T T Mboweni: Developments in the foreign exchange markets during the last couple of years

Speech by Mr T T Mboweni, Governor of the South African Reserve Bank, at the cocktail function in honour of the ACI South Africa, Pretoria, 20 September 2004.

*   *   *

Ladies and gentlemen, welcome to the South African Reserve Bank. We thank you for being here this evening, and we feel honoured that you should have accepted our invitation. As most of you are engaged in the foreign exchange markets, we thought that it might be useful to make a few remarks on our involvement in the markets and refer to recent developments in this regard. We think that you are an important and critical constituency as far as our work is concerned, and it is only correct and proper that from time to time we should come together to exchange views and interact with one another.

Allow me to congratulate ACI South Africa for being selected to host the ACI Council Meeting in Sandton from the 23rd to 27th November this year. It will be the first time that this prestigious event will be held in South Africa. We wish you good luck with the organisation of that event and we are certain that you will do us proud! We have also noted from your website that you are also taking this opportunity to draw attention to the "sights and sounds" of our beautiful country.

We are also aware of the important role, which the ACI is playing in actively promoting the educational and professional interests of the financial markets. In particular, the active role in the education of dealers with a view to establishing an accreditation standard and developing the technical skills and knowledge of financial market dealers in South Africa and Africa as a whole is to be appreciated. It is assumed here that as an organisation you are also an active participant in the financial services charter process.

We also admire your efforts in compelling your members to maintain the professional level of competence and the ethical best practices of loyalty as set out in your Model Code. We strongly support all your attempts to promote professional and ethical behaviour in South Africa as these are essential in building credible international trading relations, and in establishing, maintaining and enhancing the reputation of our financial markets.

Our remarks this evening will focus on developments in the foreign exchange markets during the last couple of years. A good starting point appears to be the last time we met with you as an organisation here at the central bank.

What were the big issues at the time of the last ACI cocktail?

Just to touch on a few issues: If my memory serves me well, we met in May 2001, at a time when the currency markets were dominated by a strong US$ on the back of strong flows into the USA, although at the time the strong economic growth seen in 2000 was already giving way to a somewhat less favourable growth prospect in the USA. We were all surprised that the US$ was still showing some resilience and continued to be generally strong. As we all now know, things did not stay that way.

In the year 2000, the Rand lost 22% of its value against the US$ and during the first five months of 2001 the Rand lost about 5.5% against the US$, which did not seem too strange based on economic fundamentals at the time. Little did we know, of course, that at the end of the year 2001 we would be talking about a 37% depreciation and that there would have been the attacks on the United States, which would precipitate more conflicts and wars, and change risk perceptions in financial markets.

We talked then about volatility in the financial markets and acknowledged that it was becoming a constant feature as the processes of deregulation, liberalisation and globalisation continued to gather momentum.

Trading in our foreign exchange markets and in the Rand was very much influenced by the existence of the NOFP and the Forward Book, with the NOFP still registering a negative balance of US$9bn, in spite of significant progress that had been made in reducing it from the precarious levels of over US$23bn in 1998. This was seen as a negative factor by rating agencies and investors, and we were constantly called upon to explain how we were going to deal with that situation.

Where did the journey take us after that?

As you all know, the period after our last meeting brought with it some major challenges for the world economy, which South Africa as a small open economy got its fair share of. However, we also had to face serious challenges that were more related to our own situation.

The second half of 2001, especially the fourth quarter saw a steep depreciation of the Rand, not only against the US$, but on a broad base. The situation got to a point where the two-way risk inherent in trading the currency was temporarily dislodged, and a perception existed in the market that the Rand was a one-way downward bet. Our observation of the existence of large speculative positions at the time compelled us to issue the now famous statement of October 16, 2001, in which we reminded market participants to adhere to existing rules and regulations covering currency trading. It is worth noting at this stage that we very much valued the cooperation we received from the ACI when we attempted to clarify certain issues to market players at the time. Whilst many reasons have been advanced, and even a commission of enquiry established, to some extent those developments still remain unexplained. That massive depreciation in the exchange rate of the rand led to a deterioration in inflation, which represented a serious setback for us in the early stages of South Africa's implementation of a formal inflation targeting monetary policy framework. Having registered some success since the introduction of formal inflation targeting, and even managing to steer CPIX into the target range in September and October 2001, the knock-on effects of the currency depreciation resulted in a sharp increase in inflation during 2002, with CPIX peaking at 11.3% in November 2002. These developments necessitated a tighter monetary policy stance, which was delivered by way of repo rate increases totalling 400 basis points during 2002.

But we are now back on track…

We are, however, pleased to say that the pressures that we faced then were relatively short-lived. Our policy responses, whilst admittedly painful at the time, together with global and domestic developments allowed us to resume the positive path we had been travelling on before the interruption of 2001. The currency has recovered very well, and contributed to better inflation outcomes as well as a much improved inflation outlook. This in turn has allowed the Monetary Policy Committee to reduce the repo rate by as much as 600 basis points between June 2003 and August 2004. It is indeed pleasing to note that the CPIX inflation measure, which is the one that our policy is judged against, has now been within the specified target range of 6 - 3 % for almost a year.

As you are well aware, owing to the combined efforts of the SA Reserve Bank and the National Treasury (NT), the net open foreign currency position (NOFP) was finally eliminated in May 2003, and the oversold forward book of the Bank was closed out, in February 2004. We are glad to say that these developments, resulted in fully transferring the function of forward cover provision back from the Bank to the authorised dealers. Those positions also had major consequences for liquidity management in the money market. In fact they complicated our lives very badly! Whereas previously the huge losses from the forward book led to a structural liquidity surplus in the money markets, which had to be mopped up by using expensive instruments such as the so called special money markets swaps, our operations in the money markets now follow what one may refer to as normal central banking patterns.

Moreover, all these achievements also enabled the Bank to focus more on increasing the official reserves to more internationally acceptable levels. What that level is, is rather difficult to say, and there appears to be no universally agreed upon international benchmark in this regard. The appropriate level may need to be evaluated against a country's specific circumstances such as the size of its economy and degree of openness, its exchange rate regime, credit rating, risk of capital flight, and many other factors. Extensive research on the subject continues to be undertaken here and internationally.

As stated previously, whilst not working toward a specific target for reserves within a specific time frame, the Bank is strengthening its reserves mainly by means of purchasing, in a reponsible manner, moderate amounts of foreign exchange in the market, as and when, in our opinion, market conditions permit such purchases without unduly influencing the exchange rate and introducing unnecessary volatility in the market. We continue to accept that the exchange rate is set in the market. From time to time the Bank was also supported by the National Treasury in the process of accumulating reserves, when the proceeds of foreign bond issuances were sold to the Bank in exchange for Rand. In addition to "creaming-off" and foreign borrowing by government, the Bank also borrows foreign currency in its own name mainly through the syndicated loan market, which increases the level of gross reserves.

The international liquidity position has increased to $8,6 billion as at 31 August 2004 and the gross reserves (including gold reserves of approximately 4 million fine ounces) increased to slightly more than $12 billion at the end of last month. This is indeed a remarkable achievement, when one considers that at the time of our meeting in 2001, the negative NOFP stood at US$9bn, as indicated earlier. Some observers at times blame the Bank for not increasing the pace at which it is accumulating foreign exchange reserves. These well 'educated and informed' folks sometimes forget that converting a negative NOFP position of $23,2 billion in September 1998 into a positive net reserve position of $8,6 billion in August 2004, implies that over this six-year period, the Bank has acquired a staggering amount of almost $32 billion, most of which was obtained from the forex markets.

After a steady appreciation in the exchange rate of the Rand since 2003, the currency depreciated moderately after the reduction in the repo rate on 12 August this year and appears to have settled between R6,50 and R6,70 per dollar - approximately the same level as at the end of 2003.

Various factors are in one way or the other responsible for the Rand's general appreciation so far this year. Firstly, the US dollar has depreciated against major currencies, benefiting the currencies of many emerging-market countries. Secondly, high commodity prices in international markets supported commodity-based currencies like the Rand. Thirdly, accommodative policy stances in some developed countries resulted in positive interest-rate differentials for emerging market countries compared with their counterparties within the industrialised countries. This is still the case with respect to South Africa despite the overall reduction of 600 basis points in the repo rate since June 2003. Fourthly, a number of significant corporate transactions resulted in an increased supply of foreign exchange and fifthly, momentum and technical trading may also have contributed to some of the Rand strengthening in recent months.

Another important factor generally supporting the above mentioned has to do with the fact that the overall perception, or sentiment as you like to call it in the markets, of South Africa has been improving, with international investors making positive assessments of the political, fiscal and monetary management process in the country over recent years.

It is also interesting to note that the volatility conditions in the domestic foreign exchange market seem to have normalised during the course of 2004. For example, the one-month historical volatility of the Rand declined from a most recent high of 28,4 percent in January 2004 to 12,2 per cent in June 2004, before picking up again to just below 20 per cent. Another measure of volatility, namely the difference between the highest and lowest exchange rate recorded during a month, declined from R1,36 in January 2004 to around 50 cents during the last few months. Although by some standards this still represents a fair degree of volatility, one should see this in the context that South Africa is an open economy exposed to international foreign exchange markets that have been fairly volatile recently. Our efforts with regard to strengthening our reserves level should over time contribute to a less volatile exchange rate.

The average daily turnover against the Rand in the domestic foreign exchange market declined to just below US$6 billion in 2002, and remained fairly subdued at US$7,7 billion in 2003. In 2004 to the end of September, the average daily turnover against the Rand increased to above US$8 billion, and reached levels last recorded in 1999. We continue to see active participation by non-residents in our forex markets, especially in the swap market, where the share of non-residents currently amounts to around 65%. Non-residents accounted for about 60% of total turnover in the foreign exchange market.

Higher turnover generally correlates positively with market activity and also provides a good measure of market liquidity. Liquidity in the Rand market usually increases when the currency behaves in a predictable manner. However, in an uncertain trading environment, bid-offer spreads widen and the market loses its depth as market participants become reluctant to quote prices, which was the case in 2001. During the latter part of 2001, bid-offer spreads widened to approximately ten cents (from only three cents earlier in that year) on regular trading amounts. Conditions have improved drastically since then and spreads have narrowed back to approximately three cents currently. The price discovery mechanism in our forex markets now follows a much more normal pattern of two-way-risk. Given that you are forex dealers, there is no need to elaborate. Many of you have lived to be able to tell the story of the Rand much better. One thing seems to be confirmed now: the Rand is no longer a one-way downward bet. Hopefully some of the lessons learnt in this regard, in the dealing rooms, were not too expensive!

Conclusion

As you can deduct from the above, there are many areas where the Bank has daily contact with yourselves in the market place. We value these relationships dearly. It is through yourselves, the banking industry and financial markets in South Africa, that the Bank is able to implement monetary policy. You are an essential pillar in our monetary policy transmission mechanism.

We wish you well as an organisation. We hope that you may grow from strength to strength. Once again thank you for the role you play in enhancing the reputation of our financial markets. Enjoy the evening with us and have a safe journey home.

Thank you.