Daniel Mminele: International financial market developments – some implications for South Africa

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the International Mbali Conference, hosted by the University of Zululand, Richards Bay, KwaZulu-Natal, 6 July 2016.

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Introduction

Good morning, ladies and gentlemen.

I would like to start by thanking our host, the University of Zululand, for affording me the opportunity to address you today. It is an honour to speak at this inaugural international conference of the University of Zululand.

It has been a rather tumultuous year in international financial markets thus far, so I thought it appropriate to focus my remarks today on a few key global financial market developments and their impact on the domestic markets and monetary policy.

International financial market developments

According to the American novelist Phillip Roth, 'fear tends to manifest itself much more quickly than greed, so volatile markets tend to be on the downside'.[1] Now while this comment falls into the broader theme of the influence of human nature on market behaviour, it nevertheless is an interesting thought. Few will disagree that excessive volatility in financial markets is undesirable since it is synonymous with unpredictability and uncertainty, which normally leads to increased speculative activity and/or a flight towards safety. This, in turn, through a higher risk premium, can increase the costs of access to capital, stifling growth and development, particularly in emerging-market economies. Furthermore, history reminds us that bear markets are generally more disorderly than bull markets.

Unfortunately, increased financial market volatility appears to have become entrenched in the post-global financial crisis era, with little sign of it dissipating in the immediate future. Even in the present context of elevated financial market volatility, there are a few episodes that stand out: the 2010–11 European sovereign debt crisis; the mid-2015 'Grexit' negotiations and Greek referendum; the rapid fall in the Chinese stock market in 2015–16; and now, more recently, the British in/out referendum, commonly referred to as the 'Brexit'.

Given how momentous the outcome of this referendum was, I would like to spend a few minutes on this particular topic. The vote in favour of a Brexit, essentially the British people electing that the UK no longer be a member of the European Union, led to a great deal of financial market volatility, both in the run-up to the referendum and indeed right up to this point in time. The UK voted to leave the EU by 52 per cent, with a voter turnout of approximately 72 per cent, in what was an unexpected result for many. On the day of the announcement, the Chicago Board's measure of market volatility (known as the VIX) jumped by 49 per cent from the previous day, the fear of the unknown aptly accounting for the spike in volatility.

The UK's present and future are now riddled with uncertainty, naturally accompanied by a flight to safety. As risk aversion soared, safe-haven assets were in high demand, and as such the price of gold breached the US$1300 mark for the first time since January 2015 while the US 10-year Treasury yield fell 19 basis points and the German 10-year bond yield

1 www.thefinancialphilosopher.com.

fell to a record low of –0,05 per cent. The relative safety of the Japanese yen saw the currency gain 11 per cent against the sterling, which in turn fell to a 30-year low the following day against the dollar. The market reaction was significant, described by some market participants as 'panic buying and selling', given the widespread expectations that the British would vote in favour of remaining within the EU. As markets slowly digested the news, however, some of these market movements were pared back, with no sustained market disruptions being reported. The decline in bond yields and demand for safe-haven assets also points to fears of the potential impact that the Brexit may have on an already weak and fragile global economy. Some of the main concerns relate to the potential ripple effects on the rest of Europe and global trade flows.

The consequences of this vote will only become clear over time, and it is anticipated that it will take about two years for the UK to finalise arrangements to leave the EU, during which period various decisions and negotiations on the way forward will take place, raising the possibility of yet another prolonged period of global volatility. In the meantime, market fears are being fuelled by concerns of contagion in the EU, the probability of Scotland and perhaps also Northern Ireland leaving the UK as well, and the uncertainty surrounding trade agreements that would follow from the negotiations.

For South Africa, the implications through direct trade links are expected to be relatively minimal. In 2015, the UK accounted for only 4 per cent of our total merchandise exports. Indirectly, South Africa is likely to be negatively affected by heightened market volatility and the impact of the Brexit on the EU and the global economy. The financial linkages between South Africa and the UK are somewhat large, if one considers that, at the end of 2014, South Africa's liabilities to the UK amounted to 46,5 per cent of domestic GDP while assets amounted to 33,2 per cent of GDP. In addition, both foreign direct investment (FDI) and portfolio flows are also significant.[2] This means that South Africa could very well be affected by the realization of tail risks emanating from asset liquidation by UK corporates and investment funds. However, as time progresses and the respective parties provide clarity on the process, the storm is likely to calm.

Let me now turn to the importance of other international financial market developments. Given globalisation and increased financial integration, global financial markets have a significant impact on South Africa. This integration means that when one major market sneezes, the rest of the globe's markets catch a cold. Thirty years ago, the threat of an incident like the Greek government default was unlikely to have a substantial impact on global markets, but today this conjecture is vastly different.

Thus far, it has been a mixed year for equity markets, with region-specific idiosyncrasies having a dominant effect on outcomes. That being said, the Brexit result has introduced such short-term volatility that the facts I am about to mention may already be outdated. Nevertheless, US equity indices are up around 3 per cent for the year to date as the economy shook off growth concerns in the beginning of the year and continues its gradual recovery. In Europe and Asia, however, outcomes have been less positive. The large correction that took place in Chinese markets has dragged down other indices in the region, including those of Japan. Meanwhile in Europe, broad-based weakness has seen equities fall by as much as 10 per cent in Germany and 12 per cent across the region on average, even with the European Central Bank (or ECB) continuing to provide record liquidity to markets.

At home, the Johannesburg Stock Exchange (or JSE) has shaken off a very poor start to the year and is currently almost 3 per cent in the black for the year thus far. After a poor showing by the mining and resource stocks in 2015, these have turned around in 2016 as commodity prices have started to come off their lows. Government bond markets have continued to rally,

[2] *Would 'Brexit' matter for South Africa?,* South African Reserve Bank Economic Note, 20 June 2016, Jean Francois Mercier and Guy Russell.

as monetary policy in advanced economies remains largely accommodative, with likely further easing in a number of key economies.

Moving to the policy sphere, it has been an eventful 12 months for monetary policy. Late last year, the Federal Reserve raised its policy rate for the first time in almost 10 years. On the other hand, the ECB, in an attempt to avert deflation, has expanded its quantitative easing programme and, more recently, has even included corporate debt while delving deeper into negative interest rate territory. On account of this, the amount of government debt having rates of return below zero has increased to over US$10 trillion – and is still rising. The Bank of Japan also introduced negative policy rates for the first time in its history. However, it is the Federal Reserve – which has not moved its rate since December – that continues to have the greatest impact on global financial markets.

Many analysts have suggested that the broad recovery in international markets over recent months had been driven by a shift in the market assessment of risk. This is premised on the view that the likelihood of much higher US policy rates has been pared back following concerns that the US recovery is perhaps not as robust as initially envisaged and on account of international developments. More recently, in light of the financial market developments emanating from the UK referendum, market indicators suggest that the Federal Reserve is likely to keep rates constant for at least the next 12 months.

Commodity market developments during 2016 have been mixed. After reaching a record low of around US$28 per barrel in January, Brent crude has undergone a remarkable rally, gaining over 80 per cent to just over US$51 since the beginning of the year – this despite OPEC (the Organization of the Petroleum Exporting Countries) not agreeing to an output cap. This rally comes notwithstanding major producers, such as Nigeria and Canada suffering production outages. It is notable that when oil prices were falling and were in the range of US$50–60 per barrel, oil rigs in the US were rapidly taken offline. It will be interesting to see if the oil price will then face resistance as shale production becomes more profitable again when oil prices reach these levels. The domestic price of petrol has increased by R1,49 in the past four months as a direct consequence of the rally in the oil price alone.

Meanwhile, after a rapid decrease during 2015, the prices of our major commodity exports have recovered somewhat since then. After declining by over 26 per cent last year, platinum prices have since recovered by around 15 per cent. The prices of other major exports, such as iron ore and coal, have also recovered to a certain extent this year but are by no means anywhere near the record levels we witnessed at the height of the commodity supercycle. Demand for commodities from China is still expected to gradually decrease over the medium term, so the current rally should be considered with that in mind. The rapid decline of capital flows into emerging markets, which began in the second half of 2015, was an unwelcome development. It is a natural consequence of, inter alia, an environment where emerging markets are no longer growing as rapidly as before while their external and fiscal metrics are less favourable than a few years ago – coupled with the uncertainties related to monetary policy outcomes in advanced economies. However, the scope and speed of this capital flight surprised many, with the Institute for International Finance (IIF) estimating that approximately US$21 billion left emerging markets in the past 12 months.[3] This represents a rapid reversal from the US$175 billion of inflows during the preceding 12-month period. Furthermore, while the extent of the relationship is not easy to determine, inflows such as these certainly contribute to the depreciation of emerging-market currencies. Fortunately, the most recent data illustrate a scenario where inflows to emerging markets have started to pick up again over the past few months. However, it remains to be seen how the situation evolves in light of Brexit-induced market uncertainty.

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[3] Institute for International Finance Emerging Market Portfolio Flows Tracker

Capital flows are particularly vital for South Africa, which has experienced a structurally stubborn current-account deficit that stood at 5,0 per cent of GDP at the end of the first quarter of 2016. While South Africa has been in the fortunate position of attracting sufficient capital to finance this deficit, this has mainly entailed portfolio inflows. According to data from the JSE, non-resident inflows to South Africa for the year to 30 June 2016 amounted to R35,7 billion, consisting of R20,4 billion in bond inflows and R15,3 billion in equity inflows.

Part of the reason for the volatility in capital flows has been linked to monetary policy developments in advanced economies which in the main impacts on risk perception. In times of heightened risk aversion, money generally flows to reserve currencies such as the dollar or euro, causing emerging-market currencies to depreciate. The rand of course has been no exception. Over the past 12 months, the rand has lost roughly 21 per cent against the greenback, 20 per cent against the euro, and a staggering 44 per cent against the Japanese yen. However, we cannot restrict ourselves to comparisons with movements against advanced-economy currencies. Take, for example, the JP Morgan Emerging Market Currency Index (or EMCI), which comprises most major emerging-market currencies, including those of all the BRICS member countries. Between January and October last year, the rand moved very much in line with this basket of currencies. During that period, the EMCI, when removing the impact of the rand – which has a weight of 8,3 per cent in the basket – lost approximately 13 per cent against the US dollar, a loss that was almost exactly mirrored by the rand.

However, since October, the EMCI has lost only 0,5 per cent against the US dollar, whereas the rand has shed a further 5 per cent. While all such calculations have their limitations, the fact of the matter is that the rand has been one of the worst-performing emerging-market currencies over the past nine months, despite emerging markets in general facing the same external conditions. This illustrates that factors unique to South Africa have had a bearing on the performance of the local currency. One such factor, which has recently drawn much attention in media and policy circles, has been South Africa’s credit ratings.

South Africa’s sovereign credit rating

South Africa’s sovereign credit rating has been a source of market uncertainty for some time. National Treasury, government in general, and the South African Reserve Bank (or SARB) have indicated that economic policy will be targeted at addressing the relevant concerns in an effort to prevent a ratings downgrade and put South Africa’s rating on an upward trajectory.

Without delving into too much detail, in simple terms a country whose debt is considered non-investment grade has to pay higher interest rates on newly issued debt. The reason is simple: markets demand higher compensation for a perceived higher level of risk. Furthermore, while there are higher yields on non-investment grade debt, some institutional investors are constrained by client mandates and are only allowed to have investment-grade assets in their portfolios. Hence, a downgrade to sub-investment status would in effect mean that certain institutional investors holding these investments would have to divest their holdings of the affected debt instruments, which is likely to lower their value, further increase the country’s risk profile, and by implication raise external financing costs. This can eventually adversely impact on the country’s economic fundamentals and growth prospects.

While the issue of South Africa’s sovereign credit rating has been covered extensively in the media, one aspect that has scarcely been discussed is the distinction between foreign and local currency ratings. This distinction is important. Put simply, the foreign currency rating is an indication of a country’s credit worthiness when issuing foreign currency-denominated debt. So, in addition to measuring the vulnerability of the balance sheet in rand terms, South Africa’s foreign currency rating also accounts for our exposure to exchange-rate risk. Bonds issued in US dollars, for example, must be repaid using the same currency, which following historical trends would imply a higher rand cost at maturity.

While foreign currency ratings commonly make the headlines, in many ways the local currency rating is of greater significance for South Africa. South Africa does not have a significant foreign currency-denominated debt burden. At the time of the last budget review, National Treasury estimated that foreign currency public debt as a percentage of gross debt was only 11,3 per cent for the previous fiscal year.[4] Furthermore, this figure is expected to stabilise at around 10 per cent over the next few years. So while a downgrade in our foreign currency rating would increase the cost of our access to foreign currency debt markets and would be seen as a serious setback, the impact of losing the local currency investment grade would be far worse. This, in effect, would make our domestic currency-denominated debt less attractive and hence more expensive. Fortunately, South Africa's local currency rating is at least two notches above investment grade by each of the major ratings agencies.

During May and June, South Africa received confirmations of unchanged credit ratings from all three major credit rating agencies. These confirmations, however, came with a very clear message: further improvements in the macroeconomic fundamentals are required, suggesting that, in the absence of demonstrable progress being made as part of a concerted effort involving all social partners, the risk of downgrades during the next reviews towards the end of this year should not be underestimated.

Recent economic growth developments

As I move towards the end of my remarks, let me make a few comments on domestic growth developments and touch on monetary policy issues before I conclude.

After achieving pedestrian growth of only 1,3 per cent during 2015, the economy contracted by an annualised 1,2 per cent in the first quarter of 2016. This contraction more than erased the gains of the previous two quarters. In fact, the size of the economy is now smaller than it was in the final quarter of 2014. Much of this decline has originated in the primary sector, which has contracted by almost 10 per cent over the past year, with mining in particular pulling the sector down. Given the linkage effects, it is not surprising that developments in the primary sector have had spillover effects into other sectors of the economy, most notably into the manufacturing sector, which has contracted by 1 per cent over the past year.

Unfortunately, the growth outlook for the rest of the year will remain challenging, as short-term indicators suggest a difficult picture for the second quarter and most forecasters predict that the economy will grow by well below 1 per cent this year. Fortunately, two of the factors that had severely constrained the primary sector lately – the drought and electricity supply issues – are expected to fade over the coming year. This may imply that growth will reach a lower turning point during this year. The most recent forecast by the SARB suggests a modest recovery over the next two years, but the assumptions underlying this forecast had not factored in any possible spillover effects stemming from Brexit.[5]

Employment numbers also make for rather disappointing reading. More than 1 in 4 economically active South Africans are still without employment. Even though the economy has added approximately 200 000 jobs over the past year, the labour force has increased by almost twice that figure.[6] Employment creation remains the single most important policy challenge for South Africa. In this regard, policymakers have recognised the need to increase potential output growth, which the SARB estimates at 1,5 per cent during 2016 – insufficient in light of South Africa's developmental needs. This requires the effective and efficient implementation of growth-enhancing structural reforms.

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[4] Budget Review, February 2016 (www.treasury.gov.za)

[5] Monetary Policy Committee statement, 19 May 2016 (www.resbank.co.za)

[6] Quarterly Labour Force Survey, Statistics South Africa, Pretoria, May 2016

Monetary policy

Allow me to now turn to monetary policy.

Currently, the policy dilemma is one of trying to address the deterioration in the inflation outlook against the background of a weakening growth outlook. Inflation is currently outside the inflation target range, and the most recent forecasts indicate that it will not return to within the target band until the second half of 2017. Inflationary pressures are currently underpinned by supply-side shocks, mainly related to exchange rate and food price movements.

Exchange rate depreciation, or rand weakness, is an issue that most of us are innately aware of. It affects every South African through a number of direct and indirect channels. Consumers immediately feel the effects of depreciation at the petrol pumps and, later, through 'first-round' impacts on imported goods. However, as the SARB's Monetary Policy Committee (MPC) has stated on numerous occasions, flexible inflation targeting allows monetary policy to see through these so-called 'first-round' inflationary effects. The greater danger is a self-enforcing inflationary process that is jump-started by these initial effects: the so-called 'second-round' inflationary impacts. 11

The SARB is concerned about the rising inflation expectations, and for good reason: these can become a self-fulfilling prophecy. Essentially, this implies that rational agents will demand compensation in line with their inflation expectations to protect their purchasing power, resulting in rises in input costs and eventually in the general price level.

This inflationary process is in some respects similar to Newton's First Law of Motion: an object in motion tends to remain in motion unless an external force is applied to it. Monetary policy is this external force that is required to bring down inflationary expectations from elevated levels. In order to prevent such a cycle from beginning, it is important for monetary authorities to display a commitment to keeping inflation within the target band and for agents to believe that this commitment is credible. In so doing, inflation expectations can be well anchored at levels consistent with the inflation target range, even as actual inflation temporarily exceeds it.

Under these circumstances, monetary policy should strive to ensure that these shocks do not result in second-round impacts and a generalised increase in prices. This was the primary motivation for the increase in the repurchase rate by a cumulative 100 basis points since July 2015. As has been stated before, the MPC is sensitive to the possible negative effects of policy tightening on cyclical growth, but will remain focused on the mandate of maintaining price stability in the interest of ensuring sustainable growth over the medium term.

Conclusion

The global economy remains entrenched in a period of sub-par growth and elevated uncertainty, which makes the path ahead a very unclear one. Just as it seems that the global economy is starting to progress and is gaining traction, we are buffeted by harsh new winds which we cannot hope to escape as a small open economy. Unfortunately, in addition to being bombarded with a confluence of negative external events, the deterioration in the domestic situation has further compounded matters. It is now almost a foregone conclusion that the path ahead will be extremely challenging; it is therefore important that we take the tough decisions that are vital to securing our long-term prosperity. 12

The SARB remains ready and fully committed to making a constructive contribution in line with its mandate, which is the maintenance of price and financial stability in the interest of balanced and sustainable growth.

Thank you.