Daniel Mminele: South Africa – challenges and opportunities in the monetary policy environment and the new financial services regulatory regime

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the South African Chamber of Commerce and Industry (SACCI) Breakfast Briefing, Johannesburg, 13 August 2014.

*   *   *

Good morning, Ladies and Gentlemen.

It is indeed a pleasure to address you today on some of the issues that monetary policy makers and regulators both internationally and domestically are currently grappling with. I am very grateful to SACCI for creating this opportunity for us to interact at this forum, which I gather is part of SACCI's policy programme of engagement with policy makers, political and business leaders. Fortunately, the difficult task of choosing a topic for this address was solved for me, as the organisers have specifically requested me to focus on three issues, namely, international monetary policy trends, challenges and opportunities in South Africa's monetary policy environment and the new financial services regulatory regime in South Africa. My address is structured accordingly.

1. International monetary policy trends

As you are aware, in many countries growth considerations dominate policy concerns, both on the fiscal and monetary policy fronts. According to the IMF's latest World Economic Outlook (WEO) Update released last month, the global recovery is expected to continue but at an uneven pace and with the outlook being characterised by downside risks. While global growth is projected to rise from 3,2 per cent in 2013 to 3,4 per cent in this year and 4,0 per cent in 2015, the most recent forecast is weaker for 2014 than what was envisaged in the April 2014 WEO. Growth outcomes for advanced countries and emerging economies for this year have been revised downwards by 0,4 and 0,2 percentage points, respectively. Despite this downward revision, it is generally accepted that the growth momentum will continue, albeit at a lower and uneven pace. Thus, raising actual and potential output will remain a priority in policy circles in many economies for the foreseeable future.

Growth in the advanced world has become dependent on monetary stimulus. Financial market developments, particularly asset price movements have reflected this stimulus injection. In general this has taken the form of equity purchases rather than green-field type investments, which has in effect limited the impetus to the economic growth momentum. An additional concern has been that debt levels in many countries have continued to rise against the backdrop of subdued long-term growth prospects. Debt-to-GDP ratios now average around 275 per cent in the advanced economies and approximately 175 in EMEs.[1] As Jaime Caruana, the General Manager of the Bank for International Settlements, has recently noted, the surge in debt may have supported current demand, but its impact on future income and future demand is still very uncertain.[2] The rise in debt makes borrowers more sensitive to tightening in the interest rate cycle.

Despite the current concerns about global growth outcomes, there is evidence of self-sustaining recoveries in some of the major economies like the United States and the

---

1 See BIS, 2014. *84th annual report*, BIS (page 10).

2 See Jaime Caruana, 2014. "*Stepping out of the shadow of the crisis: three transitions for the world economy*", BIS (July).

United Kingdom. It is now accepted that as growth recovers, policy makers in the advanced countries will start to unwind the exceptional monetary accommodation that is currently in place in these countries. This will inevitably lead to a tightening of financial conditions and higher global interest rates in the coming years. Swings in capital inflows could result in renewed bouts of turbulence in financial markets with consequent exchange rate pressures having significant adverse implications for economic outcomes in EMEs and the global economy. For example, the IMF in the most recent "2014 Spillover Report" released on 27 July 2014, estimates that an environment of sharply tighter financial conditions alongside a further weakening of emerging market growth could reduce global output by about 2 per cent.

This has brought into sharper focus the future role of monetary policy. While there is no doubt that in the medium- to long-term price stability will remain the primary goal of monetary policy, lessons learnt from the crisis clearly point to the need to give broader financial stability more prominence. Policy makers around the world are grappling with finding ways of how best to define the future relationship between price stability, macro and micro-prudential policies. Recently, there has also been a renewed interest in policy coordination at the global level as a means of reducing or containing the potential adverse spillover effects of changes in the monetary policy stance of advanced economies. Governor Raghuram Rajan of the Reserve Bank of India has been at the forefront of such calls, suggesting that central banks in advanced countries should reinterpret their mandate to consider the international spillover effects of their domestic policy actions. His argument is that in the absence of global policy coordination and cooperation, EMEs may have to resort to less optimal policy options, which include implementing macro-prudential measures such as capital controls, and excessive reserve accumulation. The IMF has also acknowledged that national policies alone may not be sufficient to address the adverse spillover effects in the global economy.[3] However, the nature and timing of such policy coordination is very much still an open question. This, in effect means that, while exogenous shocks are a distinct possibility, the nature and extent of these shocks are difficult to estimate and discern. International policy coordination, while clearly desirable, gets complicated by asynchronous monetary policies, which are informed by differing economic cycles. This is a challenge confronting monetary policy formulation and implementation in many EMEs currently, and is a reality we also face in South Africa.

2. Challenges and opportunities in South Africa's monetary policy environment

As you are aware, the SARB's monetary policy mandate is executed within a flexible inflation targeting framework. In essence, this implies that when inflation expectations are under control the SARB will tolerate temporary breaches of the upper target band of 6 per cent in the interests of containing short-term fluctuations in economic growth. The 0,6 per cent contraction of the economy in the first quarter provided strong evidence of the impact of the protracted labour strike in the mining sector. While the end to the strike in the manufacturing sector which was announced at the end of July is to be welcomed, the impact of these strikes on the second quarter growth figures and over the longer-term are still to be ascertained.

The recent Quarterly Labour Force Survey (QLFS) released by Statistics South Africa shows that the official unemployment rate has increased to 25,5 per cent from the 25,2 per cent registered for the first quarter of 2014. Of particular concern is the decline of 24 000 formal sector jobs and the increase in the number of unemployed to 5,2 million people which is the highest level since the inception of the QLFS in 2008. There is little doubt that job creation and reducing unemployment remains the single most important economic challenge confronting South African policy makers.

3 IMF, 2014. Imf Multilateral Policy Report: 2014 Spillover Report, IMF, Washington (July 2014)

The prospects for employment creation have also been adversely affected by the deterioration in the growth outlook. The Bank's most recent forecast, published at the time of our last MPC meeting, is that economic growth will average 1,7 per cent for 2014. This is approximately 1 percentage point lower than what was envisaged at the beginning of the year. The growth forecasts for the next two years was also revised downwards by 0,2 percentage points to 3,1 per cent (2015) and 3,2 per cent (2016).

There is little doubt that the envisaged growth outcomes of around 3 per cent over the next two years are insufficient to make meaningful inroads into the unemployment problem that we face in South Africa. The policy challenge is to enhance the growth potential of the South African economy. In this regard, attention needs to be given to removing the structural impediments in the economy, many of which have been identified in the National Development Plan. Government's infrastructure plans and other measures such as those directed at enhancing education and skills, and supporting small and medium enterprises are some of the proposed initiatives that need to gain traction to enhance the growth and employment potential of the South African economy.

It should also be pointed out that the South African economy can ill-afford a fractured labour relations environment, which increased the tensions that resulted in protracted strikes in the mining and manufacturing sectors. Both business and labour, with government facilitation, have a vital role to play to improve the labour relations environment in South Africa. The challenge remains for organisations like SACCI and other business associations together with labour, to find means and mechanisms to urgently and adequately address their concerns in such a way that the competitiveness of South African products on the international market is not compromised.

It is important to bear in mind that monetary policy cannot address structural deficiencies in the economy and influence long-term growth. At best, monetary policy can smooth out fluctuations in growth over the short-term. Currently, the MPC's policy dilemma has been compounded by CPI inflation breaching the upper end of the target range in the wake of a weak growth performance. CPI inflation on a year-on-year basis measured 6,6 per cent over the last two months. The food and transport components accounted for approximately 41 per cent of the headline inflation rate.

The SARB's forecast as contained in the MPC statement released in July 2014 shows inflation peaking at an average rate of 6,6 per cent in the fourth quarter of this year and returning to within the target band during the second quarter of 2015. Inflation is expected to average 6,3 per cent in 2014 and 5,9 per cent in 2015. There are indications that exchange rate impacts – particularly the lagged impacts from past depreciations – are starting to feed through into consumer price inflation.

The MPC is of the view that the risks to the inflation forecast are skewed to the upside. Underlying inflationary pressures have increased. Core inflation, measured as headline inflation less food, petrol and energy, has increased to 5,6 per cent in June from an average rate of 5,1 per cent for the 2013 calendar year. The Bank's projection is that core inflation will remain at elevated levels averaging around 5,7 per cent over the next year. This does not include the impact of the recent decision by the National Energy Regulator of South Africa (Nersa) to allow Eskom to recoup R7.8bn for the under-recoveries for the Multi-Year Price Determination period, 2010–2013. The impact of this decision on headline and core inflation will become clearer once Eskom announces how this amount will be recouped.

Inflation expectations as reflected in the survey conducted by the Bureau for Economic Research at Stellenbosch University have been anchored at the upper end of the target band for some time now. The average expectations of financial analysts, the trade union officials and businesses are that inflation will average 6,1 per cent in 2014 and 2015 before declining to 5,9 per cent in 2016. However, trade union officials expect inflation to increase from an average 6,0 per cent in 2014 to 6,1 per cent in 2015 and 2016. On the other hand, businesses are of the view that inflation will average 6,2 per cent in 2014 and increase by an average 0,1 per cent in each of the next two years. With regard to expectations for wage settlements trade union officials indicated 7.6 per cent for both years, whereas business people expect 7.8 per cent for 2014 and 8% for 2015. Thus, the expectations of labour and business, the price-setting agents in the economy, are of concern – they are not only at uncomfortably high levels but, also outside the upper-end of the target band over the forecast horizon. A wage-price spiral would severely compromise South Africa's inflation and growth outcomes. Thus, while inflationary pressures may not be of a demand-pull nature, second-round price effects from supply-side shocks need to be contained.

The MPC has indicated that we are in a tightening phase of the interest rate cycle. While price stability remains the primary focus of monetary policy, the Bank has indicated that this objective will be pursued in a manner so that economic growth outcomes are not unduly undermined. As we explained in the July MPC statement, monetary policy is on a "gradual normalisation path", which will be highly data-dependent. The SARB remains committed to its mandate of maintaining price stability in the interest of balanced and sustainable economic growth in South Africa. In this regard, it is important to note that despite the 75 basis point increase in the repo rate since the beginning of the year, the real repurchase rate is still marginally negative thus ensuring that monetary policy remains supportive of the domestic economy.

3. The new financial services regulatory regime in South Africa

The great recession, which began in 2008 has shown that imbalances between the real and financial sectors of the economy could increase the vulnerability of the financial system. In addition, with hindsight, we now know that such vulnerabilities may not become evident solely through the supervision of individual institutions. For this reason, macro-prudential aspects of financial stability have gained traction in policy circles around the globe. South African policymakers have also engaged in a process of reviewing and revamping the regulation of the financial sector.

In February 2011, the Minister of Finance announced that South Africa would be shifting to a "Twin Peaks" model of financial regulation. At the end of last year, the National Treasury published the draft Financial Sector Regulation Bill (Twin Peaks Bill), which provides some detail around the architecture of the Twin Peaks model. In terms of the Twin Peaks model, a Prudential Authority (PA) will be established within the SARB to oversee the safety and soundness of banks, insurers, financial conglomerates and key financial market infrastructures. The FSB will become the Market Conduct Authority (MCA) and will promote integrity and efficiency of financial markets in order to safeguard the interests of South African consumers of financial services. It goes without saying that co-ordination between the two regulators will be crucial to ensure the overall stability and robustness of the South African financial system.

The exact date of Twin Peaks implementation will be finalised once the necessary legislative processes have taken place. It is envisaged that the Twin Peaks model of regulation will come into effect by the end of 2014 although this is dependent on the parliamentary process and the final enactment of the bill.

While the enabling legislation for "Twin Peaks" is still in the process of being finalised, some of the support measures recently announced by the SARB for African Bank were informed by the principles contained in the G20/FSB Key Attributes for Effective Resolution Regimes, which are expected to feature in the new legislation. Allow me to make a brief comment about the measures announced by the SARB last Sunday. The legal structure of curatorship will facilitate an orderly, structured, and fair approach to addressing the current challenges at African Bank in an effort to secure a viable future on the basis of a transformed business model, while ensuring minimum disruption to our financial and credit markets. The proposed solutions were developed in a collaborative process between the public and private sector. The leadership and commitment shown by South African commercial banks and the PIC in underwriting the capital raising for the envisaged “good bank” bears testimony to the strong underpinnings of our banking and financial system, the resilience of which will be enhanced by these measures.

Once the necessary legislation has been enacted, the current Financial Stability Committee (FSC) of the Bank, will be replaced by the Financial Stability Oversight Committee (FSOC). This committee will be chaired by the Governor with the membership of this committee comprising the SARB, the Financial Services Board (FSB) and National Treasury as an observer. The primary mandate of the FSOC will be to monitor and assess systemic risks to financial stability and make recommendations on how to counter or eliminate these risks. In the execution of its financial stability mandate, the Bank relies as far as possible on the efficient functioning of market forces to ensure the stability of the financial system. Thus, the Bank’s action will be guided by the principle of the containment of systemic risk.

Given the large representation from the insurance industry in the audience today, I would like to briefly outline some of the regulatory changes confronting the insurance industry. As you are aware, some four years ago, the FSB and the South African insurance industry embarked on the Solvency Assessment and Management (SAM) project. This project is directed at establishing a risk-based supervisory regime for the prudential regulation of both long-term and short-term insurers in South Africa. In essence, the objective is to enhance the monitoring and management of risk so as to ensure that the capital requirements are appropriately aligned with the underlying risks of an insurer.

Under the Twin Peaks regulatory regime, insurance regulation and supervision will be split between the Prudential Authority in the SARB and the MCA (FSB). The Prudential Authority will supervise financial soundness and the MCA will oversee the business conduct of insurers. The SARB is currently busy with undertaking the necessary preparations for taking over the prudential regulation of insurers and insurance groups. A Prudential Authority Implementation Working Group (PAIWG) has been established to guide the implementation process of the organisational structure of the Prudential Authority as well as to facilitate a smooth integration of supervisory staff from the FSB and the SARB into the Prudential Authority in due course. The intention is that the Prudential Authority will be able to effectively assume its responsibilities once the Twin Peaks legislation has been passed by parliament.

4. Conclusion

Challenges abound for South African policymakers. An uncertain international economic environment, with the possibility of adverse exogenous shocks may very well, be par for the course. While there may be little that can be done to insulate the economy from uncertain exogenous shocks, there are important domestic impediments that warrant attention. Government, business and labour have an important role to play in addressing these problems. These challenges become a little easier to address against the backdrop of a stable macro-economic environment characterised by price and financial stability. The SARB remains committed to playing a constructive role in this regard within its mandate.

Thank you.