South African Reserve Bank

Remarks by Daniel Mminele,
Deputy Governor of the South African Reserve Bank,
at the annual Financial Markets Department cocktail function
Johannesburg
10 May 2018

Ladies and gentlemen, good evening.

It is with pleasure that I welcome you to the annual cocktail function of the Financial Markets Department (FMD) of the South African Reserve Bank (SARB), which is now in its 12th year. We are greatly honoured by your presence tonight. The deal I struck with our Financial Markets Department for moving this function from Pretoria to Johannesburg was that I would be allowed to speak for 90 minutes.

Introduction

Allow me in welcoming you to this event, to make some brief observations about financial market developments since we last met and to touch on what could be in store for us in the period ahead. I would also like to draw your attention to two of our initiatives that are gathering momentum, and which will require your cooperation over the next few months. I know that our views on domestic monetary policy are always of interest to financial market participants, but as we are on the eve of entering into the closed period for our next Monetary Policy Committee meeting, which starts on 22nd May, I shall refrain from any comments today, and ask for your patience until you get our most recent take in about two weeks' time.

The global financial markets backdrop

Since the last FMD cocktail function, global financial markets have had to ponder over a plethora of developments, including the strengthening synchronised global growth environment, changing perceptions around monetary policy normalisation, rising financial market volatility, threats of escalating trade conflicts, and rising geopolitical tensions. In many ways, the period since our last cocktail function to now has been one of transition; from markets being very complacent about risks, to the current environment in which risk-sensitivity levels appear to be rising again, even against still relatively overall supportive financial conditions. The initial period was characterised by volatility being subdued across a broad range of asset classes, in certain instances with indicators touching record lows. While US interest rate futures increased to reflect expectations that the Fed would hike interest rates, and also appeared to factor-in that the US Treasury would issue more short-term debt, the anticipated pace of such interest rates increases was expected to follow a relatively slow and gradual profile. The other major economies were seen to be still somewhat behind the US with regard to changes to their monetary policy settings. One puzzling issue for the markets had been the fact that even with expectations for better growth in the US, further stimulus coming from the implementation of tax reforms, both of which pointed to possible further hike by the Fed, the USD was weakening. During this period of a relatively benign global environment, capital flows to emerging markets also held up rather well.

We have now moved into a period where the market is adjusting to the strength of the cyclical growth momentum that has started to put upward pressure on short-term interest rates and push volatility higher. Adjustments to monetary policy by way of policy rate increases and reducing the pace of asset purchases are now featuring more prominently when assessing future developments. This has already been witnessed with the 10-year US Treasury yield rising to the psychologically significant level of 3% – a level last seen, albeit briefly, in 2013. Now all market-generated paths for policy rates suggest an upward trajectory. Concomitantly, the US dollar has been regaining the ground lost previously, which had seen the USD reaching a three-year low in February 2018.

Developments in the domestic financial markets

You are all very familiar with developments in the domestic markets, which will allow me to be very brief. Prior to the recent dollar strength, but subsequent to the FMD cocktail function last year, price formulation in the domestic financial markets reflected a confluence of idiosyncratic and global factors.

The rand was range-bound during the second and third quarters of last year, trading between R12.62 and R13.95 against a steadily weakening US dollar. The benign global environment had to an extent helped shield domestic financial assets from unfavourable domestic growth developments as well as political and policy uncertainty. However, in the latter part of the year, domestic factors were more dominant and resulted in the rand depreciating to a year's high of R14.47 in November 2017, before subsequently rebounding on positive sentiment towards domestic fiscal and political developments as well as concomitant views from credit rating agencies which were positively received by the market, which included Moody's Investor Service retaining South Africa's sovereign credit rating at investment grade level and improving the outlook to stable from negative. A key factor in Moody's assessment was their reduced nervousness about South Africa's rising economic and fiscal risks, and higher levels of comfort with regard to efforts to restore the strength of key institutions.

The strengthening rand led to a sharp decline in local bond yields, with the yield on the benchmark R186 declining by 141 basis points to 7.98% while the 30-year R2048 bond's yield compressed by 146 basis points as investors repriced the political risk premium. The five-year sovereign credit default swap spread improved by 60 basis points from its peak of just over 200 basis points in November 2017.

In recent weeks, the rand has been relatively volatile with a weakening profile currently trading around R12.40 to the USD. In line with developments in other emerging markets, this development has been more reflective of USD strength rather than exhibiting rand-intrinsic weakness.

What do we need to look out for?

While the degree of monetary stimulus of recent years has so far had surprisingly little impact on inflation, the debate remains as to whether this pattern is likely to continue, or rather at what speed any changes will occur, now that some economies are operating with positive output gaps.

There are some concerns that the shift to higher volatility may not necessarily be orderly against the background of fears of protectionism, increased geo-political risks, and uncertainty over the pace of monetary policy normalisation. This may lead to an abrupt tightening of financial conditions, which in turn may curtail global growth.

Even with some recent corrections, asset valuations remain generally stretched, and currency mismatches arising from large amounts of USD denominated debt incurred to take advantage of low rates (by both corporates and sovereigns), could make financial markets vulnerable to financial conditions tightening at a faster pace than currently anticipated.

At the most recent IMF/World Bank Spring Meetings another issue that received particular attention was the rising level of global debt, which if unchecked has the potential to trigger financial instability in the future, weighing on growth and undermining financial assets.

These developments may harbour some serious implications for emerging markets. Firstly, risk-aversion may reduce the attractiveness of the emerging market assets, including carry-trade related transactions, which may negatively affect portfolio flows to these markets, as witnessed in the sharp pull-back in flows since mid-April 2018. Secondly, export-dependent emerging economies will be impacted as commodity prices tend to fall when the dollar strengthens. Lastly, a stronger dollar would put pressure on emerging markets with large dollar liabilities, further increasing their financial vulnerabilities.

We have already seen some early signs of these risks materialising for emerging economies, with a number of emerging market currencies, including the rand, weakening not only to the dollar, but also to other advanced economy currencies, such as the euro and the yen. But admittedly others have been tested a lot more when compared to South Africa.

A key risk to the outlook on the rand remains the possibility of accelerated monetary policy tightening by central banks in the advanced economies, particularly in the US. Escalating trade conflicts and geo-political developments, present another risk factor that needs to be monitored carefully.

The impact of trade conflicts could result in decreased demand for South African exports and potentially higher volatility in currency markets.

Key initiatives to strengthen the domestic markets

Let me turn to the two major initiatives undertaken by the SARB to strengthen domestic financial markets.

The first one relates to a consultation paper on selected interest rate benchmarks in South Africa that we will be releasing in the next few weeks. This initiative partly emanates from a coordinated response by international regulators and central banks, to the instances of attempted and actual manipulation of key global interest rate benchmarks and reference interest rates, in particular the London Interbank Offered Rate in 2012. Consequently, the Official Sector Steering Group[1], established under the auspices of the Financial Stability Board, recommended that interest rate benchmarks should be underpinned by transaction data and that risk-free interest rates benchmarks should be developed to support certain financial instruments, including derivative contracts.

This initiative was also informed by research conducted into the robustness, representativeness and sustainability of the Johannesburg Interbank Average Rate (JIBAR), given its wide usage as a reference rate in South Africa, especially the 3-month JIBAR. The research indicated some shortcomings in JIBAR, which do not allow it to fully perform its role as a key indicator of underlying market conditions. The majority of floating interest rate securities and derivatives contracts are linked to the three-month JIBAR, which underscores JIBAR's importance in the transmission of the SARB's monetary policy stance through the financial market channel. This work is not limited to the JIBAR, but covers selected other interest rate benchmarks in South Africa. Following the release of the consultation paper containing certain reform proposals, there will be a two-month period for comments, to be followed by a final implementation document in due course.

[1] In July 2013, the Financial Stability Board (FSB) established the Official Sector Steering Group, which comprises senior officials from central banks and regulatory agencies, to focus on the FSB's work on interest rate benchmarks given the significant role they play in the global financial system.

I would like to call upon you to please engage with the document and provide us with your comments. This is a very important initiative for financial markets development in South Africa.

The second initiative that I would like to update you on relates to the work of the Financial Markets Review Committee (FMRC). In the 2017 national Budget speech, the Minister of Finance announced that the SARB, the Financial Services Board and National Treasury had begun working on a comprehensive financial markets review under the leadership of former SARB Senior Deputy Governor James Cross. The objective is to review the standards, practices and issues of governance, accountability and incentives in wholesale financial markets. The FMRC will consider the mechanisms that are necessary to augmenting the implementation and governance of conduct standards by market participants. Furthermore, it will identify areas where changes to legislation are needed to support a new conduct framework for wholesale financial markets.

One of the painful lessons of the great financial crisis has been the importance of conduct in financial markets, and how poor conduct can end up being globally systemic. It is therefore important that we strengthen domestic and global collaborative efforts between the private and public sector, aimed at building trust as an important contribution to creating effective, fair, and resilient markets.

The review is well underway and much progress has been made already. You may have participated in the FMRC questionnaire or in meetings held by the project team. It is envisaged, that a draft report will be published later in the year for public comment. Again, this will be an important document for you to interact with and provide comments.

There are other important initiatives that the SARB has undertaken in the past year, in relation to financial markets, many of which were in collaboration with you as market participants, such as the launch of South African Foreign Exchange Committee (SAFXC).

The SAFXC will be member of the Global Foreign Exchange Committee, the body that has been tasked with the ongoing maintenance of the FX Global Code and ensuring continuing collaboration between central banks and the private sector on developing principles for good governance in the foreign exchange market[2]. The SARB has previously announced that as from 01 September 2018 it will only transact with counterparties in the foreign exchange market that have committed to adhering to the FX Global Code.

Some of the other initiatives are contained in FMD's newsletter, the *FMD Update,* copies of which are both available here tonight as well as on the SARB website[3].

Conclusion

Allow me now to conclude by saying that we have come through another busy and challenging year, characterised by high levels of volatility and uncertainly in our markets. The collaboration between the SARB and financial market participants continued in a constructive atmosphere and ensured the orderly functioning of our markets in the wake of these challenges. Our collaboration extends to many of you being our partners in our monetary policy implementation activities, government debt operations, sharing of market information and analyses, as well as participation in various market forums. We look forward to our continued cooperation so as to enhance the effectiveness, integrity and resilience of our financial markets.

Let me take this opportunity to thank our financial markets team, under the leadership of Mr Leon Myburgh, for their hard work and dedication to the work of the Bank during the past year. Many projects had to be managed simultaneously while keeping the day-to-day operations running smoothly.

I should also mention that Mr Callie Hugo will be going on retirement later this year, and that this will be his last attendance of the annual cocktail function in his current capacity.

[2] http://www.resbank.co.za/Markets/South_African_Foreign_Exchange_Committee/Pages/Announcements.aspx

[3] http://www.resbank.co.za/Pages/default.aspx

I believe that I can speak for all of us in conveying our gratitude to Callie for the great work he has done over many years in contributing to the development of our financial markets, and being one of the key links between the SARB and financial market participants. Even if somewhat pre-mature, because you are still around and have some work to do, we wish you all the best for the future, Callie.

Last but not least, a very special thank you must also go to Ms Sharlay Madalane, from the SARB protocol section for her assistance in organising this event.

Ladies and gentlemen, please enjoy the rest of the evening.

Thank you.