T T Mboweni: Volatility in the currency markets and its impact on monetary policy

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the ACI meeting, held in Pretoria, 14 May 2001.

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1. Introduction

I would like to thank ACI for the opportunity to address you this evening. Of course I have been aware of the existence of ACI but I was reminded about it again when Mr Gibbs backed the Code of Trading Principles, as agreed to by sixteen leading intermediaries in the foreign exchange market, and released it to the press on 22 February 2001. The Reserve Bank values ACI's endorsement of these Trading Principles. I thank you all for your willingness to come to Pretoria as I believe that most of you work in Johannesburg. I understand also that your presence reflects a common interest in financial markets – and not merely a desire to gain an advantage over your competitors by obtaining better insights into the thought-processes of central bankers!

Apparently many of you are foreign exchange dealers or are close to the foreign exchange market, so I have chosen to talk to you about volatility in the currency market and about monetary policy. I will first attempt to give some background information against which volatility in the currency markets has developed and will then proceed to discuss developments in some of the major and emerging market currencies. The focus will then move to developments in the exchange rate of the rand and its potential impact on inflation and consequently on monetary policy in South Africa. I will also, as far as I am able, attempt to address some other areas you may be interested in.

2. Developments in the currency markets in 2000 and 2001

The so-called "emerging markets crisis" in 1997 and in 1998 was a major event which adversely affected many emerging market economies. Currency weakness and tighter monetary policies impacted significantly on economic performance, as was the case in South Africa. We certainly looked forward to a period of relative calm from 1999 onwards. Unfortunately, the financial markets have not afforded us this opportunity and volatility has been a somewhat persistent feature of the financial markets in the year 2000 and 2001 to date.

The most volatile markets have been the stock markets, particularly those trading technology stocks – and probably also media and telecommunication stocks – the well-known trilogy, TMT stocks. However, the volatility has also extended to the fixed income and currency markets. In the case of stock markets, the Nasdaq for example has declined by no less than 37 per cent in the calendar year 2000 and by a further 17,6 per cent in the current year to date. According to Bloomberg news services, the historical price volatility over a ten-day period reached levels in excess of 70 per cent per annum in April 2001. In early January 2001, the volatility appeared to be even higher. From its peak on 10 March 2000, the Nasdaq has fallen by a staggering 58,3 per cent. The Dow Jones index has also declined but not by the same magnitude. It declined by 5½ per cent during 2000 and has remained virtually unchanged in the year to date, with historical volatility reaching levels around 32 per cent in March and April of this year. Other stock market indices have declined in sympathy with Wall Street. Fortunately, as a matter of interest, the all share price index of the JSE Securities Exchange has increased by some 5,1 per cent since the beginning of 2000 to date.

For most of the last decade the financial world has closely watched the economic expansion of the United States, which seemed to defy what had been learnt about business cycles, and the concomitant monetary policy tightening by the Federal Reserve from late 1999. Similarly, in the euro area and in the United Kingdom, both the ECB and the Bank of England were also in monetary policy tightening modes for most of 2000. The tightening in the euro area and in the UK, however, was in reaction to inflationary pressures which resulted mainly from higher oil prices. Based on a perception that monetary policy was entering an uncertain phase in the major economies of the world in the latter half 2000, plus given the demanding price earnings ratios on the so-called hi-tech shares especially, market participants seemed to react more forcefully to macroeconomic news than usual, thus exacerbating the volatility.

Stock markets in general turned positive in January 2001 with the announcement of a 50 basis points reduction in the Federal Reserve's target for the fed funds rate on 3 January 2001. This was followed by a further 50 basis points cut on 31 January. This buoyed markets, at least temporarily. However, perceptions again deteriorated on fears that the United States might be heading for a recession which could eventually result in depressed world economic activity.

A principal feature in the ***currency markets*** during 2000 and 2001 has been the strength of the US dollar in the international financial markets. One of the important factors behind the strong US dollar were capital flows into the United States stemming mainly from its vibrant economic growth. Whilst the United States was, and might still be, the major net recipient of capital and the euro area the world's largest provider of foreign corporate investment in particular, it was not surprising that the euro remained under pressure and that the US dollar remained very strong. It is, however, currently not so easy to explain the resilience of the US dollar with the United States' economic prospects having changed over the last six months.

As a result of the strong US dollar, many currencies have weakened against the US dollar in 2000 and 2001 to date. The euro declined to its lowest level ever against the US dollar on 26 October 2000 when it breached US$0,83. It subsequently recovered but remains under pressure. The Australian dollar and New Zealand dollar have declined by 26,0 and 24,1 per cent respectively since the beginning of 2000 to date. Most currencies of emerging markets which have freely floating exchange rate regimes, have also declined significantly since the beginning of 2000 to date.

When the euro depreciated below the key resistance level of US$0,85 on 20 September 2000, the ECB reacted and, with the assistance of the G7 central banks, intervened on 22 September 2000. In the aftermath of the intervention, the euro appreciated to US$0,90. The recovery of the euro was, however, short-lived. The ECB again intervened on Friday 27 October 2000, this time without the assistance of G7 central banks. A third intervention package, also estimated at US$1 billion, was introduced to the market on 6 November 2000. This pushed the euro from a level of US$0,86 to US$0,87. It is interesting to note that Mr Horst Köhler, Managing Director of the International Monetary Fund, gave the ECB a vote of support for its intervention and said the Bank had acted 'appropriately' when intervening on behalf of the euro. He furthermore said: "Co-ordinated activities are appropriate and can work. Intervention is a legitimate instrument but it has to be very selective to have an impact."

It is perhaps also worth mentioning that the Reserve Bank of Australia has also intervened in their foreign exchange market in order to support the external value of their currency.

3. Developments in the rand exchange rate

As is perhaps to be expected from a relatively open economy, the South African rand was not immune to the developments in the world's currency markets. The rand declined by 22,9 per cent against the US dollar in calendar 2000 and by a further 5,4 per cent in the current year to date. However, measured against a basket of South Africa's most important trading partners, the rand has fared better, helped by the weakness of the euro, pound sterling and the yen. The trade weighted index value of the rand declined by 12½ per cent in 2000 and by only 0,9 per cent since the beginning of this year to date.

Besides the strong US dollar, other developments have also impacted with varying degrees of significance on the rand. Firstly, the increase in oil prices, coupled with a significant decline in the exchange rate of the rand against the US dollar, raised concerns in the first half of 2000, in particular, of mounting inflation and the possible impact on the Bank's inflation target. Secondly, concerns about South Africa's ability to achieve higher and sustainable economic growth rates was also a concern for many participants in the financial markets. Thirdly, for a few months in 2000, the rand reacted adversely to political and economic developments in Zimbabwe. Notwithstanding continued re-assurances by the South African Government that the rule of law would be maintained and with scant regard to the considerable differences between the two countries, foreigners, as well as South Africans, were concerned at the prospect, however remote, of lawlessness spreading to South Africa. Fortunately, this factor is hardly mentioned in the market at the moment. Fourthly, and not for the first time, the net open forward position (NOFP) of the Reserve Bank has played a role in rand volatility. Notwithstanding the fact that many countries find themselves in an over-borrowed position i.e. when the reserves and international indebtedness of the government and central bank are added there would be a negative balance. The perception that the Reserve Bank needs to buy foreign exchange from the market to close out the NOFP leads to a perceived "one way bet" on the fortunes of the rand.

This is a misguided notion, however, as the Reserve Bank realises that buying US dollars from the market, as and when conditions permit, has achieved what could reasonably be expected. Our policy position is that we will continue to work the NOFP down as and when economic and financial conditions are favourable. For example, from privatisation proceeds as and when available; international borrowing by government as and when it occurs; and possibly once-off inflows of a permanent nature as may accrue from the corporate sector. The exchange rate of the rand is far more of a two-way risk than many market participants realise.

Perhaps it would also be appropriate, having touched on the NOFP issue, to reiterate the successful reduction in this position which has occurred over the past number of months. As at 31 December 1998, the NOFP stood at US$22,5 billion and it has steadily been reduced to a level of US$9,0 billion as at 30 April 2001. This is, in our view, an important milestone in the implementation of our policy.

The reasons mentioned above, and others, have culminated in higher volatility levels for the rand. In 1997 the average one-month historical volatility of the rand was 4,5 per cent. It increased to an average of 12,6 per cent in 1998 – having been around 35 per cent in the midst of the Asian crisis – before decreasing to an average level around 9 per cent for 2000. For the current year to date, the average one-month historical volatility is 12,3 per cent, much higher than in previous years. But as mentioned before, we are in good company.

4. The impact of currency volatility on monetary policy

Before turning to the impact of currency volatility on monetary policy, it is important that we spend a few minutes refreshing our memories about the recent economic developments in South Africa. Economic growth appears to have levelled off in the first three months of 2001, although activity has remained at a relatively high level. Still, the creation of employment opportunities for South Africa's growing population remains the major challenge facing the country.

South Africa's overall balance of payments position remained sound during the first quarter of 2001, with a further small surplus being recorded on the current account of the balance of payments and the value of the international reserves of the country rising slightly. The growth over 12 months in the broadly defined money supply (M3) accelerated from 7,5 per cent in December 2000 to 9,4 per cent in February 2001 and further to 12,8 per cent in March. The growth in bank credit extension also accelerated in the first quarter of 2001.

Continued discipline was maintained in the finances of the fiscus with expenditure only marginally exceeding the budgeted amount for fiscal 2000/2001 and revenue rising rapidly largely owing to improved administrative procedures.

Although the depreciation of the rand exerted untoward pressure on the prices of imported goods, the overall effect on prices was counteracted by the somewhat temporary decline in international oil prices combined with moderate inflation rates in South Africa's main trading partner countries. Production and consumer price inflation have, therefore, tended downwards.

All in all, South Africa's economic performance is good.

With the advent of inflation targeting as a monetary policy framework in South Africa, the relative importance of the exchange rate has also changed. Whereas previously the Reserve Bank might have interpreted its mission of protecting the value of the rand quite literally to encompass the possibility of intervention in the foreign exchange market, we are now more prepared to accept the valuation of the market on the exchange rate.

Within this new framework we focus more on the longer term inflationary consequences of any decline in the value of the exchange rate as an additional factor to be considered when deciding on the appropriate stance of domestic monetary policy.

This emphasis on inflation per se, however, does not imply that the Reserve Bank is indifferent to developments in the exchange rate and, in particular, to the level of volatility. The fact that various other currencies have weakened by more than the rand, or have been more volatile, does not mean that the Bank is unaware of the damage done by a depreciating currency to South Africa' s economy via inflation, or, for that matter, to foreigners who invest in South Africa.

South Africa remains committed to gradual exchange control liberalisation, but there are times when the authorities are concerned by the fickleness of international capital flows, and, I dare to say, by pure speculative transactions by non-residents in our markets. To illustrate the fickleness of capital

flows, South Africa experienced net portfolio inflows for the two years 1998 and 1999 of the order of R87 billion. In the subsequent year a net outflow to the tune of R2,8 billion was recorded and for the current year to date there have been net positive flows again to an amount of some R6,2 billion. These figures refer to foreign investment in equity as well as bonds. The flows from the bond market on their own have been far more volatile.

In the emerging world, South Africa is characterised by relatively liquid financial markets. Over a longer period of time this is certainly a factor which should attract global investors. In the shorter period, however, the Bank has the impression that this might engender pure speculative activity. Often bad news in distant countries leads to a weakening of the rand with no regard to positive developments in the South African economy. This is certainly a problem with which we are grappling. There is no turning back on the road of exchange control liberalisation, but that does not preclude better scrutiny of the application of rules that are in existence.

In this connection, we are encouraged by the adoption of the code of Trading Principles by a dozen or so banks operating in South Africa. In particular, section 2 of the principles which says: "Foreign exchange managers have a particular responsibility in the execution of orders at volatile times. Intermediaries should take care to discuss with customers t he risks of operating in these environments and the possible scrutiny of actions. Market makers may reserve the right to refuse customer transactions that they feel may further disrupt or have the intent to disrupt the market." This is indeed positive.

Nonetheless, volatility is, of course, part of our economic system. Cycles of boom and bust, "irrational exuberance" and gloom, occur from time to time. With the benefit of hindsight, it is now clear that the surge in the American stock markets, in particular, in recent years was overdone and a sharp correction, with the attendant volatility, was inevitable. This has had some implications for currency markets as well. Uncomfortable as this might be for central banks focusing on inflation and stability, it is inevitable and we have to live with it – sit tight, grit our teeth and suffer in silence. It does make life difficult for central bankers as volatility might disguise underlying trends that require monetary policy adjustments.

5. Non-resident participation in the foreign exchange market

Before I conclude my address, I would like to mention a few statistics on the South African foreign exchange market which you may find interesting. The average net daily turnover on the South African foreign exchange market amounted to US$7,4 billion per day in March 2001. Of this turnover, non-residents accounted for almost 56 per cent, while resident clients accounted for only about 8 per cent. Inter-bank transactions among the authorised dealers account for the balance. Non-residents continue to dominate swap market activity with about 60 per cent of swap turnover attributable to their participation. Their activity in the spot and outright forward markets has also increased substantially. In March 2001, non-residents accounted for almost 46 per cent of turnover in the spot and forward market, compared to 34 per cent in January 2000. This increase in non-resident participation in the foreign exchange market could be explained by the decline in the number of foreign banks which provide rand liquidity in London and possibly also by increased trading in the rand.

6. Conclusion

Notwithstanding the volatility in the exchange rate of the rand, we are convinced that there is every reason to be confident regarding the future path of the rand. With prudent fiscal and monetary policies in particular, and good economic policies in general, being in place, we are expecting the current relatively modest but sustainable economic growth to continue. In these circumstances the current account should be a positive factor with South African exports performing relatively well. Inflation is coming down slowly but surely and, of importance to you, by no stretch of the imagination can the rand be regarded as overvalued.

May I conclude by quoting a press release by the Bank for International Settlements: "Maintaining price stability is the best contribution central banks can make to continued prosperity." We reiterate our commitment to pursue the appropriate monetary policy to achieve the target range of 6 to 3 per cent in CPIX (MU) on average in 2002.

Thank you.