François Groepe: Recent international and domestic economic developments and changes to the financial regulatory architecture

Address by Mr François Groepe, Deputy Governor of the South African Reserve Bank, at the Actuarial Society of South Africa (ASSA) 2015 Investment Seminar, Cape Town, 27 May 2015.

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Introduction

Good day ladies and gentlemen. Thank you for inviting me to this seminar and I look forward to sharing my views on the recent international and domestic economic developments, as well as changes to the financial regulatory architecture.

Global outlook

The global environment facing South Africa remains challenging and fraught with a high degree of uncertainty. Developments in the US, in particular, continue to have spill-over effects on emerging markets in general and South Africa in particular. While it is clear that monetary policy normalisation will (and should) take place, the timing of the initial "lift off" is still uncertain, and dependent on domestic developments in the US, not least in the labour market. This makes each data release a source of volatility, with good news in the payrolls data generally being interpreted that it will bring forward the expected commencement date of the normalisation process. Perhaps of greater importance than the "lift off" itself is the question of the future path of interest rates. The US Fed has gone to great pains to communicate a gradual path, but the "dots" (the interest rate forecasts of the individual members) that illustrate this are subject to a high degree of dispersion and change from meeting to meeting. This reflects the high degree of uncertainty.

However, uncertainties in the US economy abound. The economy appeared to be well on the road to recovery in the second half of last year, but the first quarter data disappointed, following an advanced estimate growth rate of 0,2 per cent. The general expectation is that this was due to temporary factors, but risks still remain that it could portend a more general extended slowdown. Furthermore, there is still uncertainty regarding the improvement in the labour market: in particular, whether the improvement is a result of a decline in labour force participation rates, which could reverse should the improvement in the economy be sustained. Finally, there is still a great deal of uncertainty about whether potential growth rates will return to pre-crisis levels or settle at a lower level, and this is likely to have implications for the longer term neutral rate of interest.

The Eurozone appears to be improving following a weak few quarters, with positive growth impulses from the weaker euro and lower oil prices. The partial reversal of the oil price suggests that this impulse may be waning. It does however appear that the quantitative easing by the ECB is bearing fruit, but the question remains as to whether the region can sustain the recovery without this support. A question mark also remains regarding the possible contagion effect from the Greek debt crisis. The market reaction to date suggests that this is more contained, unlike the more generalised crisis in 2011 when risk premia on all peripheral Eurozone bonds widened significantly.

The Chinese economy continues to focus on rebalancing away from investment to domestic consumption. This has resulted in a downward revision of growth targets, but has also meant that demand for commodities is not as strong as it was previously. While a growth rate of 7 per cent would seem unattainable for South Africa, it is relatively low by recent historical standards for China.

Domestic outlook

The spill overs on to South Africa from these developments are significant. The US impact is through the exchange rate and long term bond yields, which are highly correlated with those in the UK. The Eurozone is an important destination for South Africa's manufactured exports, so a slow recovery is bad for the manufacturing sector, while the (until recently) weaker euro means that the competitive advantage from a weaker rand is undermined. Although the African continent, which has been growing quite robustly, has emerged as one of the main destinations of South Africa's manufactured exports, there are downside risks to the continent's growth prospects given the decline in oil and other commodity prices. The slowdown in China has had a marked impact on global commodity prices, resulting in a deterioration of South Africa's terms of trade, which was only reversed to some extent with the collapse of international oil prices since late last year, but even this windfall has reversed somewhat. So all in all we are indeed facing a challenging international environment.

However, it would be wrong to suggest that the subdued outlook for the domestic economy is purely a function of global developments. Domestic factors are also important, and some of them are of our own making. Real GDP for the first quarter of this year slowed down to 1.3 per cent compared to the 4.1 per cent (qqsa) recorded for the final quarter of 2014. This is against the backdrop of the sluggish growth rate of 1,5 per cent for 2014 and which is well below the Bank's estimate of potential output of between 2,0 and 2,5 per cent. The weak outcome last year was partly due to the impact of protracted strikes in the mining and manufacturing sectors during the year. The Bank estimates the negative impact of these strikes to be in the order of around 1,2 percentage points of GDP. Hopefully, prolonged work stoppages will not be a regular feature each year.

The question we need to ask ourselves is why the growth prognosis is so weak. Some of it has to do with the global economy, as I outlined earlier. Secondly, there are binding constraints coming from the electricity supply uncertainties. Our estimate of growth tries to incorporate some element of the impact of load shedding on output. There are two elements here: one is the impact of longer term constraints which hamper new investment, and which is reflected in the overall lower potential output; the other is the impact of load-shedding on existing capacity and therefore on current output. We estimate this latter factor to be in the order of magnitude of around 0,5 percentage points of GDP. Load-shedding appears to have contributed to a general low level of business confidence, as evident in the various confidence indices, but also evident in the very low growth in private sector gross fixed capital formation. In 2014, gross fixed capital formation contracted by 0,4 per cent, driven mainly by the 3,4 per cent contraction in investment by the private sector, which accounts for just under two thirds of capital formation. On a more positive note, in the second half of the year growth was positive, a reversal of the strongly negative trends observed in the first half of the year. However, supply side constraints and low confidence are likely to constrain stronger growth. It is worth noting that the more favourable fixed investment outcomes observed in 2013 were mainly related to renewable energy projects.

The main driver of growth in recent years has been the consumption expenditure by households. However, the contribution to growth in 2014 declined by one percentage point to 0,8 percentage points. While we would prefer to have investment-driven growth, even consumption has been relatively subdued for some time, declining to 1,4 per cent in 2014 compared with 2,9 per cent in 2013. A further concern has been the recent sharp drop in consumer confidence, which, according to the FNB/BER survey reached a level of –4 in the first quarter of the year, compared to an average of +5. Factors undermining consumer confidence include the partial reversal of the boost to consumption provided by lower petrol prices; the increase in the marginal tax rate in the February budget; high levels of household indebtedness despite some deleveraging; and continued weak growth in credit extension to households. Employment growth trends are also not supportive in this respect, and although wage growth remains relatively high, the positive net impact on consumption could be offset to some extent by the negative impact on employment from relatively high wage growth.

Inflation is currently well within the inflation target band of 3–6 per cent. However, the focus of monetary policy is not current inflation, which is something that we cannot do anything about, but rather on the inflation trajectory over the relevant policy horizon, i.e. the time period over which monetary policy can have an impact on inflation and which is around 12–18 months ahead. Headline CPI inflation accelerated to 4,5 per cent in April, which is at the mid-point of the target range. The main drivers of the annual increase were housing and utilities (1,3 percentage points), miscellaneous goods and services (1,1 percentage points) as well as food and non-alcoholic beverages (0,8 percentage points). On a monthly basis Headline CPI inflation increased by 0.9 percentage points, up from the recent low of 3,9 per cent in February and which is mainly attributable to the previous decline in the petrol price, which has largely been reversed.

As we noted in our monetary policy statement last week, inflation is expected to accelerate in the coming months, and is expected to rise to 6,8 per cent on average for the quarter thus temporarily breaching the upper end of the headline inflation target range during the first quarter of 2016. The CPI inflation rate is expected to average 6,1 per cent and 5,7 per cent in 2016 and 2017, respectively. Core inflation is forecast to average 5,4 per cent and 5,2 per cent in the outer two years with the persistence in this measure largely being attributed to high levels of wage growth, currency depreciation and inflation expectations that are anchored at the upper end of the target range.

There are a number of upside risks to this outlook. The main one emanates from the exchange rate, given the rand's sensitivity to imminent US Fed monetary tightening. South Africa, along with other emerging markets with wide current account and fiscal deficits are seen to be particularly vulnerable. However, there is a great deal of uncertainty in this regard. How much is already priced in to the exchange rate? Will any weakening be a temporary overshoot? To what extent is this offset by QE in the Eurozone and Japan? We should also recognise that domestic factors also play a role, including the persistently wide current account deficit, weak growth outlook and uncertainty arising from the binding electricity constraints. And finally, in this regard, there is uncertainty regarding the degree of pass-through from the depreciation to inflation. We have seen far more muted pass-through in the past few years, than during previous episodes of rand depreciation and the Bank estimates that actual pass-through could be about half of what is assumed in the forecast model. The uncertainty is whether this represents some form of structural change, or whether it is cyclical – in which case it will increase when growth picks up – or whether some inflexion points exist, beyond which inflation will accelerate.

A further issue relates to electricity prices. There is some uncertainty following the application to Nersa for a 25 per cent increase in electricity tariffs. The Bank's model previously incorporated an increase of around 13 per cent, effective from 1 July 2015, but should a higher increase be granted, we will see further upside pressure on inflation.

The above backdrop provides a difficult challenge for monetary policy. It is clear that the main pressures on inflation are supply side shocks, rather than demand pressures which are easier to deal with through monetary policy. At the same time, the growth outlook remains highly constrained. We, however cannot simply ignore supply side developments, as in so doing we could allow inflation expectations to become unanchored. Furthermore, the MPC is concerned about the persistence of the medium term inflation outlook at heightened levels and the significant upside risk to this outlook, which includes electricity tariff increases, the exchange rate and the level of wage settlements. Our focus is therefore sharply on possible second round effects of these shocks to see if it spills over into more generalised inflation.

Monetary policy has been accommodative, which has been appropriate in light of the weak real economy. We are however in a hiking cycle and the deteriorating inflation outlook may necessitate policy action as the window for an unchanged stance has narrowed. The pace of normalisation will however be influenced by the data.

Regulatory reforms

As you are no doubt aware, the Bank's mandate has been broadened to more explicitly include financial stability. Following the global financial crisis, it became clear that price stability is a necessary, but insufficient condition for financial stability and it has now become a more explicit mandate of central banks in many countries. While the price stability mandate of the SARB is clearly defined and measureable, its mandate for financial stability is much broader and is a shared responsibility with other stakeholders.

National Treasury published a policy document in February 2011 titled *A safer financial sector to serve South Africa better*, which outlined government's decision to shift to a Twin Peaks model of financial sector regulation. The Twin Peaks model of financial sector regulation represents a move away from a fragmented regulatory approach which was based on the institution or activity towards a regulatory and supervision model based on objectives. It is envisaged that, once fully implemented, the Twin Peaks system of regulation will focus on a more harmonised system of licensing, supervision, enforcement, customer complaints, an appeal and review mechanism, and consumer advice and education.

National Treasury published the second draft of the Financial Sector Regulation Bill in December 2014. This bill proposes to confer upon the Bank the responsibility for financial stability and the oversight of market infrastructure and payment systems. It further proposes the establishment of two regulators, namely a Prudential Authority within the Bank and a new Financial Sector Conduct Authority. The Prudential Authority would supervise the safety and soundness of banks, insurance companies, and other financial institutions, while the market conduct authority would supervise the way in which financial services firms conduct themselves and treat their customers.

This reform forms part of the current broader overhaul of the global regulatory system which aims to address the too-big-to-fail problem of systemically important financial institutions, building resilient financial institutions, reducing the opacity of over-the-counter derivatives markets, mitigating the impact of shadow banking on financial stability, enhancing financial benchmark transparency, and promoting the convergence of accounting standards.

Within each of these themes there are a number of regulatory initiatives, such as the regulation of systemically important financial institutions under the too-big-to-fail problem, Basel III and proposals for a basic capital requirement for insurers to strengthen the theme of building resilient financial institutions.

The Bank's main activities in the financial stability arena currently include developing and implementing recovery and resolution plans for systemically important financial institutions, introducing a macroprudential toolkit of policy instruments to contain risks associated with imbalances in the financial system, and applying a top-down stress testing framework to the banking sector in South Africa.

Although the Bank's financial stability mandate is distinct from its price stability mandate, careful consideration is continuously given to the interaction between the Bank's monetary policy and financial stability objectives. This coordination is facilitated by cross-membership between the Bank's monetary policy and financial stability committee structures.

The main risks from the global and domestic environments that might impact the stability of the domestic financial system and that are monitored continuously in terms of possible mitigating actions include the possibility of severe electricity supply disruptions, volatility and risk aversion in global financial markets, a protracted period of slow growth in the euro area, low growth in the domestic economy and the escalation of global geopolitical tensions. These possible scenarios of potential threats to financial stability are rated according to the likelihood of occurrence and the expected impact on the domestic financial system. The results are captured in a risk assessment matrix and published in the latest *Financial Stability Review* which was released at the end of April. This publication is aimed at analysing these

potential risks to financial stability and to stimulate debate on pertinent financial stability issues.

Conclusion

It is clear that although the global recovery has started to gain momentum it continues to be erratic and there are a number of downside risks to the global economic growth outlook. The recent partial rebound in the price of crude oil has ameliorated some of the benefits arising from its earlier sharp decline. A further risk is a possible Grexit and other geopolitical risks.

On the domestic front, growth continues to disappoint, and the medium term growth outlook is likely to be constrained due to the binding electricity constraints. The inflation outlook has deteriorated to uncomfortable levels recently with inflation expectations remaining close to the upper-end of the target and with further notable upside risk to the outlook.

The scale of the regulatory reform process under way is probably the most significant overhaul of the financial regulatory architecture in the last few decades. Despite its ambitious scale, the Bank is making good progress in preparing itself to take up its new responsibilities as set out in the Financial Sector Regulation Bill.

Thank you!