South African Reserve Bank

African economic and financial development in challenging times

Keynote address by Mr Lesetja Kganyago,
Governor of the South African Reserve Bank

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Introduction

Ladies and gentlemen, good afternoon.

Allow me to first thank both the Institute of International Finance and First National Bank, our hosts, for inviting me to address this latest instalment of the IIF-FNB Africa Financial Summit. I am particularly honoured to join the impressive list of speakers and panellists.

I have been asked to deliver the keynote address yet I do not want to pre-empt the debates that will follow. So, I will first try to summarise some of the challenges that our continent is facing. And, looking at the Reserve Bank's own experience in the South African context, I will speak about implications for how Africa's financial systems and its developing capital markets can best address these challenges and sustain progress in developing the continent.

New global challenges for the African continent

There is no denying that Africa is facing a more challenging global backdrop than in recent years; my colleague from the Bank of Tanzania, Governor Ndulu, as well as this morning's panellists have already discussed some of these challenges. I will not dwell on them in detail, but would like to emphasise three key points.

First, global growth again is disappointing. We heard last month how forecasters at the International Monetary Fund, or IMF, again downgraded their outlook for world economic growth: it is expected to reach 3,1 per cent this year, down from the 3,8 per cent expected a year ago. This decrease in expected growth is in keeping with the times, but it raises the concern about whether the weak growth is structural. Earlier this year, the IMF highlighted how medium-term growth expectations (five years ahead) had been steadily revised down since 2010, in both advanced and emerging economies.[1]

The fact that potential growth rates are falling makes explicit our global problem and the apparent inability of the world's economy to fully recover from the global financial crisis of 2008. Rather, over the years, the crisis seems to have 'morphed' from one of real-estate bubbles and lax underwriting standards, mostly in the US, to one of unsustainable debt burdens in the periphery of the eurozone, and now to one of excess corporate leverage and deteriorating macroeconomic conditions in several regions of the emerging world. Policy responses appear uncoordinated between regions, addressing some immediate problems but also fuelling imbalances and exposing policy contradictions elsewhere.

Looking at the mix of slowing growth and high private-sector leverage in emerging Asia, in particular China, some observers wonder whether the world may face a repeat of the 1997-98 Asian crisis. Such concerns may prove excessive: in contrast to 1997, Asian sovereigns are financially more solid, with stronger reserve buffers and – a point I will return to later – more flexible exchange rates, which have limited the build-up of external imbalances. Nonetheless, the era of lofty growth rates in Asia, driven by the fast expansion of China's industrial sector, is most probably over – and this is a factor that African countries will have to take into account as their terms of trade weaken and export volumes decline.

My second key point relates to the first, insofar as it deals with the outlook for commodity prices. When expressed in inflation-adjusted terms, the composite indices of commodity prices (like the Reuters-CRB index) are back to levels seen in

[1] International Monetary Fund, 'Where are we headed? Perspectives on potential output', *World Economic Outlook*, Washington DC: International Monetary Fund, April 2015.

the early 2000s, providing evidence – in case there was still doubt over the matter – that the commodity ‘super-cycle’ of the last decade has by now truly reversed.

It is likely true that other factors have exacerbated the decline in commodity prices: the rise in supply and financial factors, including the strength of the US dollar. However, a central driver of that decline has been the slowdown in demand from key marginal importers, the largest being China. It seems sensible to me to take at face value the Chinese authorities’ aim to rebalance their economy away from investment, and for that reason it would be unwise for African commodity exporters to bank on a strong price rebound in coming years.

Finally, I would like to emphasise the potential challenges arising from the eventual normalization of monetary policy in the US. We know the debate remains open as to when this normalization will actually start and that the forecasts are for a gradual normalization. However, I fear we have been lulled into complacency by the years of abundant liquidity and a ‘search for yield’. Even a gradual unwinding of easy financing conditions will create greater competition for funds globally. The timing is not good. Sub-Saharan African countries have increased their funding needs by and large, and the potential for needs to increase is high as countries try to sustain spending even as growth, terms of trade and financing costs deteriorate.

South Africa has not been immune to these challenges. With world demand sluggish and commodity prices declining, we have seen a loss of 9 per cent in our terms of trade between the third quarter of 2011 and the second quarter of 2015. The current-account deficit widened to as high as 5,8 per cent of GDP in 2013. And, while we saw a significant narrowing since (to as low as 3,1 per cent of GDP in the second quarter of this year), the Reserve Bank still expects a fairly large external shortfall in the next two years, worth close to 4,5 per cent of GDP. Net direct investment flows not far from zero, the country remains highly reliant on net portfolio inflows for the smooth financing of that deficit. Our statistics show a continued solid net portfolio inflow in the first half of the year, but JSE data paint a more challenging picture in the past two or three months, coinciding with renewed downward pressure on the currency.

Currency implications and how to deal with them

Downward pressure on the rand, as on many other emerging and African currencies, should not come as a surprise. When portfolio flows dry up (or reverse), the ex ante financing of large current-account deficits becomes problematic. What is more of a debating point, however, is *how* to deal with such currency depreciation.

Back in the 1990s, many emerging countries opted for more or less stringent systems of fixed exchange rates (crawling pegs, hard pegs, currency boards), generally in the hope that such systems would help to get rid of perennial high inflation, bolster international policy credibility, and provide a strong basis for increased foreign investment flows. At first, fixed exchange rate systems did bring about some decline in inflation. However, they equally allowed the build-up of imbalances as they prevented the adjustment of relative prices to terms of trade, external demand shocks, and different productivity growth rates. In addition, they encouraged speculative, ‘hot money’ inflows which aimed to benefit from positive interest rate differentials while the fixed exchange rate held. Eventually, as the experience of the 1997-98 Asian crisis or the 2001 Argentinian default showed, most peg regimes had to be abandoned before policy credibility was restored – though not without a significant rundown of official reserves, a severe inflationary shock, and a need for painful austerity measures.

While we never had a formal fixed exchange rate regime, South Africa experienced some version of these problems in the early years of our new democratic dispensation. As South Africa reintegrated into the world economy, with import tariffs and capital controls significantly reduced, the prices of our major commodity exports declined, resulting in intense downward pressure on the real exchange rate of the rand. With inflation volatile and still high, the Reserve Bank intervened to stem the depreciation of the currency. But these attempts resulted in the country running a large net open forward position in US dollars – the same development that had triggered large-scale economic and financial turmoil in some Asian countries in 1997. It was only when South Africa moved to an inflation-targeting regime in 2000 and let the market determine the value of the currency relative to macroeconomic fundamentals that the sustained downward pressure on the currency eased. The contradiction between policy effort and macroeconomic fundamentals was removed, and slowly these also started to improve. Gradually but steadily, inflation moved downwards. Inflation expectations became more stable. And the Reserve Bank was able to wind down its forward position and rebuild a proper reserve buffer.

Currency depreciation has always been trickier for economies that are more dependent on few export lines and require greater currency stability to keep inflation in check. For this reason, historically, many economies in Africa used currency pegs of one sort or another. Many have now moved away from that approach, opening up a channel that might help to address external shocks. With commodity prices falling, sub-Saharan African economies face a potential worsening of their internal relative price balance between tradables and non-tradables.[2] Assuming that inflation falls with declining export prices, moderate currency depreciation will help economies to rebalance and resume growth. Where inflation is persistent and economic growth weak, however, currency depreciation can exacerbate the stagflation and has less clear policy implications. It seems sensible to allow floating currencies to absorb external shocks, to maintain policy stances that do not worsen imbalances, and to move towards the microeconomic reforms and network infrastructures needed to help export diversification and sustain investment by the private sector generally.

The experience of the Reserve Bank and reserves management

The depreciation of South Africa's currency has been in line with that of commodity exporters and other emerging markets, and substantial. So far this year, the rand has depreciated by 16 per cent against the US dollar. While the pass-through of such depreciation has been more muted than in previous cycles due to weak economic growth and moderate food price inflation, the Reserve Bank has nonetheless been closely monitoring any second-round effects from that depreciation. Aware of the risk that already-high inflation expectations are moving higher and of the overall loose stance of monetary policy, the Bank has raised interest rates by a cumulative 100 basis points since January 2014. The stance supports the economy while mitigating the risk of higher inflation. This represents a welcome contrast to the pre-inflation-targeting era when policy was tightened (by

[2] The International Monetary Fund (IMF) has recently projected that the region's terms of trade will drop by about 14 per cent in 2015.

690 basis points) and large US-dollar liabilities built up in an effort to more directly target a sharply weaker exchange rate.

Our approach to the currency has been qualitatively different. In agreement with National Treasury, we unwound US-dollar liabilities and built a positive reserve position over time, with the objective of bolstering the national balance sheet and ex ante reducing the risk of financial and/or liquidity crises. Our official reserves remain rather low by most metrics and by overall emerging-market standards.

For African countries now facing lower commodity prices and a more challenging global financial environment, the quality of a nation's external balance sheet seems of paramount importance. African central banks have slowly rebuilt reserve buffers over the last few years, but they remain relatively low by overall emerging-market standards. And as the global environment continues to worsen, policymakers need to focus more on the prudent management of external liabilities in order to maintain investor confidence.

The growing role of financial stability

Let me now say a few words about the role of financial stability and about the growing importance of stable, healthy and well-capitalised banking systems – as my colleague, René van Wyk, will no doubt discuss in greater detail in the next session. It was partly thanks to the prudent management of banks' external exposure, on both the asset and the liability side, that South Africa was able to weather the shock from the 2008-09 global financial crisis without suffering severe domestic banking stains and, consequently, limit the duration and depth of its recession.

Similarly, it was in part thanks to our prudent supervision of South Africa's banks and their prudent management of risks that we weathered the global financial crisis as well as we did. In the recent past, South African banks have taken active steps to comply with the pending Basel III regulations, increasing in particular their ratio of liquid assets to short-term liabilities as the liquidity coverage ratio, or LCR, was phased in from 1 January 2015.

For sub-Saharan Africa as a whole, issues of financial stability were mostly subsumed by the extension of financial services, reflecting in part the lack of depth in the credit markets in many countries of the region and hence the limited role that bank lending has played as a policy transmission mechanism and driver of inflation. However, things have been changing in that domain too. Credit growth has been particularly strong in several countries of the region in recent years, and while credit deepening is a welcome development, it also, if unchecked, carries risks. The IMF, in its *Regional Economic Outlook for sub-Saharan Africa* released on 27 October, points out that episodes of unusually high credit expansion tend to be associated with increases in financial risk and that phases of falling commodity prices are often linked with a deterioration in banks' financial heath, such as a higher rate of non-performing loans or a decline in the returns on banks' equity.[3]

Chances and pitfalls from growing capital markets

Admittedly, the financing of the economy, including in the emerging world, has long ceased to rely solely on banks, and capital markets have grown in the sub-Saharan African region in the past decade or so. In an environment of ample central bank liquidity and low returns on financial assets in the developed world, governments in the region have been able to take advantage of greater investor appetite for 'frontier' markets. From negligible levels prior to 2009, sovereign bond issues in sub-Saharan Africa rose to more than US$6,0 billion in 2014.[4] Similarly, the number of countries rated by the major agencies rose from only 4 in 2003 to 17 in 2014. By 2014, the stock of outstanding sovereign bonds in the region had risen to around US$18 billion, though it is still small at 1,1 per cent of regional GDP. Furthermore, development in African capital markets has not been limited to sovereign bonds. Global flows into the region's equity markets, while still very small compared to other regions, nonetheless grew in importance relative to the size of the recipient economies.

[3] International Monetary Fund, 'Where are we headed? Perspectives on potential output', *World Economic Outlook*, Washington DC: International Monetary Fund, April 2015.
[4] J E Tyson, *Sub-Saharan Africa international sovereign bonds: investor and issuer perspectives*, Overseas Development Institute, January 2015, available at http://www.odi.org/sites/odi.org.uk/files/odi-assets/publications-opinion-files/9435.pdf.

The flow of capital into Africa is critical to its ongoing development. Access to capital has been greatly enhanced and a more competitively priced supply is currently offered, moving away from a reliance on official-sector financing. However, to ensure that benefits to borrowers are maximised, it is important that financing be transparent and that risk be fairly priced. Furthermore, where lending is overly risk-averse, the development of corporate bond, equity or even venture capital markets can facilitate the expansion of a private, medium-sized business sector. Finally, over time, as financial markets grow across the continent, one can equally expect to see increased cross-border portfolio and direct investment flows within sub-Saharan Africa, helping to facilitate regional economic and financial integration.

These gains in hand, we need to be mindful of the risks associated with external portfolio financing. A tightening of financial conditions in the developed world can easily prompt international fund managers to reduce their exposure to frontier markets. What is then a small portfolio adjustment for a large US- or Europe-based fund, however, can result in significant price action on a small and relatively illiquid sovereign debt market. Rising foreign-currency external liabilities equally expose a sovereign’s balance sheet to currency depreciation, limiting the benefits I described earlier of foreign-exchange adjustment as a ‘shock absorber’.

In that respect, an increased focus on developing local-currency bond markets and on equity financing may present a solution to the risk of excessive foreign-currency leveraging. In South Africa, the existence of a large and liquid domestic government bond market, with long-maturity instruments, has limited the rise in foreign currency-denominated debt, even as our country has experienced large current-account deficits. The ratio of foreign-exchange debt to GDP stood at 26,8 per cent by the first quarter of 2015, up from 12,2 per cent in 2010. Had South Africa not been able to attract foreign capital inflows into rand-denominated bonds and equities, this ratio would have risen further.

In sub-Saharan Africa, however, growth in local-currency bond markets has been stymied by the absence of a large and diversified domestic investor base, undeveloped secondary markets, and the lack of liquidity of many instruments.[5] In most cases, moreover, the issuance of local-currency bonds has been limited to the sovereign. Where local bond financing consists mostly of domestic banks, the buying of government securities will tend to crowd out finance for a large number of private businesses and/or for much-needed infrastructure projects.

In this respect, it would be desirable to see the growth in domestic securities markets occur alongside an expansion of the domestic investor base through incentives for longer-term savings via life insurance products, pension and provident schemes, and mutual fund investments. A deep domestic investor base can also act as a 'buffer' when non-resident investors reduce their investments. In South Africa, for example, yields on ten-year rand government bonds have increased by only 30 basis points since the start of 2014, even as (according to data from the JSE) non-residents sold domestic bonds to the tune of R60 billion over the period.

If sub-Saharan Africa is to see a healthy expansion of both international and domestic investments in its securities markets, the region requires a strong governance structure, proper regulation and supervision, and adequate reporting and auditing standards in these markets. We should not underestimate, for instance, the impact on South Africa's ability to attract and retain foreign investments from our strong performance in this respect. Indeed, in the *2015 Global Competitiveness Report* published this September by the World Economic Forum, South Africa continued to score first, among 140 countries, on criteria such as 'financing through local equity market' and 'strength of auditing and reporting standards'. We came second in the regulation of our securities exchanges and third in the protection of minority shareholders' interests.

Conclusion

In conclusion, let me emphasise that the new challenges which our continent is facing, while real, are not insurmountable and, if properly handled, need not preclude continued solid economic growth in the years ahead. Major progress has been made

[5] See, for instance, M Mecagni et al., 'Issuing international sovereign bonds: opportunities and challenges for sub-Saharan Africa', *Departmental Paper 14/02*, Washington DC: International Monetary Fund, 2014.

in a range of areas that are critical to long-term economic development, not least of which was attaining a much more sustained level of macroeconomic stability across much of the region. This has been built on steady improvement in policy formulation and institutional development, but also on some favourable trade winds. These are now changing direction as commodity prices fall, so it is essential that policymakers double their efforts to sustain foreign interest in our economies and encourage diversification. Central to this effort, it seems to me, must be supporting financial and capital market development, deepening what we already have, and building robust regional linkages between our markets.

Thank you.