South African Reserve Bank

BEYOND THE RECESSION AND GLOBAL FINANCIAL CRISIS – A CASE FOR THE EXPANDED SARB MANDATE

Address by Dr Monde Mnyande, Advisor to the Governor and Chief Economist, South African Reserve Bank, to the Financial Planning Institute of SA, at the Annual FPI Convention, Emperors Palace Convention Centre, 26 May 2010

Master of ceremony and participants in this convention

I would like to thank the organisers for this opportunity and for inviting me.

It is a great privilege and honour for me to share some of my views and those of my colleagues at the South African Reserve Bank (the SARB) on the evolving ideas about the role and responsibilities of the Bank with regard to financial stability, congruent to the more traditional emphasis on price stability. These views will be followed by a brief overview of risks to the outlook, which will also serve as a conclusion.

1. Introduction

Critical financial datasets convincingly confirm that, although South Africa did not suffer the full might of the recent global financial crisis as some economically advanced countries have, South Africa's banking industry and the broader financial sector escaped the most recent financial crisis relatively unscathed – we are nevertheless licking our wounds in the real sector as evidenced by the extensive job shedding in our economy.

Being a relatively small and open economy in which the most recent buoyant economic growth levels were consumption driven, the slump in global and domestic demand, combined with high debt levels, have squeezed South African households.

Debt levels remain too high for us to be able to proudly confirm that we are now out of the woods. Credit extension is low at present. Business demand for credit is weak since sales and confidence are down. Furthermore, the business sector has been challenged by the still-tight access to credit though recently the credit criteria applied by the banking sector have eased somewhat.

As long-term financial planners, nobody knows better than you the importance of financial stability in business planning assumptions. Most financial planning models, such as those of modern macroeconomic models based on the general equilibrium view used by macro-economists, assume some validity of extrapolating past trends into the future in order to forecast future financial needs and find ways to achieve them.

They do not, as a rule, factor into their forecasting models the kind of turmoil that the global financial system has experienced during the past three years. A financial crisis presents a scenario that one can hardly plan for, and which can frustrate all efforts that had been put into sound financial planning.

There is at least one thing in the world that model-building agents, academics, macro-economists, financial analysts and the chorus of policy-makers agree on: It is that a repetition of the type of crisis that started in 2007 must be avoided at all costs. Many lessons have been learnt, and there is much to digest in terms of proposed new regulation and policy instruments aimed at maintaining both price and financial stability.

At the outset, I should state that the debate about these issues in South Africa and more specifically, at the SARB is, to a large extent, still in an evolutionary stage. This is partly because the South African financial system for historical, circumstantial and fundamental reasons has not been directly impacted by the global financial crisis.[1]

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[1] The banking sector is highly concentrated, but with modest leverage ratios, relatively limited securitisation activities, low foreign currency exposure and low foreign funding reliance.

We do acknowledge that there was also a bit of good fortune involved in our escape of the worst direct effects of the financial crisis and, therefore, we cannot afford to be complacent. We remain in unchartered territory: On the global front, the sovereign debt challenges panning out in the euro area have put us on the alert. The continued appetite among foreign investors towards the emerging markets – interspersed with occasional jitters – leaves us with a volatile exchange rate and capital flow patterns that are not necessarily sustainable, even though they help to finance our current-account deficit.

The recent financial crisis calls for all policy-makers and market operators to make a joint effort that ensures the relatively speedy recovery in the financial markets of affected economies. This has been done to prevent further spiralling of systemic risk that would have negatively impacted the welfare of individuals, corporates and that of countries.

Allow me therefore to briefly give a schematic account or an overview of the watershed declaration made by the Group of Twenty (G-20) countries to strengthen the regulation of the financial markets, marking the commencement of a co-ordinated global effort. I do so fully cognisant that you are all aware as financial planners that assumptions underpinning income projection and risk models depend partly on the stability and predictability of global and domestic markets; hence I will outline the progress made towards the incorporation of financial stability in the SARB's mandate.

The section that follows focuses on a framework within which various policy instruments are co-ordinated to prevent systemic risk before it leads to a financial crisis. Before finally closing by considering the risks to the outlook, my address briefly confirms the growing importance of this sector in South Africa and the manner in which it has been adapting to international developments.

2. Declaration of the G-20 on strengthening of financial regulations and institutions

The crucial lesson that the world leaders and authorities quickly came to grips with during the recent financial crisis was the importance of policy co-ordination by various authorities. The deliberations on policy issues by the G-20 during September 2009 placed sufficient emphasis on the tightening of the regulatory standards and strengthening the effectiveness of financial institutions and supervision that will prevent the build-up of excessive risk in a future crisis. These important considerations were delegated to the Financial Stability Board whose mandate includes, amongst others, the following:

- Monitoring and advising on market developments and their implications for regulatory policy;
- Advising and monitoring best practice in meeting regulatory standards;
- Setting guidelines for support and establishing supervisory colleges;

- Imposing stringent capital requirements for risk-trading activities, off-balance-sheet items and securitised products;
- Managing contingency planning for cross-border crisis management, particularly with respect to systematically important firms; and
- Collaborating with the International Monetary Fund (IMF) to conduct Early Warning Exercises.

The latest *Global Financial Stability Report* published in April 2010 by the IMF confirmed that the risks to global financial stability have eased as the economic recovery continues to gain momentum. Nonetheless, households and corporates continue to spend cautiously with more focus being on reducing their debt levels and recapitalising their balance sheets.

The report, however, warned that the resurfacing of sovereign risk in some developed countries, in particular Greece, Ireland, Italy, Portugal and Spain or the GIIPS countries, could reverse some of the gains already made in stabilising and restoring the health of the financial system.

The deterioration of fiscal balances in these countries raises concern over the sustainability of their governments' balance sheets, which could eventually lead to short-term strains in capital markets as creditors require a high premium to compensate for the higher risk. Authorities in these countries together with the IMF have put some measures in place to shield the financial sector from yet another collapse.

We recognise our good fortune of having escaped the direct effects of the financial crisis. Like elsewhere and typical of a cyclical downturn, the global slowdown had some negative effects on the South African economy in general and on asset prices in particular. This created a negative feedback loop to the financial system in the form of lower profitability of financial firms, rising credit impairments and subdued lending activity, all of which, in turn, weighed adversely on real economic activity.

It would therefore be unwise, in the light of developments both locally and globally during the past three years, to rest on our laurels and not move along with endeavours to strengthen the global financial system and our domestic environment and financial stability framework.

3. The SARB’s mandate and financial stability

The heightened prominence of financial stability and its role in ensuring the preservation of the wealth of households’ assets in the G-20 agenda encouraged central banks to review the role of financial stability in their respective economies and to consider its incorporation in their core mandate of maintaining price stability.

The SARB has always recognised its role in promoting and partly contributing to financial stability in the country. It has had a dedicated Financial Stability Department since 2001 that serves to enhance the surveillance capacity of the macroprudential or systemic integrity of the domestic financial system and prevailing international trends; to identify systemic risks in both the domestic and international environments; to assess the robustness of the regulatory environment; and to review and test contingency plans to handle crises in the financial sector going forward.

As with other similar functionaries around the world, macroprudential analysis is a developing science for which robustness is growing in leaps and bounds, and as a member of the Bank for International Settlements, the SARB remains at the cutting edge of international best practice. In fact, other members are looking to South Africa for some best practice models.

In his February 2010 open letter to the Governor of the South African Reserve Bank, Ms Gill Marcus, the Minister of Finance, Mr Pravin Gordhan, re-emphasised the importance of a stable and well-regulated financial sector, as well as the need for the SARB to establish an in-depth understanding of the banking sector and financial system as a whole.

The sturdiness and imperviousness of the domestic banking sector to the crisis are testimony to the proactive stance of South African authorities’ oversight approach. A great number of us consider it crucial to strengthen the microprudential strides achieved so far by ensuring that they dovetail and are compatible with the macroprudential sphere of the financial system.

The other crucial and challenging interface for policy oversight is between financial and price stability. The SARB continues to explore this dimension by considering macro- and microprudential trends in its Monetary Policy Committee meetings.

4. Macroprudential approach and its features

In an effort to cushion our economy from the impact of the recent and future financial crises, the SARB has intensified its pursuit of a conscious macroprudential framework. The financial crisis prompted the authorities to adopt countercyclical policies that will foster discipline during an upward (and indeed downward) phase(s) of the business cycles. These policies should help to smooth the effects of economic cycles, minimise unintended consequences and direct the reaction of commercial banks and those of other financial institutions towards rational decision-making, rather than fuelling and reinforcing a particular cyclical phase.

Mindful of the importance of asset prices, the financial stability function of the SARB will, in line with international guidelines, attempt to identify and monitor excessive domestic credit extension that could result in self-feeding asset-price bubbles.

Last but not least, in cognisance of the scope of financial stability that extends beyond its immediate function, the SARB intends to focus continuously on the macroprudential approach and to contribute towards a broader range of administrative and policy instruments to deal with specific imbalances.

5. Developments in the domestic financial intermediaries and the role of financial planning

The safeguard measures being put in place are merely an acknowledgment of the pivotal role the financial service sector plays in contributing towards the growth of our economy. Non-bank financial intermediaries act as a conduit for entities with savings seeking investment opportunities in the economy. Their sources of funds *inter alia* include insurance policy premiums, pension contributions, unit trust sales and loans. The SARB is in a privileged position to be able to monitor trends in this sector, both locally and internationally. The assets of non-bank financial intermediaries increased from an estimated R2,3 trillion during the first quarter of 2005 to over R4,0 trillion in the last quarter of 2009. The industry recently recorded quarterly net financial inflows to the tune of R89 billion, from about R58 billion in 2005. Given these large sums of funds available for investment, the country requires the majority of South Africans to understand fully and appreciate the importance of saving and the process of investing. It is of utmost importance to have qualified and skilled financial planners to assist individuals and companies appropriately in making their saving and investment choices that will yield good returns.

As you know, financial planning assists in increasing cash flows while monitoring the expenditure patterns and creating a strong base of capital which would, in the case of corporates and the country as a whole, be reflected in the strengthening of their respective balance sheets. In addition, the Financial Planning Institute can play a significant role in contributing to the establishment of regulation standards in the financial services industry by providing well thought-out, fact-based, constructive and consolidated submissions to authorities.

One of the key responsibilities of the SARB is to anchor inflation expectations and maintain a long-term low inflation environment that will preserve the wealth of domestic investors using a flexible interest rate regime. In pursuit of its inflation-targeting mandate, the SARB is mindful of the important role of real positive interest rates in bolstering the domestic savings culture. Key to this approach is to reflect market conditions that ensure appropriate returns on investments and savings.
I would like to strongly urge you to play a role in the concerted effort to boost the culture of saving and the drive to revitalise and grow the domestic household, corporate and government asset base. On an aggregate level, a country with a high savings ratio can better finance its investment projects without necessarily borrowing externally and creating a negative imbalance on its current account. South Africa’s savings rate deteriorated from an average of about 17 per cent of gross domestic product in the 1990s to an average of about 14 per cent in 2007.

Despite a decline in both the savings rates of the corporate and household sectors over this period, corporate saving remained the mainstay of the overall savings. Somewhat ironically, the savings rate of households and the corporate sector improved during 2009 amid recessionary conditions. During 2009 the savings rate of households improved marginally to 1½ per cent of gross domestic product.

This improvement could probably have been spurred by the desire to neutralise the declining household wealth effects in their asset portfolio which had resulted from slow or negative growth rates in the value of fixed property and a decrease in the value of other asset classes.

In addition, the households spent less in fear of the economic uncertainties at the time. The improved savings rate of the corporate sector was clearly visible when the sector decided to declare fewer dividends and recapitalise its balance sheets instead.

The loss of wealth incurred in the value of assets of households highlights the significance of a financial planner's diversification or asset allocation strategy. The choice of asset allocation has a huge bearing on the level of the exposure and the overall financial stability of the country.

In this regard, the SARB will continue to be transparent in its conduct of monetary policy and ensure that the market information is disseminated to all market participants at the same time. An appeal and advice from monetary authorities would be for financial planners to discourage households from funding or acquiring financial assets by incurring liabilities, as these will exaggerate the value of underlying assets and could increase the possibility of systemic risk. Clearly, we all have a role to play.

6. Risks to the outlook

As expected, the proposed amendments and approach to policy considerations cannot be implemented without some element of risk. The most apparent uncertainty is the remaining risk facing the banking sector, especially in some parts of Europe. The developments in the GIIPS countries should caution financial institutions to continue to build their capital base, to strengthen their balance sheets and prepare to meet future higher capital requirements if so required. The issues of transparency in terms of the balance-sheet positions and the exorbitant compensation of executives remain a risk factor in financial systems.

The other risk dimension stems from the possibility of reversal of capital flows to emerging-market economies. The asset prices of most investment classes in which financial planners invest the funds are driven by the sentiments of investors. Currently, investors are taking advantage of interest rates in most emerging and commodity producing economies, as well as the growth prospects of these economies as projected in the recent *World Economic Outlook* published by the IMF in April 2010. The potential risk in this regard is the upturn in the interest rate cycle of the advanced economies and the reduction in the margins thereof.

Although conditions in global financial stability have eased somewhat, the recent weeks have been associated with the elevation of systemic risk from financial sector risk to sovereign risk. The remarkable fact at this point of the global cycle is that global capital markets are relatively liquid compared with the first quarter of 2009, but there is a growing tier of sovereigns and the worsening of public debt sustainability could be transmitted back to the banking systems.

The uneven and uncertain recovery in global economic activity continues to be supported by large-scale monetary and fiscal stimulus conducted by various authorities. Nevertheless, forecasts of economic growth in 2010 and beyond have improved significantly over the past year. In some countries, increasing emphasis is being placed on appropriate exit strategies from the extraordinary and unprecedented crisis-related intervention policies.

Although part of the risk to the outlook is more embedded in developed economies, such risk is certainly a threat to the domestically owned assets invested abroad and that are priced in US dollar and other foreign currencies. Thus, financial planners need to be vigilant of the developments in international markets in order to act appropriately at all times.

Relying on credit rating agencies to assess various assets and asset classes is very useful but such information has limitations, and is often more retrospective in nature. For this reason, financial planners are encouraged to subscribe to and invest in information-gathering packages that are pre-emptive to be able to manage the wealth of economic agents in the country efficiently.

In conclusion and more critical for all of us as financial and economic agents is that we must be willing to learn and understand clearly the lessons from the recent global financial crisis, and the experiences and/or outcomes of our past recession which should strengthen our co-ordination of policies promptly and coherently if we are to mitigate any future economic, financial, or currency crisis.

I thank you.