François Groepe: Recent economic and regulatory developments

Keynote address by Mr François Groepe, Deputy Governor of the South African Reserve Bank, at The Webber Wentzel Leadership Network, Johannesburg, 4 March 2015.

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Introduction

Good morning, ladies and gentlemen.

Thank you for inviting me to the Webber Wentzel Leadership Network, which is aimed at reinforcing your firm's dedication to the future of South Africa and underscores the role that young professionals should play in the advancement of our country's democracy.

I look forward to sharing my views on the recent international and domestic economic developments, as well as changes to the financial regulatory architecture.

International economic developments

We have entered the seventh year since the start of the Great Recession, and despite the significant elapse of time, the global recovery can be characterised as uneven. Global economic growth decelerated significantly to an annualised rate of 3,4 per cent in the final quarter of 2014 compared to the 4,6 per cent recorded in the third quarter. This slowdown can largely be attributed to the slower growth recorded in both advanced economies, as well as a number of the large emerging market economies, such as China and India.

The US economy, after expanding strongly by 5,0 per cent in the third quarter of 2014, slowed to 2,2 per cent in the fourth quarter. Overall economic activity expanded by a solid 2,4 per cent during 2014, which represented a notable improvement in economic conditions following the contraction of 2,1 per cent in the first quarter of 2014. Although the US unemployment rate ticked up marginally to 5,7 per cent, this could be attributed to the slight improvement of 0,2 percentage points in the labour force participation rate to 62,9 per cent and which can broadly be interpreted as an improvement in labour market conditions.

Although headline CPI inflation has declined to –0,1 percentage points and Personal Consumption Expenditure inflation stands at 0,2 percentage points (year-on-year), it is likely that monetary policymakers will look through the oil price shock. Core Personal Consumption Expenditure inflation is at 1,3 per cent and services inflation is at 2,1 per cent, very close to the US Fed's 2 per cent goal. Wage growth ticked up to 2,2 per cent in January.

It is anticipated that the Federal Open Market Committee will commence with the process of interest-rate normalisation during the course of this year, despite its use of the term "patient" during its January statement, and market participants are eagerly anticipating the March statement to analyse it for any change in the language used. Although lift-off is possible towards the middle of the year, it will be data-dependent. And as the timing risk of a lift-off is asymmetric (i.e. the perceived risk of tightening too soon outweighs the risk of tightening slightly too late), there is a chance that lift-off may be delayed to the second half of this year. Should the so-called lift-off occur earlier than the market expects, market volatility is likely to heighten, despite the committee's guidance that normalisation will be at a slow and gradual pace.

The UK economy expanded by a briskly 2,6 per cent in 2014, despite growth slowing to 2,2 per cent in the final quarter of 2014 compared to the 2,6 per cent registered in the third quarter.

In the euro area, economic growth remains pedestrian despite accelerating from 0,4 per cent in the third quarter to 1,6 per cent in the final quarter of 2014, which helped to push growth to 0,9 per cent for 2014. Growth for 2015 is projected at 1,3 per cent, but with downside risk.

Although the immediate risk of a Grexit has receded, following an agreement to a four-month extension to its EU/IMF bailout programme, significant risks remain as some €10 billion in loan, bond and interest repayments is due in the next few months.

Preliminary headline inflation registered –0,3 percentage points in February 2015, which is marginally better than the –0,6 percentage points reported for January, due to the lower energy prices, thus raising the spectre of deflation. The European Central Bank announced in January 2015 that it would embark on an open-ended monthly asset purchase programme of some €1,1 trillion in total. This seems to have partly stabilised inflation expectations in the euro area. Unemployment in the euro area continues to improve marginally and is now at 11,2 per cent.

Japanese growth returned to positive territory in the fourth quarter of 2014 on the back of brisk growth in net exports. Despite this, growth for 2014 registered zero per cent. Headline inflation in January amounted to 2,4 per cent, but when allowance was made for the effect of the increase in consumption taxation in April 2014, consumer price inflation was merely 0,4 per cent and hence some way off the 2 per cent target that has been set by the authorities. The Bank of Japan increased its quantitative and qualitative easing programme to approximately ¥80 trillion per annum in October 2014.

Earlier this year, the IMF lowered its global growth forecast for 2015 and 2016 to 3,5 per cent and 3,7 per cent, respectively. This was mainly due to a more bearish growth outlook for certain emerging market and oil-exporting economies, as well as the euro area and Japan. China's real output decelerated from 8,3 per cent in the third quarter to 7,2 per cent in the final quarter of 2014 while its growth for 2014 registered 7,4 per cent, its slowest expansion in more than two decades.

The impact of unconventional monetary policy on emerging market economies

The global increase in liquidity, following the launch of widespread quantitative and qualitative easing programmes, or the unconventional monetary policy, by several advanced economies played an important role in preventing the Great Recession from degenerating into a Great Depression, and more recently, has been used to counter the possible unanchoring of inflation expectations in the face of deflationary conditions.

The transmission of global financial conditions and shocks across borders seems to have intensified following the implementation of the unconventional monetary policy in advanced economies. This is as a result of increasing global trade and integrated financial markets. The channels by which these shocks are transmitted to emerging market economies are the interest-rate channel, the exchange-rate channel, and changes in asset prices.

The interest-rate channel, and especially the yield curve, has been a key transmission channel of extraordinary monetary accommodation in advanced economies. With the decline in global interest rates to near-zero and the consequent easing of financial conditions, the term premium was compressed, which prompted investors to rebalance their portfolios towards higher-yielding assets in emerging market economies. Higher interest rates and relatively stronger growth in emerging market economies acted as a pull factor on capital flows. International financial and monetary conditions were therefore the trigger for flows into the bond markets of emerging market economies, or what Hyun Song Shin terms as the second phase of global liquidity, bringing economic benefits, but also making these economies more vulnerable to external shocks. Investors drew scant little distinction between the riskiest high-yield corporate bonds and the emerging market sovereigns while excessively accommodative monetary policy in advanced economies prevailed. However, with increased expectations of normalisation of policy rates and the end of the asset purchase programme in the US, the high-yielding emerging market economies' securities has lost their appeal somewhat.

A further channel of transmission for quantitative easing has been through exchange-rate movements. Capital inflows, particularly portfolio inflows, to emerging market economies have resulted in the appreciation of some emerging market economies' currencies. However, according to the IMF, the overall impact on emerging market economies was generally positive. It further argues that the positive spill-over effects from the relatively stronger demand in advanced economies, as well as from the lower costs of capital, cheaper sovereign financing and higher equity prices, outweighed the negative effect of currency appreciation.

Some of the positive net effects of quantitative easing on emerging market economies were, however, reversed following the "tapering" announcement in May 2013 which triggered changes in US policy expectations. Some evidence suggests that the announcement has likely reduced market participants' risk appetite for investing in emerging market economies. Indeed, many emerging market economies experienced a sharp withdrawal of private capital inflows and increased financial market volatility. The impact has, however, increasingly become differentiated among economies. Countries with stronger fundamentals, deeper financial markets and a tighter stance on capital flows and macro-prudential policies, prior to tapering, seems to have experienced less volatility.

South Africa was among the emerging market economies strongly affected by the US Fed's tapering announcement. As in other emerging market economies, portfolio inflows slowed from May 2013 and turned to outflows in the second and fourth quarters of 2013 and again in the third quarter of 2014. The exchange rate of the rand has also been volatile. Although some of this volatility can be explained by the changing expectations of the timing of the first US interest-rate increase, domestic idiosyncratic factors were also at play, including weak growth projections, large twin deficits, a sizable share of foreign holdings in rand government debt and downgrades of South Africa's credit ratings. The flexible exchange-rate system and robust macro-prudential policies in South Africa have, to some extent, served as a buffer in offsetting some of the negative spill-overs.

Market perceptions of a possible delay in US normalisation, coupled with the European Central Bank action, have changed global market risk sentiment and improved the prospects for capital flows to emerging markets over the short-term. This, however, is likely to be temporary in nature.

The third transmission channel of unconventional monetary policy has been through the increase in asset values, both through the liquidity effect and by lowering the rates used to discount future streams of earnings. This has occurred both in advanced, as well as in emerging market economies. Since the US Fed embarked on the first round of quantitative easing, the US equity market, as measured by the S&P500, has gained over 232 per cent. The equity market in South Africa gained 236 per cent over the same period in rand terms. However, even though foreign equity flows slowed somewhat since the taper tantrum in May 2013 and the actual tapering commencing in January 2014, the JSE has continued rising and equity valuations at about 17,3 times forward price-earnings ratio are firmly above their long-term trend.

While South Africa has experienced significant volatility in its exchange rate, as well as a surge in asset prices, there is little evidence to suggest that this has had a significant impact on the domestic credit cycle. The credit-to-GDP gap, which was in line with the positive levels of the credit-to-GDP gap of most advanced economies during the build-up phase of the global financial crisis, is currently below its long-term trend in South Africa.

Recently, Christine Lagarde, the MD of the IMF, argued that even if the process of interest-rate increases by the US Fed is well-managed, it may result in excessive volatility in financial markets and trigger a reversal of capital flows, particularly from vulnerable emerging market economies as investors reassess their perception of risk. South Africa, with its large budget- and current-account deficits, remains vulnerable to capital outflows and a weakening of the currency.

The impact of low oil prices on the global economy

The similarities between the transmission mechanism of the 2006 fall in US house prices and the fall in the price of oil since June 2014 have prompted some analysts to predict that the correction in the oil price could ultimately lead to negative spill-over effects to the global economy.

The US shale gas and oil industry is highly leveraged, and capitalised on the rise in the price of oil that started almost a decade ago. Banks' lending to the energy sector of billions of dollars could pose a systemic risk to the global financial system. The exposure was seen as low-risk and the pricing of risk by lenders might have been less robust during the upward swing in oil prices.

The recent precipitous plunge in oil prices from approximately US$115 to US$60 has stoked concerns over growth of particularly the oil-producing countries, fuelling fears about deflation and intensifying scrutiny of capital spending across the energy sector, with companies set to slash their exploration and development budgets. Some estimates put the figure of possible losses related to halting exploration projects at US$1 trillion. Sustained low oil prices could further trigger a wave of bankruptcies and defaults with concomitant negative spill-over effects to the financial sector.

A number of sub-Sahara African countries are particularly at risk from the fall in oil prices, with oil exports accounting for 40–50 per cent of GDP for Gabon, Angola and the Republic of the Congo, and 80 per cent for Equatorial Guinea. In Angola, the Republic of Congo and Equatorial Guinea, the oil industry accounts for 75 per cent of government revenue, while in Nigeria oil still accounts for more than 70 per cent of the national budget, leaving public institutions exposed should low oil prices persist for some time.

Although low oil prices could boost consumption, their impact on growth could be mixed, with oil-exporting countries particularly vulnerable and they may be negatively affected by these developments in the form of deteriorating fiscal and external balances. This may further result in sovereign wealth liquidating some of their investment holdings.

The lower oil prices may also accelerate the build-up of deflationary pressures in certain advanced economies.

Domestic economic developments

Although the South African economy expanded at a brisk annualised rate of 4,1 per cent in the final quarter of 2014, growth for the full year was a disappointing 1,5 per cent and represents the second-lowest growth rate recorded over the past sixteen years. The real output during 2014 was severely affected by the industrial action in the platinum, as well as steel and engineering sectors, and supply-side bottlenecks such as the interruptions to the electricity supply towards the end of last year. Although mindful of the impact that monetary policy may have on economic growth, the Bank has to remain focused on its primary objective of price stability without being oblivious to growth dynamics. Similarly, monetary policy does not cure all ills, and South Africa needs to be alive to the structural reforms, albeit painful, that may be required to place the country on a firm path to balanced and sustainable growth. These reforms extend beyond labour market reforms and according to the IMF's *2014 Article IV Consultation Staff Report*, they should include increased product market competition, as it would help to reduce the wage-productivity gap by lowering the cost of living and enhancing productivity.

The current-account deficit improved during the second half of 2014. It improved from a deficit of 6,2 per cent in the second quarter to 5,8 per cent in the third quarter of 2014. This can be attributed to mineral exports improving in the second half of the year, following the crippling platinum strikes in the first half of 2014, improved terms of trade due to the sharp decline in the international crude oil prices, and a more competitive rand exchange rate.

Headline CPI inflation decelerated to an annual rate of 4,4 per cent in January 2015, down from 5,3 per cent in December, and is now below the mid-point of the inflation target range. Consumer goods price inflation slowed markedly from a year-on-year rate of 4,8 per cent in December 2014 to 3,0 per cent in January 2015. Similarly, non-durable goods inflation decelerated sharply to 2,5 per cent in January 2015 from 4,8 per cent in December 2014, as a result of the sharp decline in fuel prices, which resulted in transport contributing 0,7 percentage points to the 0,9 percentage points decline in headline CPI inflation. Services price inflation remained sticky in January and moderated only slightly to 5,8 per cent from 5,9 per cent in December 2014.

Headline CPI, excluding food and non-alcoholic beverages, petrol and energy – the most popular measure of core inflation – accelerated marginally to 5,8 per cent in January 2015 from 5,7 per cent in December 2014. The underlying measures of CPI remain stable, but elevated, which points to fairly persistent underlying inflationary pressures.

The most recent rally in international crude oil prices resulted in a rebound in the petrol price of 96 cents per litre at the beginning of March 2015, which on its own may add approximately 0,6 percentage points to headline CPI.

Although the more benign headline CPI outlook has given the MPC some room to pause in its process of interest-rate normalisation, it had emphasised that the bar for further accommodation remains high and, as indicated, would require a sustained decline in the inflation rate and sticky inflation expectations.

Regulatory, supervisory, and financial stability matters

Following the Great Recession of 2008, the Bank's mandate of price stability has been expanded in line with most other central banks' in the world, to include the additional responsibility of overseeing and maintaining the stability of their financial systems. The Bank shares this mandate for financial stability of the South African financial system with other stakeholders in the financial and public sectors.

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 regulation represents a move away from a fragmented regulatory approach (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 licencing, 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. This list, although not exhaustive, suggests the significant scope and amount of the work still ahead. Adding to this burden are the implementation and monitoring processes, such as the Financial Sector Assessment Programme and related peer reviews to assess progress made with the implementation of internationally agreed regulatory standards by member jurisdictions.

On 1 January 2013, South Africa implemented the Basel III framework. The implementation period for several of the Basel III requirements that were incorporated into the domestic banking regulations commenced on 1 January 2013, and includes transitional arrangements, which will be phased in until 1 January 2019. The purpose of the transitional arrangements is to afford banks sufficient time to meet the higher standards while still supporting lending to the real economy.

South Africa underwent a peer and thematic review by the Financial Stability Board in 2013, and recently participated in an IMF/World Bank Financial Sector Assessment Programme, which was finalised towards the end of 2014. The purpose of such programmes is to assess the stability of member jurisdictions' financial systems as a whole; they intend to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance their resilience to shocks and contagion. Overall, the assessment of South Africa's financial sector and its supervision and regulation was positive, the report noting a high-level of compliance and strong supervision but finding that the financial sector operated in a challenging economic environment, identifying some gaps.

Conclusion

It is clear that although the global recovery has started to gain momentum, particularly in the US and the UK, it is multispeed and there are a number of downside risks to the global economic growth outlook. Although the slump in oil prices can be described as equivalent to a tax reduction of approximately US$1 – 1,5 trillion and is viewed by most analysts as net positive for global growth, the positive and negative shocks are asymmetric, and certain oil-exporting countries will be severely affected should oil prices remain at current levels for an extended period of time. Many of these countries may be downgraded by rating agencies and may experience significant capital outflows, particularly if the US economy recovers more strongly and if lift-off happens sooner or at a faster pace than markets may have anticipated. This may elevate global financial stability concerns.

Further risks to the global economic outlook include a possible disorderly Grexit and the risk of deflation, should inflation expectations become unhinged in the euro area and in Japan.

On the domestic front, growth continues to disappoint, and potential growth is likely to be constrained due to the electricity load-shedding. The inflation outlook, although materially better, remains sticky, with inflation expectations remaining close to the upper-end of the target. It has, however, provided some room for pause, but the bar for an interest reduction is high, as previously stated.

The scale of the regulatory reform process under way is probably the most significant overhaul of the financial regulatory architecture since the 1970s. Despite its ambitious scale, the Bank is preparing itself to embrace this expanded mandate in its quest to promote, maintain, and ensure a more stable financial system. That will hopefully allow all of us to sleep more soundly at night, knowing that our savings and investments are safer.