François Groepe: The South African economy, policy mandates and international central bank cooperation

Address by Mr François Groepe, Deputy Governor of the South African Reserve Bank, at the Tenth Annual International Operational Risk Working Group (IORWG) Conference, Cape Town, 22 April 2015.

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Introduction

Good evening ladies and gentlemen. I wish to extend a warm and hearty African welcome to you and I hope that you will thoroughly enjoy tonight's gala dinner.

It is my privilege and honour to host this gala dinner on the occasion of the Tenth Annual International Operational Risk Working Group (IORWG) Conference. I wish to personally thank the co-chairperson, Ms Donna Brenner, for supporting the South African Reserve Bank's (SARB) bid to host this important conference in this wonderful city. I, furthermore, wish to express my sincerest gratitude to all the delegates and their spouses, many who have travelled from abroad for gracing us with your presence and contributing to the debates and the discussions.

The SARB has enjoyed a long and beneficial relationship with the IORWG and all its member central banks and it is my wish that this conference will further cement the strong and mutually beneficial bi- and multi-lateral relationships that have been built over many years.

Before we proceed with dinner, I would like to share with you some thoughts about the South African economy and our policy mandates and the importance of international cooperation among central banks.

South Africa and the global economy

South Africa is a small open economy with a population of 54 million and a GDP of some USD 350 billion. This equates to a GDP per capita of USD 5 900 and USD 12 100 on a purchasing power parity basis. The tertiary sector has expanded rapidly over the last decade or two and now accounts for nearly two thirds of the economy. One of the huge challenges the country faces is structural unemployment, which is around 24 per cent with youth unemployment as high as 50 per cent. In order for the country to keep unemployment levels stable, the economy needs to grow at approximately 3 per cent per annum.

The country's economic recovery after the global financial crisis was initially broadly in line with the global recovery with economic growth registering at 3,0 per cent and 3,2 per cent in 2010 and 2011, respectively. Since 2011, the economic recovery has slowed with growth slowing to 2,2 per cent and 1,5 per cent in 2013 and 2014, respectively.

Growth for 2015 is projected at 2,2 per cent and is notably lower than the pre-crisis growth rates. In recent years the lower growth rates was attributable to significant supply side constraints and disruptions. The most recent electricity load shedding has become a more pronounced drag on real output and unfortunately is likely to be a binding constraint over the short to medium term.

South Africa's current account deficit has improved slightly from 5,8 per cent of GDP in 2013 to 5,4 per cent in 2014. Although this is often described as a vulnerability, it is somewhat mitigated by the fact that the public debt to GDP ratio is manageable at approximately 45 per cent, a fairly small percentage of the public debt is foreign denominated and lastly, the country's net international investment position, (i.e. external financial assets minus liabilities) stood at only –R438 billion in the final quarter of 2014.

The South African Government released the National Development Plan some two years ago. This plan offers a long-term perspective on how to eliminate poverty and reduce inequality by 2030 by, *inter alia*, growing an inclusive economy, building capabilities, and enhancing the capacity of the state. Should significant aspects of this plan be successfully implemented over the next decade or so, it will contribute positively towards lifting the potential growth rate of the economy and causing unemployment and poverty levels to drop in a meaningful way.

The slow growth rate referred to above, however, has not only been impacted by domestic idiosyncratic factors only. Certain exogenous factors, such as the moderation in emerging market economies growth rates, weaker external demand and lower commodity prices have certainly contributed to the more pedestrian growth outcomes.

The unprecedented extent of unconventional monetary policy adopted by the advanced economies and the subsequent commencement by the US on the path towards monetary policy normalisation has led to significant spill-over effects. This is as a result of the extent of global trade and the integration of financial markets and has contributed to the high levels of volatility seen in the foreign exchange markets. The rand/dollar exchange rate has depreciated by 4,96 per cent since the beginning of this year, but has appreciated by 7,25 per cent against the euro and hence, on a trade weighted basis the rand had been relatively stable.

The volatility in the foreign currency exchange markets is likely to persist and will be amplified should the timing of the so-called lift-off differ from market expectations, or a Grexit occur. The emerging market economies are likely to be affected significantly by these developments and countries with weak macro-economic fundamentals and indicators in particular are likely to be most vulnerable.

The role of the SARB in the economy

The Constitution mandates the SARB to protect the value of the currency in the interest of balanced and sustainable economic growth. We strive to achieve this objective within a flexible inflation targeting framework as it is widely believed that price stability is a necessary pre-condition for balanced and sustainable growth. The global financial crisis has, however, demonstrated that price stability in, and of its own, is not sufficient to ensure that financial stability is achieved.

This resulted in the Bank's mandate of price stability being expanded to include the additional responsibility of overseeing and maintaining the stability of the broader financial system. South Africa has opted to shift to a Twin Peaks model of financial sector regulation which represents a move away from a fragmented regulatory approach (based on the institution or activity) towards a regulatory and supervision model based on objectives. In terms of proposed legislation, the Bank will house the Prudential Authority, which 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.

These 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.

The importance of international dialogue and ERM frameworks for central banks

The increased connectedness of the world, within which we operate, has necessitated closer cooperation and coordination within the central bank community. The need for this has once again been highlighted by the global financial crisis and the subsequent attempts to not only restart the global economy but also to undertake an ambitious global regulatory reform agenda in order to address and avoid the excesses and imbalances that led to it.

This illustrates the importance of collaboration between central banks. Without strong international leadership and active collaboration it would not have been possible to progress the overhaul of the global regulatory system to the extent that had been achieved.

The expanded mandate of central banks may in the longer-term lead to demands for greater accountability and potentially attempts to curtail their independence. It is, therefore, important that central banks are proactive in further improving accountability and transparency and to ensure that their governance standards are beyond reproach. Central to such a governance framework is the risk management policy framework.

This conference provides a platform for collaborating, sharing experiences and thoughts and addressing common challenges together. It provides a useful opportunity to leverage and learn from the experiences of how best to ensure that the risks, that inhibit achievement of our objectives, are properly identified and mitigated.

It is generally accepted that central banks were late movers into the area of true Enterprise Risk Management (ERM), due to the strong emphasis on financial risk management. It soon became apparent that this is not sufficient and that operational risk management had to be brought into sharper focus. It is important that central banks move to the next phase which would require a greater appreciation of the importance of integrating all risk management across a central bank's operations in the mould of a true ERM approach. This will assist in ensuring that strategic risks, policy risks, and reputational risks are holistically integrated with operational risk management.

The IORWG has played, and I believe will continue to play, a vital role facilitating this broadening of the risk management frameworks within the broader central bank community. I have further been encouraged by the fact that many of you are appreciative of the need to move in that direction. There is no doubt that there may be some resistance to the expansion of the risk management frameworks to cover policy risks within central banks.

I am, therefore, proud that I am able to share with you that South Africa has recently expanded its risk management framework to cover policy risks and we have completed an assessment of monetary policy risks. We further envisage incorporating financial stability policy into our risk management framework once we have implemented the proposed financial regulatory architecture reforms.

In the light of what I have said, I hope you would forgive me for being so bold as to suggest that the IORWG may wish to consider changing its name to better reflect this structural shift. It may choose to consider replacing the word OPERATIONAL with ORGANISATIONAL in the IORWG acronym.

Conclusion

Central banks have many functions and operations that underlie their primary goals. Enterprise risk management is a key assurance activity that allows central banks to pursue their mandates effectively and efficiently. This is vital given the escalation in the challenges that they face such as the growing threat of concerted cyber-attacks to name but a single example.

I, therefore, challenge you to take forward the many themes covered here this week and to continue to collaborate in the cooperative spirit you have shown in the past to find ways to meet the threats facing us all. Your institutions, your countries, your fellow countrymen, in fact the whole world will thank you for assisting your institutions in realising their mandates in support of economic growth, keeping prices stable, achieving and maintaining financial stability and keeping unemployment levels in check.

Thank you for your attention, and enjoy the rest of the evening with us in this lovely setting.