Gill Marcus: Overview of the South African economy

Address by Ms Gill Marcus, Governor of the South African Reserve Bank, at the 93rd ordinary general meeting of shareholders, Pretoria, 26 July 2013.

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Dear Shareholders,

Members of the Board,

Deputy Governors,

Ladies and Gentlemen,

The past financial year has been as difficult as any since the global financial crisis began. The crisis has continued to mutate and the impact on South Africa has been compounded by domestic challenges that have at times overshadowed the global risks. The latest mutation comes in the form of a slowdown in the emerging market economies, which until recently had been the main engine of global growth.

In its recent World Economic Outlook update in July, the IMF revised down its April forecasts for global growth in 2013 by 0,2 percentage points, mainly as a result of a sudden deterioration in the outlook for the emerging markets. The Brics countries featured very strongly in this downgrade: growth in China was lowered from 7,8 per cent to 7,5 per cent; Russia from 3,4 per cent to 2,5 per cent; India from 5,8 per cent to 5,6 per cent; Brazil from 3,0 per cent to 2,5 per cent and South Africa from 2,8 per cent to 2,0 per cent. The speed of this downturn is cause for concern, and illustrates that the idea that the emerging markets can decouple from the advanced economies and become an independent engine of global growth is overly simplistic.

This slowdown is compounded by financial market uncertainties and turbulence that followed the announcement by the US Federal Reserve that it may begin to slow the pace of asset purchases. Long-term yields spiked in both advanced and emerging bond markets, as capital flowed out of emerging markets in particular. While the markets have calmed down somewhat following their original overreaction, this episode illustrates not only the difficulties that advanced economies will have in reversing their highly accommodative monetary policy stances in the future, but also the likely spillover effects on emerging and developing countries. Our challenge as a country will be to anticipate and reduce our vulnerability to these risks.

In the meantime, however, loose monetary policy is expected to persist in most of the advanced economies as downside risks to growth continue and inflation remains largely benign with a concern about deflation rather than inflation, particularly in Japan and the United States. The Eurozone remains mired in a deepening recession, the Japanese recovery is uncertain, and the US economy, while showing signs of improving, is facing headwinds from a sharp fiscal contraction.

The South African economic growth prospects have also weakened in the face of global and domestic constraints. The Bank's most recent forecast is for growth of 2,0 per cent in 2013, rising to 3,3 per cent next year. However, there are downside risks to this forecast, particularly given electricity supply constraints. At the same time, driven mainly by a depreciating currency and rising wage and salary costs, the forecast inflation path has moved up, and a temporary breach of the target range is expected in the third quarter of this year, despite an absence of strong demand pressures. Although our forecast suggests that inflation will remain within the target range thereafter, it is uncomfortably close to the top of the target range and the risks to this forecast are seen to be on the upside.

The Bank's primary mandate remains price stability within a flexible inflation targeting framework. This means that we need to be cognizant of the state of the economy, and the policy dilemma has become more marked with rising inflation and slowing growth. Against the backdrop of a volatile currency responding to domestic and global developments, we can expect a challenging year ahead for monetary policy.

As was elaborated in the Annual Report, the Bank has the responsibility to act on its expanded mandate of financial stability. This is part of a global phenomenon which has seen responsibility for financial stability and macroprudential oversight becoming increasingly the responsibility of central banks. This has raised expectations about what central banks can and should do, with the danger that expectations can become unrealistic. The move to the Twin Peaks regulatory architecture is well under way. In terms of this framework, the Bank has been given responsibility for prudential regulation of the financial sector, which will entail a move of a number of personnel from the Financial Services Board (FSB) to the Bank. In addition, the Bank has been given responsibility for macroprudential oversight. The coming year will therefore not only see logistical and personnel challenges, but also challenges of integrating our expanded mandate of financial stability with our primary mandate of price stability.

An important function of the Bank is the management of the country's official gold and foreign exchange reserves. For some time there has been a need to build up the country's holdings of foreign exchange reserves, which were – and still are – low in comparison to IMF estimates of reserve adequacy and our emerging market economy peers. The need to accumulate these reserves was driven by the imperative to reduce the country's vulnerability to sudden large outflows of capital, something to which our economy is prone. We have made good progress in this regard in the past 10 years, with gross gold and foreign exchange reserves increasing from US$8 bn in June 2003, to current levels of US$47 bn. Net reserves increased from US$1 bn to US$45 bn over the same period. During the past financial year, most of the moves in the level of reserves were a result of valuation changes relating to fluctuations in the gold price and exchange rate movements. Direct accumulation was limited given the weakening of the rand over the period. However, our responsibility for managing these reserves has impacted significantly on the profitability of the Bank.

The financial statements presented to you today show that the Bank has recorded a loss for the third consecutive year. For the 2012/13 financial year, a loss of R1,5 billion was recorded, compared with R491 million in the previous financial year. It is important to elaborate on the nature of these losses, as they arise due to the unique nature of a central bank. The structure of the Bank's balance sheet is intrinsically linked to the diverse responsibilities of a central bank. As has been elaborated in a recent paper published by the Bank for International Settlements, central banks pursue national welfare and not profits. It follows therefore that profitability is not necessarily a good guide for measuring success, and a focus on profitability can lead to sub-optimal policies for the country as a whole. The Bank's activities and financial results should therefore be seen in a broader context and not within the artificial narrow confines of its balance sheet.

The major source of our losses emanate from our accumulation and holding of foreign exchange reserves. When the Bank purchases foreign exchange, it injects rand liquidity into the market. Unless we neutralise this liquidity increase, it could have inflationary consequences. There are a variety of ways that we can do this through our open market operations, for example through foreign exchange swap transactions, conducting reverse repurchase transactions, or the issuing of Reserve Bank debentures. This process is known as sterilisation. However, while we are paying around 5 per cent (linked to the current repo rate) on these transactions, we earn very little on our holding of foreign exchange reserves. This is because the ongoing global financial crisis has resulted in abnormally low interest rates in the advanced economies. And it is the currencies of these countries that are held as our reserves.

The cost of sterilisation and the low returns on foreign currency holdings continue to impact the financial results of the Bank. The income of the Bank is mainly derived from foreign investments and, due to the low-yielding environment this was insufficient to cover the operational costs of the Bank. In addition, the total income of the Bank decreased by R282 million compared with the previous year, mainly due to a reduction in commission on banking services.

Clearly we could improve our balance sheet by not accumulating reserves or by reducing our reserve holdings. However this would not be in the interest of the country as a whole. To the contrary, our reserves are still considered to be on the low side, and over time we will need to build up these reserves further. But it is also important to point out that reserve accumulation has in fact been highly profitable for the country. As the rand has depreciated over time, the rand value of these reserves has increased quite substantially. However, in terms of the SARB Act, these revaluation gains (or possible losses) accrue to the government through the Gold and Foreign Exchange Contingency Reserve Account (GFECRA), while the current low return and cost of sterilisation accrue to the Bank. As shown in the Annual Report, the GFECRA stood at R67,6 bn at the end of the 2011/2012 financial year, growing to R125,5 bn at the end of March 2013. In this sense the artificial separation of these two components of reserve accumulation give a distorted picture, and we need to bear in mind this context of accounting conventions. We have to take policy decisions that are in the best interests of the country.

A further contributory factor to the increased losses reported this past financial year relates to the Bank's role as the sole issuer of currency in the economy. The previous banknote series had been in existence since 1992. A decision was taken to introduce a new series, and at the same time upgrade the security features of the banknotes in order to minimise counterfeiting risks. The introduction of a new currency series involves high initial fixed costs for a number of years as the stocks are built up, including buffer stocks. It is important to bear in mind that the notes and coin in circulation peaked at a level above R110 bn during the financial year, and increases at about 10 per cent per annum (compared to the peak in the previous year). In November 2012, the new Mandela banknote series was launched resulting in a R819 million increase in the cost of currency in comparison to the prior year, recognising that as we knew we were introducing the new note series, production of the old notes was deliberately kept to the minimum required so that we could draw down on the buffer stocks.

In summary, the losses experienced by the Bank since 2010 are not a reflection of bad management or poor budget controls, but are the result of the exceptionally low foreign yields and the cost of issuing the new currency series. We are not driven by a profit motive and the losses arise from us performing our functions in the interest of the economy. But at the same time we cannot be complacent and use this as an excuse for uncontrolled expenditure. We therefore remain committed to containing our costs and maximising operational efficiency.

At this time we would normally have expanded on some of the questions raised during the shareholder road shows held in Pretoria, Durban and Cape Town on 10, 11 and 12 July 2013, respectively. However, the questions posed this year were either specific to the persons attending the meetings or have been addressed in my earlier remarks.

Unfortunately, this year's shareholder road shows were not well attended and the Bank has decided that it will no longer hold the road shows in Durban and Cape Town unless circumstances dictate otherwise. However, the road show in Pretoria will still take place prior to the AGM each year. The general information letters that are distributed to shareholders at least twice each year, will continue.