Daniel Mminele: Policy implications of some key market developments

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Financial Markets Department's Annual Cocktail Function, Pretoria, 3 March 2015.

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Introduction

Ladies and gentlemen, good evening.

Thank you for attending this year's Financial Markets Department cocktail function.

It has almost become tradition for me to take stock of major global and domestic market developments that occurred during the past year, and to briefly reflect on their implications for South Africa. In the past, we also used this event to brief you, our partners in financial markets and other stakeholders, on key projects undertaken, changes and innovations introduced in the Financial Markets Department.

This year, though, I would like to take a slightly different approach. Rather than providing a detailed review of operations over the past year, I will look at what I think are potential challenges that market participants and policymakers are likely to be confronted with in the period ahead. Given the time constraints, I will focus on the policy implications of some key market developments.

You will, however, not be deprived of information about recent developments and activities of our Financial Markets Department. I have the pleasure of announcing the launch of the newsletter called *FMD update*, copies of which will be available tonight. The newsletter will also be available on the Bank's website.

What has not changed and will not change is the importance of central bank interaction and communication with the markets, especially in light of the new views on the role of forward guidance in its various forms. Forward guidance, in more formal or less formal ways, appears to have graduated from what was essentially a crisis-fighting instrument to now being advocated by some as part of the standard toolkit of central bankers, even in normal times. Recent experience has shown how sensitive financial asset prices have become to changes in signals over future policy. We therefore continue to value our ongoing interaction with yourselves as market participants, as you are in essence part of our transmission mechanism of monetary policy.

Monetary policy divergence, the stronger US dollar, and global imbalances

But let me get back to market issues and policy.

One of the key trends observed over the last few quarters has been the steady appreciation of the US dollar against the backdrop of divergent monetary policies in advanced economies. At first glance, such a recovery in the US currency seems consistent with the improvement in US economic prospects. US GDP growth continues to outpace that of the eurozone and Japan, and most economists agree that 'the healing process' of balance sheets in the private and public sectors, a necessary adjustment following the global financial crisis, is more advanced in the US than in some of the other advanced economies. In view of these improvements, and of perceptions that the US economy is likely to prove fairly resilient to foreign-exchange appreciation, market participants have discounted earlier rate hikes in the US than in other major blocs, and widening yield and forward rate differentials have favoured the US dollar. As you are aware, the actual timing for a lift-off in US interest rates remains the subject of much debate and speculation. Conversely, the resulting currency depreciation in regions like Europe, Japan and Latin America is seen as growth-enhancing and also assisting, in some cases, with warding off the risk of deflation.

The marked appreciation of the US dollar may, however, revive other concerns. We have seen a very strong correlation between the stronger dollar and weaker commodity prices. While this is in part a logical consequence as the US dollar is the currency of denomination for trading in many commodities, the firming in the US currency appears to have contributed to an unwinding of long speculative positions in commodity futures, which has possibly exacerbated the overall price decline. Some have argued that the risk that such an unwinding of positions could extend to other financial assets through portfolio rebalancing effects should not be underestimated. Hence, it may not be a coincidence that the stronger dollar was accompanied by a rise in financial market volatility, a subject I will address in more detail later. Finally, it may be worth asking whether the stronger dollar and stronger US growth will not, as has already happened in earlier decades, exacerbate current-account imbalances or result in widening global imbalances, at a time when external surpluses in the eurozone and China are rising again and the US trade deficit is drifting wider.

How has this affected South Africa? A corollary to the rising US dollar has been depreciating emerging market currencies, including the rand. The downward trend of the rand versus the US dollar continued in 2014. At R11,71 to the US dollar as of 2 March, the bilateral exchange rate is approximately 7,0 per cent weaker than a year ago and only marginally stronger than the low of R11,87 reached at the height of the 2008 global financial crisis. However, compared with other emerging market currencies, the rand was certainly one of the better-performing currencies against the US dollar and has regained some of the ground it had lost in earlier years. Yet, unlike previously, this weakening of the rand against the US dollar has not resulted in depreciation on a trade-weighted basis. In fact, the effective exchange rate has been relatively stable since the beginning of 2014. On 2 January 2014, the TWI was at a level of 68,3 while on 2 March 2015 it was virtually unchanged at 68,4. For 2015, up to and including 2 March, the rand has appreciated by 2,1 per cent on a trade-weighted basis. This is explained by the fact that while there has been a marginal depreciation against the US dollar of close to 2 per cent, the rand has appreciated by 6,3 per cent against the euro.

This reconfiguration in currency markets arising from the stronger US dollar, which happens to coincide with easing policies in other parts of the world, has led some observers to highlight the risk of new currency wars. Any currency wars which inhibit international trade will affect economies highly dependent on exports and will certainly trigger uncertainty, with an adverse impact on capital flows to emerging market economies. It is for this reason that the G-20 agenda argues against the use of competitive devaluations as a deliberate policy measure.

The volatility of domestic bond yields

Another important development over the past year has been the decline in long-term South African bond yields, even as the rand continued to weaken against the US dollar. For example, while off its late-January lows, the yield on the R186 bond is still about 130 basis points below early-2014 levels. The current yields are nevertheless still substantially higher than the levels that prevailed prior to the 'taper tantrum'. Before bond yields started rising to the current levels of 7,66 per cent, the R186 bond traded at 7,04 per cent towards the end of January. The strong bond market rally in January was due to market participants having scaled down their expectations for interest-rate hikes compared with what they projected in early 2014 due to the oil price having declined sharply, to the point that domestic inflation was no longer expected to exceed the upper end of the target range over the forecasting period, and real domestic GDP growth having also fallen short of earlier expectations. Furthermore, non-residents were net buyers of domestic bonds to the value of more than R9,1 billion.

Bond yields reversed course as non-residents started selling domestic bonds (approximately R13,7 billion in February). There were also rising concerns and uncertainty as to the sustainability of the low oil price. There were indications that broad measures of longer-term inflation expectations – as depicted by the BER survey – had not declined significantly, at least not as much as market measures like break-even inflation expectations, which was a key factor behind the decline in long-term bond yields in January.

The Bank will continue monitoring the international and domestic factors driving bond market volatility. Increased volatility would be a source of risk as it could undermine capital inflows and put pressure on the balance of payments. In that respect, it may be worth reflecting on, in particular, what the relationship should be between long-term interest rates and the price of oil. Indeed, a decline in oil prices should depress the inflation rate in the short term but at the same time provide a boost to real GDP growth, and as a result need not have a big impact on long-term inflation expectations. A strong rally in longer-term bonds on the back of lower oil prices may be justified in places like the eurozone, where market participants fear that even a few months of negative headline inflation readings might entrench deflation; yet one cannot make a similar case in South Africa. After all, more likely, the decline in long-term SA bond yields was influenced by the strong correlation between domestic and foreign term premiums, especially with the US. However, this pattern highlights the vulnerability of domestic yields to any sudden steepening in global yield curves.

Causes of the recent uptrend in volatility

While global long-term yields are still below the average levels that prevailed in the second half of last year, most indicators of financial market volatility, especially in the fixed-income and currency markets, have tended to move higher in recent months. Furthermore, at least compared to the period of relative stability around mid-2014, these indicators seem prone to swings that are both more frequent and bigger in magnitude. In a word, volatility seems to be getting more volatile.

Some commentators argue that this volatility is driven by, among others, geopolitical events, uncertainties about the timing and pace of US rate rises, tensions arising from needing to find sustainable solutions for Greece, and doubts about how successful QE will be in the eurozone. These factors have a significant bearing on this rise in volatility. Rising volatility in several financial assets seems to have been correlated with higher oil price volatility as a result of the drop in crude prices, which may sound a bit counterintuitive as lower oil prices typically bring about a better growth/inflation mix in the world's largest economies. While demand and supply factors are responsible for the over US$50 per barrel decline in the price of Brent crude, we do not have a full understanding of the drivers of the oil price decline. In fact, there are indications that financial factors, while not dominant, did have some bearing on oil price movements. Or was the oil price decline seen as a harbinger of deflation in some regions? It could also be a reflection of deeper structural economic weaknesses that will complicate the task of policymakers, and thereby challenge the valuation of many asset prices. Only time will tell.

At the same time, the side effects of regulatory changes introduced in recent years, and in particular limitations on banks' proprietary trading, appear to have reduced the willingness of established primary dealers to hold sizable inventories of fixed-income securities, and to continue to make markets in the less liquid issues. As a result, turnover has tended to decline relative to amounts outstanding in many of these markets. At a time when fund managers (both private and public) have tended to diversify their portfolios and hold larger quantities of these less liquid issues, the risk of a sudden plunge in liquidity, and subsequent sharper price swings, may rise should asset managers be required to substantially reduce their positions in a relatively short period.

Yet, while these constraints to market liquidity are likely to be a sign that new regulations could be having unintended and undesired side effects, they should not be used as an excuse to put on hold the search for greater fairness, transparency and ethics in financial markets, both internationally and at home. In a world where both the size and the complexity of financial transactions keep increasing, yet where a growing number of intermediaries and trading technologies mean a decline in the personal relationship between buyers and sellers, the need for trust, strong culture and appropriate values becomes even more important.

This requirement is illustrated by recent findings on collusive practices in reference rate setting and foreign-exchange markets over recent years, which resulted in huge financial penalties for the institutions involved. In the absence of trust, acceptable norms and values, market participants would require additional risk premiums to protect against the risk of unfair pricing, implying, in the long run, restrictions in access to credit, suboptimal returns for savers, and overall constraints to economic growth and development. In South Africa, the Bank has spearheaded several initiatives in recent years with respect to strengthening codes of conduct for Jibar and foreign-exchange markets, and, more recently, a push to enhance transparency in the broader money market. Yet professional associations and their members still need to play a key role, at home and abroad, in enforcing greater and more efficient self-regulation.

Concluding remarks – implications for the Bank's policy

What does this all mean as we go deeper into 2015? The big themes that we saw in the closing stages of 2014 are still with us. In addition to domestic growth and inflation trends, the outlook for South African financial markets, similar to other emerging market economies, will likely be dominated by four factors, namely: the pace of normalisation in US interest rates, growth and monetary policy dynamics in the eurozone, growth developments in China (large and to a lesser extent in other emerging market countries), and the outlook for commodity prices. These developments appear to have set the tone for higher volatility in global markets and a possibly more challenging environment for emerging market economies, especially those whose private and public entities have borrowed heavily in US dollars in recent years and in some instances have invested in oil-related activities. While shock changes to sentiment seem to affect markets more (as exhibited by this heightened volatility), the ability of the market to absorb such events still seems to be intact, but spill-over effects could be more pronounced.

Policymakers will have to deal with the increasingly complex nature of various cross-currents that characterise the current environment. Such factors of uncertainty require a high degree of vigilance from monetary authorities, even as inflation falls lower than we expected a few quarters ago. Although it is clear that policymakers globally have been given some reprieve as a result of the decline in oil prices, there still exists much uncertainty as to its drivers and its sustainability, which makes us vulnerable to a correction or reversal in prices from current levels. In such an environment, it is important to remain vigilant and not to declare early victories because of what appear to be temporary dynamics around headline inflation outcomes, but to continue to be guided by a forward-looking approach over the medium term.

Amid such new developments and uncertainties, the Bank will continue to abide by its mandates of price and financial stability. The Bank is cognisant of how the oil price decline has significantly changed the near-term inflation outlook, however, the former's long-term impact on both growth and inflation will depend on how persistent the decline is. Consequently, the Bank has made moderate downward revisions to its core inflation forecast, projecting average rates of 5,5 per cent in 2015 and 5,1 per cent in 2016, versus rates of 5,7 per cent and 5,3 per cent, respectively, at the time of the November MPC meeting.

Furthermore, several factors may preclude the normal positive boost that a marked oil price decline typically provides to a country's growth-inflation mix, highlighting the uncertainties surrounding these forecasts. The currency remains a major factor of uncertainty, for while the rand's real effective exchange rate is relatively low by historical standards and showed signs of stabilising last year, the persistence of a structurally large current-account deficit, coupled with the uncertainties I mentioned earlier about market liquidity and volatility and asset price valuations, highlight the risk of reduced portfolio inflows, even outflows, and further currency depreciation.

At the same time, on the wage front, the continued rigidity in wage demands and settlements, at a time when labour conflicts have risen and productivity has slowed, raises doubts as to the extent that a temporary, oil-driven drop in inflation can feed into a more benign wage-price spiral. Finally, on the real economy side, the country's well-publicised power supply constraints, while limiting the growth benefits of the oil price drop, raise questions about the extent to which potential growth, and the output gap, may be trimmed over the next few years.

Such factors of uncertainty require a high degree of vigilance from monetary authorities, even as inflation falls lower than we expected a few quarters ago. The more benign projected inflation path, in an environment where growth in credit and property prices does not signal any build-up in financial imbalances, gives the Bank some room to pause in its interest rate normalisation process. Yet, risks related to currency moves, capital flows and overall financial market volatility will have to be closely monitored in coming quarters.