T T Mboweni: Recent developments in South Africa's financial markets

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Beeld/Investec Guinness Flight Economist of the Year Banquet, held in Johannesburg, on 12 May 2000.

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1. Introduction

The South African financial markets have been characterised by great uncertainty in the recent past, leading to a depreciation in the external value of the rand, a decline in share prices and a rise in long-term interest rates and yields. Money market interest rates have remained relatively stable mainly owing to the monetary policy stance adopted by the Reserve Bank. The uncertain conditions in our financial markets were to a large extent due to the strength of the United States dollar, volatility in international financial markets, changes in oil prices and concerns about political developments in Sub-Saharan Africa (SSA), whereas domestic fundamental economic and political factors remained sound and could not be blamed for these episodes.

In my address tonight I want to discuss these developments in some detail and will concentrate on:

(i) the more important recent developments in the domestic financial markets;

(ii) the factors responsible for the greater uncertainty in the markets;

(iii) the underlying fundamental factors favouring strong financial markets; and

(iv) the monetary policy stance adopted by the authorities in these circumstances.

2. Developments in financial markets

From the beginning of the year 2000, our currency, the rand, has depreciated sharply against the United States dollar from a level of R6.15 to the dollar at the end of 1999 to more than R7.00 to the dollar from the first week of May 2000. This represents a depreciation of approximately 15%. The rand also depreciated considerably against the United Kingdom pound and Japanese yen, but faired better against the euro. As a consequence, the weighted average value of the rand has declined by about 7% from the end of 1999 to 11 May 2000. This is nevertheless a significant decrease in the nominal effective exchange rate of the rand which was well in excess of the inflation differential between South Africa and its main trading partners and competitors. After adjustments for these price differentials, the decline in the real effective exchange rate of the rand was probably between 3 and 4% in the first 4½ months of 2000.

The weakness of the rand was one of the factors responsible for a reversal in the downward movement of long-term interest rates and yields in South Africa. Domestic bond yields moved sharply downwards in the last four months of 1999 as sentiment in the market for fixed interest securities was positively influenced by the relatively low level of inflation, the fiscal discipline entrenched in the budget of the government and the introduction of an inflation-targeting monetary policy framework. In addition, a prominent credit rating agency, Standard and Poor's, upgraded South Africa's foreign-currency denominated debt to an investment grade in February 2000.

At the beginning of January 2000 this downward movement in the yield on government bonds came to an end. The daily average yield on these bonds increased from a low of 13.12% on 18 January 2000 to 15.20% on 10 May 2000. The level of the yield curve shifted higher across the full maturity spectrum, with a more pronounced upward movement at the longer end of the curve. Despite this upward movement in rates, the inflation-adjusted yield on long-term bonds rose only marginally because of the rise in overall consumer price inflation, excluding mortgage interest costs, as measured for metropolitan and other urban areas, the so-called CPIX (mu).

Trading activity on the Bond Exchange of South Africa was boosted by the uncertainty in the market. Turnover in the secondary bond market increased from an already high average quarterly value of R2.2 trillion in 1999 to an all-time high of R2.8 trillion in the first quarter of 2000. In April 2000 the value of transactions on the Bond Exchange amounted to R0.8 billion.

The uncertainties in the foreign exchange market were also reflected in developments on the Johannesburg Stock Exchange. The strong gains in share prices during the last three months of 1999 were followed by a consolidation phase which developed into a substantial correction in the current year due mainly to events in the United States' stock markets. The daily all-share price index declined by 28% from a record level on 17 January 2000 to a low on 17 April, i.e. its lowest level since 23 September 1999. Subsequently this index increased again by 14½% on 10 May 2000 as investors saw increasingly good value for South African shares.

The general decline in share prices from mid-January was at first countered by increases in the share prices of gold mines and information technology enterprises. The decline in the index at that stage was driven by decreases in the share prices of financial institutions, non-gold-mining companies and the industrial consumer sector. From February 2000, when the dollar price of gold fell below US$300 per fine ounce, the gold-mining shares declined by 17% up to the end of April. The general surge internationally in the share prices of the information sector at first supported the prices of these industries in South Africa, but information technology share prices weakened markedly from mid-March.

Although conditions in the share market are still volatile, price movements have shown a distinct upward trend since the middle of April 2000. The increases in share prices were discernible in most of the main sectors. The volatility in the market was responsible for a further sharp increase in the value of shares traded to an all-time high of R155 billion in the first quarter of 2000.

In contrast to the unstable conditions in the foreign exchange and capital markets, interest rates in the money market were largely unchanged. For example, the bankers' acceptance rate fluctuated in a narrow range of between 9.83% and 9.92% from the beginning of March, while the rate on interbank funds remained constant at a level of 9.5%. The stability in the money market can mainly be ascribed to the monetary policy stance that the Reserve Bank pursued.

3. Factors responsible for uncertainties in markets

The factors responsible for the uncertain conditions in our financial markets arose mainly outside the borders of our country and were largely related to perceptions about the effect on South Africa of developments in neighbouring countries as well as the strength of the US dollar. In the past week, I have visited London and Basel. In the process, I met market participants in London and my colleagues in the Central Banking fraternity at the Bank for International Settlements in Basel. Again and again, it was emphasised that political conflicts in Sub-Saharan Africa were harming investor sentiments, which were not doing South Africa and the region any good at all. One person even referred to what he called "the depressingly present African psychological factor". Sentiment is an important ingredient in market decisions and public authorities must take cognisance of this. It is clear therefore that conflicts in Sierra Leone, Ethiopia/Eritrea, the Democratic Republic of Congo, Angola and the management of the land question in Zimbabwe have had a major impact on our financial markets. In this connection, and in order to remove any doubts about South Africa's position, the President of the Republic has committed South Africa to supporting the peaceful resolution of these conflicts and lawful processes of land reform. He further assured everyone that South Africa's land question will be resolved through an orderly legal and constitutional process. And indeed this is how things should be in open and democratic societies.

At the same time, our foreign exchange and capital markets were also seriously affected by the strength of the US dollar. The dollar has in particular strengthened considerably against the euro. From the beginning of the year up to 11 May 2000, the euro has depreciated by about 10% against the dollar. The dollar has also been exceptionally strong against the currencies of Eastern Europe, Australia and some of the Latin American countries. This strength of the dollar and the exceptionally high and sustained economic growth in the United States, led to large foreign investments in that country. In particular, long-term investments from Europe and Japan contributed to the continued economic recovery in the United States.

Taking these circumstances into consideration, it is not surprising that non-residents became large net sellers of South African bonds. After having been net investors in South African bonds to the tune of R16.5 billion from the beginning of 1999 until the end of January 2000, non-residents' net sales of bonds amounted to R13.4 billion up to 10 May 2000. However, the greater proportion of these sales were financed in the market for repurchase transactions, indicating that they do not only reflect disinvestment by non-residents. The change in investor sentiment was echoed in the eurorand market where the net proceeds of rand-denominated bonds issued by non-resident entities also reverted to net redemptions of R0.5 billion in the first quarter of 2000. These net sales of bonds by non-residents contributed in a significant manner to the depreciation of the rand.

Non-residents generally remained net purchasers of shares on the Johannesburg Stock Exchange, amounting to R40.6 billion in 1999. The net purchases of shares by non-residents then declined considerably from nearly R7 billion in the fourth quarter of 1999 to R0.6 billion in the first quarter of 2000, before increasing again by R3.4 billion up to 10 May. These purchases continued despite the reduced South African weights in world equity indices and the negative market sentiments about political developments referred to above. The continued attractiveness of South African shares is related, amongst other things, to the sound economic fundamentals in the country.

4. Fundamental economic factors

One of the most important factors that foreign investors take into consideration in their evaluation of investment in a specific country is how appropriately the currency of a country is valued. Any suspicion that the currency is over-valued tends to be an important deterrent to the inflow of capital.

The nominal trade-weighted value of the rand has declined by 28% from 1995 to 1999, or on average by about 7% per year. This depreciation exceeded the inflation differential between South Africa and its main trading partners and competitive countries. In real terms, the average weighted value of the rand has therefore declined by about 15% over the past four years. A part of these adjustments in the real value of the rand reflected a worsening in the South African terms of trade and reduced import protection and export subsidisation. In September 1994 the import surcharge was lifted, from 1995 exchange controls were relaxed, in mid-1996 the government's commitment to stepwise tariff reductions was announced and in July 1997 the General Export Incentive Scheme was abolished. Taking these developments into consideration, as well as the continued good performance of manufactured exports, it can still be concluded that the rand is competitively priced and should not really be prone to a sharp correction on a trade-weighted basis.

This conclusion is also confirmed by South Africa's healthy overall balance of payments position. The deficit on the current account of the balance of payments amounted to a low of ½% of gross domestic product in 1999. Moreover, trade figures for the first quarter of 2000 indicate that the current account deficit has probably improved somewhat in the first quarter of 2000. Despite the substantial increase in international oil prices and a recovery in the domestic economy, the current account deficit has therefore been maintained at low levels. This was mainly due to a strong export performance. The favourable growth prospects for the world economy suggest that the demand for South African exports should remain buoyant.

In addition to the low current account deficit, South Africa is attracting considerable funds from other countries. In 1999 the net inflow of capital in South Africa exceeded R27 billion and direct investments of non-residents came to R8.4 billion. Preliminary information for the first quarter of 2000 indicate that non-residents' net sales on the Bond Exchange were more than offset by other capital inflows and that a further net inflow of capital was recorded. This is substantiated by an increase in the gross foreign reserves of the Reserve Bank of nearly R5 billion from the end of 1999 to the end of April 2000 and a considerable decline in the foreign loan commitments of the Reserve Bank.

The underlying soundness of the South African economy is confirmed by many other developments. For instance, the economy has moved into a recovery phase, with growth in real gross domestic product reaching a seasonally adjusted annualised rate of 3½% in the fourth quarter of 1999. This growth also became more widespread. Initially it was mainly concentrated in the agricultural and tertiary sectors. In the second half of 1999 growth was recorded in nearly all the major sectors of the economy.

Inflationary pressures were well contained in an environment of rising fuel and food prices. Large productivity increases combined with a lower rate of increase in the earnings of workers brought the growth in nominal unit labour costs down to a level of only 3.5% in 1999. Growth in the money supply and bank credit extension remained subdued and there are no signs of excessive demand pressures.

In addition, the fiscal picture is sound, with government expenditure concentrating on the social and other needs of the community, and considerable effort being made to improve tax administration. The discipline applied in expenditure allocations and the progress made with revenue collection, resulted in a decline in the public sector borrowing requirement from 5.8% in the fiscal year 1994/95 to 1.7% in the first nine months of the fiscal year 1999/2000.

Notwithstanding all these positive developments, employment creation has been disappointing. Considerable effort will have to be made in the coming years to address this serious problem, by amongst others, driving through the process of the restructuring of state assets and the productive side of the economy.

5. Monetary policy

From the middle of January 2000 the Reserve Bank managed the daily liquidity requirement in such a way that the repurchase rate remained at a level of 11.75%. As already indicated this led to relatively stable money market interest rates in a climate of general uncertainty in the foreign exchange market and in the domestic capital markets.

The question may be asked whether this was the right policy stance. Shouldn’t the Reserve Bank have taken more restrictive measures to relieve the pressures on the exchange rate of the rand? Obviously there may be different views on the stance adopted by the Reserve Bank. In the Bank we reasoned that a monetary tightening would have been the wrong response to date. Although consumer price inflation increased moderately towards the end of 1999 and during the first three months of 2000, this was mainly due to exceptional circumstances and there is little reason to expect that inflation may get out of hand. In fact, economic fundamentals indicate a continued decline in the targeted inflation rate over the medium to longer term.

In these circumstances, it is important for the Reserve Bank not to overreact to exchange rate weakness. Too quick a tightening of monetary policy could endanger the growth prospects of South Africa and encourage an outflow of capital. This would put greater and more lasting pressure on the exchange rate of the rand with important consequences for inflation. Besides, if the factors responsible for the weakness in the exchange rate are taken into consideration it seems unlikely that a tightening of monetary policy would have the desired effect of more stability in the foreign exchange market.

The policy stance adopted by the authorities does not imply that the value of the exchange rate is regarded as unimportant when setting monetary policy. On the contrary, the impact of exchange rate changes on inflation is carefully taken into account when managing domestic liquidity and determining the repo rate. If signs do emerge of increased inflationary pressures arising from a depreciation of the exchange rate of the rand, the Reserve Bank will not hesitate to take appropriate measures.

6. Conclusion

The domestic financial markets have adjusted in a mature manner to the rise in oil prices, adverse developments in other parts of Sub-Saharan Africa, the strength of the dollar and heightened volatility in international financial markets during the first four months of 2000. Had the Reserve Bank attempted to intervene in the currency market in order to slow the process of adjustment to these events, the success of the intervention would have probably been thwarted if only by the strength of the dollar. Moreover, such intervention may well have exacerbated the downward pressure on the value of the rand. The Bank accordingly has rather attempted to maintain stability in the domestic money market. In view of the sound underlying economic conditions in the country, we are of the opinion that this is the correct approach to follow and should eventually lead to stable market conditions at the least cost to the country. The Bank will nevertheless carefully monitor any further developments in the financial markets.

“We are indeed living in challenging times!”