Remarks by Daniel Mminele,
Deputy Governor of the South African Reserve Bank,
at the annual Financial Markets Department cocktail function

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Good evening, ladies and gentlemen.

It is once again that time of the year when we welcome you all to the annual cocktail function of the Financial Markets Department of the South African Reserve Bank (SARB). Thank you for accepting our invitation and joining us tonight.

Introduction

As you are aware, the main idea behind this function is to create a networking opportunity between SARB staff members and other market participants in order to facilitate an exchange of views on financial market developments in a more relaxed environment. This annual event also provides an opportunity for us as the central bank to convey our appreciation for the cooperation we have been receiving from market participants over the past year, both in the execution of open market operations and when we conduct financial markets research to enhance our understanding of market dynamics. These interactions are crucial for our role in the financial markets as we seek to give effect to the monetary policy stance which underpins the execution of our price stability mandate.

My colleagues in the Financial Markets Department remind me every year that this is not the occasion to deliver my 'speech of the year' but that I am merely a curtain-raiser to the main event, namely conducting 'special' liquidity management operations.

In welcoming you to the SARB, allow me to make a few remarks to take stock of the recent developments in international and domestic financial markets and their implications, last year's cocktail function being the reference point. Before I conclude I would also like to touch briefly on market conduct issues. I will try and heed the advice that Franklin D. Roosevelt once gave: "Be sincere, be brief, be seated."

Developments in global financial markets

Since the previous cocktail function, policy uncertainty has come to dominate price action in global financial markets. Among other things, this is due to what Marvin Barth has called the 'politics of rage'[1], referring to the rise in anti-globalisation sentiment, populist rhetoric, and countries increasingly turning inward. While an element of this uncertainty may have diminished, at least as far as the election outcomes in certain parts of the world are concerned, the outcomes themselves have ushered in a period of unusually high levels of uncertainty as regards policy direction, the timing with regard to the adoption of policies as well as the likelihood of successful implementation. The risks stemming from the possible election outcomes across Europe this year appear to be receding, but one thing last year taught us is that impossible things are possible.

As a result of this, global financial markets may well be in for further bumpy rides, not least because market risk indicators such as high-yield corporate bond spreads, the spread on foreign currency emerging market debt, and general equity market volatility – which often reflect investor nervousness – remain low, pointing to a possible dislocation that could understate the downside risk profile to economic growth. Nevertheless, as is the norm, markets have moved ahead of 'the fact', for

[1] Marvin Barth, *The Politics of Rage,* 2016, Barclays, United Kingdom.

instance pricing in a higher trajectory for US[2] economic growth. Analysts expect real GDP[3] in the US to average 2.2% in 2017,[4] more or less in line with the median projection of the Federal Open Market Committee (FOMC). The positive momentum in terms of growth prospects is not confined to the US and is relatively broad-based, particularly when it comes to advanced economies.

Against a backdrop of an improving growth trajectory, economic policy uncertainty presents a new challenge for the already complex environment in which central banks operate – more so because the actual and expected inflation figures are seemingly on an uptrend. For central banks, who have said for so long that rising inflation is a necessary precursor to 'normalising' their policies, the macro-financial implications of this increasingly uncertain political environment could complicate monetary policy normalisation. As the forward guidance thresholds are being reached, the question remains whether central banks (specifically those in Europe) will once again re-emphasise the broader notion of economic slack that may result from the current political landscape as an additional qualitative feature of their policies. The UK[5] facing headline inflation that is now above the central bank's official target and, on the other hand, threats to its economic growth is a classic example. The US is in a slightly different position. Having gradually lowered the projected path of its policy rate since the time of our previous cocktail function, the FOMC changed its course in September 2016 and revised upwards the future path of interest rates that it deems most likely to foster outcomes for economic activity and inflation that best satisfy its dual mandate. The FOMC's projections now point to two additional 25 basis point increases in the federal funds rate following the March hike. These expectations are in line with those implied from Fed funds futures and are also evident in the pricing of US currency and fixed-income markets. The US dollar index has appreciated by 6.2% since April 2016, reflecting the change in the outlook for US monetary policy. At the same time, the US Treasury curve has bear flattened, with yields at the shorter end rising by as much as 60 basis points.

[2] United States
[3] gross domestic product
[4] This was the Bloomberg median forecast as at 23 March 2017.
[5] United Kingdom

In the emerging market economies, things look slightly better than over the previous year. Soon after last year's cocktail function, we noted an increase in the universe of negative-yielding bonds that, in an environment dominated by the search for yield, benefited certain emerging markets. During this period, yields on emerging market local- and hard-currency debt declined and equities rallied, but currencies presented a mixed picture, although in most cases still with an appreciation bias. The rally in emerging market assets was largely driven by signs of stabilisation in China's economy and financial markets, a rebound in energy and other commodity prices, and more supportive central bank policies in developed markets. Furthermore, on the back of the last-mentioned, net capital flows to emerging economies (excluding China) peaked at US$26.1 billion in June 2016, according to estimates by the Institute of International Finance. However, after this June peak and for the remainder of 2016, the build-up to and outcome of the US presidential election sparked a wave of outflows from emerging markets, with portfolio flows estimated to have plummeted to a 41-month low as the so-called 'Trump Trade' favoured a stronger US dollar and higher US yields. Emerging market capital flows have since rebounded across the major developing regions but potential headwinds persist, especially given that it cannot be argued that such were in any way related to a change in economic fundamentals.

Developments in domestic financial markets

Price action in the South African markets was more or less in line with that of other developing economies. The most notable development has been the strengthening of the rand which, by last week, had appreciated to a low of R12.31 against the US dollar since our previous cocktail function. This was the strongest that the rand had traded since mid-2015. On a trade-weighted basis, the South African currency had appreciated by about 19%.

This rally can be attributed to a number of factors, including the pickup in commodity prices, investor positioning, and a reprieve from international credit rating agencies regarding a possible downgrade of South Africa to sub-investment grade. The rand was also supported by more favourable terms of trade and an improvement in the current account balance that has reduced the perceived vulnerability of the currency to possible capital flow reversals. This made the rand more resilient even during externally induced risk-off episodes, appreciating alongside a stronger US dollar and/or depreciating by less compared to its emerging market peers.

Other financial assets followed a similar path of appreciation over the year. Bond yields rallied and breakeven inflation declined. The yield on the benchmark R186 bond had declined from just over 9% a year ago to a low last week of 8.32% while breakeven inflation on the R197 (5-year) inflation-linked bond declined from 7.2% in April last year to around 5.8% last week. With the lower inflation expectations, the (FRA) market had, by last week, priced in more than one rate cut by the first quarter of 2018, with the 12x15 FRA trading below 7.0%.

The Monetary Policy Committee (MPC) noted the improvement in the inflation outlook, which over the past year had allowed multiple downward revisions to the forecast, and expressed last week, at the conclusion of its most recent meeting, the view that we may have reached the end of the moderate tightening cycle. According to our most recent forecast, we expect headline inflation to fall below 6% in the second quarter of 2017 and to remain within the target range for the remainder of the forecast horizon. Notwithstanding the fact that there was one member of the MPC who preferred a 25 basis point reduction in the repo rate at the March meeting, the general feeling was that evidence of a more sustained improvement in the inflation outlook is required before interest rates can be reduced. The MPC remains concerned about the elevated levels of inflation expectations that are still around the upper end of the inflation target band.

As you are aware, some of the positive trends we had been observing were interrupted by political events during the last week, which triggered a significant movement in the financial markets. Since last Monday, the rand traded in a range of 163 cents, between its strongest level of R12.31 to the dollar on Monday and its weakest level of R13.94 around midday today. The currency did, however, appreciate somewhat and was at levels of around R13.55 to the dollar earlier this afternoon. The R186 yield also lost most of the gains it had made last year and is now trading at just above 9.0%. The 12x15 FRA is back to 7.49%, implying an unchanged repo rate for next year.

Financial markets will likely need more time to fully process the recent political events and their economic consequences. It remains to be seen whether the recent market developments represent a reassessment or a repricing of the South African credit. It is similarly too early to draw any firm conclusions on how these developments will affect SARB's own inflation forecasts. The MPC has previously cautioned that, should some of the factors which had contributed to a more favourable outlook reverse and undermine the inflation outlook, it may reassess its views; the MPC stands ready to respond appropriately in line with its mandate should the need arise.

Yesterday's decision by S&P Global Ratings to lower South Africa long-term foreign currency sovereign credit rating to sub-investment grade, with a continuing negative outlook, is a serious setback for the country. We will now need to redouble our efforts in providing assurance and communicating continued commitment to sound macro-economic policies and their consistent and predictable implementation, so as to reverse the current ratings trajectory. This will require a continued collaborative effort between Government, business and labour to boost domestic and international investor confidence.

Market conduct developments

Before I conclude, let me touch on an issue that has been receiving some attention recently. While it is true that traders and investors need to continually evaluate the fundamental drivers of asset prices, the behaviour of market participants should always meet the highest conduct standards. Ensuring and continuously promoting adherence to high standards of ethical conduct is an integral part of contributing to the efficiency, integrity and reputation of our financial markets.

The Competition Commission of South Africa has referred for prosecution to the Competition Tribunal allegations of collusive and therefore unlawful practices among certain financial institutions in their foreign exchange trading operations involving the rand. As stated previously, the SARB views these allegations in a very serious light and is of the view that those found to have violated the law should accept full responsibility and bear the consequences. However, it is also important that we do not jump to conclusions and allow the steps now initiated to be completed, following due process.

Building on the review of foreign exchange operations of local authorised dealers conducted in 2015, National Treasury, the Financial Services Board and the SARB will soon embark on a more comprehensive review of conduct in the wholesale money, debt capital, foreign exchange, commodities and derivatives markets in South Africa in order to strengthen market conduct. The exercise is expected to be similar to the Fair and Effective Markets Review conducted in the UK. The review, which is scheduled to commence next month (with further details to be announced in due course), will look at the standards and practices in South Africa's wholesale financial markets, both regulated and unregulated, in terms of governance, accountability and incentives; it will ultimately develop recommendations for overall conduct standards to enhance the integrity of our financial markets.

The Bank for International Settlements is in the process of developing a Global Code of Conduct for Foreign Exchange Markets which will set out the principles of good practice in the foreign exchange market. The code will be released on 25 May 2017. The SARB participated in its development and is now in the process of consulting with a wide range of market participants via the Foreign Exchange Subcommittee of the Financial Markets Liaison Group with the view that South Africa should be an early adopter of the code within any proposed time frames.

Conclusion

Let me conclude by once again expressing, on behalf of the Financial Markets Department and the entire SARB, our appreciation to all the market participants for their cooperation and support over the years. We look forward to continuing our interactions in the future.

I would like to thank our financial markets team for the sterling work over the past year, for their dedication and commitment to the task.

Allow me to also draw to your attention some changes that have taken place in the senior management of the Financial Markets Department. In preparation for the upcoming retirement of Mr Callie Hugo in 2018, with effect from 01 April 2017 Callie assumed the role of Special Projects Manager in the office of the Head of Department. Mr Zafar Parker, who previously headed up our Reserves Management team, has taken over from him as Head: Market Intelligence and Operations this week. While Callie still has his work cut out for 15 months or so, it is only proper that we already thank him today for his tremendous contribution in guiding our money market operations over many, many years.

Thank you also to our staff at the Conference Centre for organising this event.

As in previous years, a newsletter called *FMD Update* has been prepared for the occasion, which provides information on some of the key strategic initiatives that the Financial Markets Department is involved in. It is available for you to take home, but you can also find it on our website.

Thank you for your attention. Enjoy the rest of the evening.