A D Mminele: South Africa amidst the crisis

Address by Mr A D Mminele, Deputy Governor of the South African Reserve Bank, at the "Spire Awards" Ceremony, Johannesburg Stock Exchange, Johannesburg, 3 November 2009.

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1. Introduction

Good evening distinguished guests, nominees for the 2009 Spire Awards, Sponsors of the Awards, ladies and gentlemen

It is an honour to be invited to speak at this prestigious event, which is held in recognition and celebration of excellence in South Africa's fixed income market. The Spire Awards have become a key event in the South African financial markets calendar.

BESA has undergone numerous changes over the past two years, having successfully completed its demutualisation and recapitalisation at the time of the 2008 Spire Awards and now, just more than a year later, has become a wholly owned subsidiary of the Johannesburg Stock Exchange (JSE). BESA should be congratulated for the role it played in the development of South Africa's bond market. In the more than 10 years of its existence, BESA played a prominent role in advancing South Africa to its position as one of the most liquid and developed amongst global bond markets, and a leader in emerging markets. This fact is clearly illustrated by the significant rise in turnover in recent years, from R9, 5 trillion in 1998 to R19, 1 trillion in 2008. The World Federation of Exchanges places BESA as the fourth largest exchange in terms of turnover recorded for bond trades in 2008.

We wish BESA well in the new partnership with the JSE, which will benefit the interest rate and derivatives market in South Africa and contribute towards the further development of our financial markets. Allow me to take this opportunity to convey my appreciation for the manner in which the JSE has kept the markets and relevant stakeholders informed about the integration process.

2. Importance of a well developed bond market

I need not tell you that the central bank takes a keen interest in the fixed income market, having played a key role in the development and expansion thereof prior to 1998. The bond market plays a vital role in the achievement of both monetary and financial stability. A well functioning bond market should improve the transmission mechanism of monetary policy, allow the central bank to infer inflation and interest rate expectations of market participants, and contribute to the promotion of economic growth, by facilitating more efficient pricing of borrowing and lending. Without a well-developed local currency debt market, balance sheet vulnerabilities could emerge, the risk of default would increase, there would be a concentration of credit and maturity risks in the banking system, and vulnerabilities from capital inflows and limited macroeconomic policy instruments would increase. The ability to cope with financial distress would be diminished.[1] Because of our well-developed local currency bond market, the Government has over the years been able to meet its funding requirements mainly in the domestic market, and this has indeed been one of the reasons why South Africa fared rather well in the global financial crisis. For many emerging markets, the further development of local currency debt markets has become a priority.

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[1] CGFS Papers no.28, Financial stability and local currency bond markets, June 2007.

It is also for these reasons that the Committee of Central Bank Governors in SADC (CCBG) approved the creation of a financial markets subcommittee during 2008. This committee was established precisely because of the recognition that robust, well diversified and liquid financial markets are critical to the implementation of monetary policy, for maintenance of financial stability, and that they can contribute towards increased economic activity throughout the region. Under the auspices of this committee, central banks have agreed to co-operate in developing and strengthening their national financial markets with the intention of creating a regional financial market as part of the initiatives towards the implementation of the SADC Finance and Investment Protocol (FIP). I am aware that the JSE, as part of the Committee of Stock Exchanges in SADC (CoSSE) is already in conversation with this subcommittee to advance the development of bond markets in the region.

3. Conundrum or catastrophe?

As we have witnessed in recent times, even in well-functioning, deep and liquid bond markets, inefficiencies and market failures can still occur. It was not too long ago that the world was perplexed by the so-called "Greenspan conundrum", where there appeared to be a decoupling of monetary policy from long-term interest rates. The increase in the US policy rate from 1 per cent in 2004 to 5, 25 per cent in 2006 had little or no impact on long-term US Treasury yields, ultimately resulting in low and stable long-term mortgage rates. This phenomenon raised concerns that a possible housing bubble was brewing in the US, concerns which were not unfounded.

There were many explanations put forward for this conundrum, from the immense credibility the Fed had gained in keeping inflation and inflation expectations low, to Fed Chairman Bernanke's "global savings glut". Whatever the reason, it was not long before the Greenspan conundrum turned into a disaster. Risks of the housing bubble bursting indeed materialised and the rest of the story you all know very well. Needless to say, the conundrum that existed is no longer. As central bankers began to ease monetary policy, investors began to worry about inflation, boosting long-term interest rates and in the process mitigating the action that policymakers thought was necessary. Unconventional forms of expansionary monetary policy were instituted, for fear that long-term interest rates would not remain low and therefore would dull any possible improvement in economic activity. The combined impact of quantitative and credit easing on central bank balance sheets has been extremely large.

4. The rise of emerging economies

It is said that the crisis did not derail but rather accelerated the rise of emerging economies.[2] It is now just more than two years since the onset of the sub-prime crisis and it appears that the global economy is finally emerging from recession, even if significant risks remain. The IMF's latest World Economic Outlook shows improved prospects for global growth in 2009 and 2010 compared to previous forecasts, with a strong performance by Asian economies supporting the global recovery.

Emerging markets, accounting for one third of global output, play an increasingly important part, and it is for this reason that the G20 has assumed a leading role as a forum for global co-ordination. After losing approximately 60 per cent of value since the collapse of Lehman Brothers until the low point reached in March 2009, the Morgan Stanley Capital International Index (MSCI) gained more that the 60 per cent until the end of October, led by an almost 90 per cent improvement in the MSCI for emerging markets. The EMBI plus yield had increased

[2] Antoine van Agtmael, FT.com.

by almost 600 basis points between January 2007 and October 2008, and has since declined by a similar magnitude.

Emerging market currencies have also appreciated significantly, the rand being no exception. A currency remaining at non-competitive levels for too long might have adverse consequences for the real economy. Some countries opted to deal with currencies perceived to be too strong through a combination of verbal and actual market intervention. Brazil, in addition to previous measures, also recently imposed a 2 per cent tax on capital inflows into both equity and bond markets to contain short-term capital flows and to reduce any further upward pressure on the currency. The appreciation in emerging market currencies, including the rand, has been mostly driven by external factors, such as increased global liquidity, the depreciation of the USD and renewed investor-appetite for more risky assets. Domestic factors, such as relatively strong macroeconomic fundamentals and wider interest rate differentials, have also played a role. These gains, unfortunately, increase the likelihood of an uneven economic recovery.

Whilst the monetary and fiscal authorities in South Africa have at times expressed concern about the impact of the appreciated currency on the overall macroeconomic balance, SARB policy remains that of no intervention in the foreign exchange market with the objective of managing the currency. The floating exchange rate regime helped to cushion South Africa from more severe effects of the global crisis. The Bank will, within the broader context of policy coordination with the National Treasury, continue with its strategy of accumulating foreign exchange reserves when market conditions are conducive. Over the past year, reserves accumulation was constrained by the volatility in the foreign-exchange markets, the level of global risk aversion and cost considerations. More recently, conditions in the foreign exchange markets have been somewhat more favourable, allowing the Bank to increase its purchases of foreign exchange in a responsible manner.

5. South Africa amidst the crisis

As we are all aware, South Africa was not immune to the global crisis, the domestic economy contracted for three consecutive quarters. The monetary policy tightening cycle which commenced in June 2006 came to an end in June 2008. The MPC was initially more concerned about the impact of multiple supply shocks on inflation. It was only later that global developments began to have a significant impact on the economy. Keeping in mind that the MPC's focus is on the medium to long-term expected inflation trajectory, and that there is a lag in the reaction of inflation to interest rate changes, the significant widening in the output gap and inflation continuing its downward trend after peaking at 13, 6 per cent in August 2008, allowed for the MPC to reduce the repurchase rate by 500 basis points between December 2008 and August 2009.

The contraction in economic activity and the change in the monetary policy stance impacted the domestic bond market in two ways. Firstly, while monetary policy easing exerted some downward pressure on bond yields, this was counteracted by increased supply of government bonds. Given the rapidly slowing economy, revenue intake was substantially lower than projected, causing an increase in the budget deficit. Increased risk aversion also resulted in non-residents reducing their exposure to the domestic bond market. Amid the economic conditions described above, the benchmark yield curve inverted. The dynamics in the bond market changed significantly over the past year. Whereas in previous years, strong economic growth and revenue collections resulted in government being net redeemers of bonds, since the end of 2008, activity in the primary bond market has been driven primarily by the public sector, Government and state owned enterprises. For the first nine months of 2009, the public sector issued a net R74, 5 billion, compared with net issuance of R800 million in the same period last year. The Medium Term Budget Policy Statement indicates that for 2009/10, revenue collections will be R82 billion lower than projected in the February

Budget, resulting in the projected budget deficit for 2009/10 increasing from 3,4 per cent of GDP to 7,6 per cent.

Notwithstanding the turmoil in global financial markets and conditions in the domestic economy, bond listings on BESA grew in 2008, albeit at a slower pace. While on the one hand, the bulk of growth was attributed to the increased issuance of commercial paper by corporates as well as increased issuance by state owned enterprises, on the other hand, growth in listings was dampened by contractions in the securitisation and "other" corporate categories. Similarly, conduit sizes have almost halved, driven by negative perceptions towards asset back commercial paper following the sub-prime crisis and the slowdown in economic growth. As for corporate listings in general, these were held back by the slowdown in domestic economic activity which forced many corporates to scale down activities. There are, however, indications that appetite for credit in the South African market is returning, judging from the strong senior bank bond issuance in the third quarter. South Africa has fared rather well throughout the crisis in comparison to some other emerging and developed economies.

6. Conclusion

In conclusion: While there continues to be much uncertainty regarding the strength and sustainability of the recovery, increasingly central banks are beginning to ponder exit strategies. The quantitative easing employed by central banks, the fiscal stimulus packages and record increase in government debt issuance has created concerns about exit strategies of central banks and their impact. The question is whether central banks will be able to exit from these unconventional policies in such a manner that the nascent economic recovery is not jeopardized, while also ensuring that the timing is correct such that inflationary pressures do not build. Central banks face important challenges in several areas, such as determining the timing and extent of reversing policy easing, coordinating with fiscal authorities and other central banks, and communicating their strategies to the public. A disciplined analysis of the data will test the science of central banking, whereas a good assessment of the operating environment and judgement will put the spotlight on the art of central banking.

Finally, I would like to congratulate all the nominees for this year's Spire Awards. Whether you or your team walk away with a prize or not, the fact that you were nominated is indeed already a great recognition by your clients and your peers for the contribution you have made to the South African bond market.

I thank you all for your attention.