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Department:
National Treasury
REPUBLIC OF SOUTH AFRICA

Global Challenges and Emerging Economies

Welcoming address

Nhlanhla Nene
Deputy Minister of Finance
Address to the Board of the International Banking Federation (IBFed)

2 October 2012

Good afternoon ladies and gentlemen and thank you for the opportunity to address you today.

I would like to welcome you to South Africa. I hope you have an excellent stay here, and enjoy South African hospitality.

I hope your discussions are fruitful and useful. As the representative body for key national banking associations, you play a very important role in engaging regulators, governments and a variety of stakeholders on issues of common interest. The global financial crisis has made us re-evaluate many aspects of financial regulation. Frank, blunt and constructive discussions between industry and government are an important part of designing a new system that works for all.

The different needs of different countries

The global financial crisis and the recession that followed it have signalled the beginning of a new global era. The global economy has been thrown into turmoil, and each economy faces a unique set of challenges. As early as January 2011 the update to the IMF's *World Economic Outlook*, noted that while economic conditions were improving across the globe, the return to growth was then, and continues to be, uneven, taking the form of a two-speed recovery.

There is subdued economic growth and high unemployment in advanced economies such as the United States, United Kingdom, France and Japan, in contrast to buoyant economic growth in emerging economies such as China, India and Brazil, which face the risks of overheating and rising inflation.

Many developed economies are unable to achieve meaningful growth; several are struggling to reign in their national budgets and contain sovereign debt; and many are still seeking to constrain private financial sector activity. In many countries, financial sector's activity grew too fast relative to the underlying real economy.

In contrast, one of the greatest challenges facing economies in Africa for example, is how to *increase* financial intermediation in order to finance infrastructure backlogs. A 2008 report by the African Infrastructure Country Diagnostic (AICD), which is a World Bank project, concluded that for the foreseeable future Africa would only be marginally above the level of investment required to maintain and operate its existing infrastructure. The African Development Bank estimates that a shortage of roads, housing, water, sanitation and particularly electricity, already reduces sub-Saharan Africa's output by some 40 per cent.

Given the nature of a majority of these infrastructure investments, they will rely heavily on public funding. Government expenditure is however; limited by how much tax revenue can be collected without hurting economic growth, and by how much debt can be borrowed. Across the globe, governments' revenue collection and ability to borrow are constrained by weak economic conditions, and given the size of the infrastructure deficit in many developing countries these sources would likely prove inadequate in any event. There is thus limited capacity for governments to pay for everything that is needed.

This creates significant opportunities for the private sector, particularly the financial sector, to play a crucial part in the realisation of these infrastructure projects. The financial sector is indispensable to the development of these countries because government cannot meet all infrastructure needs. Governments cannot meet all infrastructure funding needs; therefore there is a role for the financial sector to play in channelling private funds appropriately. In contrast to the developed world, Africa and other developing regions are in dire need of increased, not decreased, financial intermediation.

Furthermore, not only do developed and developing countries have differing views on the stability/growth trade-off, they have different policy objectives altogether.

The challenge then for developing countries is to put in place regulations that can achieve an appropriate level of stability, without compromising the financial sector's ability to meet their unique needs. In contrast the priority for many developed economies is largely to restore stability to their financial systems.

While none truly escaped the recession that followed the 2008 financial meltdown, many developing countries did not experience a financial crisis. In Africa the main transmission mechanism for the crisis was the collapse of export revenues following the decline of world demand for mineral and fossil resources. The conditions that led to the crisis in the developed countries were not as prevalent in many developing countries. It is hard to see how subjecting the financial systems of the developing countries to arduous constraints that are intended to rectify problems that exist in the developed world could be of any significant benefit.

What protected the financial sector in South Africa?

The South African financial system, for example, was shielded by a number of factors.

- First, a sound framework for financial regulation and well regulated institutions ensured that potential risks were anticipated and appropriate action was taken to mitigate them. South African regulators, for example, have generally not followed a light-touch approach. Sustainable credit extension was made possible through effective legislation, such as the National Credit Act, and strong and transparent regulatory action.

- Second, appropriate and conservative risk management practices at domestic banks, such as the adoption and implementation of the Basel II Capital Accord in 2008, have led to improved risk management practices and stronger crisis management arrangements. In addition, conservative practices at banks have ensured that much less securitisation and derivatives trading has taken place, relative to advanced markets.

- Third, the prudential regulation of foreign exposure as applied in the last decade, including limits on the extent of exposure to foreign assets by institutional investors and banks, helped to limit overall foreign risk

- Fourth, registered banks have to be subsidiaries of the domestic or foreign parent company, so their assets and liabilities are ring-fenced even when the parent company is in distress. The listing requirement also ensures transparency, rigorous disclosure standards and high standards of corporate governance, forcing banks to satisfy shareholders and stakeholders at all times.

In addition, the South African financial system was protected by a much broader set of prudent economic, fiscal and financial sector policies that insulated the economy from the worst of the global shocks. These include:

- A robust monetary policy framework that is capable of absorbing relatively large external shocks with minimum impact on the domestic economy. In addition, the flexible exchange rate can lessen the impact of disruptive capital flows. In contrast, Eurozone countries, for example, are locked into a fixed exchange rate with their neighbours, reducing their ability to manage shocks.

- Counter-cyclical monetary policy. Leading into the crisis, rapid growth in credit extension posed a risk to the inflation target. In response, the Reserve Bank gradually raised the repo rate, from 7 per cent in 2005 to 12 per cent by mid-2008. This acted to stem excess credit growth and mitigate the risks of the global surge in financial activity. Then, as the financial crisis unfolded, the Reserve Bank reduced rates rapidly, which cushioned the domestic economy from adverse global conditions.
- A proactive approach to dealing with bank credit risks. As credit extension boomed, the Registrar of Banks took proactive steps to reduce potential risks – including the raising of capital adequacy requirements and setting conservative leverage ratios. This placed sensible limits on credit extension.
- A focus on reducing household vulnerability. The introduction of the National Credit Act for example, protected households and consumers from reckless lending practices.
- Counter-cyclical fiscal policy. The crisis led to a substantial fall in domestic tax revenue and the need for increased spending to deal with the worst of it. South Africa‘s strong fiscal position meant the country could respond appropriately. Countries that overspent during the boom years before the crisis have found it extremely difficult to survive the crisis, and face an austere fiscal consolidation process.

This is not to say that South Africa or developing countries with similarly robust financial sector regulation can afford to be complacent. The elements I have listed are part of a comprehensive set of policies that will continue to ensure financial stability, and provide an excellent foundation to build on in order to increase the resilience of the financial sector. And indeed South Africa has already begun a transition to a twin peaks model of financial sector regulation which will, through the consolidation of prudential regulation and the creation of a dedicated market conduct regulator, strengthen the ability of the regulators to ensure that financial firms behave appropriately.

But we should be wary of imposing unnecessary additional regulations on countries that came through the crisis relatively unscathed. In particular we should be aware that regulations that are sensible in the developed country context may not applicable in the developing world. For example: even though debt markets in developing markets have expanded in size and breadth in recent years, their depth is substantially below that of advanced economies. As a result liquidity in those markets is more vulnerable to economic and financial sector developments, including those arising from internationally agreed regulatory reforms. Many of the multilateral initiatives and reforms are already being scrutinised and heavily criticised for their failure to adequately incorporate the emerging market perspective.

Emerging markets and developing economies

International efforts at financial sector reform have rightly been aimed primarily at the developed world – which is, after all, where the global financial crisis originated. However, against this background, it is necessary to ask whether these reforms have adequately taken into account the perspectives of emerging markets and developing economies.

At their most basic, banks and financial markets manage risk, channelling funds from those with excess capital to those with investment opportunities. As a result there will always be a trade-off between stability on the one hand and growth on the other. The most stable financial system would be one that doesn't do anything at all and therefore doesn't incur any risk, but it certainly wouldn't be of any benefit to the economy. Where exactly a country wishes to position itself on the continuum between the sometimes conflicting objectives of absolute stability, and maximum growth will be dependent on the particular challenges that country faces.

It would be hard to justify rules that effectively dictate to countries struggling under the burden of extreme poverty, that because a handful of developed countries got the balance of risk wrong, that everyone should now prioritise stability above all else.

Some have therefore argued for a "two-track" approach, in order to accommodate emerging markets' perspectives on financial regulation. That is to say, they have argued that emerging markets should be subject to an entirely different set of rules and standards of financial regulation, separate to those for advanced economies. This is however, not a good idea. Out of all sectors, the financial sector is the most globally integrated, and the smallest difference in regulation amongst countries often creates regulatory arbitrage, leading to problematic behaviours in the system and threatening what should be a level playing field. It would therefore be equally foolhardy to establish a set of rules that would allow a country to forgo any and all stability concerns in the name of growth.

Basel III

In response to the crisis the Basel Committee on Banking Supervision (BCBS) introduced two sets of reforms, known as Basel 2.5 and III respectively, to the international capital framework for banks.

It is heartening to see that the Basel Committee is listening to many of the concerns of emerging and developing economies. Indeed, the Basel Committee on Banking Supervision has proposed several options to mitigate the problems arising from insufficient supplies of high quality liquid assets, (such as allowing banks access to a contractual committed liquidity facility provided by the relevant central bank for a fee), and that both of the liquidity standards are currently subject to an observation period that includes a review clause.

However, the point I wish to emphasise is that it is always necessary to be aware of the possibility that standards that are appropriate for advanced economies, may yield very different results in emerging economies, and it is not always as clear that these concerns are being adequately addressed or even that they are being voiced.

Trade finance which is fundamental to many of these economies is a sector that is heavily impacted by the enhancements to the risk coverage under Basel III. Trade finance continues to play an important role in emerging markets, many of which rely heavily on international trade. The Internal ratings-Based framework in Basel II and the leverage ratio in Basel III have been argued to impose excessively restrictive requirements on an otherwise low risk, short-tenor, self-liquidating activity. While the Basel Committee on Banking Supervision has already reviewed and made adjustments its capital rules as they relate to trade finance, many in the developing economies are concerned that the 100% credit conversion factor that is applied to off-balance sheet items, including trade finance exposures, for Basel III leverage ratio purposes, will increase the cost and reduce the demand for trade finance.

Conclusion

The difficulty that the world faces is this: The challenges and priorities that developed and developing countries face are not the same, the environments in which banks in developed and developing economies operate are not the same, and even pre-crisis the risks that built up in many advanced economies were simply not prevalent in many developing economies, and the role that financial institutions need to fulfil in different countries is not the same. Yet it is necessary to construct a set of rules for the financial sector that is applicable to, and appropriate for, everybody.

I said at the very beginning of this address that the focus has up until now justifiably been on the financial sectors of developed economies. But there is no doubt in my mind that multilateral institutions such as the Basel Committee, G20, FSB and other global bodies, as well as private sector organisations such as your own, will need to increasingly be aware of, and focus on solving, the issues that are specific to emerging and developing economies.

Thank you