T T Mboweni: Monetary policy and South African bond market developments

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the South African Bond Market Conference organised by the Debt Issuers Association, Johannesburg, 5 October 2006.

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Honoured guests
Ladies and gentlemen

1. Introduction

Thank you for giving me the opportunity to open this conference on the South African Bond Market. There are several reasons for developing debt markets. The most fundamental reason is to make financial markets more complete by generating market interest rates that reflect the opportunity cost of funds at each maturity. This is essential for efficient investment and financing decisions. If bond markets do not exist, firms may have to finance the acquisition of long-term assets by short-term debt, and investment policies may be biased in favour of short-term projects. Furthermore, debt markets can help the operation of monetary policy as prices in the long-term bond market give valuable information about expectations of likely macroeconomic developments and about market reactions to monetary policy moves. In my opening remarks today I will touch briefly on monetary policy and bond market issues.

2. Monetary policy developments

As you are all no doubt aware, monetary policy does not determine bond market yields. Nevertheless, monetary policy and the bond markets do impact on each other in important ways. Expected monetary policy developments are reflected in bond yields and we, in turn, get a lot of information from the bond market about market expectations concerning future monetary policy, inflation and growth. More recently, the development of the inflation-linked bond market has provided us with further insights into longer-term inflation expectations in the market.

Not surprisingly, the change in the monetary policy stance in recent months has been felt in the local bond markets. The repo rate had been unchanged for 14 months, but in June of this year, the Monetary Policy Committee decided to raise the repo rate by 50 basis points, and this was followed by a further increase of the same amount in August. Although capital market rates reflect expectations, these expectations are not always correct. At the time of the first increase, these changes were not fully reflected in bond yields, but we have seen a significant adjustment since then.

Although our actions took many by surprise, for some time we had been sounding warnings that we perceived the risks to inflation to be on the upside. Our warning remains the same today, as we still see significant upside risk to the inflation outlook.

Our major concern remains the growth of household consumer demand which grew at an annualised rate of 8 per cent in the second quarter of this year. This expenditure is still being driven by credit extension growth in excess of 25 per cent, and household debt as a proportion of disposable income has risen to an historically high level of 70 per cent. Despite the obvious dangers of such developments and the recent hikes in interest rates, there are no indications of any meaningful change in consumer behaviour. It is hard to imagine that such trends, if unchecked, will not have inflationary consequences.

Another area of concern has been the current account deficit, which although narrowing from the 6,4 per cent of GDP registered in the first quarter of 2006, still stood at a high of 6,1 per cent of GDP in the second quarter. As we have noted in the past, current account deficits are not in themselves inflationary. There is however a possible risk to the exchange rate if the deficits are perceived by the markets to be unsustainable, particularly if the deficits are reflecting higher consumption expenditure. On numerous occasions we have pointed out the possible implications of the deficit for investor sentiment and for the rand. The recent exchange rate reaction to the higher deficit is indicative of this, but it is also part of the adjustment process. Nevertheless the adjustment in the exchange rate has reached levels which may pose a further threat to the inflation outlook.

Fortunately it is not all doom and gloom, and there has been at least one significant improvement in the risk factors affecting the inflation outlook. International oil prices have offered some respite and come down from their highs of almost US$80 per barrel in early August, to levels below US$60. We are aware that this positive development can change at any time, given the delicate balance between supply and demand in the oil market, and the acute sensitivity of the oil price to changes in risk perceptions. We are nevertheless fortunate regarding the timing of this respite.

Domestic economic growth averaged 4,5 per cent and 4,9 per cent in 2004 and 2005 respectively. Despite the change in the monetary policy stance, we do not anticipate that growth prospects will be significantly undermined. The exchange rate developments are expected to be positive for export growth, and it will not be a bad thing if domestic growth is driven by exports and infrastructural spending, rather than by consumer spending as has been the case in the past two years. Our focus, however, remains on the inflation target, and we will continue to strive to maintain CPIX inflation within the 3-to-6 per cent target range. The credibility of our actions will of course be reflected to some extent in the bond market.

3. Domestic bond market developments

The South African bond market has for some time had an important role in the financial system, and it is particularly pleasing to note the significant developments in the corporate bond market. It is also of interest to note the burgeoning literature on bond market development internationally. A recurring theme in the literature is the ability of governments or corporates to borrow from non-residents in their own currency. The inability to borrow in ones own currency, referred to in the literature as ‘original sin’, often leads to currency mismatch, and ultimately to balance sheet vulnerability in the event of significant exchange rate changes. South Africa stands out as one of the few emerging market economies that does not suffer from ‘original sin’, given the long history of resident and non-resident participation in the domestic bond market. The development of the corporate bond market adds a further important dimension to the market.

It is common knowledge that the South African bond market is highly developed and very deep. There are continuous innovations as is witnessed by the listed products offered by both the Bond Exchange of South Africa and the Yield-X of the JSE. Whereas in its infant stages the Bond Exchange was dominated by government and parastatals, in the recent past corporate issuances have been increasing. Since the South African bond market has historically been a predominantly government and government-related debt market, the use of credit ratings has been limited. With the introduction of corporate bonds in recent years, this has changed as a need has emerged for a better understanding of credit risk.

The corporate bond market is today the fastest-growing segment of the bond market, as new issuances of corporate bonds have overtaken those of government bonds. Government has also been borrowing less because of fiscal discipline and more efficient tax collection by the South African Revenue Services. Securitisation issuances have also picked up considerably, and while the banks are major issuers in this market, there are other active players as well. The number of issuers accessing the debt capital markets has grown from a single issuer in the period prior to 2000 to 14 issuers in 2005.

The secondary market for bonds in general is developing very slowly. Contributing to this state of affairs is that buyers tend to buy-and-hold due to the attractiveness of these instruments in their portfolios. However, there are early signs of a more active secondary market beginning to resurface as turnover has increased in the past year.

4. Conclusion

The stable inflation environment means that the fixed income structure of bonds has become relatively more attractive to investors with risk profiles that demand a steady real rate of return. Also, economic growth has been more robust in recent years amid heightened investor optimism about the country's future prospects. Improved economic fundamentals translate into enhanced growth prospects for South African corporates and a concomitant need for long-term debt financing. The development of this sector of the bond market offers borrowers in the private sector access to long-term finance from the capital markets.

I am aware that some of South Africa's important corporates are here to participate in this conference. We look forward with keen interest to your contributions to the growth of this sector of the market. I wish you well during your deliberations.

Thank you for your attention.