South African Reserve Bank

An address by Francois Groepe,
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at the RMB Morgan Stanley Investor Conference

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Distinguished guests, ladies and gentlemen.

It is a pleasure to be with you today and to share the stage with such an illustrious group of speakers.

Today, I would like to discuss what has been a recurring theme in our economic discourse for the past decade – the pursuit of structural reforms in the interest of inclusive growth. It is top of mind for investors, businesses, labour unions, academics and policymakers alike, including the Monetary Policy Committee (MPC). It has also attracted a wide range of research and analysis, most prominently the National Planning Commission’s diagnostic report, and has been central to the proposed government policy interventions as captured within the National Development Plan (NDP).

First, I will share my thoughts on this critical topic, and second, I will touch on the role of the South African Reserve Bank (SARB) in relation to structural reforms.

Introduction

Structural reforms are policies mainly undertaken to improve the supply side of the economy by reducing constraints on the production of goods and services. These may include policies to reduce ‘red tape’, curtail monopoly power, raise the efficiency of key public services, and even amend taxes and public spending programmes with the intention of ensuring fiscal sustainability. Underlying these reforms is often an attempt to strengthen the institutional fabric of the economy by ensuring that 'the rules of the game' incentivise individual behaviour that contributes to the common good.

The need to lift productivity and growth through structural and institutional reforms has received a significant amount of attention – not just domestically, but internationally. Indeed, it is a challenge faced by economies of all income levels in many different parts of the world. For example, in its latest *Global Economic Prospects* report, the World Bank notes that both advanced and emerging market economies have experienced a decline in their growth potential over the past decade. In a reference to the global economy, the report emphasises 'an urgent need to press ahead with growth-enhancing policy adjustments – including reforming product and labor markets, raising investment in human capital, and building the policy buffers needed to allow an appropriate countercyclical response to shocks when they materialize'.[1] This policy recommendation for the global economy applies equally to South Africa. Our growth challenges are thus not unique, but they are certainly a cause for concern.

Similarly, the pressure to enhance the inclusiveness of economic growth in South Africa is also being felt in many other parts of the world. While income inequality *between* countries has fallen over the past 20 years, amid a rising middle class in many emerging market economies,[2] *within*-country inequality has increased in many countries.[3]

The recent rise in populist rhetoric internationally appears to be, at least in part, a reflection of rising inequality and a sense that economic gains are neither equally nor widely shared. This perception was exacerbated by the global financial crisis which, like many large crises, affected the poorest in society the worst.

The power of inequality and perceived economic injustice as contributing factors towards political outcomes is being demonstrated in advanced and emerging

[1] World Bank. 2018. *India – Systematic country diagnostic: realizing the promise of prosperity: Global Economic Prospects: the turning of the tide?* Washington, DC: World Bank.
[2] Milanovic, B. 2012. 'Global income inequality by the numbers: in history and now'. *World Bank Policy Research Working Paper 6259*. Washington, DC: World Bank.
[3] Atkinson, A, Piketty, T and Saez, E. 2011. 'Top incomes in the long run of history'. *Journal of Economic Literature* 49(1): 3–71.

economies alike. The consequences of these outcomes have been profound. In particular, decades of global economic integration, so widely held to be beneficial, are now at risk of being reversed. A key implication of this reaction is that the policies targeted at increasing gross domestic product (GDP) growth must also aim to be inclusive if they are to be sustainable in the long term.

Considering South Africa's challenges in moving to a more equitable economy, it is disconcerting to observe the notable moderation in the potential rate of growth over the past decade. Part of this moderation can be attributed to the legacy of the global financial crisis and a lower level of growth in some of South Africa's export-partner economies. However, a significant share is self-inflicted, reflecting slow gains in productivity, policy uncertainty and a lack of investment in key sectors.

At the current level of potential GDP growth – which the SARB estimates to be between 1.0% and 1.4% over the next three years – the economy is not able to generate real per capita income gains on a sustained basis. This is because population growth is currently at about 1.6% per year.[4] Achieving a more equitable distribution of income is particularly challenging if it is not possible to grow the economy faster than the rate of population growth. In such an environment, difficult conversations about redistribution are unavoidable. However, if we could meaningfully lift the GDP growth rate, redistribution could take place more easily through the sharing of the additional gains.

Reforming the economy has therefore become imperative, particularly if the standard of living is to be improved for all South Africans.

Government has put substantial effort into the development of the NDP, which provides a clear and holistic structural reform framework. This plan has received support from across the political spectrum. However, implementation has been disappointingly slow.

[4] https://www.statssa.gov.za/publications/P0302/P03022017.pdf

The recent change in political leadership gave rise to a renewed sense of optimism around the structural transformation agenda – not least because the President was the Deputy Chair when the National Planning Commission drafted the NDP. Encouragingly, the new administration has started to implement a number of reforms aimed at improving governance, tackling corruption and reducing pressure on the fiscus.

Despite the improvements in business and consumer confidence earlier this year, the short-term economic outlook has remained subdued. Some analysts have noted that the reform progress has not been sufficiently rapid to ignite economic activity. With the economy now in a technical recession, following two consecutive quarters of contracting economic activity, concerns about the implications of low growth for employment creation, government finances and poverty alleviation have intensified.

The governance and fiscal reforms currently being implemented are better thought of as improving institutional strength and the resilience of the economy. While they may not meaningfully lift short-term growth, they are important in reducing downside risks over the medium term and providing a degree of confidence to the private sector. Embedding a sound institutional environment is essential for creating the virtuous cycle in which iterative structural improvements are self-perpetuating.

To raise the growth potential of the South African economy, additional reforms are required, specifically aimed at lifting productivity and increasing the efficiency of product and labour markets. Structural reforms, even when small, have in the past brought tangible benefits to our economy. The licensing of mobile phone operators in the 1990s brought down the costs of land lines and moved South Africans to near universal access to a telephone – over 90% of adults have had access to a land line or mobile phone since 2016.[5] In addition, allowing for private sector participation in the electricity sector since 2010 has enabled the connection of 3776MW[6] to the electricity grid and increased private sector investment, and minimised the negative impact of

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[5] Independent Communications Authority of South Africa (ICASA). 2018. *Third Report on the State of the ICT Sector in South Africa*. Pretoria, ICASA.

[6] Department of Energy. 2018. Opinion piece by Minister Jeff Radebe, 'Renewable energy independent power producer agreements will benefit South Africa in the transition to an environmentally sustainable economic future', 27 July.

power shortages in 2015/16. There is room for more reforms which, as articulated in the NDP, can lower the cost of living and improve the competitiveness of our exports.

Indeed, National Treasury has recently estimated that the potential growth rate of the economy could be doubled by, among other things, releasing broadband spectrum, increasing the skill levels in the economy, and addressing anti-competitive practices.[7] Other analyses show that there is a positive correlation between the employment of skilled workers and unskilled workers. In this regard, measures to increase the number of workers with critical skills, including higher university throughput, the training of artisans and easing visa regulations for individuals with critical skills, could be beneficial.

While some of these reforms will take time to show in the growth numbers,[8] more immediate gains can be achieved by addressing the policy uncertainty that has constrained private investment for some time now. In fact, providing a clear and consistent message about the reform agenda will be as important as the agenda itself. Former United States (US) Treasury Secretary Larry Summers has often been quoted as saying that 'confidence is the cheapest form of stimulus'.[9] However, in an environment of rising inflation and fiscal constraints, it is also likely to be the most effective stimulus currently available. In this regard, further clarity on the modalities of the recovery package recently announced by the President will be important.

Over the medium term, it is important to emphasise that while the rate of growth in the economy is set to rise only gradually, with a faster uptick contingent upon further reforms, South Africa's macroeconomic framework and strong set of institutions continue to display remarkable resilience under challenging conditions.

This is no accident. South Africa's Constitution was carefully drafted to provide for an independent judiciary, free media and democratic accountability – all of which are underpinned by an active civil society. Meanwhile, the macroeconomic framework has

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[7] http://www.treasury.gov.za/documents/national%20budget/2018/review/FullBR.pdf
[8] Rodrik, D. 2016. 'The elusive promise of structural reform'. *The Milken Institute Review* 2: 26–35.
[9] https://www.washingtonpost.com/news/wonk/wp/2015/11/02/larry-summers-where-paul-krugman-and-i-differ-on-secular-stagnation/?noredirect=on&utm_term=.68d0b3a3e284

been designed to ensure, among other things, that the exchange rate can effectively absorb shocks from abroad without transmitting instability, alongside other automatic stabilisers.

I would now like to discuss the role of the SARB in South Africa's institutional landscape and what we are doing to contribute to the country's macroeconomic resilience and growth.

The South African Reserve Bank's role in South Africa's institutional landscape

The primary role and the independence of the SARB are clearly articulated in South Africa's Constitution. It calls for the central bank to 'protect the value of the currency in the interest of balanced and sustainable economic growth', and states that the SARB 'must perform its functions independently and without fear, favour or prejudice'.[10]

Central bank independence in the context of the SARB refers, at the minimum, to *instrument* independence, that is, the SARB has the flexibility to use any and all of the tools at its disposal to achieve the set inflation target range.

The SARB communicates regularly with the public, trade unions, civil society, parliament and representatives of government to explain and discuss economic developments, as well as what informs the monetary policy stance. Through this process, the SARB remains accountable to the South African public. The SARB's independence, however, allows it to avoid the trap whereby monetary policy is being constrained by short-term political motives.

I wish to emphasise that the current shareholding structure of the SARB has no bearing on its policymaking. Furthermore, the independence that the central bank enjoys is unrelated to its shareholding structure as policymaking is the responsibility of the four governors that are appointed by the President. Thus, the recent discussions about government potentially changing the shareholding structure of the SARB are

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[10] http://www.justice.gov.za/legislation/constitution/SAConstitution-web-eng.pdf

largely inconsequential to the way in which the central bank operates. Nevertheless, should the independence of the SARB come under threat for any reason, we will make full use of all the legal avenues available to protect the independence of the SARB as it is a very important pillar for monetary policy credibility.

To illustrate this point, allow me to briefly outline a temptation which is described in the literature as a key reason for central bank independence. The temptation is known as ‘time inconsistency’. It simply means that there is always an incentive for a central bank to surprise the market with a more lax policy than is implied by its historical behaviour. The incentive exists because unexpected stimulus will initially give rise to an uptick in the economy. This is because prices are fixed in the short run, so the stimulus will translate directly into higher output.

However, the economy will soon run into a capacity constraint, meaning that the higher demand caused by a lax monetary policy will result in businesses marking up their prices and unions raising their wage demands. As this occurs, the growth boost will give way to higher inflation and job losses. The unexpected monetary policy shock will dent the credibility of the central bank, as economic agents will be forced to reassess the central bank’s reaction function. This, in turn, will result in higher inflation expectations, while the medium-term growth prospects will, at best, be no better than they were before.

It is easy to see why this type of behaviour could be attractive to a government in search of short-term growth. However, if repeated, it can lead to escalating inflation and a loss of confidence in the currency. One only needs to glance at the recent news headlines to observe that such calamities are not confined to the history books.

The adoption of the inflation targeting framework was a significant structural shift for South Africa following periods of persistently high inflation. Since the introduction of inflation targeting in 2000, the SARB has worked hard to anchor inflation expectations and to embed the inflation target range in the minds of South African citizens. We have achieved hard-won credibility by avoiding the time inconsistency problem.

Nevertheless, we believe that it is possible to do better. In particular, we are aware that inflation expectations have been anchored towards the upper end of the 3–6% inflation target range rather than at the midpoint. This, in turn, has resulted in headline inflation outcomes that have been uncomfortably close to 6% in recent years.

When inflation settles near the 6% mark, exogenous shocks, such as exchange rate depreciation, can easily push inflation outside of the target range. The SARB operates a flexible inflation-targeting regime. The MPC therefore looks through the initial impact of supply-side shocks, with the aim of reacting to any second-round effects that these shocks may cause. However, the flexibility of the SARB to do this is constrained when such shocks quickly push inflation outside of the target range. Therefore, we are, as part of an ongoing effort, attempting to steer inflation expectations towards the midpoint of the inflation target range.

To increase transparency, the MPC has begun to publish a more detailed list of forecasts as well as the endogenous repurchase rate path that is generated by our macroeconomic model. Over time, the policy actions and communiqués of the SARB are expected to anchor inflation expectations (and inflation itself) closer to the 4.5% level. The benefits of such an outcome include increased policy flexibility, a lower inflation differential between South Africa and its major trading partners (implying less pressure on the exchange rate), lower long-term interest rates and, of course, a smaller annual erosion of purchasing power, which is particularly beneficial to the poor.

We are aware that, in the short term, there will be a trade-off between inflation and growth, which implies that the transition to a lower inflation path will not be without costs. To minimise these costs, the MPC will gradually guide expectations lower through clear communication and appropriate policy-rate adjustments, as deemed necessary. As with many important policy transitions, the long-term benefits will significantly outweigh any short-term costs.

An expanded mandate

Over and above the primary mandate of price stability, the SARB has also recently been given an explicit mandate to oversee financial stability. This mandate is provided for in the Financial Sector Regulation Act 9 of 2017 (FSR Act), which was signed into law last year. The FSR Act is the most fundamental reform of the South African financial sector regulatory architecture in more than three decades.

The mandate for financial stability calls for the SARB to take steps to prevent systemic events from occurring and to mitigate the adverse effects of a systemic event if and when one does occur. The tools necessary for addressing system-wide risks are commonly known as macroprudential tools.

Since the global financial crisis, it has become apparent that even if individual financial institutions appear sound, there may still be a risk of broader financial instability due to either excess leverage across the system or a high degree of common exposures to a particular risk. Thus, the microprudential tools that have commonly been used to safeguard individual banks, such as minimum capital and liquidity ratios, need to be supplemented with a macroprudential approach to regulation. The SARB is currently researching a variety of potential macroprudential tools and financial stability risk indicators to improve the resilience of the broader financial system.

The SARB's Financial Stability Committee has been set up to protect and enhance financial stability. It is tasked with considering qualitative assessments of the conjunctural assessments of risks to, and imbalances in, the broad financial system and formulating policy action to mitigate identified threats, as well as considering the appropriateness and adequacy of resolution policies and measures for crisis management. The SARB's toolkit is continually being refined and includes the ability to deploy a countercyclical capital buffer for banks. This provides the SARB with the means to raise aggregate bank capital buffers during upswings in the financial cycle, and allows for the release of these buffers during downswings. Currently, given the modest level of credit growth, the countercyclical capital buffer is set at zero.

The FSR Act has also established a Twin Peaks approach to financial regulation, which means that prudential and market conduct regulation are now managed by two separate entities. The SARB, as the prudential regulator, has received expanded oversight responsibilities extending beyond banks, to include insurers and financial market infrastructures. Meanwhile, a new entity, called the Financial Sector Conduct

Authority, has been established as the market conduct regulator.

The FSR Act meaningfully builds on South Africa's institutional strength within the financial sector by ensuring that the regulatory architecture is in line with best practices globally. In particular, establishing a clear separation between prudential and conduct regulation is an important reform because it ensures that there is adequate oversight of both the soundness of financial institutions and the fair treatment of clients. Over the longer term, we believe that centralising financial regulation within the SARB will generate economies of scale and improve our ability to monitor risks across South Africa's highly interconnected financial sector.[11]

As I mentioned earlier, some important structural reforms do not show in the GDP data. The financial sector reforms that I have been describing are an example. Avoiding systemic crises does not necessarily result in a higher growth trajectory, and hence its benefits are less apparent. One would need to consider counterfactuals to determine the value of a stable financial sector. While this type of analysis is difficult, we need only to observe the persistent effects of the global financial crisis to appreciate the importance of a stable financial system. Certainly, the benefits extend beyond the avoidance of economic losses and include a more stable social and political environment. The fact that South Africa has not had a large-scale banking crisis since attaining democracy serves to demonstrate the resilience of our financial sector.[12]

Other structural reforms that have been critical for South Africa's economic expansion include the significant liberalisation of the capital account and the development of the domestic bond market, which have deepened our financial markets. I provide these examples to highlight that structural reforms can be varied but all have an important role to play.

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[11] Kemp, E. 2017. 'Measuring shadow-banking activities and exploring their interconnectedness with banks in South Africa'. *South African Reserve Bank Occasional Paper 17/01*. Pretoria: South African Reserve Bank.
[12] Reinhart, C and Rogoff, K. 2012. 'Banking crises: an equal opportunity menace'. *NBER Working Paper 14587*. Cambridge, MA: National Bureau of Economic Research.

At the SARB, we believe that price and financial stability are complementary goals, which together contribute towards creating an enabling environment for economic growth. These goals reinforce each other because neither one is possible without the other. And while we are working hard in both areas, we also recognise that our contributions provide the necessary, but not sufficient, conditions for achieving sustained, higher levels of growth.

A final point that I would like to touch upon is the work currently underway at the SARB in the area of financial technology (fintech). Fintech is a key regulatory priority, but also a potential area of growth for the economy – we do not have to look further than Estonia and Singapore to realise the growth and transformational potential that the use of technology may hold. As such, we have set up a unit focused solely on understanding and utilising emergent fintech developments. Despite being in its infancy, this unit reached a remarkable milestone recently by collaborating with various banks to demonstrate that the domestic real-time gross settlement of interbank payments can be decentralised and executed through distributed ledger technology. We are anticipating many exciting developments in the fintech space over the coming years, and will attempt to remain as close to the frontier in this domain as possible.

Concluding remarks

South Africa's economy is expected to stage a gradual recovery over the next two years, as both domestic investment and export growth are forecast to rise. However, a modest cyclical rebound of this nature is insufficient to address the high levels of unemployment and inequality in our country. In order to reach more transformative growth rates, as envisioned in the NDP, government will need to act decisively on the recent reforms.

The SARB will remain focused on achieving its price stability and financial stability mandates and, in concert with other regulators, it will continue to work towards further improvements in the soundness and efficiency of the financial sector. Our efforts to enhance what we do form part of a broader thrust towards an even stronger and even more resilient institutional architecture in South Africa.

Thank you.