X P Guma: SARB's Financial Markets Department

Welcoming remarks by Dr X P Guma, Deputy Governor of the South African Reserve Bank, at the Financial Markets Department's 4th Annual Cocktail Party, South African Reserve Bank, Pretoria, 28 July 2009.

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1. Introduction

Ladies and gentlemen, it is with much pleasure that I welcome you here this evening to the Financial Market Department's fourth annual cocktail function. I thank you for taking time out of your busy schedules to be present here this evening.

Last year we emphasised the importance of communication between central banks and market participants, highlighting that it was essential for the smooth functioning of markets and in the interest of financial stability. The events of the past twelve months are a good example of the importance of communication. In May 2008, the time of our last gathering, it would have been difficult to imagine that a top US investment institution such as Lehman Brothers would collapse. On 15 September 2008, the unthinkable happened and Lehman Brothers filed for bankruptcy protection. This began a whole chain of events with which all in the financial world have had to deal.

South Africa has been in a very fortunate position; the domestic financial system has not been impacted directly. Our banking system remains sound as domestic banks have very limited exposure to so-called "toxic assets". Being a small and open economy, however, we could not escape the negative effects on the real economy. In the fourth quarter of 2008, the South African economy contracted for the first time in a decade, officially entering a recession in the first quarter of 2009, at the same time recording the worst quarterly economic performance since the 1980s. Domestic financial markets also suffered as investors became increasingly risk averse.

Nonetheless, I am not here to discuss economic or financial market developments, as you are all too well aware of this. I would, however, like to briefly comment on the happenings in the Financial Markets Department of the SARB over the past year in the midst of all this turmoil.

2. SARB money market operations

Central banks around the world injected significant amounts of liquidity into the money markets as they sought to avoid the worst outcomes of the crises on their respective economies. To avoid a repetition of the Great Depression, central banks acted with much flexibility, speed and urgency. It is perhaps for this reason that we are increasingly hearing about the green shoots of economic recovery.

While everyone may breathe a sigh of relief once a recovery is underway, central banks will once again find themselves in a somewhat challenging position, as they now would have to concentrate on appropriate exit strategies such that the growth in their balance sheets do not pose a huge inflationary risk. There are also the "expectations effects", where these expanding balance sheets may be perceived to signal less commitment to fighting inflation.

I am happy to state, however, that in South Africa it has been "business as usual". The Financial Markets Department has not had to undertake any special liquidity-providing transactions in the market. The domestic banking sector and financial markets, especially the interbank market, continued to operate effectively during the crisis. There was no upward pressure on overnight rates as witnessed in the US and European markets. The spread between the South African Benchmark Overnight Rate on deposits (Sabor) and the Bank's repo rate remained relatively stable. This spread continued to fluctuate in its usual range, with the Sabor remaining below the repo rate.

The liquidity requirement remained in a range of between R8 billion and R13 billion, in line with that prevailing the previous year.

Typically, the purchases of foreign exchange for purposes of building reserves would be the single biggest contributor to increased liquidity in the money market and the SARB would have to drain this liquidity through various open market operations. In the 2008/09 financial year, SARB activities in the foreign exchange market were somewhat muted, however, as compared to previous years. This can partly be attributed to the extreme volatility in financial markets.

The SARB and National Treasury continue to cooperate in an effort to reduce the country's external vulnerability and increase the level of reserves. The gross gold and foreign exchange reserves declined marginally from USD34,3 billion in April 2008 to USD34,1 billion in March 2009. Although the SARB purchased over USD1,5 billion in foreign exchange for purposes of increasing the country's foreign exchange reserves, this was offset by valuation adjustments, given that the country's reserves are denominated in various currencies. The SARB did not at any time intervene in the currency markets to influence the level of the rand in any way.

The international liquidity position increased marginally, owing to the SARB's decision to reduce its foreign loans. The substantial increase in reserves over recent years, reduced the need to hold significant amounts of borrowed reserves. Foreign loans declined from over USD1,0 billion in April 2008 to approximately USD650 million in March 2009. Over the past few months, gross foreign exchange reserves have increased to levels above USD35 billion, largely due to the successful international bond issue which took place in May this year. As you are aware, the National Treasury placed part of the proceeds of this issue in a foreign deposit account with the SARB which, in future, will be used towards fulfilling government's foreign currency commitments falling due.

Nonetheless, the SARB increased its open market operations during the year, using the traditional sterilisation instruments at its disposal. SARB debentures increased by R9,6 billion to R28,0 billion at the end of April 2009. The longer-term reverse repos were mostly unchanged around R7,6 billion. Government deposits at the SARB increased by R2,7 billion; much of this is related to accrued interest. Liquidity was also drained via an increase in the notes and coin in circulation of R4,3 billion and an increase in the cash reserve account balances of banks of R5,4 billion. To square their end-of-day positions, banks predominantly utilised the cash reserve accounts and only on a few occasions did the SARB have to conduct standing facility operations. These standing facility operations, it must be emphasized, were not in any way linked to stresses in the financial system; rather, they arose due to unexpected increases or decreases in notes and coin flows or because it was the end of the cash reserve maintenance period.

The SARB did not effect any changes to the refinancing procedures over the past year, but continues to engage with market participants through the Money Market Liaison Group meetings to discuss issues related to the money markets and SARB operational procedures. As indicated last year, a number of other fine-tuning operational issues, including the coordination of the maturity dates of the SARB's open market operations with MPC dates, are under consideration but have not yet been finalized.

One of the most challenging tasks facing us has been accurately to forecast the quantity of notes banks will need each day. In an attempt to improve the liquidity estimates provided to the market, the SARB plans to use the end-of-day notes and coin figure with a one-day lag in its liquidity calculations. This will assist the SARB in calculating much more accurate liquidity estimates and thereby also allow for the more efficient management of liquidity: There should be less cost and inconvenience to both you and the SARB. The exact details of this arrangement are currently being worked out and will be communicated shortly.

The SARB, on behalf of the National Treasury has conducted a number of special Treasury Bill auctions to the value of R8 billion over the past few months. Furthermore, government bond issuance has increased, while R58,6 billion of the R153 bond was switched with market participants. The remainder of the R153 bond will be split into three legs on 31 August. The close relationship which the SARB enjoys with the National Treasury and the market assisted in the smooth implementation of these transactions. We anticipate that we will continue to enjoy the same level of support going forward.

3. SARB reserves management

We have heard a lot of talk about the dual responsibility some central banks might have for monetary policy and financial stability. Less remarked upon is the fact that many central banks have become large wealth managers, clearly reflected by the International Monetary Fund (IMF)[1] data which show that global reserves have increased from just over USD1,3 trillion in 1995 to USD7,0 trillion in the second quarter of 2008 (global reserves declined to USD6,5 trillion in the first quarter of 2009). Along with this phenomenal growth in reserves, came the challenge of finding means by which to achieve higher returns. Accordingly, some central banks slowly moved away from traditional asset classes such as Treasury bills and public sector bonds to more sophisticated asset classes. Needless to say, recent market volatility and credit concerns have exposed central banks to the vulnerabilities and risks which attach to such investment decisions. Therefore, the importance of risk management in reserves management has increased exponentially. Managers of foreign exchange reserves within central banks have become much more risk-averse since the global credit squeeze started, with safe assets being back in favour.

With just over USD34 billion in net reserves, the management of these remains an important function of the SARB. Being relatively new in the world of reserves management, the SARB has generally been a conservative manager.

In line with most other central banks, the SARB tightened its investment guidelines for the management of reserves so as to avoid any potential losses. The greater portion of funds is invested in “AA” and “AAA” rated instruments and with similar-rated counterparties. There were no significant currency allocation shifts in the wake of the crisis. However, because the country’s foreign exchange reserves are diversified, currency fluctuations have impacted on returns as measured in USD.

The Strategic Asset Allocation (SAA) was reviewed during 2008/09, while the SARB also embarked on the external fund management review, which is conducted every three years. The revised SAA will be implemented later this year, coinciding with the appointment of new external fund managers and/or reappointment of some existing ones.

4. Other initiatives in the financial markets arena

The hard work and determination of the planning committee of the Association Cambiste Internationale (ACI) – now known as ACI The Financial Markets Association – is much in evidence and I am happy to report that the 48th Annual ACI International World Conference held in Cape Town in March 2009 was a resounding success. The South African Reserve Bank is proud to have been associated with an event of this calibre, the first ACI Conference to be hosted on the African continent.

The SADC financial markets subcommittee is now operational and has met twice in the past year. At its most recent meeting in May 2009, the Committee of Central Bank Governors approved the work programme of the subcommittee and in fact the Committee holds its third

[1] Currency Composition of Foreign Exchange Reserves (COFER), IMF.

meeting in Lesotho starting tomorrow. We wish them every success in their efforts at building and developing financial markets in Africa.

5. Conclusion

It has certainly been a very trying year for financial market participants and indeed, central banks around the world. We certainly seek evidence of the existence of the "green shoots of recovery".

I wish to thank you all for the close relationship, we as the central bank, enjoy with you. We certainly value the interactions and I trust that the channels of communication will be enhanced further. From our side, we will endeavour to keep you informed of the strategic and operational issues with which we are involved.

I also wish to thank the Financial Markets Department, under the leadership of Roelf, for the hard work and determination throughout the year and for making us proud to be associated with the SARB. With them, it is I think appropriate to congratulate your former colleague, Daniel Mminele, upon his appointment as Deputy Governor of the South African Reserve Bank.

Please enjoy the rest of your evening!