T T Mboweni: Recent developments in the global and domestic financial markets

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Microsoft Senior Information Technology Officer Summit, George, 18 May 2006.

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1. Introduction

Ladies and Gentlemen, thank you for the invitation as keynote speaker at this event in one of the most beautiful parts of our country. Please allow me also to congratulate you on the selection of your theme for this year, "Pathways to Growth", which I think is most appropriate in the light of the current state of the domestic and global economy.

Indeed, it is a pleasure to deliver a speech focussing on recent economic and financial market developments in the current environment. In your sector, no one needs to remind you of the painful experience when the Nasdaq Composite Index lost almost 70 per cent of its value between 2000 and 2002. Giving a speech of this nature at that time would have been considerably more difficult. Fortunately, those times are now well past, and the picture today is a much rosier one.

2. Developments in the world economy and financial markets

The Ministers of Finance and central bank governors of the Group of Seven industrialised countries issued a statement, after their most recent meeting on 21 April 2006, in which they confirmed that the strong global economic expansion continues into its fourth year and that the outlook remains favourable. Being then on a "pathway to growth", we should not miss this opportunity to take a step back and assess some of the recent developments in international and domestic financial markets.

World output has grown by 5,3 per cent in 2004 and by 4,8 per cent in 2005, and is forecast to remain close to the 5,0 per cent level over the next two years, according to the IMF's latest World Economic Outlook. Growth in emerging markets has been particularly strong, staying well above 7,0 per cent in 2004 and 2005, and forecast to remain in that region over the next two years. Sub-Saharan Africa, which has historically suffered from low or even negative growth rates, managed to grow by close to 6,0 per cent. Generally, these growth numbers have exceeded expectations.

One of the clerks working in the SA Reserve Bank has over the past few years qualified herself through part-time study as an Advocate of the High Court of South Africa under very difficult circumstances, whilst at the same time raising two small children. She quoted Einstein as saying that: "In the middle of difficulty lies opportunity". To a large extent this wisdom can be applied to the world economy and financial markets. There are numerous examples of how it sometimes takes a disaster or a crisis for a structural improvement to occur. It was only after the Asian crises of the late 1990s that Asian emerging markets started to build foreign exchange reserves and strengthen their macroeconomic fundamentals. Today, emerging markets are the net savers of the world, and reap the good results of their macroeconomic discipline in the form of low risk premiums and borrowing rates, ratings upgrades, increased foreign investment and accelerated growth rates.

On a micro level, companies have behaved in much the same way. After having been plagued by accounting scandals, downgrades to "junk" status, section 11 classifications and some verging on the edge of bankruptcy, they have pulled themselves together. Corporations have deleveraged their balance sheets and became net savers, accounting standards have improved and corporate governance has become a major focus area. In an environment of strong economic growth, this should definitely put them on a 'pathway to higher growth'. Consistent with the strength of corporate profits, improved balance sheets and diminishing excess capacity, investment is expected to be strong, contributing to renewed growth.

A positive development in the global economy that tentatively seems to be emerging is that growth is becoming more balanced and broad-based. In 2004, the US growth rate was double that of Europe and Japan. Although the US remains the main engine of growth among the industrialised countries, the gap in growth rates is expected to narrow, with US growth moderating from 4,2 per cent in 2004 to 3,4 per cent in 2006, European growth remaining around 2,0 per cent and Japanese growth accelerating from 2,3 per cent in 2004 to 2,8 per cent in 2006. Developing Asia is also likely to remain an engine of growth, with output expected to increase by 8,2 per cent in 2006, and that of China alone by 9,5 per cent.

Another remarkable thing about the current cycle of strong global growth is that it has been taking place whilst oil prices have been hovering between USD60 and USD75 per barrel for some time now – levels that would have been almost unthinkable a few years ago and which would have caused market analysts to significantly revise down their growth forecasts. Perhaps more surprising is that high oil prices do not seem to have filtered through to other prices to the extent that might have been anticipated. The so-called "core inflation", which excludes energy and other volatile prices, remains subdued in most countries.

A third factor that distinguishes growth in the current and next few years from previous years is that, while the period of expansion started in an environment of highly accommodative monetary conditions worldwide, it (growth) is now forecast to continue in an environment of higher interest rates. The US Fed has increased the fed funds target rate to its current level of 5,0 per cent, from 1,0 per cent at the start of the tightening cycle, and the general expectation is that it might be close to its peak. The ECB started to increase rates in December 2005 with further increases expected, and market expectations are that the Bank of Japan would follow suit later in the year, having ended their policy of quantitative easing (pumping liquidity into the banking system) in March 2006. Nevertheless, global financial market conditions remain favourable, characterised by unusually low risk premiums and volatility. Despite monetary policy tightening, long-term rates remain below average. The relatively flat US yield curve is a "conundrum" which even Mr Greenspan could not solve before going into retirement!

Given this favourable environment, equity prices have risen significantly. Since the beginning of 2003 until the end of April 2006, the Dow Jones has risen by 35 per cent, the Nasdaq by 77 per cent, the German Dax by no less that 117 per cent and the Japanese Nikkei 225 by 104 per cent. In this bull run, equity markets experienced an unprecedented flurry of activity with regard to mergers and acquisitions, which further boosted investor sentiment. (Some retracement in equity prices occurred in the first part of May 2006 – let us hope that it is temporary and that share prices will continue to be supported by positive economic fundamentals.)

Low bond yields in industrial countries caused funds to flow into alternative investment opportunities and into emerging markets. Despite a recent warning by the Bank for International Settlements (BIS) in its quarterly bulletin that emerging-market assets might be becoming overvalued, investors continued to favour these assets. In South Africa, non-residents increased their holdings of domestic bonds and equities by a net amount of R48,4 billion in 2005, and by a further R49 billion in the year to the end of April 2006. Some sell-off in emerging-market assets occurred during May 2006, due partly to three factors: seasonal position squaring ahead of the holidays in the northern hemisphere; developments in specific emerging markets; and higher returns now being possible in developed markets. It is too soon to judge the possible extent and effects of this sell-off – hopefully it would not disrupt financial markets in affected countries.

However, having painted such a rosy picture, one cannot help but also highlight the risks and uncertainties that currently face the world economy and financial markets. At the forefront of everyone's minds is most definitely the behaviour of the oil market. It remains to be seen for how long the general level of inflation can withstand the current high oil prices, and recent comments by prominent central bankers the world over seem to point to increased concern about the impact of oil on inflation, going forward. South Africa is no exception, and in the most recent statement of the Monetary Policy Committee of the SA Reserve Bank, rising international oil prices were once again highlighted as a key risk for inflation. The effects of the very high oil prices are likely to increase if inflationary expectations start to react.

Secondly, the world remains plagued by geopolitical uncertainties in the Middle East and other parts of the world. Partly as a result of these tensions, combined with inflationary concerns starting to increase, the gold price has recently surpassed a series of 25-year highs, trading above USD730 per fine ounce early in May 2006 before retracing to just below USD700. There are some in the market whose forecast is that the gold price might test the USD1000 per ounce level in the near term.

A third risk to the global economy is substantial further increases in interest rates. Despite various degrees of monetary policy tightening in industrial countries during the past two years, monetary conditions can still be described as relatively accommodative. Any exogenous or endogenous factors that could lead to a sharper increase in rates could well threaten the strength of the global economy. In such circumstances, volatility and risk premiums are likely to pick up.

A fourth concern that again surfaced recently was the issue of rising global imbalances, and in particular the widening current account deficit in the US, combined with significant surpluses in most of the Asian countries, in particular China. The fact that the US has to date found it relatively easy to finance the current account deficit through capital inflows has to some extent obscured the risks associated with this imbalance. However, the US current account deficit, which according to the latest numbers amounted to 6,5 per cent of US GDP, cannot keep growing indefinitely. One can only hope that the inevitable adjustments in global imbalances will occur in a controlled and synchronised manner and that it will not lead to increased protectionism. Such an adjustment would require the participation of all regions and countries. The IMF was mandated at the recent April meetings to focus on the issue of resolving these global imbalances (the so-called multilateral survey during the Article IV country consultations).

As a necessary step to start addressing global imbalances, the most keenly awaited event in the currency markets finally came to pass in July 2005 - the revaluation of the Chinese renminbi (RMB) when the People's Bank of China (PBoC) finally abandoned its decade long peg of the RMB, placing it under a managed float against an un-specified basket of currencies. Subsequently, more steps were taken by the PboC to liberalise the foreign exchange market, such as: announcing the currencies in the basket, widening the daily band of the renminbi against non-dollar currencies, abandoning quotas of foreign currency for domestic companies to invest abroad and allowing more instruments to be used in the foreign exchange market.

3. Developments in South Africa

Let me then briefly turn to developments in our own economy.

Against the background of a growing global economy, the South African economy has continued to grow at a healthy pace since 2004, with the GDP growth rate of 4,9 per cent in 2005 exceeding the 4,5 per cent registered the year before. Continued sound fiscal and monetary policies have resulted in good budgetary and inflation outcomes. CPIX inflation has been within the target range of between 3 and 6 per cent for 31 months. The outlook for inflation continues to be generally favourable, with CPIX inflation expected to remain inside the target range until the end of the forecast period in 2008, although risks and challenges remain. Vigilance is, therefore, required as is always the case in these matters.

Financial markets have also performed well. Yields on domestic government bonds declined to record lows in February 2006, and have only moderately started to increase since then. The All-share index of the JSE reached record highs in April 2006, and has already gained around 18 per cent in the year to the end of April, before retracing somewhat in May, following trends in the global markets and lower commodity prices. It is particularly encouraging that share prices performed so well despite the resilience of the exchange rate. This is true even for sectors that have historically been very sensitive to exchange rate fluctuations. Part of this buoyancy is, of course, attributable to high commodity prices. However, in the Bank, we like to see this also as a sign that, in general, companies have adapted to a relatively robust exchange rate.

As for developments in the South African foreign exchange markets, the exchange rate of the rand remains resilient and liquidity remains high relative to other emerging markets, despite the retracement in recent days. We have seen the average net daily turnover (in respect of transactions involving the rand) increase from around USD8bn in 2004 to just below USD10bn in 2005. In addition, the volatility of the ZAR exchange rate has also subsided. From the most recent peak of around 30 per cent and 25 per cent in January 2004, the one-month historical volatility and one-month implied volatility were at a level around 10 and 12 per cent, respectively, in March 2006.

It is this positive environment that has attracted substantial investment flows into South Africa, allowing the central bank to build up the official gross foreign exchange reserves from USD8,0 billion in January 2004 to slightly more than USD23 billion in April 2006. It is partly owing to this increase in the reserves in recent times that the country was awarded credit ratings upgrades by all three rating agencies in 2005, to BBB+ with a stable outlook. This has also contributed to a decline in sovereign risk spreads.

A more stable currency is critical to an attractive investment environment. Exchange rate volatility has in the past made the rand vulnerable to speculation and discouraged direct investments. The recent build up in reserves, together with some structural impediments that have now been dealt with (e.g. the Net Open Foreign Currency Position), should over time add to the stability we have already seen and reduce uncertainty for both domestic as well as non-resident long-term investors.

The sell-off in emerging-market assets and currencies during the first part of May 2006, and the effect that it had on financial markets and exchange rates, including our own, has once again reminded us of the vulnerability of emerging-market economies to a sudden and sharp change in sentiment by non-resident investors. In the case of South Africa, the effects could be even greater, against the background of a current-account deficit of around 4,5 per cent of GDP. In the past, sell-offs of emerging-market assets had been triggered by a wide array of events, which were infrequently related to actual developments in the domestic economy.

Conclusion

Despite these risks, let me conclude by reiterating that the world and South Africa seems to be well set on a “pathway to growth”. It is conferences such as this one that are likely to sustain this growth. It is also conferences such as this one that will contribute to overcoming obstacles, reducing uncertainty and managing risks. Let us not be discouraged by those, but use a position of relative strength to plan for the future and be mindful of the risks that undoubtedly exist.

Thank you for your attention.