South African Reserve Bank

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Building resilience

Distinguished guests, ladies and gentlemen. It is a great pleasure to be here.

The recent World Economic Outlook highlights that although global economic conditions remain benign, in recent months growth in both emerging and advanced economies has begun to decelerate. At the same time, risks to the global economy are tilted to the downside, linked to both political and financial developments. An important element of managing risk in such an uncertain environment is to focus on building macroeconomic resilience.

My comments today will be centred around that theme. In particular, I'd like to share some thoughts around how emerging market central banks can contribute to economic resilience.

I will begin by outlining a broad definition of resilience in the macroeconomic context. In addition, I will put forward some principles that can underpin a policy framework aimed at supporting resilience. I will then discuss the experience of emerging markets and finally South Africa in addressing vulnerabilities and building macroeconomic resilience.

Resilience conceptualised

When thinking about economic resilience, it is important to focus on two distinct issues. The first is about how an economy responds to adverse shocks.

The other relates to an economy's propensity to avoid these shocks. As such, resilience can be defined as minimising both the depth and the frequency of economic downturns.

Resilience is important because the incidence of a downturn may influence the future growth potential of an economy. Indeed, there is a growing body of scholarly evidence indicating that recessions are associated with permanent output losses.[1] In particular, the longer output remains below its pre-crisis trend, the less likely it is to return to that trend. Containing shocks and minimising their frequency could, therefore, produce lasting benefits.

Another important justification for striving to achieve macroeconomic resilience is that it can shield the most vulnerable in society from adverse outcomes. We know that lower-income families and smaller firms are less able to smooth consumption during downturns. As a result, negative

[1] See, for example: Cerra, M and Saxena, M. 2017. 'Booms, crises, and recoveries: a new paradigm of the business cycle and its policy implications'. *International Monetary Fund Working Paper No. 17/250.*

shocks can have severe and lasting effects on the economically vulnerable, even if the aggregate output loss is relatively small.

In thinking about resilience, we do, however, need to be guided by some broad principles.

Resilience principles

Since the global financial crisis, many central banks have seen an expansion of their mandates. The South African Reserve Bank (SARB) has been no exception, as we have recently been given the significant, but shared, responsibility for promoting financial stability.

The expanded mandate comes with a larger policy toolkit. Consequently, central bankers face a distinct challenge in coordinating their monetary, exchange rate and financial stability policies.

One useful way of achieving coordination is by assessing whether a particular policy mix is supportive of macroeconomic resilience. To facilitate this, I would like to suggest four key principles, which should underpin any policy framework aimed at promoting and sustaining macroeconomic resilience.

In short, policy should aim to increase the flexibility of an economy in response to shocks, to be countercyclical as far as possible, to be consistent, and attempt to contain negative externalities.

Let me expand on each principle briefly.

On the topic of flexibility, various policies can be undertaken to ensure that an economy is able to adjust to changing conditions in a way that minimises disruptions. Within the realm of central banking, this calls for a focus on the way in which financial shocks propagate through an economy. For example, ensuring that the banking sector is liquid and well capitalised improves the ability of banks to finance projects through the cycle. Having buffers in place to reduce shock amplification also frees up policy space.

This leads me to the second principle, which is countercyclicality. The scope to support an economy during a downturn, and curb exuberance during a boom, is a key element of resilience. The Keynesian revolution in economics popularised monetary and fiscal stimulus during recessions. Now, central banks are increasingly introducing countercyclical macroprudential policies. Although the theory clearly supports this approach, there are significant challenges in achieving countercyclical policy outcomes. I will elaborate on some of these challenges later in this speech.

Next, let me briefly expand on the principle of consistency. It is very important to regulate same activities in a similar way. This reduces opportunities for regulatory arbitrage and avoids the inefficiencies associated with gaming regulation. Similarly, in monetary and macroprudential policy, a consistent and predictable reaction function ensures that policy itself is not a source of significant uncertainty.

The final principle is that of addressing negative externalities. Economic downturns are often caused by exuberance in prior periods, be those strong capital inflows or rapid increases in private credit. What such episodes often have in common is the tendency for private actors to expose the broader economy to undue risk. This is a so-called negative externality because the persons taking the risk do not bear the full economic cost, should the risk materialise. As a result, more risk than is socially optimal is undertaken in the absence of regulation. It is therefore necessary to have a policy framework that incentivises, the alignment of private and social interests as far as possible. There are a number of areas in which this principle is currently being explored. For example, some jurisdictions regulate the variable pay of bank CEOs[2], to limit their incentive for risk taking.[3]

I think that, by applying these four principles, central bankers can craft a set of policies that appropriately reinforce resilience.

Let me turn now to a discussion of resilience within emerging markets and South Africa specifically.

Resilience in emerging markets

Reforms

Since the crises of the 1990s, emerging market policymakers have undertaken a number of key reforms to reduce external vulnerabilities and build macroeconomic resilience, many of which have been in the spirit of the principles I have just outlined.

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[2] chief executive officers
[3] See, for example: Cerasi, V, Deininger, S, Gambacorta, L and Oliviero, T. 2017. 'How post-crisis regulation has affected bank CEO compensation'. *Bank for International Settlements Working Paper No. 630.*

A particularly important policy choice has been to reduce the risks associated with foreign currency-denominated debt. One strategy has involved building foreign exchange reserve buffers and working with international organisations to strengthen the global financial safety net. Indeed, over the past 20 years, global foreign exchange reserve assets have grown more than sixfold,[4] with the bulk of the growth driven by emerging market economies. Meanwhile, bilateral swap lines and regional financing arrangements have grown in prominence, complemented by increased International Monetary Fund (IMF) resources.

A supporting strategy has involved structural reforms to limit reliance on foreign currency debt. This broadly includes the development and deepening of domestic capital markets, as well as legal and institutional reforms to address frictions impeding bank credit growth. The shift towards local-currency borrowing in emerging markets has provided an important layer of resilience against external shocks.

There has also been a concerted effort to enhance monetary policy frameworks and stabilise inflation at lower levels. Many countries, including South Africa, have opted for an inflation-targeting framework in order to shift the public's focus away from the exchange rate as a nominal anchor. By moving the focus to a stable inflation anchor, it has become easier and less costly to contain inflation shocks. Reduced inflation risk has also helped to support credit growth, particularly at longer durations. All of which has been positive for resilience.

[4] This is total reserve assets including gold. (Sources: IMF and World Bank.)

Linked to the change in monetary policy frameworks has been an increase in exchange rate flexibility. Such flexibility has introduced greater scope for monetary policy countercyclicality and has allowed the exchange rate to play a role in absorbing shocks.

Meanwhile, most emerging market economies have undertaken some form of financial sector liberalisation, be it increasing private involvement in the sector, reducing controls on capital flows, or increasing the extent to which markets determine the price of credit.

We, however, must acknowledge that while these reforms have provided important benefits, in some cases an excessive pace of capital account liberalisation has been associated with heightened volatility and even crisis. But, generally, the research on this topic shows that the adverse effects associated with capital flow liberalisations have tended to be concentrated in those countries where financial development is relatively low.[5] This indicates that the sequencing of reforms is also an important consideration.

Challenges

Despite significant improvements over the past 20 years, emerging market central banks continue to face challenges in building and sustaining macroeconomic resilience.

As I've alluded to earlier, procyclicality has been difficult to avoid in some countries. Indeed, we continue to see central banks give in to the

[5] Furceri, D, Loungani, P and Ostry, J. 2018. 'The aggregate and distributional effects of financial globalization: evidence from macro and sectoral data'. *IMF Working Paper No. 18/83.*

temptation of providing stimulus, even when an economy is operating near full capacity. This is particularly prevalent in countries that lack central bank independence.

However, other challenges related to procyclicality are also present. For example, there are significant difficulties in measuring business and financial cycles in real time. This has been compounded by substantial changes in potential growth across various parts of the world in recent years.

A further source of procyclicality is that many emerging market central banks have not had the luxury of considering only domestic conditions when setting policy. The widespread emerging market currency sell-off in 2013 was a prime example of an exogenous shock that forced procyclical tightening in some countries. Nevertheless, that episode also provided an important lesson. Those economies that had created policy space by anchoring inflation expectations were under less pressure to act in a procyclical fashion.[6]

An associated challenge with respect to policymaking is that of data gaps. These preclude regulators from accurately monitoring risk and making cross-country comparisons. Such gaps may also be exploited by firms seeking to avoid regulation. Policy challenges in this area are exacerbated by developments in cybersecurity and financial technology, which pose new types of risk.

[6] Bems, R, Caselli, F, Grigoli, F and Gruss, B. 2019. 'Gains from anchoring inflation expectations: evidence from the taper tantrum shock'. *IMF Working Paper No. 19/75.*

But, the familiar problem of elevated debt level poses the greatest risk to resilience. Since 2008, private non-financial sector debt in emerging markets has more than tripled to almost US$40 trillion.[7] While China has played a significant role in this outcome, the trend of rising private debt has been broad-based. Furthermore, benign financing conditions have supported substantial foreign currency borrowing in a number of key economies, increasing debt risks. This is a real challenge to resilience because a large debt overhang can amplify adverse shocks and weaken recovery.

Let me now turn to the resilience of the South African economy.

Resilience in the South African context

I believe that South Africa's macroeconomic framework has contributed to significant resilience in spite of various challenges. In particular, the combination of a floating exchange rate, inflation targeting and sound prudential regulations has helped to contain externalities and has provided for significant flexibility to macroeconomic shocks.

South Africa has been an exception to the trend seen in other emerging economies of late. It is one of only a few countries that have experienced a decline in private sector debt over the past decade. Despite receiving strong capital inflows after the global financial crisis, bank credit extension has remained relatively muted. Instead, capital inflows have largely found their way into listed assets and bonds. Indeed, foreign ownership of

[7] Source: Bank for International Settlements

domestic government bonds has increased significantly, from 22% in early 2011 to approximately 38% today.

Flows into the bond market have supported substantial public sector borrowing. General government debt, as a share of GDP[8], has more than doubled over the past decade. At 56% of GDP, gross public debt is relatively high by emerging market standards. The trajectory and size of this debt implies a lack of fiscal space. However, the National Treasury has taken a number of steps to contain the negative externalities associated with the debt. For example, the average maturity of the outstanding debt stock has been increased to about 15 years, reducing rollover risk, while almost 90% of the debt is denominated in rand.

Similarly, South Africa’s private debt is mostly in domestic currency. The economy’s large banking sector, alongside deep capital markets, has provided a stable source of local-currency funding, allowing the corporate sector to keep its foreign currency liabilities low.[9] Furthermore, in the spirit of containing externalities, the SARB has in place a number of prudential limits on the banking sector with respect to foreign currency risk. For example, domestic banks are required to keep their net open foreign currency position below 10% of their capital.

As a result, South Africa’s foreign liabilities are largely in local currency, while its foreign assets are nearly all foreign currency-denominated. This structure makes the flexible exchange rate a powerful shock absorber. In addition, full exchange rate flexibility reinforces the structure of the economy’s liabilities by disincentivising foreign currency borrowing.

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[8] gross domestic product
[9] Foreign currency-denominated debt of the non-bank private sector is approximately 8% of GDP.

Given the make-up of South Africa's assets and liabilities, periods of exchange rate weakness have been associated with an improving net international investment position (IIP). The IIP itself has been further supported by strong growth in domestic equity investments abroad. Consequently, South Africa belongs to a small group of emerging market economies with a positive IIP.[10]

As a result of the shock-absorbing capacity of the exchange rate, the SARB has not had to actively utilise its international reserves since adopting inflation targeting in the year 2000. Instead, we have opted to gradually rebuild the country's reserve buffers, having faced substantial losses while defending the currency during the 1990s. The SARB currently holds approximately US$50 billion in gross international reserves, largely as a precaution against severe market dysfunction.

This level is regarded as being well below the IMF's assessed reserve adequacy. However, at about 15% of GDP, the SARB holds a similar level of reserves (relative to the size of the economy) as various other large emerging markets do – a level which for many countries exceeds the IMF's assessed reserve adequacy. Furthermore, as I have mentioned, South Africa's foreign currency debt levels and IIP are better than many of its peers.

Indeed, a key driver of South Africa's assessed reserve shortfall is the large share of portfolio liabilities. The extent to which we should hold reserves against these liabilities is a subject of debate, particularly

[10] The IIP was 16.3% of GDP at the end of September 2018.

because the SARB does not actively intervene in the exchange rate. Nevertheless, we remain committed to reserve accumulation and will continue to grow our reserve assets on a measured basis.

The fact that capital inflows have been directed largely towards listed, local-currency investments has both positive and negative dimensions for resilience. On the negative side, portfolio investment is believed to be a more volatile source of funding, potentially exposing the economy to the risk of rapid capital flow reversals. Furthermore, the disproportionate demand for financial assets has, in the past, reflected relatively weak domestic GDP growth and a perceived lack of direct investment opportunities.

On the positive side, however, foreign procurement of listed assets means that asset prices adjust rapidly to changing demand. Fast price discovery is key for ensuring that capital flow volumes remain intact even as global conditions fluctuate. Indeed, we often observe counterbalancing behaviour by domestic residents during periods in which foreign investors are selling assets. This is usually prompted by sizable asset price changes, which encourage domestic investors to repatriate capital from abroad.

Moreover, the international demand for South Africa’s financial assets is an indication of the relative strength of our financial markets. Daily foreign exchange turnover, for example, is among the largest of any emerging market economy (when measured as a share of GDP).[11] This ensures a high level of liquidity for portfolio investors.

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[11] IMF Article 4 Assessment of South Africa (2018)

Improving the depth and sophistication of the domestic financial markets has been a joint effort between the authorities and the private sector. One of the most important outcomes associated with more complete markets is enhanced sharing and allocation of risk. For example, there are relatively liquid currency hedging opportunities in South Africa, which means that foreign investors can acquire local-currency assets even if they do not wish to have exposure to the rand.

Now let me turn to the banking sector, which we believe to be a key pillar of macroeconomic resilience. The sector is well capitalised, with ample liquidity. It was strong enough to withstand the global financial crisis without any bank failures or recapitalisations required. Presently, South Africa's regulations are broadly compliant with Basel III.

To further build on the resilience of the financial sector, the SARB, alongside other regulators, is currently introducing deposit insurance and a resolution framework for banks and other systemically important financial institutions. Deposit insurance is expected to reduce the risk of retail bank runs, while the resolution framework will formally introduce the possibility of private creditor bail-in. Both regulations will limit the public cost of bank failures. This is particularly important for preserving fiscal space.

Moving to monetary policy, the introduction of inflation targeting in 2000 has steadily improved the anchoring of inflation expectations and has reduced the level of inflation. In recent years, the SARB has been attempting to steer inflation expectations closer to the midpoint of the 3-

6% inflation target range. We believe that this will improve policy flexibility and increase the scope for countercyclicality.

However, while much has been done to boost domestic resilience, a number of challenges remain. Rising public debt and the threat of further sovereign credit rating downgrades pose risks to both the financial sector and the real economy. In particular, these developments have already lifted longer-term borrowing costs and adversely affected private investment. Furthermore, should a crisis materialise, the scope for fiscal stimulus will be very limited – a fact which further underscores the importance of creating monetary policy space.

Perhaps the biggest threat to the economy’s resilience is the presence of various binding structural constraints. These have given rise to persistently low GDP growth. The SARB estimates that South Africa’s growth potential is a little over 1% at present. This pace of growth is insufficient to address the high level of inequality and joblessness in the country. Aside from eroding growth potential, structural challenges are a real threat to resilience because they reflect a substantial degree of inflexibility in the economy. Various reforms are therefore required if South Africa is to grow faster and become more resilient. However, these are beyond the remit of the SARB.

Concluding remarks

To recap: I believe that central banks can play an integral role in building economic resilience. In particular, this can be achieved by operating in a countercyclical fashion, ensuring policy consistency, addressing financial sector externalities, and putting in place policies that increase the flexibility of an economy in response to shocks. Of course, the central bank's contribution is necessary, but not sufficient, to ensure broader economic resilience. Well-functioning product and labour markets as well as sound fiscal management are also key.

Thank you.