Daniel Mminele: The South African Reserve Bank's activities in financial markets

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Financial Market Department's Annual Cocktail function, Pretoria, 3 June 2010.

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Introduction

Good evening ladies and gentlemen and welcome to the fourth annual cocktail function of the Financial Markets Department (FMD). It is our privilege to host this event. Thank you for accepting our invitation.

You are all familiar with recent economic and financial market developments, but please allow me to just briefly touch on these events from the perspective of the central bank. I will then discuss the Bank's activities in the financial markets given that, in some form or another you are all counterparties to our operations and activities in the financial markets, or are affected by what we do.

International developments

Since the previous FMD Cocktail at the end of July 2009, there have been a number of economic developments, which have had a significant impact on global risk appetite and trends in financial markets. For much of 2009, the EUR was relatively strong, appreciating to USD 1,51 in early December 2009. Speculative currency positioning, as represented by weekly data from the Commodity Futures Trading Commission (CFTC), showed aversion towards the USD in this period. The USD showed a net short position of over 280 000 contracts. The VIX index, a popular measure of expected volatility, and often referred to as the "fear index", hovered around its long-term average of 20 index points, while advanced and emerging market equity markets were recording double digit gains. In developed bond markets, short dated yields were declining owing to the still lax monetary policy, while long-term yields were rising in reaction to increased government debt issuance. Emerging market bond spreads as measured by the Emerging Market Bond Index (EMBI) plus spread, had come off their high levels of almost 900 basis points in October 2008 to 280 basis points in December 2009. Credit Default Swap (CDS) spreads for the advanced economies and for certain European countries recently in the spotlight were also stable over this period, indicating little concern about sovereign default risks. Money markets were also relatively stress-free, as reflected by the continued narrowing in Overnight Index Swap (OIS) spreads at the time.

The global economy emerged from recession in the latter half of 2009, much sooner-than-expected and at a pace that was stronger than even the most optimistic forecasts. This development proved to be the catalyst for the rally in financial markets. Furthermore, the pace and speed of the recovery, differed vastly across countries and regions, with emerging markets proving to be the engine for global growth. Together with record-low interest rates in advanced economies, risk aversion having dissipated and abundant liquidity, emerging market countries started to attract significant capital inflows.

However, towards the end of 2009, some headwinds emerged, which more recently intensified with the sovereign debt crisis in southern Europe and with markets becoming particularly concerned about a possible default by Greece and the contagion effects thereof. Was this to be the start of a new crisis? Was the nascent global economic recovery now at risk? Was the confidence we saw in financial markets misplaced and needed to be replaced by renewed risk aversion? The initial comfort provided by the EUR750 billion rescue package announced in early May by the European Union (EU), IMF and European Central Bank

(ECB), soon gave way to concerns and uncertainty as to whether the measures taken would be sufficient to resolve the underlying solvency problems and whether the required fiscal consolidations would be politically and socially feasible.

Budget cuts imposed across the euro zone spurred debate about the sustainability of the euro, the ramifications of fiscal tightening on European economic growth and the impact of a slowdown in the euro zone demand on the overall global recovery. Speculative currency positioning now showed aversion towards the EUR instead of the USD. The net long EUR contracts changed to net short positions of almost 120 000 contracts. Over the same period, the EUR depreciated to USD1,21 in mid-May. Risk aversion subsequently increased and the VIX index spiked to over 40 points in May 2010. Equity markets lost ground and CDS spreads, most particularly for Portugal, Ireland, Greece and Spain, increased. Strains in the money market came to the fore once more and the US OIS spread ticked up from around 10 basis points to approximately 30 basis points. Central banks that had been slowly and carefully embarking on exit strategies from unconventional policies, found themselves pondering about and indeed implementing re-entry strategies.

It is clear that there is an urgent need for countries to consolidate their fiscal positions and bring their public debt ratios and fiscal deficits back to within more sustainable parameters.

Domestic financial markets

These developments are important for South Africa, being a small and open economy with deep and liquid financial markets. Against the backdrop of the stronger global and domestic economic environment, domestic financial markets also rallied in the latter part of 2009. The ZAR appreciated by almost 23% per cent on a trade-weighted basis in 2009, reversing the 23.5% decline recorded in 2008. This appreciating trend continued until mid-May 2010, supported by stronger commodity prices, the search for yield, liquid domestic markets, a relatively favourable economic and fiscal backdrop and the reduction in risk aversion. The All share index, as well as the Morgan Stanley Capital International index (MSCI) for South Africa, registered double digit gains, P/E ratios improved and domestic government bond yields declined. The fixed income market was supported by the easing in monetary policy and healthy appetite for domestic bonds by non-residents. Non-residents purchased a net R24 billion worth of domestic bonds in the fourth quarter of 2009 and purchased over R 30 billion in the first four months of 2010. The international bond issues of the South African Government in 2009 and 2010 were also well received, as confirmed by the latest USD 2,0 billion issue in March 2010, which realised the lowest coupon ever achieved on a USD bond issue.

Nonetheless, the recent bout of risk aversion caused the rally in domestic financial markets to also run out of steam, while the appreciation in the ZAR dissipated and volatility increased from 13 per cent in April to almost 18 per cent in May.

Market development initiatives

An important milestone was reached in February 2010, when South Africa’s multibillion rand money market industry officially commenced the electronic issuing, trading and settlement of securities in place of the manual paper based system.

As the largest issuer of money market securities (on our own behalf and on behalf of Government), the Bank welcomed the implementation of a fully-dematerialised money market. All SARB debentures and Treasury bills are now being processed in the new electronic format, representing not only a milestone for the South African financial markets, but also being the very first fully automated dematerialised settlement environment globally. Many of the people here tonight were involved in this project, and I want to sincerely thank you for your contributions to this very important project.

As part of the FMD's own contribution to market development and to enhance our exchange of information with market participants, a platform known as the Money Market Liaison Group (MMLG) was initiated in 2005, mainly to consult with banks on the modifications to the Bank's refinancing system at the time. Earlier discussions were dominated by issues such as the extension of the pool of eligible collateral for the Bank's refinancing operations and improvements to the benchmark overnight interbank rate. More recently, the need to reform this body to make its scope wider became apparent. A review of the MMLG was undertaken, resulting in the reconfiguration of its membership to cover the broader spectrum of financial markets, and the change of its name to the Financial Markets Liaison Group (FMLG).

To meet the objectives of this consultative body, the FMLG will have four subcommittees that are in the process of being finalised. The Money Market subcommittee will focus on issues impacting the functioning of the money market, the Financial Market Infrastructure subcommittee replaces the former Money Market Association and will discuss ways of strengthening and improving market infrastructure. The FMLG will also have a Foreign Exchange and Fixed Income and Derivative Market subcommittee, which will engage on the safe and efficient functioning of these underlying markets, as well as derivative-related developments.

Open market operations

Managing the overall liquidity in the money market is of the utmost importance to the successful implementation of monetary policy. Having not had any difficulties previously, since December 2009 the Bank began to encounter some challenges in conducting its open-market operations in order to manage overall liquidity. In the process, the money market shortage at times declined to quite low levels. This was mainly due to dwindling demand for SARB debentures, owing to a slowdown in the growth of banks' balance sheets, which resulted in lower demand for liquid assets that banks have to hold for prudential purposes. The National Treasury's increased funding in Treasury bills and government bonds similarly impacted demand, while the longer-term reverse repos (LTRRs) were constrained by the ample availability of government bonds in the secondary market, in addition to traditionally limited participation in this instrument.

The Bank consulted market participants not only to obtain a better understanding of reduced participation in the debenture auctions , but also to explain why the participation of banks in central bank open-market operations is essential for the effective implementation of monetary policy. An effective monetary policy implementation framework contributes towards financial stability, which is in the interest of all banks and the system as a whole.

In light of the aforementioned challenges, we are considering some changes to the way in which the Bank conducts its open-market operations and we will be in a position to make announcements soon. For example, the measures being considered relate to modifications in the operation of standing facilities offered by the Bank as well as the use of longer-term foreign exchange swaps. The Bank conducts money market swaps in foreign exchange as a fine-tuning tool to manage money market liquidity.

Foreign exchange market

The size of the South African foreign exchange market, measured in terms of average daily turnover in USD, has fluctuated between USD10bn and USD15.2 since the time of the last FMD cocktail, with the composition in terms of spot, forward and swap transactions remaining relatively unchanged. Very much like in other parts of the world, conditions in the foreign exchange market continued to be volatile.

The Bank has continued its involvement in the foreign exchange market mainly for reserves accumulation purposes. As a result of the appreciation in the rand exchange rate in 2009 and earlier this year, there were heightened calls for the Bank to intervene aggressively in the foreign exchange market or to even peg the rand to the US dollar. As indicated before, the Bank remains committed to a flexible exchange rate regime, with the exchange rate determined primarily by the market.

The commitment to a flexible exchange rate should, however, not be misunderstood as an indifference towards the exchange rate. The rand is one of the most volatile currencies and the Bank is cognisant of the impact that this can have on business, and the uncertain operating environment it creates. Extended periods of misalignment can lead to a misallocation of resources between sectors within the economy and lead to an uneven and unbalanced economic recovery.

Having acknowledged that certain sectors of the economy have been affected by what may be perceived to be a relatively strong exchange rate, it is also crucial to again highlight the importance of inflation management. One must bear in mind that a depreciation in the nominal exchange rate together with an increase in inflation would not lead to an improvement in the level of competitiveness of the rand. Any consideration for more aggressive participation in the foreign exchange markets would also have to be carefully assessed against, among others, the prospects of success given the factors that may be driving the exchange rate in any particular direction at any given point in time.

More aggressive intervention or pegging the rand to the US dollar would be a very costly exercise. Firstly, how much foreign exchange reserves would be required to artificially peg the rand to the US dollar and to maintain this peg in the event of pressure to depreciate? South Africa's reserves, at just over USD42 billion, are relatively low for that type of exercise. Furthermore, pegging the rand to the US dollar would not imply an automatic peg to other currencies, such as the EUR, which is the currency of our biggest trading partner bloc. Pegging also has the problem that if prices and wages are increasing, any competitive advantage will soon be eroded and there will be calls for changing the peg. Aggressive reserves accumulation either in the context of a peg or to prevent or moderate appreciation also carries significant costs, given the wide interest rate differential between the interest paid on sterilization and the interest earned on reserves. This results in a negative cost of carry and places the Bank's income position at risk. The Bank recorded a loss of approximately R1,0 billion during the 2009/10 financial year. It is however important to point out that this loss was incurred as a direct result of the bank executing its public policy responsibilities rather than owing to any inappropriate risk taking or wasteful expenditure.

Over the past year, the Bank continued to purchase foreign exchange as part of its strategy to steadily increase the level of foreign exchange reserves. Gross reserves increased by approximately USD8,0 billion from April 2009 to USD42,3 billion in April 2010. The international liquidity position increased by USD5,0 billion to USD38,5 billion over the same period. Apart from foreign exchange purchases by the Bank, this increase in official reserves was also due to foreign currency deposits from government, the allocation by the IMF of SDRs to South Africa and valuation adjustments. Although valuation adjustments contributed positively to reported USD official reserves over the financial year, there were periods where the Bank published substantial declines in the level of reserves due to valuation losses stemming from the diversified nature of reserves in terms of currencies.

The Financial Markets Department continued to enhance reserves management policies in order to adjust and streamline our investment strategies.

The Investment Policy, which provides a strategic and operational framework for reserves management, was reviewed during 2009/2010. The Investment Policy is reviewed every three years for governance purposes and also to ensure that it is responsive to and keeps pace with changes in the reserves management activities of the Bank and the external environment. The recent global financial crisis provided an ideal opportunity to incorporate into the policy the lessons learned, while also aligning the policy with refinements to international best practice.

Conclusion

The turmoil experienced in the euro zone with regard to sovereign debt risks highlights the importance of fiscal sustainability. Markets have become increasingly sensitive towards sovereign risks and therefore policymakers need to recognise the urgency of reducing excessive public debt. Fortunately, in this regard South Africa is on a solid footing when compared to challenges faced elsewhere.

South African financial markets are an integral part of global markets and will continue to be subjected to global developments. As one of my colleagues recently said: “the best defence is to stick to sensible policies”.

But we must now turn our focus to successfully hosting the 2010 FIFA Soccer World cup starting in about a week’s time, for the first time ever on the African continent. South Africa has again shown its mettle, and has overcome all scepticism, and we are now ready to welcome the world!

In closing, I would like to convey my appreciation to the management and staff of the Financial Markets Department, not only for paying the bill tonight, but for the sterling work that they do for the Bank and our markets. Thank you also to the staff of the SARB Conference Centre for taking care of us tonight.

Thank you and enjoy the evening.