South African Reserve Bank

An address by Lesetja Kganyago,
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at the ninety-ninth annual Ordinary General Meeting
of the SARB shareholders

South African Reserve Bank, Pretoria
26 July 2019

Global economic conditions

The past year began with significant challenges for emerging markets, including South Africa. In contrast to the synchronised pickup in economic growth of 2017, which had surprised most observers by its magnitude, the major economies began to display divergent growth patterns in 2018. While the United States (US) maintained a strong pace of growth amid a sizable fiscal stimulus and a buoyant labour market, the eurozone and Japan lost some momentum. Chinese demand felt the negative impact of earlier monetary and regulatory tightening. Growth in world trade volumes also began to slow, a move that was exacerbated by a flare-up in trade tensions as the US slapped tariff increases on certain imports.

This confluence of factors, together with negative current account and price developments in countries like Argentina and Turkey, resulted in downward pressure on emerging market currencies and fixed-income assets. This move was compounded by the appreciation of the US dollar, as investors anticipated a further normalisation of US monetary policy and a widening of interest rate differentials with other major economies. By early July 2018, the South African rand had depreciated by 12% against the US dollar from its earlier peak of mid-February, a decline that extended to 25% when the rand reached its trough in September 2018.

So what has changed since then?

Some of the concerns about global growth that prevailed in mid-2018 have proved accurate. Business confidence, trade flows and economic activity have continued to lose momentum in most of the major economies. Now that the impact of the 2018 fiscal stimulus has started to fade, the US is not immune to those trends.

The trade tensions that sprang up more than a year ago remain unresolved, despite the June 'truce' between China and the US that prevented an immediate tariff escalation. Geopolitical tensions, especially in the Middle East, are adding to a climate of uncertainty that weighs on business investment decisions globally. In this month's update on the World Economic Outlook, the International Monetary Fund (IMF) is projecting global economic growth of 3.2% this year, compared to a forecast of 3.9% a year ago.

Support for the global economy and financial markets, however, has come in the form of a quick 'change of tack' by the world's major central banks, as they shifted from a gradual removal of stimulus to indicating renewed easing, at least in the US and the eurozone. The lack of inflation pressures provides room for such an approach. In fact, core inflation in both the US and the eurozone is currently short of its 2% target, while oil prices, amid slowing global demand, are off the highs reached in October 2018.

Meanwhile, in China, the authorities have loosened both fiscal and monetary policies in an attempt to limit the pace of economic deceleration. Against such a background, emerging market assets have rallied, and with inflation generally showing only a limited response to last year's currency depreciation in several emerging countries, the scope for their central banks to provide at least some accommodation has increased.

Domestic economic conditions

This less favourable global growth and trade environment has added to South Africa's economic concerns at a time when the domestic drivers of growth were already stuttering. Addressing this audience a year ago, I highlighted how the rebound in business optimism following changes in political leadership had already started to erode in the second quarter of 2018.

This erosion has unfortunately continued over the past 12 months. Both the Rand Merchant Bank (RMB) / Bureau for Economic Research (BER) survey of businesses as well as other indicators, such as the Absa Purchasing Managers' Index (PMI) and the Sacci Trade Conditions Indicator, are signalling low business confidence amid a challenging environment in all sectors. Such low business confidence, coupled with uncertainty about future economic growth, has weighed particularly heavily on private sector fixed investment, which contracted by 2.5% year on year in the first quarter of 2019 and, overall, has stagnated over the past half-decade.

Weak private sector fixed investment has indeed been a key cause of the disappointing performance of South African gross domestic product (GDP) growth. Much has been said and written about the sharp contraction in first-quarter GDP growth – 3.2% on an annualised basis – and whether it was a true reflection of the state of the economy. There is no denying that, from quarter to quarter, GDP has been quite volatile of late. Indeed, the SARB's internal econometric models estimate that activity will recoup part of that first-quarter decline in the second quarter of the year.

That said, the less volatile year-on-year comparison shows that GDP growth slowed to zero in the first quarter of the year, which was the weakest performance in exactly three years and one that was indeed consistent with other indicators of activity. And while our models envisage an improvement in the remaining quarters of the year, the SARB projects GDP growth of only 0.6% in 2019 after 0.8% in 2018. This means that in both years, as indeed in all but one of the past four years, real GDP would grow slower than the population growth rate of 1.6%, thus contracting on a per capita basis.

Weak economic growth does not just hinder efforts to reduce poverty and inequality; it also weakens public finances. For the current fiscal year, National Treasury projects that the consolidated government deficit will rise to 4.5% of GDP and will only decline to 4.3% next year. By contrast, in the 2018 Budget, projections were for a deficit of only 3.6% of GDP for both fiscal years.

Inflation

In a constrained economic environment, it is not unexpected that some voices argue that monetary policy could do more to support economic growth. But what exactly is the SARB's margin of manoeuvre, bearing in mind that any policy move must comply with our mandate of price and financial stability?

Encouragingly, the past year has seen several favourable developments on the inflation front. First, headline consumer price inflation averaged 4.6% between July 2018 and June 2019, and stood at 4.5% over the past month. Overall, this is a more benign pace of increase than the SARB had projected a year ago, even against a background of higher oil prices, significant rand depreciation, and a 1 percentage point increase in the rate of value-added tax (VAT) in 2018.

Second, the SARB's Quarterly Projection Model (QPM) now forecasts average inflation of 5.1% in 2020 and 4.6% in 2021, both well within the target range. In fact, our projections for the less volatile core inflation rate are even closer to the midpoint of that range.

Finally, several measures of inflation expectations, including the quarterly BER survey of inflation expectations among analysts, businesses and unions as well as the bond market-based metrics, have shown a steady decline over the past year, after many years of remaining uncomfortably close to the top end of the target range.

Faced with rising longer-term upside risks to the inflation outlook, the SARB felt that it was appropriate to act against such risks, especially in light of policy normalisation in advanced economies – which would most likely imply a higher neutral real interest rate for a small and open economy like South Africa's. Hence, in November 2018, the Monetary Policy Committee (MPC) decided to raise the repurchase rate (repo rate) by 25 basis points, reversing the cut that had been implemented in March of the same year. By early 2019 though, inflation performance was more benign than anticipated and the risks to the inflation outlook had eased sufficiently enough for the SARB to maintain an unchanged policy stance.

At the time of its latest meeting held on 18 July 2019, the MPC felt comfortable enough with the recent downward trend in inflation outcomes, as well as the ongoing decline in inflation expectations, to lower the repo rate by 25 basis points.

Overall, when looking back at the last few years, it is important to acknowledge the progress that has been made in reducing inflation volatility in South Africa, including in response to exchange rate shifts, and how this has allowed for a better anchoring of inflation expectations and, in turn, how this has also limited the need for sharp monetary adjustments. Since 2016, surveyed inflation expectations have declined by 100 basis points.

A more stable and predictable path of interest rates will enhance the environment for sustained economic growth, as the experience of many advanced economies and, increasingly, also the emerging economies has shown. The persistence of such gains is, however, not certain, meaning that the MPC will continue to exercise vigilance in the years ahead.

Financial stability

With the implementation of the Financial Sector Regulation Act 9 of 2017 (FSR Act) in April last year, the SARB was provided with an explicit statutory mandate to protect and enhance financial stability. The FSR Act further requires the SARB to monitor and keep under review the strengths and weaknesses of the financial system, as well as any risks to financial stability. To this end, the SARB has developed frameworks for identifying, monitoring and mitigating systemic risks.

On the whole, the SARB currently assesses the financial sector to be strong and stable. Nevertheless, potential vulnerabilities exist, as we have observed a few emerging trends over the past year, particularly in the banking sector. While South African banks remain adequately capitalised and profitable, the implementation of the new expected credit loss accounting standard, namely the International Financial Reporting Standard 9 (IFRS 9), has resulted in a deterioration in the quality of credit on bank books. Furthermore, as persistently low domestic economic growth starts to

have an increasingly tangible impact on the balance sheets of both households and corporates, credit quality may be expected to deteriorate further.

During the course of 2018, the SARB undertook stress tests on six major banks to assess the resilience of the banking sector to hypothetical yet extreme macroeconomic shocks. The outcome of the 2018 common scenario stress test exercise suggests that, at an aggregate level, the South African banking sector would be able to withstand the possible materialisation of a confluence of the main financial stability risks. With respect to solvency, the banks were assessed to be capable of maintaining their capital levels above the minimum capital adequacy requirements, under the adverse macroeconomic scenarios considered. The SARB also discovered that no material risks were emanating from the liquidity positions of the six major South African banks.

The SARB regularly conducts an assessment of the prevailing financial stability risks. These assessments are reported to the Financial Stability Committee (FSC) and published biannually in the *Financial Stability Review (FSR)*. The risks identified since the second quarter of 2018, which currently form part of the SARB's assessment, include:

- a deteriorating domestic fiscal position, exacerbated by, among other things, weak domestic growth, a poor revenue outlook, and the fragile financial positions of SOEs;
- spillovers from weaker global economic growth;
- the possibility of renewed and unexpected tightening in global financial conditions and the subsequent potential rapid repricing of risk; and
- rising cyber-dependency and security risks attributed to the ever-increasing digital interconnection of people, systems and organisations.

The identification and monitoring of financial stability risks, while important, would be rendered ineffective if we did not have the necessary tools at our disposal to mitigate the occurrence and/or the impact of these risks. Over the past few years, the SARB has been actively developing a macroprudential policy framework, complete with tools and instruments. This past year, work continued to enhance the framework and the financial stability toolkit.

There is a saying about the best-laid plans 'of mice and men'. Thus, while the SARB ultimately aims to mitigate systemic risks, it also needs to plan for potential crises and how to deal with them. In this regard, the SARB has taken a number of significant steps towards strengthening South Africa's resolution framework over the past year. Two separate but related projects were initiated in this area, namely to implement a resolution framework and a deposit insurance scheme.

The resolution framework, once promulgated into law, will bring South Africa's resolution framework in line with the Financial Stability Board's Key Attributes for Effective Resolution Regimes. This framework will also formalise the SARB's role as the resolution authority, and will outline the responsibilities with respect to the orderly resolution of designated financial institutions.

Meanwhile, the imminent establishment of the Corporation for Deposit Insurance (CDI), as a subsidiary of the SARB, will provide explicit guarantees to protect depositors should a bank ever fail. As a result, not only will depositor confidence in the banking system be enhanced; the CDI will also assist government that, in the past, may have compensated depositors with taxpayers' money.

Financial sector supervision and regulation

As you will recall, the FSR Act lays the foundation and the financial system regulatory architecture of the Twin Peaks model. The Twin Peaks regulators, being the Financial Sector Conduct Authority (FSCA) and the Prudential Authority (PA), work alongside the SARB and other regulatory bodies to ensure the stability of our financial system for the well-being of all South Africans. The PA was established on 1 April 2018 and has been operating within the administration of the SARB, as prescribed by the FSR Act.

While much of its first year was spent on refining and implementing the integrated framework for supervision, including assuming responsibility for the insurance industry and market infrastructures, the PA also had to complete the resolution of VBS Mutual

Bank. On 25 June 2019, the PA released its first Annual Report, which reflects all its activities for the 2018/19 financial year.

The proposed nationalisation of the South African Reserve Bank

The debate about the proposed nationalisation of the SARB continues in the public domain, fuelled by perceptions that private shareholders have control over the central bank. The SARB has clarified, on a number of occasions and through various communication channels, that its private shareholders participate as preference shareholders and do not own or control the SARB, nor do they influence monetary policy or any of the other regulatory functions.

Let me reiterate what I have repeatedly been saying in the public domain: the Board of the SARB focuses on governance issues, while policy and regulatory decisions are the preserve of the Governor and Deputy Governors. The South African Reserve Bank Act 90 of 1989 (SARB Act) provides for 15 Board directors, eight of which are appointed by the President, including the Governor and three Deputy Governors. The remaining seven directors are elected by shareholders.

As shareholders of the SARB, you are fully aware that the SARB Act prescribes that no shareholder or their associates are allowed to beneficially hold more than 10 000 shares. A fixed annual dividend of 10c per share is issued if profits are made, resulting in the potential total annual dividend payout to shareholders by the SARB being limited to R200 000. After setting aside contingencies, reserves, tax and the like, 90% of any remaining surplus accrues to government.

Celebrating 25 years of democracy

This year, we marked 25 years of democracy in South Africa through the launch of new commemorative circulation and collectable coins under the theme ‘SA25’. This series includes six new commemorative circulation coins: five themed R2 coins and a themed R5 coin. Through these coins, we celebrate the Constitution, more specifically the Bill of Rights, which is considered to be the cornerstone of our democracy.

We picked this theme because, aside from being the most iconic feature of our democracy, the Constitution provides for independent institutions, including the SARB. It defines our price stability mandate. The inflation-targeting framework aims to ensure that inflation remains low to preserve the purchasing power of households and the competitiveness of firms. We have endeavoured to ensure that the financial system remains safe and that our policies aim to bolster the resilience of the economy.

Conclusion

As the public debate about the role of central banks continues, the SARB has ensured that it continues to execute its mandate in the public interest. In this regard, we have endeavoured to be transparent in the execution of our duties, including by providing clear reasons for our decisions and clarifying the limitations in our ability to influence long-term economic growth. In all our decisions, we must consider the trade-offs between short-term and long-term gains. Anchoring inflation expectations, gaining credibility, and building institutional capability are all important elements in enhancing the resilience of the South African economy.

Thank you.