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
7 May 2019

Introduction

Good evening, ladies and gentlemen.

It is that time of the year when we have the pleasure of welcoming you to the Financial Markets Department's (FMD) annual cocktail function. Thank you for joining us. When we agreed the date for this function, we did not know that we would be meeting on the eve of a rather crucial day for our country. Allow me to remind you that voting is an important responsibility of citizenship.

This event allows the South African Reserve Bank (SARB), and specifically FMD, to convey our appreciation for the working relationships we have developed with you, our counterparties – whether it be through the execution of open market operations or by engaging with you on the ever-increasing complexities of financial markets through our regular meetings or access to your research. These engagements make an important contribution to enriching our understanding of financial market developments in support of the formulation and implementation of monetary policy and financial stability policy. We also value that we get to network a little less formally at this event than at our various official forums.

Allow me to take stock of what has again been a rather eventful year in international and domestic financial markets since we last met for the annual cocktail function. And, as it has now become tradition, I will also provide an update on some of FMD's key initiatives, especially those that relate to financial market development and thus have a direct bearing on your work. I will try to be brief, and heed the words of Josh Billings: “There’s a great power in words, if you don’t hitch too many of them together.”

The global financial markets backdrop

The past year has been characterised by a mixed environment for asset prices. The significant shifts that we have observed were mainly influenced by both the adopted and expected policy stances of major central banks. Initially, growing divergence between the US economy and major trading partners, coupled with increasing trade tensions and perceived higher geo-political risk, placed upward pressure on the US dollar (USD). The USD had also found support from the US Federal Reserve (Fed) continuing with its gradual path of monetary policy normalisation, while other major central banks lagged behind by keeping policy rates constant. US equities also outperformed their European and Japanese counterparts.

These developments resulted in emerging markets with relatively weak fundamentals, compounded by spill over effects from developments in Argentina and Turkey, seeing their currencies and financial assets coming under pressure, South Africa being no exception. There was a discernible change in the final quarter of 2018 when indications of slowing economic activity in the US (against the background of already weak growth outside the US) led the market to anticipate a slower pace of Fed policy tightening and some downward pressure on the USD. Concerns around a stronger than anticipated slowdown in global growth, together with geo-political developments, then led to a sharp increase in volatility and a correction in equity markets. The Chicago Board Options Exchange Volatility Index rose to a nine-month high of 36 index points in late December, while the S&P 500 fell by 9.2% during the same month. The MSCI All Country World Index, which includes both developed and emerging markets, also ended up recording its worst year in a decade by posting an 11.2% loss (although it has posted a 14% recovery year-to-date). Around the same period, yields on 10-year bonds in the US and Germany declined, the latter to two-year lows as safe-haven demand increased.

Turbulence in markets, alongside the expected fading effect of US fiscal stimulus, and slower growth in the eurozone, contributed to the significant change in monetary policy forward guidance given by the Fed and European Central Bank (ECB). This has resulted in some easing in financial conditions and has been supportive of a rebound in risk assets in recent months. The Fed has pledged to be patient in respect of any further interest rate increases (with some market participants predicting the next move to actually be a cut), and to adjust the pace of balance sheet normalisation, while the ECB also changed course, delaying any previously envisaged interest rate adjustments to 2020 and committing to offer banks a new round of cheap loans to help revive the eurozone economy.

In addition, multilateral institutions have recently downgraded their economic growth projections. The International Monetary Fund (IMF) has, in its latest World Economic Outlook report[1], pencilled in a 3.3% global growth forecast for this year, with an expected pickup in 2020 predicated on Chinese stimulus measures, improved market sentiment, dissipating temporary drags on euro-area growth, and stabilisation in certain stressed emerging market economies.

However, there are still uncertainties which will keep policymakers and market participants awake. Policy and political uncertainty will include geo-political developments, a possible disorderly Brexit, escalating trade tensions, and a sudden renewed tightening in financial conditions. The IMF has also flagged vulnerabilities stemming from China's financial imbalances, volatile portfolio flows to emerging markets and fiscal challenges in some highly indebted European countries. However, the expectation overall, even with the generally limited policy space, seem to be for a soft landing of the global economy rather than a recession.

Developments in domestic financial markets

Domestic financial markets have been influenced by a combination of global developments and domestic idiosyncrasies. The local unit was not immune to the broad sell-off in the emerging market foreign exchange (FX) complex, which began last April and accelerated into September. The rand reached a 'peak' of R15.42 against the US dollar on 5 September 2018, while the nominal effective exchange rate depreciated to an over two-year low of 53.81.

---

[1] See https://www.imf.org/en/Publications/WEO/Issues/2019/03/28/world-economic-outlook-april-2019

It is interesting to note that, despite the rand's depreciation of roughly 16% against the US dollar since we last met, the sell-off in domestic bonds was not as pronounced relative to the currency depreciation as was the case during previous periods of market stress. The yield on the R186 bond has increased by approximately 24 basis points since last April. Lower inflation outcomes have gone some way in capping the rise in bond yields, underscoring the importance of central banks keeping inflation expectations anchored. Moody's recent credit opinion, stating that it expects South Africa's credit profile to remain in line with those of similar Baa3-rated sovereigns, has also provided some relief to local bond markets. However, elevated government debt and contingent liabilities related to state-owned enterprises, as well as persistently low growth, are credit constraints. While the JSE All-Share Index looks relatively unchanged to when we last met, this masks some volatility, with declines in the latter half of 2018 and a subsequent recovery this year.

South Africa has not been immune to the volatility in flows to emerging markets. Non-residents sold R112.4 billion worth of domestic equities since May last year, with outflows of R27.5 billion reported on a calendar year-to-date basis. For bonds, net non-resident outflows totalled R86.1 billion over the last year, although some stability has returned with bond inflows of R26.3 billion since the start of this year.

In response to new developments and changing risks, monetary policy continued to keep its focus on maintaining inflation comfortably within the target range and anchoring inflation expectations closer to the 4.5% midpoint of the inflation target band. It is a stable price environment which contributes towards broader macroeconomic stability and protects the purchasing power of all South Africans. While the MPC assessed the risks to the inflation outlook as more or less evenly balanced, the most recent developments in relation to oil prices and the exchange rate, along with other previously identified risks, such as electricity and water tariffs, and food prices, show that vigilance and data dependency must remain the order of the day.

As previously indicated, appropriate monetary policy settings need to be complemented by prudent fiscal and budgetary policies to help raise potential growth and lower the cost structure of the economy.

Key domestic initiatives

Let me now touch on some initiatives undertaken by the SARB to strengthen domestic financial markets.

Firstly, I would like to make a few remarks on the reform of the major interest rate benchmarks, which needs to be framed in the context of global developments. Many of you will know by now of the work to reform interbank offered rates, collectively referred to as 'IBORs'. For the major IBORs, reform efforts have focused on strengthening their resilience and reliability, including ensuring that they are underpinned by transaction data to the greatest extent possible. But what is perhaps most pertinent is the looming 2021 deadline for when the Financial Conduct Authority will no longer compel banks to contribute to the London Interbank Offered Rate (LIBOR). There are worries about the possible end of LIBOR, the most notable being the transition of legacy LIBOR-linked contracts to the new reference rates. Elsewhere in Europe, methodological changes have been made to the Sterling Overnight Index Average to strengthen the benchmark, while the method used to calculate the Euro Interbank Offered Rate will be overhauled by 2020.

Progress has, however, been made in identifying risk-free rates (RFRs) and other alternative reference rates in currency areas reliant on major IBORs. The focus is now shifting to efforts to manage what is bound to be a complex transition to these alternative reference rates. Industry bodies such as the International Swaps and Derivatives Association have been consulting with stakeholders regarding contract fallback options, with the aim of agreeing ex ante rather than ex post, on any fallback arrangements. For cash markets, the Bank for International Settlements suggests that floating-rate instruments could be converted to fixed-rate contracts or to an adjusted RFR-based term rate, similar to the option for derivatives contracts. We could also see some issuers recalling LIBOR-linked debt instruments and replacing them with those linked to the new benchmarks. Indeed, the Intercontinental Exchange (ICE) has proposed a US dollar ICE Bank Yield Index. ICE Benchmark Administration anticipates launching the Bank Yield Index[2] in early 2020 should there be a favourable market response.

Evidently, a blanket solution for benchmark rates does not exist. The ultimate outcome of transitioning may feature the coexistence of multiple rates and/or benchmarks. It is important for those of you that have exposures to Libor to not leave it too late in making appropriate arrangements.

For South Africa, the SARB's publication of a consultation paper[3] on selected interest rate benchmarks last August marked a key step towards the reform of existing interest rate benchmarks. The consultation paper proposes the adoption of new benchmarks with the aim of enhancing transparency in the domestic money market while also enriching the framework for the monitoring and identification of systemic risk. Extensive research into the robustness and sustainability of the Johannesburg Interbank Average Rate (Jibar) and the South African Benchmark Overnight Rate (Sabor) had revealed shortcomings. Specifically for Jibar, the insufficient number of transactions in negotiable certificates of deposit means that this rate does not meet the International Organization of Securities Commissions' requirements on data sufficiency.

The SARB has decided to follow a 'market choice' approach to identifying an alternative reference rate to replace Jibar. By way of clarification: when we talk about reference rates in the domestic market, we mean benchmark rates that are used in the pricing of derivative and other financial contracts, while benchmark rates provide price indications in the general market. To facilitate market choice, the Market Practitioners Group[4] (MPG) was formed. The MPG is a joint public and private sector body, which I have the privilege of chairing, with the aim of guiding final decisions on the choice of alternative reference rates and the operationalisation of proposed reforms. The MPG has recently established work streams for the purpose of executing

---

[2] See https://www.theice.com/iba/Bank-Yield-Index-Test-Rates

[3] See http://www.resbank.co.za/Publications/Detail-Item-View/Pages/Publications.aspx?sarbweb=3b6aa07d-92ab-441f-b7bf-bb7dfb1bedb4&sarblist=21b5222e-7125-4e55-bb65-56fd3333371e&sarbitem=8722

[4] For further information, see http://www.resbank.co.za/Markets/MPG/Pages/default.aspx

its mandate. These work streams will also advise on transition and other implementation issues.

Allow me to take this opportunity to thank those of you who have provided comments on our consultation paper. We plan to publish a report on 24 May 2019 reflecting key takeaways from the public consultation process, together with our responses and adopted positions in respect of the reforms. The SARB is as resolute as other international regulators and policymakers about the need for reform.

All final decisions regarding the reform project will be published in a technical paper later in 2019, which will detail the benchmark interest rates to be published in the future. Given the identified shortcomings of Jibar, it is our expectation that the reform of Jibar will be prioritised by the MPG and its work streams. The interim reform measure that will ultimately be decided on shall become effective from a future date that will recognise all data collection and transitioning considerations.

Another collaborative effort – this time between National Treasury (NT), the Financial Sector Conduct Authority (FSCA) and the SARB – was establishing the Financial Markets Review Committee (FMRC) to develop recommendations aimed at reinforcing conduct standards in wholesale financial markets. The earlier review by the Foreign Exchange Review Committee had recognised room for improvement in conduct and governance related to the over-the-counter fixed income, currency, commodities and derivatives markets. In September 2018, the FMRC released a draft Financial Markets Review[5] for public comment. You will be relieved to hear that I do not intend to discuss all 43 of its recommendations in this speech, but that I would only like to highlight a few which hold particular relevance for this audience.

The first is the development of a general code of conduct for financial market participants that would be pre-empted by the formation of a Financial Markets Standards Group. This group, led by senior market professionals, would provide a forum to discuss compliance issues and to resolve conflicts in standards of market practise. Another recommendation is that the necessary data to carry out cross-market

[5] See http://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8743/2018%20FMR%2007.pdf

monitoring and surveillance could be collated via trade repositories, aiding both market discipline and transparency. Regulation covering conflicts of interest and market abuse will also be considered. And in addition to our review of benchmark interest rates, regulators may also investigate ways to expand the repurchase market and encourage technological innovation to aid the competitive landscape.

A final version of the review is being deliberated and will be handed over to the Financial Markets Implementation Committee comprising representatives from the NT, FSCA and SARB, to give effect to the recommendations.

Finally, of specific interest to the audience here tonight, may be the progress that the SARB has made in accommodating collateral substitution in its operations. Changes to our systems will allow banks to replace or substitute assets used as collateral in the main repurchase auction, in line with international best practice. In particular, the SARB will be transitioning the current Master Repurchase Agreements into the Global Master Repurchase Agreement (GMRA) to allow for this substitution. System changes are in progress, and full functionality for market participants is anticipated around mid-May. Once the GMRAs have been signed, our counterparties will be able to substitute collateral posted at the SARB. Collateral substitution is expected to ease some of the demand for high-quality liquid assets through a more efficient use of such assets.

More information on these and other initiatives is contained in the FMD newsletter[6], accessible on the SARB website, with some printed copies available here as well.

Concluding remarks

Let me conclude by once again extending, on behalf of FMD and the SARB, our appreciation to all market participants for your continued support and cooperation, which has aided the orderly functioning of our markets. A further thank you to those who participate in our various consultative structures; taking part in these groups is

[6] See http://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/9229/FMDUpdate%20May%202019.pdf

crucial as we strive to increase the transparency and efficiency of South Africa’s financial markets within an increasingly complex environment.

Last but not least, I would like to thank team FMD for the sterling work they perform for the SARB and in the interest of our financial system. We also owe thanks to the SARB protocol and events team, who have temporarily taken over liquidity management operations from the FMD.

Please enjoy our hospitality, but do save some energy for casting your ballot tomorrow.

Thank you.