Daniel Mminele: Global monetary policy normalisation and South African financial markets

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Annual Conference of the Bureau for Economic Research, Johannesburg, 12 June 2015.

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Introduction

Good morning, ladies and gentlemen.

It is a pleasure to address you at this Annual Conference of the BER, and thank you to the BER for inviting me.

Let me take the opportunity to express our appreciation for the work that the BER has been doing over the years: a research house that has built a local and international reputation for excellence since its establishment in 1944, making it one of the oldest economic research institutes in South Africa. The BER also contributes towards sound monetary policy by conducting the quarterly inflation expectations survey on behalf of the South African Reserve Bank, which, as you know, is an important piece of information for an inflation-targeting central bank.

It has been approximately seven years since the global financial crisis began – more or less the period which Reinhart and Rogoff[1] predicted it would take the global economy to recover from the crisis and set the scene for monetary policy normalisation. The global economic environment continues to be characterised by various global headwinds, not least of which is the return to "normal".

My remarks this morning will focus on the period after the global financial crisis, what it means for South African financial markets, and the resulting policy implications. I will also briefly touch on how international forums are dealing with the uncertainty and volatility created by divergent monetary policy.

After the global financial crisis, or the GFC

Reflecting on the post-GFC period, the first thing that comes to mind is the set of spill-over effects from almost seven years of extremely loose and accommodative monetary policy in advanced economies. Monetary policy developments in advanced economies – and the associated robust capital inflows to emerging markets chasing higher yields – supported financial market asset prices, lowered borrowing costs, and, for a while, created pressure on the US dollar to depreciate. However, policymakers at the time already warned that this unprecedented monetary accommodation was unchartered territory which created its own challenges, such as the so-called "currency wars", and that ultimately the tide would turn and potentially have even more severe implications for emerging-market economies. Indeed, the turning point came on 22 May 2013, when the then-Chair of the Federal Open Market Committee, Ben Bernanke, announced the intention of the US Federal Reserve to start scaling down its quantitative easing (or QE) bond buying programme. The reaction to these remarks became known as the "taper tantrum", a period marked by the sharp repricing of risk and unusually high market volatility. This "taper tantrum" was the likely consequence of an unanticipated turning point in US monetary policy amid one-sided market positioning accompanied by very low implied volatility, as expressed in options prices.

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[1] Carmen M. Reinhart and Kenneth S. Rogoff, *Recovery from the crisis: evidence from 100 episodes*, American Economic Review Papers and Proceedings, May 2014.

The "taper tantrum" is behind us and the US QE programme has since come to an end, but vast uncertainties have re-emerged in recent months, firstly with regard to the timing and pace of the Fed's rate hikes, and secondly because both the European Central Bank and the Bank of Japan have embarked on more aggressive QE programmes of their own. These divergent monetary policies by three of the world's largest central banks, and the resultant "complex forces" that the International Monetary Fund refers to in its latest *Word Economic Outlook*[2], have already had a significant impact on global financial markets.

The uncertainties over the Fed's rate-hiking cycle are captured by the divergence in the views expressed by market participants and the Fed's policymakers. As of a few days ago, market-based estimates, as reflected by fed fund futures, are for a 25 basis points (bps) increase in the US policy rate in the fourth quarter of 2015 or at least by December, followed by another 75 bps in both 2016 and 2017. It is worth noting that the divergence between the estimates of the Federal Open Market Committee and markets has narrowed in recent months, reflecting more or less consensus for a 50 bps hike by December 2015 or early 2016. The divergence in the following two years, however, is large, at around 75 and 125 bps for 2016 and 2017 respectively. This reflects considerable misalignment and a possible underestimation by market participants of the extent and pace of the Fed's hiking cycle. Such misalignments are not surprising as the Fed has started to extricate itself from explicit forward guidance and is moving to communication that indicates greater data dependency in policy decisions during an uneven economic recovery. Just a few days ago, in its annual review of the state of the US economy, the IMF suggested that the Fed wait until 2016 to raise interest rates, cautioning that the central bank's credibility was at stake and that there was too much uncertainty to justify a much-anticipated lift-off.

What should we understand by "monetary policy normalisation"?

Monetary policy normalisation implies the removal of extraordinary policy measures that had been implemented to deal with a particular economic episode. In this sense it refers to a path taken to return to a more "normal" monetary policy setting, although no qualification is made as to what exactly constitutes "normal" in the post-GFC world. Furthermore, it should be noted that monetary policy normalisation in the aftermath of the GFC will most likely differ from previous cycles.

During rate-hiking cycles, a key concern for global markets is the path of US bond yields, as these tend to have knock-on effects on other markets. In this regard I would like to mention some factors which could constrain and/or prevent abrupt and unexpected increases in US Treasury yields – or, in other words, which could smooth the normalisation path.

Firstly, most central banks have adopted some form of forward guidance as part of their normal monetary policy toolkit, and although this may at times have contributed to volatility in markets because of the highly uncertain environment in which communication takes place, the aim remains for central banks to be as transparent as possible in terms of the policy outlook and attendant risks so as to avoid spells of excessive volatility associated with unanticipated policy adjustments.

The second important dynamic is that the longer end of the US yield curve is also interrelated with the Fed's balance-sheet dynamics. The Federal Open Market Committee has indicated that it will consider the cessation of reinvestments of maturing securities only after it starts hiking the policy rate. In the meantime, it will not sell any securities. Until such time as the Fed has signalled that it will cease to reinvest bond maturities, the Fed will have no direct impact on the net supply of bonds in the market.

[2] *World Economic Outlook*, April 2015.

Thirdly, there is debate on how much the "equilibrium" interest rate has declined structurally in the US, contributing to the downward pressure on the long end of the yield curve.

Fourthly, the declining trend in eurozone bond yields has in the past also played a significant role in driving US Treasury yields lower. This was evident during the eurozone crisis of 2011/12 and again in 2014 when the European Central Bank stepped up liquidity-provision measures and ultimately implemented QE earlier this year. As a result, the 10-year Bund traded below 1,0 per cent in late 2014 and even closer to 0 per cent earlier this year. This pulled US Treasury yields lower as investors switched out of low-yielding eurozone bonds into more attractive yielding US Treasuries. Interestingly, during the past week we have seen Bund yields exerting upward pressure on US Treasuries when the Bund yields went above 1,0 per cent for the first time since September 2014.

Aside from divergent monetary policy, financial markets have in recent months also been affected by a variety of uncertainties in the global environment. These include the still relatively low oil prices, the possibility of Greece exiting the euro area and its likely impact on the latter's already-weak economic performance, the changing Chinese growth model and therefore slower economic growth, and the US dollar appreciation as markets get ready for the Fed's lift-off. Although markets have, to some extent, priced in the lift-off by the Fed, there remains considerable uncertainty regarding the timing and extent thereof.

South African markets and global monetary policy normalisation

As financial markets and systems became more integrated in recent years, the monetary policy cycles of major economies also became increasingly important for emerging-market economies. The impact from US monetary policy normalisation could transpire through two channels: firstly the real channel (trade), and secondly the financial channel. The real / trade channel implies that US policy tightening is associated with an acceleration in economic growth, with subsequent spillovers for emerging-market economies. South Africa is unlikely to directly benefit to any significant degree from this channel, given that the US portion of our exports is only approximately 8 per cent compared to 21 per cent for the euro area. The financial channel is much more important for us, whereby US policy tightening triggers a reallocation in financial assets, for example, in South Africa's case, portfolio outflows with a subsequent impact on the various asset classes.

Let us take the "taper tantrum" as another example. Similar to other emerging-market economies, portfolio inflows into South Africa declined in the aftermath of the "taper tantrum". Reserve Bank statistics show that total portfolio inflows reversed from R85 billion in 2012 to an outflow of R55,5 billion in 2014, comprising R13,4 billion equity inflows and R68,9 billion bond outflows. More recent data from the Central Securities Depository[3] reveal that, in the first half of 2015 to date, non-residents bought R19,0 billion worth of equities but sold R1,6 billion worth of bonds, amounting to total inflows of R17,4 billion. South Africa's vulnerability to US policy tightening is augmented by our dependence on external financing to deal with the current-account deficit.

It is well known that South African bonds – and those of countries such as Brazil, India, and Mexico – have a strong correlation with US Treasuries. This correlation was clearly evident during the "taper tantrum" when the 10-year US Treasury yield increased from 1,63 to almost 3,0 per cent and the South African 10-year benchmark bond increased from 6,58 to almost 8,0 per cent between May and August 2013. In 2014, South African bond yields also adjusted (downwards) in line with US Treasuries despite various negative domestic developments, including rating downgrades and the deprecation of the rand, which under normal conditions would have driven yields higher. As the US policy rate hike was believed

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[3] Strate data.

to be getting closer, the persistent strength of the US labour market, as reflected by the closely watched non-farm payrolls data, drove US Treasury yields significantly higher. Over the past four months, 10-year US Treasury yields have increased by approximately 75 bps, which is quite large given the current soft US economic backdrop. This was mirrored by a 140 bps increase in the comparable R186 domestic bond yield.

The importance of the US interest-rate cycle for South Africa is also apparent in terms of funding costs for both the sovereign and domestic corporates. With reference to the former, the external funding costs – as reflected by JP Morgan's Emerging Market Bond Index (or EMBI) – the spread for South Africa over US Treasuries has increased to 216 bps due to domestic factors but also in anticipation of US tightening, from 170 bps a year ago. The funding costs for domestic banks have, on the other hand, been negatively influenced by a further dynamic in the aftermath of the GFC, namely more stringent global financial regulations which are being implemented locally. With the upcoming introduction of the Net Stable Funding Ratio, the spread to Jibar on 5-year floating-rate NCDs issued by commercial banks increased significantly across all maturities, in some cases more than double the levels seen around mid-2013, as banks are forced to issue longer-term instruments.

There is a general view that financial regulatory reform may have had certain unintended consequences, such as limitations on banks' proprietary trading reducing the ability of Primary Dealers to hold sizeable inventories of securities, which have contributed to less liquidity in the markets. This lower level of liquidity introduces new risks that could amplify negative spillover effects in stress situations.

The foreign-exchange market, however, is probably the market that may suffer a more pronounced impact from global monetary policy normalisation. This risk was illustrated during the 2013 "taper tantrum" when the rand – together with the currencies of certain other emerging-market economies perceived at the time to be most vulnerable (such as Brazil, India, Indonesia, and Turkey) – depreciated by more than 10 per cent against the US dollar[4]. The period that followed was characterised by increased differentiation between emerging-market economies. As such, countries that implemented appropriate macroeconomic policies, with a reasonable reform agenda to improve economic potential, have been more resilient.

The popular narrative tends to focus on the rand-dollar exchange rate. Given the outlook for the normalisation of monetary policy in the US, the US dollar has surprised with its appreciation since mid-2014. The US currency has appreciated by 26 per cent on a trade-weighted basis[5] to reach US$1,05 against the euro, a level that was only expected towards the end of 2015 amid actual US tightening[6]. This was the largest appreciation ever in the run-up to an interest-rate tightening cycle in the US. The dollar's appreciation was triggered mainly by the European Central Bank announcing the Targeted Long-term Refinancing Operations[7] and speculating on full-scale QE, which implied increased monetary policy divergence.

The outlook for the US dollar will, to a large extent, depend on two fundamental factors: the pace of widening interest-rate differentials and the performance of the US economy relative to its major trading partners. But there are also other factors which could contribute to future

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[4] May to August 2013.

[5] Mid-2014 to mid-March 2015 (Since then, however, the US dollar has depreciated by about 5 per cent until 5 June 2015.)

[6] Market analysts' models were showing that the US dollar performance was consistent with an actual 100 bps increase in the US policy rate.

[7] This new form of Long-term Refinancing Operations, amounting to EUR400 billion, was designed to provide funding to banks at 10 basis points above the main refinancing rate for as long as four years, subject to meeting certain loan criteria.

US dollar appreciation, such as safe-haven buying due to geopolitical developments or Greece exiting the euro. Historical patterns since the early 1970s show excessive US dollar appreciation during the periods coinciding with the two aforementioned fundamental variables, such as during 1983–84 and the late 1990s.

Therefore, actual US policy normalisation could result in further weakness in the rand against the dollar, and could also negatively impact on portfolio flows by reducing the willingness of fund managers (a large share of them having US dollar liabilities) to hold unhedged positions in South African bonds and equities. At the same time, a weaker exchange rate would probably raise implied rand volatility, adding to overall risk aversion and weak sentiment towards rand-denominated assets. Allow me to point out, however, that, unlike previous episodes of rand depreciation, the nominal effective exchange rate of the rand has been reasonably stable since the beginning of 2014, and, relative to baskets of commodity-exporting or large emerging-market economies, the rand has regained some of the ground it had lost in earlier years.

Nonetheless, exchange-rate developments continue to pose the single biggest risk to South Africa's inflation outlook. Sharp movements in the rand-dollar exchange rate have translated into large swings in the Reserve Bank's inflation forecasts. Between the Monetary Policy Committee (MPC) meeting at the end of 2014 and its subsequent meeting in March, inflation forecasts had changed substantially, initially reflecting a significant improvement as a result of the decline in oil prices, then changing to a less favourable outlook in March owing to adverse exchange-rate developments. Such swings complicate the task of monetary management.

For South Africa, the favourable impacts of a weaker currency on the current-account deficit have not been forthcoming, which is a concern in the current international environment of volatile capital flows. While there has been some narrowing in the current-account deficit in the fourth quarter of 2014, it is unclear to what extent this represents the beginning of a sustained compression of the current account after a long period of real exchange-rate depreciation. Furthermore, a stronger US dollar tends to dampen commodity prices, with adverse implications for commodity producers like South Africa. Although a number of emerging-market economies have been able to reduce their policy rates in response to the favourable impact from oil prices on inflation, this could be thwarted by developments in currency markets. This in an environment where economic growth for emerging markets has slipped to its slowest pace since 2009 as countries battle to deal with the combined impact of a stronger dollar and weaker commodity prices.

Another frequently discussed challenge is that of foreign-currency corporate borrowing in US dollars and the impact of the stronger dollar on debt-servicing and refinancing risks. For South Africa, this does not present a significant risk, given the relatively low foreign liabilities of local companies and banks. However, should this have ramifications for other emerging markets, the effects could very well spill over to South Africa. It is clear that we cannot afford to be complacent, as the risks related to global monetary policy developments remain high given the globalised nature of the world economy. This is unchartered territory; the risks are tilted to the upside, with significant implications for financial stability.

On the positive side, we should remember that the beginning of the US monetary policy tightening cycle will not necessarily be bad for the world, in particular for South Africa and other emerging-market economies, as it would indicate that the US economy is in better shape and therefore supports the global recovery. In addition, without QE in the euro area, world GDP would be less positive and slow growth more persistent, and while exchange-rate impacts are not positive for inflation, they are positive for emerging-market economies' growth, while QE is likely to dramatically reduce deflation risks in the euro area.

Let me turn to the international efforts being made to understand the current paradigm and galvanise global policymakers to work towards more coordination while putting in place regulation aimed at strengthening the financial system against future crises.

Strengthening cooperation among global policymakers

It has become clear that, in this increasingly interconnected global economy, the determination of optimal domestic policy in large economies needs to consider the impact on other economies. For some, policy actions can and do have significant spillovers and spillbacks. Analysing these issues provides policymakers with a more comprehensive and thorough understanding of the challenges we ourselves face but also that others face, and helps us to better position domestic policy and communication at a level that is appropriate and calibrated to these risks.

The G-20 Finance Ministers and Central Bank Governors have lengthy discussions about many of these issues. Just last year, we introduced what is called a “Scenario Analysis” into discussions, whereby international organisations calibrate various scenarios informed by recent developments and issues that are of critical importance to policymakers, such as developments in monetary policy globally, commodity price developments and so forth. The Bank for International Settlements (or the BIS) conducts a great deal of research on similar issues, particularly as they pertain to the work of central banks. BIS meetings provide central bank governors with the opportunity to further share their views.

It would not be sufficient for the G-20 to focus on the risks facing the global economy without taking into consideration global financial safety nets. As you will know, many changes were made to the IMF toolkit following the GFC, recognising that it was simply not enough to have facilities which kicked in only once countries were in trouble, but that there was a need for precautionary facilities as well as liquidity facilities. Similarly, the BRICS countries signed the Contingent Reserve Arrangement Treaty in July 2014, which is a reserve-pooling arrangement to serve as a precautionary instrument that the BRICS countries can use in the event of short-term liquidity pressures. Mutual support will thus be provided, financial stability will be strengthened, and the treaty will complement and strengthen the global financial safety net and existing international arrangements. Our work on global financial safety nets continues and remains an important agenda item for the G-20.

Conclusion

The GFC has significantly transformed the environment in which monetary policy operates. While uncertainty is always part of monetary formulation, it is the ever-escalating level of uncertainty in the aftermath of the GFC that has presented the major challenge for policy formulation in the current environment.

What, then, are the implications for monetary policy in South Africa going forward? As indicated earlier, the main risks stemming from global monetary policy normalisation are embedded in the exchange rate of the rand and bond yields, and in their resultant impact on portfolio flows, particularly in the context of South Africa’s twin deficits. Any significant weakening of the exchange rate in reaction to US monetary policy tightening could cause inflation to diverge even further from target, which may lead to second-round inflationary pressures. In addition, domestic risks to the inflation outlook persist, including electricity tariffs and wage settlements.

We at the South African Reserve Bank are mindful of our mandate and are committed to achieving our inflation target in the interest of sustainable and balanced economic growth. The MPC has indicated that the balance of risks to our inflation outlook continues to be tilted to the upside, and that recently inflation risks have increased, which suggest that an unchanged monetary policy stance cannot be maintained indefinitely.

The current environment calls for continued vigilance from policymakers and preparedness to respond to the fast-changing, domestic and global, economic and financial markets environment. As indicated previously, the MPC therefore stands ready to adjust the monetary policy stance when deemed appropriate.

Thank you.