South African Reserve Bank

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Introduction

Good morning. It is a pleasure for me to address this Annual Sovereign Funds Roundtable hosted by the Sovereign Investor Institute and Institutional Investor, and to continue where yesterday's presentations and debates left off. Management of foreign exchange reserves and other sovereign funds have indeed become a highly challenging task in the past few years. It is an environment for which economics and finance textbooks did not prepare us, like negative interest rates, quantitative easing and long-term forward guidance on monetary policy. In my remarks today, I will first briefly allude to how these international developments have come to influence economic and policy developments, including reserves management, in South Africa. Before discussing how reserves managers can look for alternative investments, in particular in sub-Saharan African countries, I shall then dwell in somewhat more detail on how the SA Reserve Bank handles the issue of capital preservation in a world of ever-declining yields.

Economic environment and challenges for South Africa

The economic situation facing South Africa, as well as a large number of emerging economies, remains rather challenging. Six years after the "Great Recession" triggered by the global financial crisis, the domestic economy has yet to return to the pace of growth that prevailed in the middle of the previous decade. In the last five years, real GDP growth in South Africa has averaged only 2,4 per cent per annum, compared with 4,8 per cent over the 2002-07 period. Furthermore, the long-awaited meaningful acceleration in activity remains elusive, and year after year, both official and private sector forecasters have kept scaling down their growth prospects for the year ahead. For example, at the beginning of 2013, the SA Reserve Bank anticipated 3,8 per cent growth in 2014 but recent estimates show the economy only grew by 1,5 per cent. Similarly, at the time of the January 2014 Monetary Policy Committee meeting, the Bank anticipated growth of 3,3 per cent in 2015; this projection has now been scaled down to 2,2 per cent. And the National Treasury's 2015 Budget, released two days ago, only foresees GDP growth of 2,0 per cent this year and 2,4 per cent next.

Yet several developments would appear supportive of stronger growth. Both nominal and real policy rates are still near decades' lows, even after the cumulative 75 basis-point increase in the repo rate in 2014. Admittedly, the recent decline in headline inflation has pushed the ex-post real repo rate back into positive territory. However, when compared to inflation expectations one-year ahead (5,9 per cent according to the Bloomberg consensus) or the Reserve Bank's own forecast for 2016 inflation of 5,4 per cent, the real policy rate remains near zero. Loose global financial conditions have pushed capital flows toward higher-yielding markets and thereby providing financing for our fiscal and current account deficits. Another consequence of this "search for yield" has been to boost prices of South African financial assets; thus, long-term bond yields and earnings yields on JSE-listed equities are unusually low, easing the cost of financing for both public and private sector. Finally, both actual and expected inflation have displayed more stability than in earlier cycles, despite a pronounced depreciation of the rand over the past three years.

So then, why is South Africa still mired in what can only be described as subdued growth, compared to the type of expansion that would be needed to make a significant dent in domestic unemployment? Why is the economy failing to produce the pace of growth that would help reduce public debt ratios? According to the Budget, this ratio will only stabilize in 2017/18, despite a tightening in the fiscal stance worth about R52 billion, or 1,7 per cent of last year's GDP, over the next two years. Part of the answer lies in global conditions, and the disappointing performance of the world economy in 2014. Just like domestic growth forecasts that were scaled down, so were forecasts for most of the world's largest economies. But domestic factors also played a key role, not least structural factors such as electricity shortages and insufficient skills development. The decline in prices of South Africa's major commodity exports for most of 2013-14 also weighed on economic activity, dampening corporate sector earnings, undermining employment and fixed investment prospects, and keeping the current account deficit at an elevated level.

Will the global environment be more supportive in 2015 and 2016? At first glance, several factors appear encouraging. International institutions project somewhat faster global growth, albeit with downside risks. For example, in its January update to the World Economic Outlook, the IMF expected world output to accelerate to 3,5 per cent in 2015 and 3,7 per cent next year, from 3,3 per cent in 2014. At the same time, the lower oil price will bring relief to consumers and producers alike.

However, the global environment will continue to bring challenges. First of all, the global economic outlook remains both uncertain and uneven across major regions. For example, indications point to a continued moderation and re-balancing of the Chinese economy, which may further weigh on the outlook for industrial commodities, offsetting in part the benefits to South Africa from cheaper oil. At the same time, monetary policy divergences between the major economies may cause tensions within the global financial system, including significant currency shifts as witnessed by the marked appreciation in the US dollar since mid-2014.

Such potential developments complicate the task of a central bank like the SA Reserve Bank, not only in its role as monetary policymaker but equally in its role as a manager of official reserves. How should a central bank address cross-currency volatility, and in particular deal with US dollar appreciation at a time when the trend has been towards a diversification to non-dollar currencies? How can a central bank improve its return on reserves in the current low-yield environment, without jeopardizing its prudential mandate? How should it protect itself against a possible rise in risk and term premiums across a broad range of assets? These are questions I will now attempt to answer, with reference to the Reserve Bank's experience.

Investment of central bank reserves and risk management

The solid growth in the SA Reserve Bank's foreign currency reserves portfolio over the past decade, from what was initially a negative level when netted off with the oversold forward foreign exchange position, was primarily due to reserve accumulation during a phase of strong foreign capital inflows throughout the pre-crisis boom years. However, market conditions have changed considerably. With world economic growth still in the doldrums, capital inflows have become more volatile and public finances are more stretched. This means that not only is it more challenging to accumulate reserves due to the higher cost of holding reserves, but managing them has become complicated.

In the past, capital preservation, which is the key objective of official foreign exchange reserves management, was achieved with relative ease by investing in fixed income securities and holding them to maturity or enjoying capital gains as yields fell in response to improving credit profiles. The opposite scenario has prevailed in recent years. Credit ratings for many government, government agencies and corporations have been downgraded, reflecting less certainty about timely receipt of principal and interest. Loss sharing between taxpayers and investors in the event of a bail-out of a failed bank, or even when governments are bailed out themselves, has become accepted practice. It is a world where the safe-haven status of bonds has become eroded, at least in perception, if not in practice.

This leaves us with the key question of what should comprise a strategic asset allocation in order to achieve capital preservation, or indeed whether we need to redefine how we interpret and pursue capital preservation.

Interpreted literally, capital preservation means ensuring that you do not incur a loss. By extension, it means reserve managers have very limited appetite to be exposed to risk. However, what is a central bank to do when it must take risk simply to prevent making a loss or to preserve capital, as is the case now with negative yields in the highly-rated countries such as Germany? In this case, a purchaser will get less money back than what it invested in the first place, and so, capital is lost.

The most common response to lower and negative yields has been for reserves managers to lengthen the benchmark duration of the portfolio. By lengthening duration, fund managers want to enjoy the benefit of the higher-yielding longer dated assets. In doing so, one can avoid the very low or even negative interest rates seen in the front part of the curve. Another common way to achieve the higher yield is to introduce more risky assets in the portfolio, either through investing in new asset classes like mortgage-backed securities, or to lower the minimum acceptable credit rating for issuers and deposit-taking counterparties. However, all of these actions introduce new forms of risk, ones which not too many years ago were seen as unpalatable. Very specifically, lengthening duration while yields are at historic lows introduces significant risk to the portfolio at a time when the debate is on the timing of normalization in US policy rates. And the same can be said of lowering the credit standards as credit spreads are tight by historical standard, for as the policy rates normalize, these spreads are at risk of widening.

This is the nucleus of the paradox facing reserves managers. If we chase flat or positive returns at all cost, we introduce the very risks that we have tried to avoid for so many years. So the question becomes whether we should view capital preservation as an absolute or relative principle. If it is absolute, then the reserves manager must pursue non-negative returns at all cost. However, perhaps some consideration should be given to risk-adjusted returns, and if the risk is deemed too high, then one should simply accept negative returns in the short term and enjoy the benefit of the better risk profile. In such a paradigm, buying German bonds with negative yields could be seen as more prudent than searching for higher yielding bonds when there is a reasonable risk of a higher negative total return due to revaluation effects.

Does this mean there is no room for riskier assets in a reserves portfolio, as we are now willing to hold negative yielding assets? The answer lies in the level of reserves, the income and capital appreciation needs, and the risk tolerance of the reserves manager. For a central bank with reserves lower than its ability to cover its short term known and contingent obligations (referred to here as the core reserve requirement), its efforts must be towards ensuring that it keeps it reserves liquid and freely available for meeting obligations. Central banks who find themselves in this position will have limited room to enhance returns through the diversification into riskier assets. The currency composition for this category of central bank should be derived from the currency of its potential and actual obligations and the typical instrument would be bank deposits, Treasury bills, short-term government and agency bonds.

A central bank that has reserves in excess of this core requirement can consider investing the extra portion in assets that offer higher yields, although these must still be liquid enough to liquidate should the need arise. The ideal overall return objective for reserves management is typically to ensure that the overall return covers the cost of holding the reserves. However, this objective should be pursued with due consideration to risk, as an all-out pursuit to recover this cost may require substantial risk taking for countries that have high domestic yields.

As the overall size of reserves increases relative to the core requirement, the central bank may consider managing the portion of reserves that are well in excess of the core requirement under a different regime. At a general level, one can view this as the group of central banks who have enough reserves to cover capital outflows at a two or more standard deviation level. This is where the role of a sovereign wealth fund becomes relevant, or if the reserves are managed within the central bank, they are invested with a higher return objective. The important point is that for all central banks, we have now come to a point where the risk of capital loss due to negative yields is a reality, but the higher the level of reserves, the greater the freedom to apply stratified risk tolerances to negate the impact of negative yields.

How then should we express capital preservation in this environment? With yields close to historic lows, the popular measure of Probability of Negative Returns has become less useful. Many reserves managers will target a Probability of Negative Returns below a certain level, based on an appropriate time horizon and confidence interval. However, the low yields naturally increase the probability of a loss, forcing the duration of a portfolio even shorter. Consequently, this metric has become problematic and many central banks and other official reserves managers have started using the conditional value-at-risk (CVaR) statistic to measure the maximum expected loss that the reserves may incur. Its advantage is that it gives a lower bound on the losses that may be incurred on the reserves. Therefore the CVaR provides more certainty in in case of a “black swan” event happening.

At the SA Reserve Bank, as is typically the case with other central banks, we perform risk-return simulations under different economic and stress scenarios to determine the most suitable asset class combination within our risk tolerance. This is commonly known as the Strategic Asset Allocation. The traditional investment universe has been fixed income, usually government bonds. But as per the previous discussion, central banks need to consider other asset classes that in portfolio context would improve the risk-return profile of reserves while at the same time being mindful of downside risks. Surveys conducted by various institutions indicate that while some reserves managers have shifted their reserves out of the traditional reserves currencies in search for yield, other investors are willing to keep funds in low yielding safe-haven currencies such as the Swiss franc.

Indeed, the SA Reserve Bank recently began strategically investing in alternative asset classes such as mortgage backed securities, covered bonds and Chinese local-currency debt. This was done in a measured manner, through the adoption of new risks while still recognizing the need for capital preservation. The Bank has reviewed the separation of its reserves, which now comprise two tranches – the Liquidity Tranche and the Investment Tranche. The Liquidity Tranche is invested in gold, Special Drawing Rights, short-dated government bonds and cash of currencies that represent our potential obligations. This portfolio is constructed in a manner that allows for quick liquidation should the need arise. This tranche has a short investment horizon and is managed with a low risk tolerance. The Investment Tranche, while adhering to the core objective of capital preservation, is structured in a way to achieve a higher return, subject to risk tolerance constraints prescribed by the Bank, and has a longer investment horizon. In this Tranche, investments include longer term government bonds, mortgage and asset backed securities, covered bonds and corporate bonds, and allows for more diverse currency composition.

While extending the investment horizon and the introduction of new instruments and currencies in the Investment Tranche brings new avenues to enhance the return on overall reserves, it also creates the risk of losses over short time horizons, thereby potentially being in conflict with the capital preservation tenet. Diversification is used to mitigate against this risk.

Central banks that have accrued significant excess reserves relative to the core requirement, have the opportunity to diversify into more risky but less correlated assets, such as equities or even listed property. For some, this diversification may include investing into the sub-Saharan region. However, as no African currency is currently classified as a reserve currency, this diversification is likely to be restricted to countries that have established sovereign wealth funds. In light of this, I would like to conclude my speech by briefly discussing the prospects for the Sub-Saharan African (SSA) region.

Prospects for Sub-Saharan Africa

For several years now, SSA has been the topic of many studies and analyses, and commentators have occasionally described it as the "new frontier" or the "continent on the move." And there are genuine justifications for investors to look at opportunities on the continent. First, SSA has over the past decade grown faster than in any other decade since most African countries acceded to independence in the 1960s: According to the World Bank, average GDP growth in 2005-14 is estimated at 4,8 per cent, twice the average of 2,4 over the previous thirty years. Furthermore, unlike in earlier decades, this growth has not been mostly the result of demographic developments but, rather, of faster capital accumulation and stronger productivity growth. It has also been more diversified than in previous growth cycles, with faster expansion, among others, of sectors like retail, banking and mobile telephony.

Second, growth in SSA has been relatively resilient to the Global Financial Crisis: In 2009, when the majority of the world was mired in recession, it continued to expand by a relatively solid 2,0 per cent. Third, it has over the past ten years or so been more stable than in the past, in part a consequence of the diversification of economies and their reduced reliance on drought-prone agricultural production. Fourth, it is still expected to outpace overall growth in the emerging world, helped among others by continued strong public spending on infrastructure, as well as sustained growth in agriculture and services. In 2015 and 2016, the IMF projects SSA growth of 4,9 and 5,2 per cent, respectively, versus 4,3 and 4,7 per cent for emerging market and developing economies. Fifth and finally, these factors, coupled with the high relative returns offered by some SSA investments, have resulted in recent years in frequent decoupling between these “frontier markets” and larger emerging markets, providing an additional opportunity for risk diversification.

This improved growth performance has been matched by market returns. Generally, equity markets continued to gain in 2014, and yields on both local and dollar bonds have stayed low or continued to decline, though some African financial markets have sold off of late, undermined by their exposure to the falling oil price.

Like in any investment, investors must be cognizant of the risks to the economic outlook. I will list a few. First, SSA remains sensitive to the global economic cycle, and in light of shifting international trade patterns over the last ten years or so – in increasing fashion – to the BRICS economies. Second, several relatively large and fast-growing economies will be affected by the lower oil price, although this negative impact on the region will be in part buffeted by the boost to oil importers. In fact, in recent years, African oil importers (excluding South Africa) had already provided a stronger contribution to regional growth than oil exporters.

Third, some SSA countries have witnessed widening current account and budget deficits in the recent past, driven partly by broad infrastructure spending but also by looser public wage policies. Coupled with the region’s economies limited success in broadening their manufacturing base and therefore not diversifying their exports, at a time when the outlook for commodity prices remains uncertain, this exposes some of these economies to exchange rate and asset price correction in the event that global risk aversion suddenly adjusts higher. Finally, geo-politics and the risk of military conflict or spreading terrorist action remains a non-negligible risk factor. While these geo-political risks mostly affect countries within or near the Sahel region and the Horn of Africa, other nations could also become targets of hostile action, for instance as a result of involvement in joint peace-keeping operations.

In conclusion, I would like to stress that the SSA region is likely to keep presenting opportunities for investors in coming years, linked to the demographic dynamics, the structural diversification of economies, and the “catch-up” of the production process towards the technological frontier. But such economic progress is not going to be without hiccups, and the performances of the region’s highly diverse countries are likely to reflect facets of their own idiosyncratic factors, depending among others on policy choices, strengthening of institutions and ability to deal with a less favourable commodity price environment. Investor differentiation has already been the norm in the last couple of years for the more advanced emerging markets and hence, it is increasingly likely to be the same for Africa.

Thank you.

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