 billion of foreign exchange for this purpose. The process of sterilising the impact of these purchases on domestic liquidity contributed to the Bank reporting an after-tax loss of R490,5 million, compared with a loss of R1,2 billion in the previous financial year. The losses arise due to the extremely low rates of return available on foreign exchange deposits, while the liquidity is withdrawn by issuing SARB debentures and conducting reverse repurchase agreements at or around the prevailing repo rate. Some of the costs of sterilisation were delayed by swapping a portion of the purchases into the forward market. However, what also contributed to the losses incurred this financial year was the significant actuarial loss incurred in meeting the post-employment medical benefit liability as at 31 March 2012.

Going forward, the deteriorating global situation and heightened expectations of central banks will pose continued challenges for us. The International Monetary Fund (IMF) recently revised down its forecasts for global growth in 2012 and 2013. While these downward revisions were relatively small, the downside risks were seen to "loom large", and predicated in part on appropriate policy responses in the Eurozone to resolve the crisis. The situation looks increasingly precarious. A quick resolution to the Eurozone crisis is unlikely, and this poses continuing risks to our own growth prospects. At the same time the Bank needs to remain vigilant to inflation and financial stability risks, and to respond appropriately in line with our mandate. We will continue to implement policy in a responsible manner and will strive to remain a beacon of stability in a turbulent environment.