Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Bank's Financial Markets Department's Annual Cocktail Function, held at the South African Reserve Bank's Conference Centre, Pretoria, on 7 April 2011

1 Introduction

Good evening, ladies and gentlemen, and a sincere welcome to you all to the fifth annual cocktail function of the Financial Markets Department.

As you are aware, the Financial Markets Department hosts this function both to convey its appreciation for the co-operation it receives from counterparties in its market operations and to give an update on its operations to market participants. Tonight's function also provides an opportunity for us to bid farewell to our long-time colleague and friend, Dr Roelf du Plooy, who officially retires from the service of the Bank at the end of this month. I know that many of you have already met and interacted with Ms Zanele Mavuso Mbatha in her new capacity, but I should also like to use this opportunity to introduce her formally to market participants as the new head of the Financial Markets Department. She took up the role in January 2011, and has been working with Roelf du Plooy to facilitate a smooth transition and succession.

Before I give you an update on the market operations of the Financial Markets Department, allow me briefly to touch on the global economic and financial markets backdrop and its implications for South Africa and our operations.

2. Global economic and financial market developments

Global economic developments continue to be characterised by high levels of uncertainty. While the global economic recovery appears to be on track, it remains

uneven with the advanced economies growing slower than emerging-market economies. Sovereign debt challenges and high levels of unemployment still present risks to growth in advanced economies, and many emerging-market economies have to grapple with risks of overheating economies and rising inflationary pressures. More recently, downside risks to growth have increased on the back of recent developments in the Middle East and North Africa (MENA), which have led to a further increase in the oil price, to more than double the levels that prevailed about a year ago. Food prices have increased substantially in many countries and have added to the pressures being observed. It is generally anticipated that the effects of the earthquake in Japan on the global economy will be of a short-term nature, but until the full extent of the damage and implications of the nuclear disaster are known, risks and uncertainty remain.

Global financial markets have been reflecting these levels of uncertainty and have been experiencing increased levels of volatility, with the VIX index spiking to 30 index points in mid-March. Efforts to try and find lasting solutions to the European sovereign debt crisis, currency interventions in the wake of the Japanese disaster, sovereign rating downgrades and bank stress tests are all impacting on developments in financial markets. As they say, the only certainty in financial markets is uncertainty.

The recent global and financial market developments are presenting challenges for monetary policy makers around the world, who have to ensure that they maintain credibility and protect macroeconomic stability by managing inflation risks, while at the same time avoiding undue damage to growth prospects by possibly acting too hastily to remove accommodative policies.

3. Implications for South Africa

As a relatively small and open economy with sophisticated financial markets, South Africa will not escape the impact of global economic and financial market developments. A third of South Africa’s exports of manufactured products are destined for Europe. The country sells commodities to Asia and has been witnessing increased exports to that region. Japan is South Africa’s fourth largest trading partner, with

platinum and other semi-processed metals being the major exports. South Africa is a significant importer of oil.

At the conclusion of the most recent Monetary Policy Committee (MPC) meeting on 24 March 2011, we highlighted these international developments and indicated that, based on short-term economic indicators, the domestic growth momentum would likely be maintained. We lifted our forecast for economic growth from 3,4 to 3,7 per cent for 2011. Consumption expenditure – particularly by households – is holding up well, credit extension figures released last week show a better take-up of credit by businesses, implying that the recovery in investment spending will pick up and that subdued growth in gross fixed capital formation will improve. The improved reading on the most recent Purchasing Managers Index to a level of 57,2, with very encouraging readings for the business activity and new order components, appears to confirm the favourable outlook for the manufacturing sector. Unfortunately, the employment subindex confirmed the serious challenges the country is facing with job creation.

The MPC also highlighted the Bank's view that the risks to the inflation outlook are on the upside, with food and administered prices – particularly oil prices – being among the biggest risks. While we expect to remain inside the target range until the end of 2012, our most recent forecast, showing CPI averaging 5,7 per cent for 2012, indicates that the room to manoeuvre is becoming less. We all witnessed another significant increase in petrol prices earlier this week, and while South Africa's food price inflation is coming off a low base as a result of previous bumper maize crops and a favourable exchange rate, Producer Price Inflation (PPI) numbers show rising trends for both agricultural and manufactured food prices. This situation will require careful monitoring going forward.

The MPC is committed to achieving the inflation target within the parameters of its mandate. However, given that inflationary pressures are currently seen to be mainly of a cost–push nature and not demand-driven, any future policy action and its timing will be based on the MPC's assessment of any second-round impacts.

During the global financial markets crisis – and even now with the current risks that could threaten markets and financial stability – the South African financial markets

continue to function effectively. We have, however, experienced capital and foreign-exchange market volatility in line with international developments.

When we met here about a year ago, sentiment in the domestic and international financial markets improved amid a plethora of positive global economic indicators that pointed to a sustainable global economic recovery. The JSE All-Share Index traded at a level of over 29 000 points while the VIX Index declined to well below 20 index points in March 2010. The strong upward momentum in the domestic equity market continued until mid-February 2010, when the All-Share Index reached near-record levels. However, since then, gains in the domestic equity market have been limited, although on a year-to-date basis, the All-Share Index has increased by about 2,4 per cent. The domestic market continues to be impacted by negative developments in the euro zone and the MENA region, as well as global inflation concerns and monetary policy tightening by some emerging-market economies. In addition, the All-Share Index has been affected by industrial action, volatile exchange rate movements and sharp losses in the platinum index, following the shutdown of auto production in Japan.

On the domestic bond market front, government bond yields were on a declining trend in March last year, supported by subdued inflation, reductions in the repo rate, the appreciation in the rand and improved public finances. In 2011, however, yields on domestic government bonds increased significantly amid increased volatility. From slightly below 7,0 per cent, the yield on the R157 (2016) bond increased to almost 8,0 per cent in March 2011, due largely to a sell-off by non-residents, increased supply and expectations of higher interest rates in response to rising inflationary pressures.

After recording strong bond inflows for most of 2010, non-resident demand for South African bonds started to wane in October 2010. During the fourth quarter of 2010, non-residents sold R22 billion worth of bonds. The sell-off was attributed to a global reallocation of emerging-market portfolio investment towards equities, given the favourable economic backdrop for this asset class and increasing policy rates in some emerging-market economies. Domestic factors that contributed to the sell-off in domestic bonds were related to perceptions that the interest rate cycle had bottomed out and to profit-taking. Nonetheless, in 2010 non-residents bought R53,2 billion worth

of bonds; three times the amount purchased in 2009, representing a shift from previous trends when portfolio inflows tended to be dominated by equity inflows. The strong appetite for domestic bonds continued to diminish in 2011. Non-residents sold R8,3 billion worth of bonds in the year to 6 April 2011, although we have seen significant net purchases in the last few days. Despite net sales by non-residents, and the continued purchases of foreign exchange by the Bank, the rand has remained firm but volatile, and in the process appreciated to R6,6848 on 6 April 2011. For 2010 as a whole, the rand appreciated by about 12 per cent against the US dollar and by around 10 per cent on a trade-weighted basis. Total turnover in the domestic foreign-exchange market increased to a record high of almost US$20 billion in January 2011, mainly due to an increase in hedging activities by non-residents.

Strong capital inflows into emerging market economies (including South Africa) witnessed during 2010 have presented policy-makers with some challenges, such as appreciating exchange rates (which raised concerns regarding the competitiveness of export markets) and increased sterilisation costs. In the light of these considerations, some emerging-market economies made noticeable shifts towards curbing capital inflows and, hence, currency appreciation. Measures considered and implemented include limits being placed on government bond investment by foreigners; taxes imposed on the purchase of fixed-income securities and stocks by foreign investors; and the pre-announcement of currency market intervention programmes in order to build foreign-exchange reserve balances and to limit currency appreciation. Other countries imposed reserve requirements on foreign-exchange swaps and forward trades conducted by non-residents, and on non-resident accounts with domestic banks. South Africa has carefully studied these measures, and our view is that the efficacy of most of them, in terms of what they were intended to achieve, has been rather doubtful and that such means would not be appropriate for South Africa at this stage. Any potential consideration of any such measures would need to be informed by our own country-specific circumstances, which include the fact that our savings/investment imbalance makes us dependent on portfolio flows to finance our current-account deficit.

3. Financial market operations

The market operations conducted by the Financial Markets Department are associated with two of the key functions of the Bank, that is, (i) the implementation of monetary policy and (ii) the management of the official gold and foreign-exchange reserves. My remarks in this section will therefore cover open-market operations, reserves management and also touch on market development initiatives.

3.1 Open-market operations

As you are aware, the successful conduct of the Bank's open-market operations is essential for the effective implementation of monetary policy. A number of refinements to the monetary policy implementation framework, and measures aimed at streamlining the daily monetary policy operations were identified and have been implemented since August 2010. The changes comprised the following:

- The Bank discontinued the practice of providing estimated ranges of the weekly liquidity requirement and began to announce, at 9 o'clock on every business day, the actual liquidity requirement of the previous day, while announcing on a weekly basis only the average estimated weekly liquidity requirement
- As from 1 March 2011, there was no longer any need to accept Category 2 assets (bonds issued by Eskom, Transnet, Trans-Caledon Authority, the Development Bank of South Africa and the South African National Roads Agency) as eligible collateral for the Bank's refinancing operations
- The South African Multiple Option Settlement (SAMOS) penalty facility was abolished after a new automated end-of-day square-off process had been introduced to replace the previous system of manual auctions
- The spread between rates on the standing facilities and the repo rate was widened from 50 to 100 basis points below and above the rep rate
- The Bank started using longer-term foreign-exchange swaps with maturities up to 12 months to manage money-market liquidity more efficiently.

The changes were intended to streamline the Bank's daily activities in the money market and to enhance the participation in the SARB debenture and longer-term

reverse repo auctions. The success of the changes made to the open-market operations resulted in an increased take-up of SARB debentures and reverse repos, and led to an increase in the level of the money-market shortage. The shortage was, on average, above R15,0 billion, with a high of R22 billion on 7 March 2011, compared with an average of R10,0 billion for the period August 2009 to August 2010. The phasing out of Category 2 assets as eligible collateral in the Bank's refinancing operations also had no adverse impact on the yields of bonds issued by the state-owned enterprises concerned.

It is also important to note that more banks are now participating in the Bank's weekly repo. The number has increased from four banks to five and, more recently, to six, with a seventh institution also occasionally taking up a portion of the amount on offer in the weekly repo. The broader participation by banks in the main weekly refinancing operations is encouraging, and will further enhance the implementation of monetary policy.

The Bank started using longer-term foreign-exchange swaps with maturities of up to 12 months as an instrument to manage money-market liquidity and to facilitate accelerated foreign-exchange purchases. The consequence of using foreign-exchange swaps is that the Bank now reflects an overbought forward position, currently amounting to approximately US$4,0 billion. The bulk of the forward position represents swaps related to foreign-exchange purchases and the Bank's ongoing objective of foreign-exchange reserves accumulation.

3.2 Reserves management, including accumulation

Strong capital inflows into South Africa in 2010 provided the Bank with an opportunity to increase the level of foreign-exchange reserves. Gross reserves have increased by approximately US$9,6 billion since January 2010 to US$49,3 billion in March 2011 (with an increase of about US$5,5 billion recorded in the first quarter of 2011). The international liquidity position or net reserves increased by US$5,7 billion to US$44,7 billion over the same period. During the 2010 calendar year, the Bank purchased US$7,4 billion for foreign-exchange reserves accumulation, while approximately US$3,8 billion was purchased during the first three months of 2011. Going forward, the

Bank will continue to work closely with National Treasury to continue building reserves. The Bank's policy remains that of accumulating reserves and not of defending or achieving a particular level for the exchange rate. The exchange rate remains market-determined, and any speculation that the Bank may currently have a preference for a stronger currency or may have even been selling foreign-exchange reserves is misplaced.

The Bank continues to manage the country's official foreign-exchange reserves in a prudent manner, and has continued its successful partnership with its external private and official-sector fund managers.

3.3 Market development initiatives

The Financial Markets Liaison Group (FMLG) is a joint initiative between the Bank and key participants in the financial markets. The objective of this consultative forum is to promote the efficiency, integrity and stability of South Africa's financial markets, and to discuss international market and structural developments that could affect domestic financial markets. The FMLG, which emerged from the Money Market Liaison Group, has recently been reconstituted and held its first meeting in November 2010.

The November 2010 meeting was preceded by several meetings of the sub-committees comprising the FMLG, namely the Money Market, Foreign Exchange and Fixed Income and Derivatives subcommittees, and progress on a wide range of projects was reported. These projects include, among others, investigating the maturities of SARB debentures and longer-term reverse repos; the pricing of floating rate notes in the secondary market; the impact of algorithmic trading on the foreign-exchange market; the monitoring of the over-the-counter (OTC) market in foreign-exchange derivatives; and the revision of reference rates in the money market. A working group was also established to review credit value adjustments (CVAs) and credit support annexures (CSAs), which might impact the efficiency and liquidity in the interbank derivative market.

4. Concluding remarks

Let me conclude by thanking you for your co-operation during the past financial year. We may find that when we gather here next year, the financial and economic landscape may be vastly different to what it is today. No doubt the future holds surprises and interesting challenges in store for us, but I trust that the spirit of co-operation and co-ordination that we have developed in our financial markets over the years will allow us to rise to these challenges.

In conclusion, I should also like to thank my own colleagues, the management and staff of the Financial Markets Department, for their hard work and dedication to the task at hand, both for the Bank and in the interest of our financial markets. Thank you also to the staff of the South African Reserve Bank's Conference Centre for, once again, arranging this function.

Last, but not least, I indicated that we are saying "goodbye" to Dr Roelf du Plooy who is going on retirement. On behalf of all of us, I should like to wish Roelf a happy and healthy retirement.

Roelf retires after many year of service at the Bank, having first joined the Bank in 1974. He has been head of the FMD since 2007, having occupied a number of other positions in the Bank. Roelf has been instrumental in the implementation of the repo-based accommodation system in the Bank. He was active in the development of the domestic fixed-income market at the time when the Bank was the market maker in government bonds and options on government bonds. He has also contributed significantly to the MPC, as one of the presenters since its inception. He has assisted in regional development initiatives and was an active member of various other external and internal committees.

We thank Roelf for his good leadership and wise counsel over the years. and wish him well for the future.

Thank you and enjoy the evening.