Remarks by Dr Mnyande, Chief Economist and Executive General Manager of the South African Reserve Bank, at the launch of the *Financial Stability Review* on 6 May 2009

Invited guests, members of the press and colleagues from the South African Reserve Bank.

It is my privilege to welcome you to the release of the latest *Financial Stability Review (FSR)* of the Bank.

The purpose of this publication is to identify and analyse potential risks to South Africa's financial system stability, and to communicate such assessments in an endeavour to stimulate serious debate about pertinent financial stability issues and their implications for overall economic activity.

The Bank has been publishing the *FSR* on a six-monthly basis since March 2004, making this the eleventh edition. However, with this edition the Bank enters a new phase: it is the first time that the *FSR* is officially launched at a press conference. This is in line with other major publications of the Bank, such as the Bank's *Quarterly Bulletin, Monetary Policy Review and Annual Report.*

Raising the profile of this publication in this current global environment gives the Bank an additional tool and opportunity to communicate its views about the stability of the South African financial system, which has, in the most recent years, become critical to the understanding of the overall global financial system. The global financial crisis, which started in mid-2007, has compelled the Group of Twenty (G-20) countries, among others, to raise the level of transparency regarding financial system arrangements.

Thus, this press conference serves as a concrete manifestation of the growing importance of financial stability as a central bank function, alongside its conventional and primary function of maintaining price stability. This greater emphasis on financial stability is a global trend and one that we expect will change the way in which central banks conduct their business. As we speak, internationally much attention is being given to central banks' role in promoting and preserving financial stability - in the context of both supervision and policy. Various central banks have also restructured and enhanced their legal mandates to give full effect to these responsibilities.

In a supervisory or macroprudential context, central banks, as agreed by both the International Monetary Fund (IMF) and the Bank for International Settlements (BIS), should have the capacity to

- identify systemic threats at an early stage;
- promote measures to reduce these threats;
- develop and test contingency plans and crisis preparedness; and
- in extreme cases, implement safety net measures to support systemically important financial institutions, maintain confidence in financial markets and restore the efficient functioning of markets.

In a policy context, a central bank's financial stability function is complementary to, rather than in conflict with, its monetary policy function. Greater emphasis on financial stability issues certainly does not imply that the Bank would pursue these objectives at the expense of price stability. The major central banks that have intervened in unprecedented ways and to astounding amounts in markets in pursuit of financial stability have categorically stated that these interventions should not be inflationary, and proper exit strategies should be formulated in order to prevent them from becoming so.

In our case, the Bank has increased the frequency of meetings of the Monetary Policy Committee from every second month to monthly this year, in order to monitor internationally and locally both the real and financial economic developments on a more frequent basis. We are therefore simultaneously and continuously reviewing the role that the Financial Stability Department plays in this process, and this was one of the key topics for discussion at the recent Strategic Planning Session of the executive and senior management of the Bank.

The financial stability and monetary policy functions of a central bank are complementary, primarily due to the linkages that exist between the two: monetary policy implementation becomes impossible in the absence of well-functioning markets and an effective transmission mechanism. This is a topic for discussion at the next monetary policy strategy meeting of the Bank, which will be held early in June. Furthermore, recent experience internationally has shown the severity of the cost associated with unsustainable asset bubbles when they burst.

It is for these reasons that monetary policy-makers here and elsewhere have to take cognisance of systemic developments - such as unsustainable asset price increases that do not reflect fundamentals, over-leveraging, liquidity pressures and excessive credit growth. As mentioned earlier, the purpose of the *FSR* is to highlight any such developments, and to review regulatory aspects that could impact on financial markets. At this point, allow me to proceed with a short summary of the key issues that are raised in this edition.

Since the release of the September 2008 *FSR*, the global financial crisis has intensified. Many industrialised economies have fallen into recession and emerging-market economies (EMEs) now appear much less immune to the effects of the deepening recession in these major economies. Global deleveraging, sharp declines in international trade and a so-called flight to quality by investors have taken their toll on output growth and have markedly reduced investors' demand for EMEs' financial assets.

Key risks in the global recessionary environment that are feeding back into the financial system include a decline in net lending to households and businesses, lower corporate profits, higher default rates, further losses in equity markets, weaker property and commodity markets, and volatility in currency markets. Monetary authorities in some industrialised countries have provided liquidity support and reduced their policy rates drastically to help restore confidence and increase credit extension, and several governments have announced fiscal stimulus packages to support the crippled domestic demand.

The G-20 leaders (of which South Africa remains a key member) agreed on a Global Plan for Recovery and Reform at the London Summit in early April 2009[1] to repair the global financial system, restore confidence and lending, and to avoid a prolonged deep global recession. This plan is also aimed at benefiting economic growth in EMEs and in other developing countries, including those in Africa. The G-20 meeting stressed specific economic, financial and social risks stemming from the financial crisis, which are summarised in a box in the *FSR* on page 8.

The general conclusion of this edition of the *FSR* is that South African financial markets have so far been spared the worst of the direct effects of the recent global financial calamity. Analysis will show that the South African banks have maintained levels of capital well in excess of the already prudent regulatory requirement, and their degree of leverage and their off-balance-sheet risk exposures have been much lower than those of the failed banks in other G-20 countries.

Evidence will also reveal that South African banks have primarily felt the impact of the global financial crisis indirectly, through higher funding costs and increased impairments. Higher funding costs and increased impairments are, however, also attributable to the negative impact of the lower real economic activity on borrowers, following years of high credit growth. Fortunately the South African banking sector

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[1] G-20 Communiqué from the London Summit. 2 April 2009. The Global Plan for Recovery and Reform.

was further shielded from developments in global financial markets by its limited exposure to foreign currency-denominated assets, and by its limited dependence on foreign currency-denominated funding liabilities.

Notwithstanding this, conditions in the South African financial markets and banking sector have deteriorated in recent months. Share prices on the JSE Limited have declined, foreign portfolio investment flows reversed and impaired advances of banks increased as the profitability of financial institutions declined somewhat. However, these developments, as we are all aware, have mainly resulted from the spill-over effects of the international financial crisis, rather than from direct exposure to toxic assets from some major economies, liquidity squeezes in the domestic banking system, malfunctioning South African financial markets, funding constraints on banks, excessive leverage in the financial sector or the effect of currency depreciation on foreign debt.

As evidenced in the recently released South African Reserve Bank *Quarterly Bulletin*, the global economic slowdown has also impacted on real economic activity in South Africa. South African financial and non-financial entities are experiencing pressures as a result of the global financial turmoil and the slowdown in economic activity. Some firms, particularly in mining and manufacturing and notably in the motor industry, retrenched a significant number of employees in the first quarter of this year – leading to an increase in the unemployment rate by 1,6 percentage points from the fourth quarter of 2008 to 23,5 percent in the first quarter of this year.

In the fourth quarter of 2008 confidence in the financial sector dropped to its lowest historical level and the business confidence level also declined significantly. In the first quarter of 2009 though, this was ameliorated by factors such as reduced interest rates, lower petrol prices, a relatively stable rand exchange rate and a stimulatory National Budget announced in February 2009.

The uncertainty in financial markets and the more pronounced slowdown in the economy from the third quarter of 2008 affected consumer confidence and undermined the outlook for consumption. Consumption expenditure continued to be subdued as households reduced spending and postponed their purchases of mostly durable goods. Although there has been a moderation in the growth rate of household debt, households remain highly indebted. Since the previous *FSR*, there have been continuing signals of financial distress in the household sector which has been mainly aggravated by further negative economic shocks or what seems to be a sustained slowdown in the real economy. Nominal house prices have started to decline amid high borrowing costs and more stringent lending criteria by financial institutions. Fears continue of further retrenchments in certain sectors of the economy. Recent reductions in interest rates may of course moderate the slowdown in the property market.

An effective regulatory infrastructure is integral to the smooth functioning of a financial system. The domestic regulatory infrastructure should keep abreast of international developments in the financial system and, as such, is subject to continued change and enhancement. Developments in the financial infrastructure and regulatory environment that are likely to strengthen the resilience of the financial system include new legislative developments to improve competition, consumer protection and corporate governance. Implementation of relevant findings of the joint IMF/World Bank 2008 Financial Sector Assessment Program (FSAP) evaluation of the South African financial system should further contribute to the resilience of the South African financial system. An overview of the findings of the FSAP mission is presented in a separate box on page 30 of the *FSR*.

The ongoing programme of local financial development to increase the robustness of the financial system will, to a large degree, be influenced by the international agenda of responses to the global financial crisis. Although the South African financial system has been less affected, as mentioned earlier, South Africa has been active in formal and informal international forums analysing the crisis, and will be expected to respond to relevant regulatory changes deemed necessary to strengthen the global financial system. This may entail matters such as the legal mandate, role and responsibilities of authorities to support financial stability; the scope and design of the financial safety net; cross-border co-operation between regulators; countercyclical prudential requirements; and stronger macroprudential regulation and analysis.

The national payment system (NPS) is a vital component of the broader financial system, and its smooth and efficient functioning is regarded as essential for supporting financial system stability in South Africa. A conceptual description of the risk mitigation measures that have been built into the NPS is provided as a separate section of the *FSR*.

The issue of how to promote financial stability through countercyclical policy measures has become very topical in the current global circumstances and is attended to at various levels in the international regulatory arena. It is increasingly recognised that some of the prudential tools, valuation methods and accounting practices that have been applied have tended to encourage procyclical behaviour, that is, increasing the upswings and exacerbating the downswings. A more detailed discussion on countercyclicality is presented in a box of this FSR issue on page 32.

Finally, the *FSR* contains a note that gives a South African perspective on the global financial market turmoil and central bank intervention. Various aspects and indicators of turmoil in international financial markets are compared to the South African situation. The general conclusion is that, although conditions in the South African financial markets and banking sector have deteriorated in recent months, the international financial crisis has, to date, not resulted in severe instability in the domestic financial system. The Bank did not have to inject additional liquidity into the money market or provide special liquidity assistance to any of the major financial and non-financial institutions in South Africa. Neither did it have to use foreign exchange reserves to intervene in the foreign exchange market. Interbank markets continued to function as normal, both in terms of prices (typically interest rates) and volumes. South African banks were not as excessively geared as some of their distressed counterparts in the developed countries, their off-balance-sheet exposures were modest and their capital-adequacy ratios remained very healthy.

I have briefly highlighted the key issues raised in the *FSR*. Much more detailed analyses are available in the publication itself, and I trust that you will find these interesting, stimulating and relevant to the current environment.

Thank you