François Groepe: The expanded research opportunities for students in economics

Address by Mr François Groepe, Deputy Governor of the South African Reserve Bank, to the Economics Department of the North West University, Potchefstroom, 15 August 2013.

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Introduction

Prof. Waldo Krugell, Director of the School of Economics, Staff members of the Faculty of Commerce, Students, ladies and gentlemen. I wish to thank you for the opportunity to address you at your seminar series.

Global economic developments

Despite some positive developments recently, the global economic crisis continues and the recovery is best described as hesitant and fragile. In the past, the Bank has referred to the mutating nature of the crisis, with the crisis starting out as a sub-prime crisis which mutated into a systemic banking crisis, a liquidity, fiscal deficit and sovereign debt crisis, and more recently in some countries a youth unemployment crisis. The altered patterns of capital flows and the rising long-term bond and mortgage interest rates that may follow the tapering of the asset purchases programme by the US Federal Reserve and the eventual exit of quantitative easing by monetary authorities in advanced economies could well result in a further mutation of the global financial crisis.

Six years into the crisis, most of the major advanced economies continue to grow below potential and unemployment, particularly in the Eurozone area has remained elevated. The level of youth unemployment is of particular concern with possibly significant long-term implications for social stability in the worse affected countries.

While there are signs of positive economic growth and rising employment in the US, this growth is still too low to significantly close their output gap. The haphazard fiscal contraction and the potential headwinds that may flow from this are likely to pose a risk to the robustness and sustainability of the recovery. The anticipated exiting of quantitative easing by the advanced economies is likely to contribute to rising long-term bond and mortgage interest rates. This could bring pressure to bear on the housing recovery in the US, but will furthermore have a pronounced impact on emerging market economies, particularly their financial market asset prices and currencies may prove vulnerable.

The Eurozone, after six quarters of contraction has finally emerged out of its recession in the second quarter of 2013, and recorded a growth rate of 0.3 per cent, which was slightly ahead of the median forecast of 0.2 per cent growth. This growth performance appears to be broad based on the economic outcome in core countries such as Germany and France, as well as certain of the peripheral countries such as Portugal, is positive. The recovery in the Eurozone economy is, however frail overall. The most recent IMF forecast for Eurozone growth was revised downward to –0.6 per cent, with a weaker recovery, than previously forecasted in 2014.

The Japanese economy recorded strong growth in the first quarter of 4.1 per cent, which has since been revised to 3.8 per cent. Growth, however moderated in the second quarter to 2.6 per cent, (quarter-on-quarter saar). The growth in Japan is underpinned by strong consumer spending and exports and although the economic growth is stronger than in the more recent past in response to the stimulus measures undertaken, it remains too early to conclude on the sustained success and the efficacy of the various stimulus measures that were adopted. The July consumer confidence index fell by 0.7 per cent to 43.6 per cent and the proposed increase in the sales taxation is expected to act as a drag on growth.

Growth in developing countries, for some time the mainstay of the world economy, is also slowing and contributing to the recent downward revision of global growth by the IMF in the order of 0.2 per cent to 3.1 per cent and 3.8 per cent for 2013 and 2014, respectively. In the immediate future, emerging market economies will have to balance possible capital outflows related to tapering with weaker currencies, rising inflationary pressures and underlying imbalances.

Domestic economic developments

South Africa's economic performance is closely aligned to international economic developments due to the openness of our economy. Domestic economic growth has been disappointing, with the Bank recently lowering its growth projection for 2013 and 2014 to 2.0 per cent and 3.3 per cent, respectively. The Bank projects growth to accelerate to 3.6 per cent in 2015, but we assess the risk to the growth outlook to be on the down side in the light of the further delays in overcoming the electricity supply constraints, relatively weak business and consumer confidence levels and possible labour market developments.

The low growth in real gross fixed capital formation, which had moderated from an annualised 4.3 per cent in the fourth quarter of 2012 to 2.5 per cent in the first quarter of 2013, is seen as one of the factors that underlie the weak economic growth outlook. Growth in capital outlays by private business enterprise slowed for the first time since the fourth quarter in 2011, and was mostly evident in the mining and manufacturing sectors. Gross fixed capital formation, expressed as a percentage of GDP remains low at 19.3 per cent, compared to the high of 24.6 per cent achieved in the fourth quarter of 2008.

The official unemployment rate increased from 25.2 per cent in the first quarter of 2013 to 25.6 per cent in the second quarter. The youth unemployment rate has risen to 52.9 per cent during the first quarter of 2013 and is of particular concern.

The inflation outlook had worsened at the time of our last Monetary Policy Committee meeting and is now expected to be slightly higher at 5.9 per cent and 5.5 per cent in 2013 and 2014, respectively. Inflation is projected to temporarily breach the target range in the third quarter of 2013, at a slightly higher average level of 6.3 per cent.

The challenge that we face is how best to achieve our primary mandate of price stability against the backdrop of rising inflationary pressures and weaker growth. I should add that a sustained breach of the inflation target is not the Bank's central forecast.

The Monetary Policy Committee, whilst maintaining the accommodative policy stance by keeping the repurchase rate unchanged at 5 per cent at its last meeting in July, indicated that given the upside risk to the inflation outlook, the scope for further monetary accommodation is reduced. However, tightening of the monetary policy stance does not automatically follow, as a shift will be highly dependent on how we see he inflation trajectory unfolding against the backdrop of the prevailing uncertain environment.

The Global Financial crisis and its impact on financial stability

I now wish to turn to the impact of the global financial crisis, particularly its impact on South Africa and other emerging markets and the challenges it poses to financial regulation. In particular, I want to underscore the need for more research in an area which has gained pre-eminence since the onset of the global financial crisis, namely the macro prudential approach to financial regulation.

There is no doubt that the global financial crisis has permanently changed the course of the global economy and has established a new normal. The severity of the 2008 financial crisis brought about the most damaging effects to domestic economies of the developed countries and possibly the longest lasting negative externalities to the world economy, in history.

Although the emerging market economies performed better than the advanced economies, they were nonetheless affected through the trade and finance channels and as a consequence their growth rates too had been negatively impacted.

The crisis has forced many central banks to look more closely at the build-up of financial imbalances in the wider financial system and to undertake regulatory reform which has expanded central banks' role with regard to ensuring financial stability. The latter is known as the so-called macro prudential regulation and which concerns itself with more than just idiosyncratic risk and the soundness of individual institutions but is concerned with the soundness and stability of the entire financial system, i.e. systemic soundness.

Fortunately, South Africa and its financial institutions fared well during the crisis. Our policy makers however appreciated that there was no room for complacency and decided to be proactive. Hence in 2007 the National Treasury launched a review of South Africa's financial regulatory system. This work culminated in the Minister of Finance publishing a policy document, *A Safer Financial Sector to Serve South Africa Better*, also known as the *"Red Book".*

In terms of the reforms outlined in the "Red Book" the South African Reserve Bank would assume responsibility as macro prudential regulator, micro prudential regulator and resolution authority for the wider financial system. This means that the Bank's previous role as micro prudential regulator of Banks (since 1990), would be expanded to include prudential regulation responsibility over the insurance sector and all financial market infrastructures, including the payment system, central clearing counterparty and trade repositories. Moreover, the Bank is also becoming the Systemic or Financial Stability Regulator. It is important to note that the Bank had been pursuing financial stability since 2001. However, it was an implicit mandate. Since 2010, the Bank has had an explicit financial stability mandate complementing its price stability objective. This, however, is in line with the mandates of most central banks around the globe.

In pursuit of this expanded role, a Financial Stability Oversight Committee (FSOC), chaired by the Governor, will be established which will include representation from the Bank, the market conduct regulator and the National Treasury. The FSOC will have financial stability policy responsibility, in the same way as the Monetary Policy Committee does for price stability, and will be able to hold to account various authorities or economic agents on actions to be taken to mitigate against / reduce systemic risk.

Research underpinning of the work of the SARB as systemic regulator

The immediate challenge of the FSOC which is the same for other financial stability regulators around the globe, would be the further development and refinement of macro prudential frameworks. This will include both an analytical framework of looking at and overseeing systemic risks and a toolbox of measures to be considered to be implemented towards the achievement of the objective of financial stability. While the interest rate and inflation targeting are well developed frameworks for the attainment of price stability, it is less the case with the financial stability mandate or objective of central banks.

This is the research challenge I want to pose to you. Charles Goodhart argues that as far as he is concerned, central banks can just focus on financial stability and abandon price stability. I wish to differ from him, but it does demonstrate the sheer size of the challenge of financial stability for the role of the central bank in the post crisis world.

To date, international financial institutions like[1] the Bank of International Settlements (BIS), the FSB and the IMF have been doing research on macro-prudential policy frameworks,

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[1] Borio C, "Towards a macro prudential framework for financial supervision and regulation", BIS Working papers (2008).

including tools to mitigate the impact of excessive capital flows following the global financial crisis. However, a number policy and research questions remain either unanswered or not fully answered, including:

- What should be the objectives of a macro prudential policy framework?
- What is the toolkit of instruments – are these micro prudential or macro prudential in nature or even macro-economic or other?
- What is the efficacy of such instruments?
- What challenges are posed by macro prudential / financial stability regulation to the traditional understanding of central bank independence?
- What are the analytical tools necessary for the identification and monitoring of systemic risk?
- What is systemic risk?

These are only a few of the policy questions which policy makers around the world are grappling with particularly since the onset of the global financial crisis. Clearly there is a role to be played by senior students and post graduate researchers in providing answers to these important research questions and the Bank would eagerly consider partnerships on coordinated research on these and other important research endeavours which relate to the policy mandate of the Bank.

Conclusion

In conclusion, although the outlook for the South African economy has weakened as reflected in the lowered forecast for growth, it is important to appreciate that it is against the stark backdrop of very sluggish global growth. South Africa continues to have much going in its favour and it is important that we capitalise on these not least the role that bright young minds like yourselves can play in leveraging your education and helping to change the world. Helping us through research to better understand some of the issues I had alluded to earlier would be such an example and could in a meaningful way contribute towards achieving greater financial stability, not only in South Africa but indeed across the globe.

I thank you.