South African Reserve Bank

An address by Lesetja Kganyago,
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at the 100th annual Ordinary General Meeting
of the SARB shareholders

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Global economic conditions

We mark the 100th annual Ordinary General Meeting (AGM) of the South African Reserve Bank (SARB) at a time when the world is facing one of the most disruptive and challenging crises in recent memory. The COVID-19 pandemic has placed significant pressure on the global as well as domestic economies, and the livelihoods of citizens.

The unprecedented restrictions imposed by countries to try and contain the spread of the virus have contributed to plunging economic activity, ending the global economic expansion that had started in 2010.

In its latest update on the *World Economic Outlook*, the International Monetary Fund (IMF) estimates that global gross domestic product (GDP) will contract by about 4.9% in 2020. The World Bank highlights that this will be the deepest global contraction since 1945, with a record 93% of the world's economies expected to experience economic contraction this year.

The decline in global GDP has been compounded by increased risk aversion and extreme volatility in financial asset prices, with sharp and deep market sell-offs. Business and consumer confidence has also fallen as uncertainty levels reached new highs. Resource-exporting economies and countries with a high reliance on debt markets for funding will become even more vulnerable if capital continues to flow out of emerging market economies.

The global policy response has matched the magnitude of the crisis. Fiscal authorities have contributed by delivering stimulus packages that are estimated to be larger than the response to the global financial crisis of 2008 and 2009. This stimulus has provided support to the health sector and to vulnerable households and businesses.

Central banks around the world responded swiftly by lowering interest rates and providing liquidity to maintain market functioning. These response measures have helped to ease global financial conditions, allowing governments and companies to continue accessing domestic and international financial markets, and thus being able to sustain business operations and provide support to households. As a consequence, the high-frequency indicators suggest that the gradual lifting of lockdown restrictions in the major economies (first China, then Europe) has seen a rebound in manufacturing production and retail spending.

While major economies in Asia and Europe appear to be on the road to recovery, the United States (US) and most of the emerging world are still very much in the midst of the crisis. Many countries – especially in Africa, Latin America and South Asia – are still experiencing increases in new COVID-19 infections. This has resulted in a delay in economic reopening or, in some cases, has led to renewed lockdown restrictions.

As the pandemic persists, it is clear that some sectors of the economy, like travel and recreation, will experience a prolonged drop in demand. Households may continue to maintain high precautionary savings, and uncertainty is likely to weigh on business capital spending plans.

For many countries, the room for additional fiscal stimulus is limited should there be a ‘second wave’ of infections, resulting in significantly higher debt-to-GDP ratios as well as higher costs of accessing finance.

Domestic economic conditions

In South Africa, the COVID-19 crisis appeared at a time when our domestic economy was already vulnerable and in a technical recession. Real GDP had contracted at an annualised rate of 0.8% and 1.4% respectively in the last two quarters of 2019. This decline accelerated to an annualised rate of 2.0% in the first quarter of 2020, despite the nation-wide lockdown only coming into effect in the last few days of March. This was due to falling export demand, weak business confidence and investment, and the return of load-shedding.

While second-quarter GDP data are not yet available, there is sufficient evidence to confirm that the lockdown has exerted a drag on economic activity. For example, mining and manufacturing production plunged by 37% and 44% month on month, respectively, in the month of April. And while there are signs of recovery in some sectors, much uncertainty remains. The COVID-19 outbreak is having major health, social and economic impacts, which presents challenges in forecasting.

The SARB expects that the lockdown will cause output to contract by 7.3% in 2020. The last time a figure of this magnitude appeared in our data was in 1931, during the Great Depression, when output fell by 6.2%.

In line with a partial global recovery, we expect economic activity in South Africa to start recovering as lockdown measures are gradually eased. Our projections for 2021 and 2022 are for GDP to recover to 3.7% and 2.8% respectively.

Due to global economic and financial conditions, as well as country-specific factors, South Africa experienced an increase in capital outflows and significant currency weakness between March and April. The South African rand depreciated by 22% between February and the end of April. Over the same period, the yield on the 10-year government bond rose by more than 200 basis points, and money market liquidity was thin. Although many of these moves have been reversed, on balance, capital inflows remain below those of our emerging market peers.

Inflation has moderated since the beginning of the year. Consumer price inflation fell to as low as 2.1% year on year in May, down from 4.6% three months earlier. Longer-term inflation expectations have continued to decline towards 4.5%, which is the midpoint of the inflation target range. Inflation expectations for 2020 are at around 3.9%, the lowest in recorded history. Consequently, the SARB's inflation forecast now sees core inflation remaining within the lower half of the target range for the remainder of the forecast period, that is until the end of 2022.

The SARB expects headline inflation to average 3.4% in 2020, and 4.3% in both 2021 and 2022. This benign inflation outlook has allowed the Monetary Policy Committee (MPC) room to reduce the repurchase rate (repo rate).

The South African Reserve Bank's actions during the COVID-19 crisis

As a reminder, let me briefly outline the measures undertaken by the SARB since March.

Monetary Policy Committee decisions

The MPC has reduced the repo rate by a cumulative 275 basis points, to 3.50% per annum.

Four repo rate cuts have been made since March 2020, as follows:

- a 100 basis points cut in March 2020;
- a 100 basis points cut at a special MPC meeting in April 2020;
- a 50 basis points cut in May 2020; and
- a 25 basis points cut in July 2020.

Domestic money market liquidity management

The SARB acted swiftly to ensure the continued smooth functioning of financial markets. Revisions to liquidity management operations comprised four elements.

- First, we put in place Intraday Overnight Supplementary Repurchase Operations (IOSROs) aimed at providing liquidity support to commercial banks.

- Second, we introduced a three-month term repo facility, which is offered in addition to the weekly main refinancing operations. The SARB has indicated its willingness to offer longer-term repo facilities of up to 12 months, subject to liquidity conditions in the market.

- Third, the end-of-day lending rate on the Standing Facility was reduced from repo plus 100 basis points to the repo rate. At the same time, the borrowing rate on the Standing Facility, which is the rate at which the SARB absorbs liquidity, was also adjusted lower. Commercial banks’ deposits at the SARB now earn interest based on the repo rate less 200 basis points, compared to the repo rate less 100 basis points previously. This measure is meant to discourage banks from depositing money at the SARB, and to encourage money market liquidity.

- Lastly, as an extra measure to add liquidity and promote the functioning of the bond market, the SARB commenced with a programme of purchasing government securities in the secondary market. More than R30 billion worth of government bonds has been bought since the commencement of the programme in March this year.

Regulatory and supervisory relief measures

Since the 2008/2009 global financial crisis, South Africa has implemented reforms to strengthen its regulatory framework for financial institutions and improve the resilience of the financial system. This has enabled the Prudential Authority (PA) to deliver temporary regulatory relief for banks in a manner that is consistent with internationally agreed regulatory standards.

The PA has provided guidance covering accounting matters and imposed a limit to the payment of dividends and bonuses by banks and insurers to ensure the conservation of capital and retained capacity in an environment of heightened uncertainty caused by COVID-19.

Expected impact of the South African Reserve Bank’s response

The SARB’s policy responses are an important element of providing support to the economy.

Interest rate decisions are expected to play an important role in replacing displaced income. The relaxation of certain regulatory measures has enabled banks to provide support to households and businesses through continued lending activities, alongside the government loan guarantee scheme. In addition, the liquidity operations have supported market functioning, which is important for financial stability.

While there is limited information to assess the impact of interest rate adjustments and other regulatory measures, the decline in indicators of bond market frictions and the improvements in money market liquidity conditions testify to the positive impact of the SARB’s liquidity management measures.

Financial stability

The SARB has a statutory mandate to protect and enhance financial stability in South Africa by monitoring global and domestic conditions, using various indicators to identify the risks and vulnerabilities which may impact on the financial system.

During the past year, the main risks to financial stability were identified as weak and deteriorating domestic macroeconomic conditions, government’s fiscal position, cyberattacks on key financial infrastructures, and climate change.

The COVID-19 pandemic has placed all of these risks at the centre of the financial system. Government’s debt issuance is higher; the deteriorating economic conditions have increased the credit risks faced by financial institutions; periods of market stress and volatility have placed a higher strain on market infrastructures. In addition, the prolonged period of remote working has increased cybersecurity risks.

The SARB continually monitors for signs of stress in the system, and will continue to act as appropriate to mitigate any risks. Our assessment to date finds that the financial system remains resilient.

COVID-19 and South African Reserve Bank operations

It would be amiss of me not to reflect on how the SARB itself is managing the impact of the pandemic. After all, everything we do is through our people.

While the focus has been on monetary policy, coupled with regulatory and liquidity management measures, it has been essential for the SARB to ensure that key functions in the economy are not negatively affected by any disruptions to the national payment system and our currency operations.

The SARB initiated a process in January to monitor the effects of the pandemic on its operations, including the operations of its subsidiaries. A Joint Operational Committee (JOC) was established in February to lead the SARB's response and ensure business continuity.

Since March, the majority of our staff has been working remotely. We have also prioritised the implementation of medical and wellness protocols throughout the South African Reserve Bank Group (SARB Group).

The SARB's key operations have not been affected by the remote working arrangements.

To ensure the continuity of the cash supply chain, an industry forum was established to monitor the availability of cash in circulation in the economy, along with the ongoing production of new currency.

Conclusion

Let me conclude with some key points for reflection in the ongoing discourse about the role of the SARB in the economic recovery.

The COVID-19 pandemic has demonstrated the extent of interconnectedness of the global economy through production value chains, trade, financial markets, travel, and the exchange of knowledge.

Within the central banking community, the actions of major global central banks have provided space for the SARB to respond to our unique domestic conditions.

We have also seen the value in being part of a global community through the contributions that we were able to make through our advocacy in global forums, strengthening the global financial safety net.

As we move towards economic recovery, the opening up of global trade channels will be important for South Africa as a small open economy. However, as policymakers, we must ensure that our economy is well placed to take advantage of improving global conditions.

To place our economy on a sound and sustainable growth path, the SARB stands ready to provide support to the economy within its mandate. Lower longer-term inflation outcomes are important for maintaining purchasing power, containing the costs of living and of doing business, and supporting our country's global competitiveness.

However, as we have indicated in the past, improving the potential growth rate of the economy cannot be left to the central bank alone. Coupled with prudent macroeconomic policies and structural reforms, a lower cost of capital can support growth in long-term investment. The recovery of the South African economy requires a multi-pronged policy approach.

As we navigate through this COVID-19 storm, the SARB will continue to deploy its tools, as appropriate, in accordance with its mandate, to provide support to the South African economy.

This is not a time to despair. Neither is it a time to venture into policies or instruments that have proved a failure in economic history. There are tough choices for us to make as a society.

Thank you.