T T Mboweni: What is happening in financial markets?

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Cape Town Club, Cape Town, 5 October 2007.

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Honoured guests,
Ladies and Gentlemen

1. Introduction

Thank you for providing me with the opportunity to address you this evening on the recent turmoil experienced in global financial markets which began in July this year. At the time of our last Monetary Policy Committee meeting in August, the turbulence on the international financial markets had intensified and it was unclear how developments would unfold. As we prepare for the MPC meeting next week, the dust appears to have settled. In fact, if one looks at the conditions in the financial and commodity markets today and compares them to the conditions prevailing in mid-July, one would not think there had ever been any disruptions. My remarks to you this evening will focus on the developments in the international and domestic financial markets, potential implications for global growth and the policy implications.

2. The build-up to the turbulence

For the past few years now, global financial markets have prospered and seen innovation and integration on an unprecedented scale, leading to more prominent roles being played by investors such as hedge funds, and new derivative instruments and structured products. This boom in financial markets was a result of low interest rates in developed markets, and the financial system being flooded with liquidity. Investors, in an attempt to earn higher returns, invested in riskier assets. As more and more investors jumped on the bandwagon, and demand for riskier assets increased, the excess yield these assets offered diminished. However, this strategy remained beneficial given that the global economy was characterised by low and falling inflation and robust economic growth. This demand for excess yield gave rise to, amongst other things, the boom in the US sub-prime market.

The economic and financial environment has almost been a utopia situation in certain respects, displaying a remarkable resilience, even during recent periods of correction. However, this resilience only served to increase the level of complacency about the nature of the risks involved. The central banking community had consistently expressed concern about the level of pricing observed in markets, which did not seem to adequately reflect the level of risk being taken. Now, the sub-prime "bust" has led to a tightening of both liquidity and credit conditions, creating turmoil in financial markets. I am reminded of a comment by Warren Buffet: "It's only when the tide goes out that you learn who's been swimming naked."

3. Recent financial market turbulence

A rising wave of risk aversion prompted by increasing foreclosures in the US sub-prime mortgage market resulted in an abrupt deterioration in global financial market conditions in August 2007. Rising foreclosures and delinquencies were linked to sub-prime borrowers who had taken out adjustable rate mortgages. As interest rates reset to higher levels, in line with the rising US interest rate environment, these borrowers found it difficult to pay their mortgage loans. This turbulence was not confined to the US sub-prime market, spreading to the broader mortgage market and financial markets more generally.

In mid-June and July, the ratings agencies cut the ratings on a number of securities backed by sub-prime loans and put on review a number of mortgage backed securities for downgrade. Soon after, US foreclosures were reported to be almost 90 per cent higher than the previous years' level. Two large hedge funds were shut down as a result of exposure to the sub-prime market. Thereafter, some large sub-prime lenders collapsed, while holders of sub-prime residential mortgage backed securities also suffered losses. These events resulted in a tightening in underwriting standards, with fewer households qualifying for sub-prime loans. Investors reassessed their tolerance for risk, most notably for structured financial products and for securities of highly leveraged firms.

All of these events culminated in increasingly impaired short-term and interbank funding markets in August. Many issuers of asset-backed commercial paper programs found rolling over their paper increasingly difficult. This occurred due to a lack of transparency in the financial system, with no-one quite sure of whom owns what and therefore uncertainty regarding the losses faced by financial institutions and their counterparties. Investors started treating all counterparties with suspicion.

The exposure to the sub-prime market became all the more pervasive, with banks and hedge funds in the US, UK, and Australia, to name a few, indicating exposure to this market. The global nature of the problem was particularly highlighted when the second largest bank in the Eurozone froze access to certain of its investment funds on 09 August 2007. Risk aversion increased over this period, as clearly witnessed in the almost 200 basis points drop in the US three-month Treasury Bill yield in early August. Banks began to hoard cash to cover their funding needs and as interbank liquidity dried up, banks found it difficult to raise term funding. Surging liquidity demand spilled over into the short-term money market, causing overnight interest rates to soar.

Volatility in financial markets, as measured by the VIX[1] index, moved from 14 index points on 17 July to touch a record 31 index points on 16 August. Volatility at levels of around 20, has generally led to a re-pricing of riskier assets. Major equity markets lost between 8 and 12 per cent, with the Japanese equity market worst affected as it was dealt a double blow with the appreciation of the Japanese yen. Emerging market equity markets followed their international counterparts lower as risk aversion increased and investors fled to safe haven assets. The Morgan Stanley Capital International (MSCI) index for emerging markets lost over 16 per cent. The "flight to safety" led to a precipitous fall in developed bond market yields. In the space of a month, the two-year US Treasury yield dropped almost 70 basis points, below 4,00 per cent. The EMBI plus spread above US Treasuries widened by 82 basis points to 250 basis points.

Currency markets also experienced increased volatility. The USD appreciated from USD1,38 to USD1,34 against the euro, and appreciated against most major and emerging market currencies. The Japanese yen (JPY) was the exception, as it appreciated by 9,0 per cent against the USD from over JPY122 at the end of July to JPY112 in mid-August, reflecting the role that Japanese interest rates played in supporting risk-taking in recent years. The unwinding of carry trades in particular supported the JPY. The same trend was witnessed in the International Monetary Market data which showed a significant turnaround in speculative forward currency positions from net short JPY positions in July to net long positions in August.

[1] VIX is the ticker symbol for the Chicago Board Options Exchange Volatility Index, a measure of the implied volatility of S&P 500 index options. It represents one measure of market's expectation of volatility over the next 30 day period.

4. Central banks react

Central banks responded in order to prevent a potential financial crisis caused by near-dysfunctional money markets in developed countries. Since 9 August 2007, the Fed and ECB offered three-month term funding, and together with other central banks injected significantly more liquidity into the financial system. The types of securities against which banks could borrow were broadened by the Fed and ECB to include mortgage backed securities – the Fed went a step further and accepted asset-backed commercial paper. The relaxation of key restrictions on lending between banks and broker/dealers also helped to reduce liquidity pressures as it allowed banks to fund their own and other non-bank dealers more easily. On 16 August, the Federal Open Market Committee lowered its discount rate by 50 basis points, returning some calm to markets. In the case of the United Kingdom, it was necessary for the Bank of England to provide emergency liquidity assistance to one financial institution, Northern Rock. As central banks rarely provide this kind of assistance easily to one institution, financial markets will continue to keep a watchful eye on possible subsequent developments in the United Kingdom.

The most significant action, however, was the 50 basis points reduction in the target federal funds rate and a further 50 basis points reduction in the discount rate by the FOMC in mid-September. This had a pronounced impact on financial markets. Risk appetite returned, and the VIX index declined from over 31 index points to 19 index points by 21 September. Stock markets rebounded between 7 and 16 per cent and bond yields increased as investors moved back into riskier assets. The increased risk appetite over this period led to the JPY reassuming its depreciating trend, from JPY112 in mid-August to JPY116 on 21 September. The USD, however, depreciated to over USD1,40 against the EUR, breaching the USD1,40 level for the first time on 20 September, pressured by interest rate expectations. Market expectations of monetary policy have changed markedly since these events from a general environment of tighter monetary policy to easier monetary policy. Commodity prices have reached highs not seen for over 20 years. The gold price has moved above USD740 per fine ounce, but sadly, oil prices have also risen, to over USD80 per barrel.

Emerging markets also regained their composure since the Fed lowered its target federal funds rate. The MSCI for emerging markets gained over 25 per cent since mid-August and the EMBI plus spread declined by 56 basis points. It is notable however, that throughout this crisis, there has been limited reaction from emerging markets. One can ascribe this to healthy economic fundamentals. Emerging markets over the past few years have increased their reserve levels significantly, reduced their external balances and debt servicing. Equally important is the fact that debt buybacks have continued and net external debt reduction is still prevalent in many key emerging market countries. Thus, overall, it would appear that emerging markets are far less susceptible to credit events than they may have been in the past.

5. South Africa's experience

South African money markets were relatively unaffected by these events as our banking system had negligible exposure to the subprime market. Liquidity conditions domestically remained healthy, and there was no need for the South African Reserve Bank to provide extra liquidity to markets.

However, South African financial markets did not go unaffected. After trading below R6,80 against the USD in July, the rand depreciated to over R7,60 in mid-August. Domestic bond yields increased and the Alsi retreated quickly from the almost 30 000 level reached in July to below 26 000 in August. As calm returned to the markets, so the rand appreciated to below R7,00 against the USD, the Alsi ratcheted up gains above the 30 000 level, surpassing the record highs reached before the crisis, and government bond yields declined.

As with many other emerging economies, South Africa's macroeconomic position places it in good stead. Despite the turmoil in global financial markets, non-resident interest in South African assets remained positive. In fact, for the month of August, South Africa witnessed record purchases of domestic bonds by non-residents. Nonresident purchases of South African shares exceeded R10 billion. Nonetheless, the sustainability of these inflows will depend in part on global liquidity conditions as well as domestic growth prospects. Conditions in the local foreign exchange market also allowed for further accumulation of foreign exchange reserves.

There does not appear to be any evidence at this stage that the recent turbulence in the international financial markets will have marked effects on the domestic growth outlook, although this will depend to some extent on the impact of these developments on the US growth performance.

6. Implications for global economic growth

Whilst initially the developments in the financial markets appeared to be limited to a liquidity problem, they later transpired to present a credit problem as well. The big question now is to what extent these developments will affect the real economy.

It seems logical that the US economy will bear the brunt of the damage of the sub-prime crisis. The tightening of lending standards and therefore the restrictions of credit extension to weaker households could exacerbate the housing downturn in the US even further. Dampened business sentiment and falls in the equity market, combined with the weaker housing market and deterioration in consumer sentiment could mean a more intense negative impact on wealth. The most recent evidence by way of economic data releases seems to suggest that the problems in the housing market may be deeper than initially assumed and harbour real risks for consumption and growth. The recent policy actions from the FOMC very much seem to acknowledge this change in prospects.

As the IMF has noted, most of the world will likely emerge relatively unscathed from this crisis. The recent shifts away from the US as being the key driver of global growth, together with the better balance achieved during the last two years represents significant support for the global economy. However, the ramifications of any sharp slowdown in the US always remain and should not be underestimated. As for emerging markets, lower external debt, better reserves levels, more prudent fiscal management, leading to much more improved fundamentals, have undoubtedly already delivered dividends.

Whilst the global economy is deemed to be robust enough to shake off US weakness, contagion effects means that the sub-prime problems can contaminate other countries. As noted, emerging markets are better prepared for, but certainly not immune to global financial market risks. A reduction in global risk appetite would curb net capital inflows into emerging markets, placing downward pressure on emerging market currencies and in turn exacerbate inflationary pressures.

7. Policy implications

The recent events and actions by central banks around the world have raised an interesting debate on "moral hazard". It raises the question of whether central bank support of the markets does not amount to a bail-out of careless investors, thereby paving the way for more careless behaviour in future. In a recent speech by Federal Reserve Bank Chairman, Ben Bernanke, he noted that well-functioning financial markets are essential for a prosperous economy. Central banks need to ensure the functioning of financial markets, but in a very difficult balancing act, also need to guard against recreating conditions of careless lending that preceded the market turmoil.

In this context it is important to point out that central banks can ill-afford to take any chances with systemic risks. In the process of addressing problems "for the greater good" there could be some by-product of unintentionally providing help to those who do not quite deserve it. This was the dilemma faced by the Bank of England when it eventually had to provide assistance to Northern Rock. But this should never allow financial market participants to work on any assumption of some inbuilt automatic guarantees against failure.

As the IMF points out in its September 2007, Global Financial Stability Review, policymakers and market participants need to learn from the present situation and make amendments to the global financial system in order to strengthen it. Key in this is the recognition that there needs to be improvements in a wide range of areas:

- Greater transparency between on- and off-balance sheet entities, so that the market is able to properly differentiate and price risk.
- better risk monitoring;
- improvements by ratings agencies;
- better valuations of complex financial instruments and products; and finally
- wider risk perimeters that go beyond the accounting and legal perimeters.

Policy makers in both mature and emerging markets therefore face considerable challenges going forward, to ensure the stability of the financial system and continued healthy global growth.

8. Conclusion

In recent weeks, the present situation has been likened to events in 1998 or 2001. However, what should be borne in mind is that the current situation has occurred against the backdrop of broad-based strength in the global economy. A deeper understanding of what led to the turmoil is required, lessons need to be drawn and where necessary, improvements made.

The correction we have observed may have proven painful for many, and I have little doubt that the pain is not yet over. Ultimately, the correction should be seen as positive for the financial sector and the economy overall, especially if spill-over to the real economy can be contained. Hopefully it will allow for more differentiation in pricing of credit and less aggressive mortgage lending and leveraged loan practices, and in so doing, compensate investors and lenders more appropriately for the risks they are taking.

I thank you.