A D Mminele: Insulating South Africa against global risks – challenges

Address by Mr A D Mminele, Deputy Governor of the South African Reserve Bank, at the 13th Southern Africa Internal Audit conference, Sandton, Johannesburg, 18 August 2010.

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1. Introduction

Good morning ladies and gentlemen, and thank you to the Institute of Internal Auditors for the invitation to speak at this 13th Southern Africa Internal Audit Conference.

It has been well over three years since the onset of the global financial and economic crisis. As with any crisis, many questions have been asked. Could it have been avoided? What were the causes? What needs to be done to safeguard the financial system in the future? Blame was apportioned everywhere. Central banks were not spared the scrutiny, with some even suggesting that central banks were to blame for having a too narrow focus in the fulfilment of their mandates. It is argued that low policy rates, as a result of low and stable inflation, created the necessary environment for excessive risk taking. Others blamed the crisis on a lack of proactive risk management practices. While there is no risk management system that can provide absolute assurance that events such as the financial crisis will not occur, it certainly did heighten awareness about risk management practices of companies. There is little doubt that the expectations of the internal audit profession have been raised considerably since this crisis.

In my remarks today I shall touch on the evolution of the crisis, discuss some of the key global risks and their impact on South Africa, look at some of the challenges that central banks are facing, and conclude with a few observations around what we need to do to ensure that, as a country, we are resilient and better prepared for future challenges.

2. From sub-prime debt to sovereign debt

No sooner had the global economy emerged from recession in 2009 that it seemed there was yet another crisis brewing. Some have argued that we actually never emerged from the crisis and that we were dealing with a continuum and just moved into the next phase of it. Extraordinary policy measures implemented by governments and central banks around the world helped lift global output. However, in the process, there was also a significant transfer of debt from the private to the public sector as government spending in advanced economies was ramped up and substantial tax incentives were implemented. The combined effect of slower growth and higher spending was an increase in budget deficits in many advanced economies, to levels in excess of 10 per cent of gross domestic product (GDP). The International Monetary Fund (IMF) projects that as a consequence, public debt ratios will most likely increase from around 70 per cent of GDP to average approximately 110 per cent of GDP in 2014. While credit standing, funding conditions, and thus the degree of vulnerability vary across countries, we have to remind ourselves that not too long ago, a debt to GDP ratio in excess of 60 per cent was viewed to be bordering on fiscal irresponsibility, much as we are facing exceptional circumstances that require exceptional solutions.

As the European sovereign debt crisis intensified, it increased the likelihood of a systemic financial crisis. The solvency of European banks was questioned, given their large holdings of debt of affected countries. At the end of 2009, European bank holdings of Portuguese, Spanish and Greek bonds totalled EUR1,2 trillion, with a high concentration of holdings by German and French banks[1]. The credit default swap (CDS) spreads of European banks

[1] Europe's sovereign debt crisis: no place to hide?, John Makin, June 2010.

moved in tandem with sovereign CDS spreads, reflecting the exposure of European banks to sovereign debt. Spillovers between sovereigns and the banking system increased market and liquidity risks during May 2010, and in some of the euro area countries, banks became less willing to lend to each other, risk appetite declined and asset prices in financial markets experienced increased volatility. CDS premia in respect of the debt of certain European sovereigns increased substantially.

Market strains have receded somewhat since May 2010, largely due to the EUR750 billion package assembled by the European Union and the International Monetary Fund, and the results of the European banking sector stress tests, which indicated that the banking sector was in better shape than feared.

3. Key global risks

The rise in CDS spreads for various southern European countries, by and large did not affect emerging markets. The stability of emerging markets during the sovereign debt crisis can be ascribed to comparatively low government debt to GDP ratios, better growth prospects and a limited use of countercyclical fiscal policy during the global recession. Furthermore, the prognosis looks good as the public debt ratios in emerging markets are expected to decline from around 60 per cent of GDP to 40 per cent over the next four years.

Although emerging markets came away relatively unscathed from the recent debt crisis in Europe, problems in advanced economy debt markets could very easily spill over to emerging markets, as we have already seen on numerous previous occasions. A sharp rise in investor risk aversion could lead to funding strains in emerging markets as European banks withdraw cross-border credit facilities. Cross-border bank exposures can be the conduit for spillovers of sovereign risks to banks and for this to spread further to other banking systems in the region and beyond.

Heightened uncertainty about financial sector exposure to sovereign risks and increased funding costs could curtail the supply of bank credit. Lower consumer and business confidence, together with fiscal consolidation, could suppress private consumption and investment. The combination of these forces would derail global growth owing to substantial negative spillovers to other countries and regions due to financial and trade linkages.

Even in the absence of an increase in risk aversion, the process of fiscal consolidation will place most of the burden of adjustment on monetary policies, implying that policy rates in advanced economies would have to remain “lower for longer”. Indeed, the exit from extraordinary fiscal, monetary and financial policies has become more complicated. We have already witnessed the Fed’s decision last week to plough proceeds from maturing mortgage bonds into government bonds, effectively implying a continuation of the quantitative easing policy. In contrast to a situation of heightened risk aversion, such a scenario would result in increased portfolio inflows to emerging markets, intensifying pressure on exchange rates to appreciate with potentially negative ramifications on growth, increasing the potential for asset price bubbles.

4. Impact on South Africa

The financial crisis has shown us that countries such as South Africa with limited or no exposure to toxic assets were also severely affected by developments in the rest of the world. While a stronger budget balance and lower debt ratio did allow some room for countercyclical policy, the South African economy still contracted by 1,8 per cent in 2009 as compared to an average GDP growth rate of 4,9 per cent achieved during the preceding 5 years.

The South African economy emerged from recession in the third quarter of 2009, and growth has since accelerated to 4,6 per cent in the first quarter of 2010. Growth was fairly widespread, with the manufacturing sector playing a strong role, together with commerce and mining and a pick-up in household and government consumption expenditure. While the South African growth trajectory has improved considerably, indications are that second quarter growth is likely to have been less stellar. The Bank's latest projections show that economic growth should average around 2,9 per cent during 2010, with the uncertainties emanating from the global economy posing the main downside risks. CPI inflation has been inside the target range since February 2010, with the outlook being generally favourable, although developments around wage settlements and administered price increases continue to pose upside risks.

The low interest rate environment prevailing in advanced economies has resulted in a consistent search for yield, and as a consequence, South Africa, like other emerging markets, has attracted significant capital inflows. Since the beginning of the year, non-residents have purchased over R75 billion worth of domestic bonds and equities.

The rand exchange rate has been somewhat volatile and in the past two months the rand/dollar exchange rate fluctuated between R8.10 and R7.18. After declining from 45 per cent in October 2008 to 13 per cent in April 2010, historical volatility of the rand increased briefly to 18 per cent in May 2010, but has since eased from these levels. Much of the underlying volatility can be ascribed to changes in global risk aversion related to events in Europe in particular, with significant volatility experienced in the USD/EUR exchange rate. However, it is worth pointing out that the volatility in the exchange rate of the rand has been in line with the volatility observed in respect of currencies of other emerging market and developed countries.

It is generally accepted that currency volatility and excessive appreciation unrelated to economic fundamentals can have an undesirable effect on the domestic economy, through adverse impacts on both the export and import-oriented sectors. While the Bank is cognisant that an over-valued exchange rate over an extended period can be very costly to the economy, it also needs to be recognised that the open nature of our economy makes us more susceptible to all kinds of spillovers from the global economy and financial markets, making any attempts to seek to control the exchange rate at a particular level not feasible. Not having or not seeking any particular target for the exchange rate, however, does not imply that reasonable and responsible steps cannot be taken to manage abrupt adjustments. As we have said on numerous occasions, any actions would have to be consistent with the inflation target. While the rand exchange rate is a critical variable, we need to take a more holistic view to ensure that the overall policy mix is designed and implemented in such a way that policies are complementary in order to raise economy-wide productivity, growth and employment while keeping inflation in check.

5. New challenges for central banks?

Over the past two decades, central banks in advanced and emerging economies adopted monetary policy frameworks with price stability as the primary objective. Monetary policy worked through interest rates and therefore, only influenced current and future expected short-term interest rates, which in turn, impacted on long-term interest rates and asset prices. Central banks were successful in bringing down inflation to levels not seen since the 1950s and were credited with contributing to an exceptionally long period of stable growth[2]. Through focusing on price stability, monetary policy was believed to have contributed to financial stability. The crisis has taught us that too narrow or single-minded a focus on price stability can contribute to unintended outcomes. Conventional monetary policy proved not to be sufficient. Exceptional policy actions had to be implemented which resulted in the

[2] Central banking lessons from the crisis, International Monetary Fund, May 27, 2010.

expansion of central bank balance sheets in advanced economies, in certain instances to more than twice their pre-crisis size.

A number of weaknesses were exposed in the process, in particular, the role of central banks in maintaining financial stability. It is clear that more attention needs to be given to macro-prudential policies and central banks can bring a wealth of expertise and information to increase the effectiveness of macro-prudential policies. Ineffective macro-prudential tools increase the onus on monetary policy to reduce the build-up of financial imbalances and can increase the likelihood that central banks have to provide emergency liquidity, which could ultimately impair their balance sheets and complicate the conduct of monetary policy. It is argued that if macro-prudential policy had been able to increase the resilience of the system, and to moderate the supply of credit to the economy, the crisis could have been less costly.

The debate as to whether central banks should lean against emerging financial imbalances by altering policy rates has therefore been reopened by the crisis. Previously, the argument was that such an approach could lead to inflation volatility, requiring strong interest rate responses and therefore impose high output costs which may be counterproductive in small open economies where high interest rates can attract capital inflows[3]. However, the costs of the financial crisis appear to strengthen the case for using monetary policy to counter asset price bubbles, but much more work is needed on how monetary policy can best deal with the potential conflicts of attaining both financial stability and price stability. Monetary authorities are increasingly shifting towards the view that central banks should be in charge of the micro-prudential supervision of banks, and overseeing systemic risks. However, the crisis also exposed the weaknesses in central bank liquidity management and the need for more flexible frameworks.

6. Insulating South Africa

Given this background, what is it then that South Africa can do to insulate itself against these global risks?

Well-coordinated and sound policies are required going forward. South Africa's macro-economic policies have served us well and the need for fiscal consolidation, whilst important to ensure continued fiscal sustainability, is less pressing if one compares the country to other developed markets. It has already been noted that while countercyclical policy did prevent a more severe recession, our public debt ratio remains comparatively low while there is a clear medium-term plan to reduce the budget deficit.

Policymakers need to monitor at all times global economic and financial sector developments, understand linkages between global and domestic developments, and ensure that policies and regulations are calibrated to allow appropriate responses in a flexible and quick manner.

One of the reasons for South African banks coming out of this crisis in good shape is due to the prudent regulatory and supervisory framework. The G-20, of which South Africa is a member, continues to do much work on financial regulation, through the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS). South Africa is represented on both the BCBS and the FSB as well as various working groups. Consequently, the developments and discussions in international fora are closely monitored to ensure the ongoing alignment of the South African framework with international developments where applicable and appropriate.

South Africa is also an active participant in the Mutual Assessment Process (MAP), a working group formed by the G-20 as part of its work to deal with the impact of the financial

[3] Bank of England, 2009, The Role of Macro-prudential policy.

crisis. The MAP working group was formed to provide the G-20 with a framework for strong, sustainable and balanced growth. Global co-ordination and global responses are required given the nature of the challenges we are facing, but that does not necessarily always imply uniform measures and synchronised timing. Country-specific circumstances must continue to be taken into account.

7. Conclusion

Although the worst of the sub-prime crisis is behind us, it has left behind a legacy of indebted nations, which will complicate the future conduct of both fiscal and monetary policy. These challenges, unless adequately addressed, could derail the nascent global economic recovery. The continued recovery in emerging markets and South Africa in particular, is dependent on how some of the key global risks unfold. Being a small and open economy, it is impossible to insulate ourselves against global risks, however, it is possible to manage the risks and minimise our exposure in such a manner that we are less affected by events such as these. The events of the past two years have exposed an essential need to alter the thinking on global risks and how they are managed.

The financial crisis has determined that there will be "no return to business as usual". The link between the financial sector and the real economy is now considerably stronger than was the case in the past. The attainment of financial stability is heavily dependent on improved regulation and its effective implementation at both the domestic and international levels. The role of the audit profession in this process should not be underestimated.

Thank you.