Financial stability through regional cooperation in Southern Africa

Remarks by Andre Bezuidenhout, Head: Financial Stability Department, South African Reserve Bank, at the SAIIA-InWEnt-DIE conference on "Enhancing regional financial cooperation in Southern Africa against the backdrop of the global financial crisis", Pretoria, 26 May, 2009

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Distinguished participants;
Ladies and gentlemen,

I feel honoured and grateful for the opportunity to present a view at this important conference. I am aware of the good research work the South African Institute of International Affairs (SAIIA) has been doing, and of its contribution to the policy debate on regional economic integration. I am especially pleased with the apparent emphasis being placed in its recent publications on regional financial stability. I am also impressed with the considerable vision and assistance of InWEnt Capacity Building International (InWEnt) and the German Development Institute (DIE) in bringing together such considerable expertise for this conference. I have no doubt that it will help strengthen our regional network on development policy. It may sound like a cliché, but this is indeed a most opportune time to be discussing how this region can combat the effects of the global financial and economic crisis and avert such dislocations in future through cooperation. It appears that the global financial crisis has reached our shores, and all around there is an increasing consciousness of the vulnerability of Africa due to its particular human and social dimensions.

A fresh look at the causes of the global financial crisis

It has apparently become obligatory in these times to start any economic discussion with the causes of the global financial crisis. The shortest and simplest explanation of the causes of the global financial crisis was apparently given last week by a lady member of Iceland's Monetary Policy Committee (MPC), who said that it was the result of an overabundance of male bankers high on testosterone taking too much risk[1]. I might not go that far, but would still like to try and look at the crisis from a new angle.

The global financial crisis is in fact in its third year, and has entered its third phase – one which can unfortunately still turn out to be the most damaging for Africa and our region. The first phase, the US sub-prime crisis, was purely a financial crisis which started in large financial institutions in an industrialised country. Without elaborating on the causes, let us just say that underlying all other fault-lines in the system, like rapid de-regulation, excessive financial innovation and massive global trade and savings imbalances, there was one common error that made the US sub-prime crisis possible – everyone made the assumption that house prices will always go up. This is the only thing that can explain to me why lending standards dropped as far as they did, and why there were always more investors in credit as an asset class willing to fund even more mortgage origination. Just how bad it became was best described in September 2008 by a recently dismissed Washington Mutual ex-employee who, when asked why WaMu was in trouble, said that the lending policy in the heady days of 2003 to 2007 was simply: *If the borrower is alive, the loan is approved. If the borrower is dead, it's also possible.*

Ergo, with such an assumption built into every business and financial model, even those of the rating agencies, widespread panic was inevitable at the first

[1] Iceland MPC member: too many men led to bad banks, CentralBankNews, May 18, 2009.

signs that the asset class underpinning a major component of the unprecedented credit extension might actually be overvalued.

Thanks to globalisation, the second phase of the crisis soon followed, as the crisis rapidly spread across geographical and market-segment borders, to the rest of the industrialised world's financial markets. Wherever they were held, asset classes derived from mortgages suddenly lost value as every investor ran for cover, not certain which counterparty has the most exposure. Here, the essential common error that made this rapid spread to global financial markets possible was simply miss-pricing of risk – first the systematic under-pricing of risk, for whatever reason, whether opacity of risk information, greed for yield, or perverse incentive systems, followed in many instances by panicked over-pricing of risk as balance sheets became stretched, markets became illiquid and sources of funding dried up.

Uncertainty and lack of confidence ensued in global financial markets, and the inevitable liquidity hoarding and de-leveraging that followed ensured that the crisis enter a third phase – the spillover to the real economy. The single common cause of this? – Intermediation, a key function of the financial system, failed, so there was no avoiding considerable slowdowns in the real economies of the affected financial systems.

What it means for our region

Up to here this crisis has been quite different from previous ones, which have tended to be first and foremost in developing and emerging market economies (EMEs). This time, for a while at least, it seemed we, the EMEs, would escape the worst effects of the global crisis. Unfortunately, while we did escape most of the first-round effects, we could not ward off the second round effects on our economies. In our globalised world, the synchrony and depth of the slowdowns were such that there was a collapse in world trade and the demand for

commodities and other exports of many African countries. The real economies of our SADC countries were thus indirectly affected by the economic crisis that followed the initial financial crisis, notwithstanding the fact that our financial systems were not as integrated with the global financial system and as exposed to toxic assets. The clear and present danger now, heaven forbid, is the fourth phase, where the negative feedback loop reverses and the slowing real economies of affected EMEs cause their financial systems to be impacted through credit impairments as a result of closures and lay-offs of borrowers. The real economy and the financial system are inextricably linked, so we can be sure that if systemic problems in the financial system can harm the real economy, then a sharp, deep or prolonged slowdown in the real economy can similarly harm the financial system.

The importance of financial stability

My over-simplification of the global financial crisis is deliberate, because it helps to illustrate both how important and fragile financial stability is, and how easily financial stability can be a casualty of events that are outside of our control, in fact that are totally exogenous. Here in our region, we had just experienced, in the past ten years or so, a period of excellent growth during which our economic fundamentals also improved. Because our banks are less globalised than in other continents, we had very little exposure to the toxic derivative assets whose re-pricing triggered the crisis. Our banks also had limited off-balance-sheet exposures. Yet, we are experiencing declines in commodity prices, lower export demand, slower growth, declining investment flows and the prospect of higher risk premia on borrowing globally. This threatens to reverse many of the gains our region has achieved in growth and poverty reduction over recent years. It threatens achievement of our Millennium Development Goals (MDG) as well as our SADC integration agenda. When I look at the integration targets and convergence indicators set out in the Regional Indicative Strategic Development

Plan (RISDP), it is not difficult to see that any economic setback or financial system disturbance will make the plan much more challenging to achieve.

What can we do to combat the effects of the crisis on our region?

Without pre-empting the deliberations over the next two days, let me share some thoughts about what the short-term policy responses and longer-term reforms might be that we should be cooperating on. Yes, I will show that regional cooperation is essential in some cases and helpful in all. There have been many excellent discussions of the lessons from the global financial crisis. I will try and focus on those that are most relevant to our region and most pertinent to the objectives of this conference. I shall naturally also focus on the perspective of a central bank.

Urgent policies to counter the effects of the global slowdown on our economies

The first priority must be to devise and implement sensible policies to counter the indirect effects of the global economic slowdown on the economies in our region. Southern Africa tends to suffer from three common growth vulnerabilities, all of which are in danger of being exacerbated by the spillover from the global crisis: first, we are very susceptible to reductions in commodity prices and exports; second, we are vulnerable to declines in diaspora remittances from countries that are in recession; and third, we are sensitive to acute pro-cyclicality of bank credit, trade financing, foreign direct investment (FDI), foreign portfolio investment (FPI) and even official development assistance (ODA). All these factors have deteriorating effects on our respective balance of payments, both on the current and financial accounts. In addition, some factors specific to our region could make it more difficult to avoid all effects of the crisis. One such factor is the high dependence on banks for funding and the fact that they still play a primary role in

financing. Another complicating factor is that we are having an ongoing battle to generally enhance access to finance and financial inclusion in our region, which has not been helped by the crisis. If we do not proactively implement sensible macro-economic policies, our region may turn out to be one of the hardest-hit, albeit indirectly and belatedly, from the global crisis.

It is interesting to note that the managing director of the IMF last week[2] urged African governments to consider policies which would counteract the crisis, not worsen it. He encouraged fiscal policies, within permissible fiscal space, which allow deficits to increase as growth slows, and monetary and exchange rate policies that help the adjustment to falling commodity prices and the drying up of capital flows.

One consequence of adopting such proactive policies is the acceleration rather than delay of infrastructure developments to stimulate growth and provide jobs. This will require funding, some of which must come from private capital. It follows that we will need to do what we can to ensure that our credit, money and capital markets are functioning as efficiently as possible. Although risk premia are currently high and appetite for high-yielding financial assets (including debt issued by countries in Southern Africa) has diminished, this will not last forever. We should be looking “through the smoke” of the crisis, and be ready to benefit optimally from the inevitable restoration of efficiency in global capital markets. Looking at the agenda of this conference, I believe that opportunities to cooperate on these issues will be adequately addressed in the first two sessions.

Reforms to strengthen our financial systems

The second area of work relates to strengthening our financial systems and their inherent ability to withstand exogenous shocks. One of the ways to approach

[2] Strauss-Kahn D, “The Global Financial Crisis: The Challenge for Africa”, address to African ambassadors in Washington DC in celebration of Africa Week 2009, May 19, 2009.

this is to adopt more deliberately a macro prudential approach to monitoring and promoting financial stability. The global financial crisis has shown that central banks have a vested interest in financial stability, and that the financial stability objective is a necessary corollary to the price stability objective. Else, monetary policy execution can be too easily thwarted by financial system disturbances. Whether responsible for supervision of banks or not, central banks need to expand their mandates and resources to assess and foster broader financial stability. Aspects of such a macro prudential approach include the capacity to monitor, assess and mitigate potential systemic threats caused by large or rapid changes in exposures, risk management practices, leverage, the structure of the financial system, interconnections and procyclicalities. It requires the capacity to assess the robustness of the financial infrastructure and resolve regulatory gaps that pose risks for the financial system. It also entails the provision of a safety net mechanism and resolution strategies for when systemically significant financial institutions fail.

Although clearly complementary to the necessary but insufficient micro prudential supervision of individual institutions, macro prudential oversight requires rare skills and a different focus. It seems to me to be an area that can benefit tremendously from cooperation and coordination in a regional context.

Related areas in which I believe we can cooperate include contingency planning, systemic crisis management and systemic stress testing. In this regard, the South African Reserve Bank (the Bank) and the Training and Development Forum of the SADC Committee of Central Bank Governors (CCBG) jointly arranged and hosted recently a financial crisis preparedness seminar and generic crisis simulation exercise presented by the Toronto Centre and the World Bank. The workshop was attended by key decision-makers from SADC central banks and, as such, can easily become the forerunner of a broad-based “regional regulatory college” which focuses on the coordination of preparations for managing systemic events in the region.

We also need to review regulations and supervisory practices in the areas of capital and liquidity risk management and consolidated supervision. Regulatory capital has to be more counter-cyclical in nature to allow the buildup of buffers in good times that can be used in adverse conditions. Liquidity management should extend to seeing how liquid assets will hold out under stressed market conditions, not just normal times. And consolidated supervision should be enhanced to assess risks on a truly firm-wide basis for all systemically significant financial firms and to prepare detailed contingency plans for resolving problems in such firms. Although there is much disparity between the sizes of banks in SADC countries, this is certainly an area that can benefit from more cooperation in the regional context. In this regard, there are already forums in place that bring together, from all the jurisdictions where they have significant operations, the supervisors of banks and NBFI's of the large South African financial conglomerates. Consideration should probably be given to expanding participation to more host supervisors of the operations of SA banks in other SADC countries.

The South African Reserve Bank's March 2009 *Financial Stability Review* contains a section on some additional generic financial stability and regulatory policy principles that require to be reviewed following the global financial crisis. The problem with regulation is that it is asymmetrical – bad regulation can cause a systemic breakdown, but good regulation cannot always prevent it. It is therefore better to put our heads together in grappling with the complexities of devising regulations for efficient, but also sustainably stable, financial systems. The key is to keep it simple and return to basics. Perhaps a modification of Warren Buffet's investment rules should be considered: *Make regulations that are simple to understand and comply with, and enforce them. Never allow any activity that you cannot understand yourself and whose risks cannot be defined in terms of simple regulations.*

Again, looking at the agenda of this conference, I believe that the last two sessions should prompt some robust discussion on opportunities for cooperation

within the region on matters relating to financial stability, regulation and supervision.

Conclusion

Allow me in conclusion to recap briefly some of the established structures and projects for cooperation that we have in the SADC region. According to the latest Annual Report of the SADC Committee of Central Bank Governors (CCBG), the following projects of the respective sub-committees seem to me to be very relevant to the additional challenge of cooperating on our response to the crisis:

- The two flagship projects on the development of data banks of monetary and financial statistics and policies and structures of SADC central banks should provide a sound basis for research on domestic policy options for SADC countries.
- The SADC Payment Systems Project has, in addition to its work on risk reduction and mobile banking, been helpful in collecting information on remittances which will be of help in informing cooperation on this aspect in our region.
- The Training and Development Forum of the CCBG has laid a sound foundation for coordination of training and development, which can easily be adapted to brainstorm workshops on the urgent intellectual challenges of the day, such as our policy responses to the crisis.
- The Legal and Operational Frameworks project has provided the basis for discussion about a harmonised approach to mandating an enhanced financial stability role, or macro-prudential remit, for central banks.
- The SADC IT Forum has established experience of cooperation on matters such as business continuity management (BCM), which is relevant to crisis preparedness.
- The SADC Banking Supervision Sub-committee has long established cooperation mechanisms in place that can be very effective in debating

issues such as capital and liquidity risk management and ensuring harmonised approaches to any regulatory responses to the crisis.

- The CCBG Financial Markets Subcommittee has objectives that most closely resonate with the challenges put by this conference, namely to deepen and strengthen financial markets.

In addition to these initiatives of the CCBG, those of the SADC Banking Association (SADCBA), where the Public-private partnership capacity-building project is of particular relevance, and the Committee of SADC Stock Exchanges (COSSE) should also be considered as ways to enhance cooperation in the aftermath of the crisis.

My thinking is therefore that we don't have to search for new structures and initiatives to pursue regional cooperation in responding to the crisis, but that we should re-commit our energies and resources to making the structures that we have already as effective as they can possibly be.

I hope that this conference will form the basis for more proactive cooperation on ensuring financial stability in the SADC region. Without financial stability there can be no sustained growth, without which there can be no achievement of MDG's or regional convergence and ultimately integration.

I wish you good luck and success with your deliberations.

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