Daniel Mminele: Monetary policy implementation – the impact of the changing regulatory landscape on the policy transmission mechanism

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Rand Merchant Bank FICC Research Macro Forum, Cape Town, 31 May 2012.

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1. Introduction

Good morning and thank you to Rand Merchant Bank for inviting me to what has certainly been an enlightening morning. The topic I have been asked to address you on is a very interesting one from a central bank policy perspective, and relates to an area of our work in central banking which is still evolving, and the real impact of which remains uncertain.

The two speakers before me provided some interesting insights around the fiscal and political dynamics locally, both areas which in the international context carry a fair share of the responsibility for the current sovereign debt crisis and financial market stresses. It seems quite appropriate to round off the day with a discussion on monetary policy, which has been playing an increasingly central role in recent years, given the limited, and in some cases, exhausted fiscal space, and a seeming lack of political will to meaningfully resolve the crisis. The result of this has been an unprecedented expansion in the demands on monetary policy, which necessitated an enlargement of the toolkit in a manner that one would have thought impossible only a few years ago. However, as we know, all actions have consequences, and while central bankers in many ways can be credited with coming to the rescue when fiscal policy no longer could, there are many challenges going forward, not least of which remains the illusion of unlimited intervention[1] and potential for moral hazard, when to exit from these unconventional measures and ultimately how best to exit without creating another crisis. It seems we keep returning to this question of "exit", only to get derailed again by a further upset or deterioration in the global environment.

In my remarks today I will touch on the costs of an unstable financial system and developments around macro-prudential policies, before I discuss the impact of regulatory changes on the transmission mechanism.

2. The costs of an unstable financial system

The economic and social costs associated with an unstable financial system are well known. Fiscal policy went to extraordinary lengths to try and secure the stability of the real economy and the financial system, but in so doing, was sowing the seeds of the sovereign debt crisis. To remedy the situation in Europe, harsh austerity measures were implemented in order to put public finances on a sounder and more sustainable footing, and to inject the necessary confidence into financial markets. In reality, however, while one cannot doubt that such measures were implemented with the best of intentions, it is doubtful that the desired outcomes are being achieved, and in some instances these measures turned out to be self-defeating. Austerity measures came at the expense of growth, and as a consequence, public finances have not been able to recover as quickly as expected and fiscal deficit targets have not been met. The result has been that the debt crisis has lingered longer than anticipated, and ultimately spread from peripheral Europe to other countries within the Euro zone. Hence there is an argument now raging between those who continue to favour austerity and those who favour less austerity and more stimuli to support growth. The

[1] Monetary policy in the crisis: testing the limits of monetary policy, Herve Hannoun, Deputy General Manager, Bank for International Settlements

austerity versus growth debate has found its way into the political discourse, such that the euro zone fiscal pact is now being challenged with the scales seemingly now tilted more in favour of growth rather than too much austerity. The ideal scenario would some combination of measures that support growth in the short term, but do not put fiscal sustainability in the medium term at risk.

When it became clear that fiscal policy had been exhausted and in some cases over extended, monetary policy had to step in. Interest rates in a number of advanced economies had already been cut to near zero. Central banks found themselves turning to unconventional measures such as quantitative easing or balance sheet policies[2] and conducting large scale interventions in financial markets to resuscitate market segments that were no longer functioning. Liquidity was provided to the dysfunctional interbank and credit market to mitigate a credit crunch and to prevent a complete collapse of the global economy. These policies were used to stabilize financial market tensions and dampen the rise in credit and liquidity risk premia. In short, the balance sheet policies were employed to target overnight and term money-market rates, long-term government bond yields and various risk spreads, with an impact on a wider range of asset prices. Via these channels the central bank actions were meant to be eventually transmitted to the real economy.

These policy actions by central banks have certainly played a significant role, by preventing a higher degree of financial instability and buying some time to get the needed repairs done. Unfortunately, it seems the time bought is not being used in the most opportune manner.

3. Macro-prudential policy

Given the severe repercussions of the financial crisis, the question arose as to whether "it is better to pick up the pieces after a bust or rather to try to prevent the build-up of bubbles"? Olivier Blanchard[3] stressed that "financial intermediation matters" and while markets are segmented and there are specialized investors operating in specific markets, they are all linked through arbitrage. For this reason, a withdrawal by an important investor from a market (segment) might create severe distortions in asset prices and therefore policy interventions will become necessary to restore dislocated prices and to align them with fundamentals. This was quite clearly played out during the US subprime crisis. In this context he argues in favour of preventative measures, rather than to be reactive.

We have learnt firstly that systemic risk cannot be prevented by focussing only on regulation and supervision, and secondly that achieving price stability does not equate to achieving financial stability. Hence, the birth of macro-prudential policy which pursues financial stability as its objective, whereas the objective of monetary policy is price stability. The latter uses interest rates as its instrument, but it is well known that interest rates can be a blunt tool in dealing with excess leverage, extreme risk taking, or unwarranted deviations of asset prices from fundamentals. A combination of monetary and regulatory tools is needed, such as increases in regulatory capital ratios when leverage is deemed too high, or changes in margin requirements to reign in excessive asset price moves. It is true also that macro-prudential policy is not sufficient on its own to ensure financial stability, as we have seen with the euro zone debt crisis, where markets doubted the solvency of the sovereign and in this manner, fiscal policy led to financial instability. Nonetheless, I will focus purely on macro-prudential policy for now.

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[2] Balance sheet policies involve central banks using their balance sheets to influence broader economic and/or financial conditions, particularly when the policy rates have reached their zero limits.

[3] Chief Economist of the International Monetary Fund

In an interview[4], Olivier Blanchard notes that macro-prudential measures are likely to have a more targeted impact than the policy rate on the variables they are trying to affect. Whereas the policy rate is best used primarily in response to aggregate activity and inflation, the specific macro-prudential instruments should be used to deal with specific output composition, financing, or asset price issues. The two policies have different objectives, however, the implementation of macro-prudential policies will have an impact on the transmission mechanism of monetary policy, given that both work through the same channels (bank lending and balance sheets of financial institutions) and focus on the same institutions (monetary and financial).

The question is whether macro-prudential policy will amplify or dampen interest rate cycles? Jaime Caruana[5] noted that the troughs may become less extreme as macro-prudential policies should reduce the likelihood of financial crises and their disinflationary consequences. Similarly, interest rate peaks may be less severe, assuming that macro-prudential policy succeeds in restraining asset price and credit booms. On the other hand, by having to contribute to financial stability and thereby placing additional weight on the risk of imbalances, there may be a need for larger interest rate increases during expansions. Interest rates, he believes, could move more symmetrically over the financial cycle and there would be reduced risk of hitting the zero lower bound and of having to resort to balance sheet policies. As I mentioned in my introduction, this is uncharted territory and there is still much research which is going into this topic. South Africa has not used any macro-prudential tools, but a number of changes have been implemented to enhance macro-prudential policy. These changes include an elevation of the Financial Stability Committee to equal status as the Monetary Policy Committee, as well as the creation of a Financial Stability Oversight Committee, chaired by the Governor of the SARB and the Minister of Finance.

4. The regulatory changes and impact on the transmission mechanism

The global financial crisis has forced a revision of the international regulatory framework. Reform is being implemented in a number of areas, including the strengthening of macro-prudential policies, strengthening the supervision of individual financial institutions, oversight of key market infrastructures, and the monitoring of the financial markets.

Basel III capital and liquidity requirements are currently the most prominent regulatory changes with the greatest potential to impact the monetary policy transmission mechanism. Although Basel III is envisioned to increase the resilience of the banking system and in so doing, improve the effectiveness of the monetary policy transmission mechanism, and South Africa as a member of the G20, the Basel Committee for Banking Supervision and the FSB in principle supports these regulatory reforms, there are nonetheless risks of unintended consequences associated with the implementation of these requirements. Basel III requirements are not of a macro-prudential nature, but like previous Basel requirements, are aimed at the balance sheets of commercial banks and could therefore impact economic activity and hence monetary policy. I would like to focus specifically on the liquidity framework which requires banks to adhere to a new liquidity coverage ratio (LCR) to ensure that they have sufficient high-quality liquid assets to survive a month-long significant stress scenario. The LCR aims to ensure that banks maintain an adequate level of unencumbered, high-quality liquid assets that can be converted into cash to cover net outflows during the period of stress.

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4 Interview with Olivier Blanchard, IMF Survey Magazine, IMF Explores Contours of Future Macroeconomic Policy, February 12, 2010

5 Monetary Policy in a world with macro prudential policy, Speech by Jaime Caruana, General Manager of the BIS, at the SAARCFINANCE Governors' Symposium 2011, Kerala, 11 June 2011

In South Africa, like in other countries, the Basel III liquidity regulations aim to reduce the reliance of banks on short-term funding. South Africa has very large and persistently high levels of income inequality, as reflected by a high gini coefficient of over 60. It is not surprising therefore, that households saving is very low, and that a large portion of the population is unable to make a significant contribution to national savings. Gross saving by the household sector has been around 1.6 per cent of GDP over the past two years. Consequently, national savings are concentrated in wholesale savings, resulting in a structural constraint, in that banks rely heavily on wholesale funding rather than retail deposits. The relatively high reliance on wholesale funding, increases the requirement in terms of both the LCR and the other component of the liquidity framework under Basel III, namely the net stable funding ratio (NSFR)[6] , and therefore will result in a higher cost of funding for domestic banks. There is a double whammy, however, because at the same time, the opportunity cost to acquire high quality liquid assets will imply that there will be a decline in the supply of loanable funds. Implementing the Basel liquidity risk standards in South Africa could reduce the availability of long-term credit, particularly in South Africa where assets that meet the Basel III qualifying criteria for the new LCR are in short supply (paradoxically also as a result of having pursued responsible fiscal policies and avoided excessive government debt). This intuitively would result in a reduction in broader economic activity, without raising policy rates, and would possibly compromise the transmission mechanism based on the prevailing monetary policy settings.

South Africa implements monetary policy through a classical cash reserve system, where a liquidity shortage is created in the money market through the cash reserve requirement and other open market operations, such as the issuing of SARB debentures and reverse repos. Through the shortage, the Bank impacts on marginal cost of funding of commercial banks, as banks have to refinance this shortage at the SARB once a week at the repo rate. This places additional pressure on the demand for liquid assets, because banks refinance this shortage against eligible collateral, which is in addition to the assets needed for the prudential liquid asset requirement. I should add that one of the national discretion options available to authorities in jurisdictions with inadequate qualifying liquid assets is to make available a committed facility from the central bank, from which commercial banks can draw in times of liquidity stress. As you are all aware, the Bank has recently announced its intention to make available such a committed liquidity facility against eligible collateral to all South African banks to help them meet the required LCR. This should help avoid any abrupt changes to the business models of bank, which could both complicate the transmission mechanism of monetary policy and have a detrimental effect on the real economy. The bank is presently investigating options to also deal with the challenges presented by the NSFR should it be applied in its current form.

In addition to the economic impact, the LCR may have a host of other unintended consequences, such as increasing the interlinkages with governments (although in theory it should enhance the attractiveness of corporate bonds and therefore spur activity in this segment of the market), encouraging disintermediation, as well as cross-border interlinkages, while inadvertently negatively impacting on liquidity in debt markets. Thus, under Basel III, banks may appear safer, but systemic risk may not necessarily be lower.

In sum, faced with these structural constraints, the Basel III liquidity requirements may result in South African banks reducing their lending, and therefore the availability of credit to the real economy. This will most certainly have negative consequences for economic growth and employment creation, which will further reduce available savings.

The BIS concedes that Basel III will impact on the transmission mechanism of monetary policy, however, formal research studies are still in their infancy. While we understand the

[6] This funding ratio calculates the proportion of long-term assets which are funded by long term, stable funding.

qualitative impact, it is not possible to measure it at this stage, while the impact will differ according to each country's initial conditions. These are the issues which central banks are grappling with today and the challenges they present for the conduct of monetary policy going forward.

The new Basel requirements do not suggest that there needs to be any changes to the South African monetary policy implementation framework, unless we change the operating framework from the current classical cash reserve system to an overnight targeted rate framework. South Africa's money markets are not yet sufficiently developed to potentially justify a change from the current classical cash reserve system operating framework to an overnight target rate framework. This segment of the market needs to be developed much more, and this forms part of the on-going work at the Bank in consultation with market participants such as the Money Market Subcommittee of the Financial Markets Liaison Group.

Thus, at least over the medium term, the monetary policy implementation framework in South Africa is unlikely to be affected by these regulatory changes, however, they will have an impact on the monetary policy transmission mechanism and therefore on monetary policy and interest rates and need constant monitoring.

5. Conclusion

In conclusion, the global financial crisis has forced a rethink about monetary policy and financial stability, resulting in new macro prudential frameworks. The consequences thereof are still unknown but could have significant implications for the conduct of monetary policy and the institutional set up of central banks. What is certain is that the operating procedures of central banks will become much more complicated, with a much wider variety of tools available.

I thank you