South African Reserve Bank

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the 6th Annual Cocktail Function of the Financial Markets Department, Pretoria, 10 May 2012

1. Introduction

Good evening ladies and gentlemen and welcome to the Financial Markets Department's annual cocktail function. It is customary for us to take stock every year of what has happened in the global and domestic environment. We last met in April 2011, at a time when adverse developments in the euro zone were gathering momentum and financial stability risks were intensifying, thereby threatening the sustainability of the global recovery. It is a year later, and while much has been done on various fronts to try and resolve the crisis, we continue to face significant global economic and financial market challenges. Downside risks remain elevated and continue to hold back a strong and sustainable global economic recovery. Geopolitical tensions remain a threat, with the potential to again trigger a sharp rise in oil prices.

Central banks have continued to play a fundamental role, in an attempt to prevent a collapse of the financial system and continued downward economic adjustments. In the process central banks ventured even deeper into new territory, which Martin Wolf of the Financial Times last week described as the new world of post-financial-crisis central banking, which will create significant institutional and intellectual challenges. In Europe, firewalls were increased after long debates, and under the auspices of the G20 and IMF, countries have also come together to provide additional financial resources to the IMF for purposes of crisis resolution and prevention. Will these measures, beyond ensuring that the global economy does not fall back into recession, be enough to restore the required level of confidence in financial markets? Recent market moves appear to suggest not. Have all these actions not raised the risk of moral hazard, with investors expecting central banks to continue pumping money into the financial system; and will the system become hooked on central bank money? Jaime Caruana[1] has pointed out that these actions have bought time, but in so doing, may have actually made it easier to waste that time, increasing the risk that the "balance sheet recession" leads to protracted weakness, and also potentially raising political economy risks. It would indeed be unfortunate if what is essentially a temporary relief were to breed a sense of complacency with regard

[1] Central banking in a balance sheet recession. Panel remarks by Mr Jaime Caruana, General Manager of the BIS, at the Board of Governors of the Federal Reserve System 2012 conference on "Central banking: before, during and after the crisis", Washington, 23-24 March 2012.

to the repair work that is still necessary. While we may not be able to answer these questions tonight, let me briefly touch on global and domestic financial market developments, before updating you on the activities of the Financial Markets Department over the past year.

2. Global economic developments and financial markets

While volatility in global financial markets declined during the first half of 2011, the third quarter witnessed a renewed rise in tensions, first driven by the congressional debate over the debt ceiling in the United States, and then by renewed concerns about the solvency of peripheral euro area sovereigns. Greece may have been at the forefront of the news flow, but by late 2011, concerns had spread to a number of other sovereign issuers in the euro zone periphery, resulting in a sharp widening in spreads, which in turn spilled over to banks' funding costs and generally tighter financial conditions in the rest of the world.

As already indicated, it again became necessary for central banks to respond in an unconventional manner: the US Federal Reserve lengthened the maturity of its securities portfolios (in what became known as "Operation Twist"); the Bank of England and the Bank of Japan expanded their respective balance-sheets via additional securities purchases; while the ECB for the first time (and in two instalments) supplied banks with almost EUR1 trillion in three-year repo funding. The goals of these measures, however, were broadly similar: stabilizing the funding structure of the banking system, and thereby fending off the risk of a severe credit crunch. These measures helped to limit undue market volatility that risked forcing illiquid but solvent sovereigns into insolvency. At the same time, public and private creditors worked out a voluntary restructuring plan for Greek sovereign debt.

The market's initial response was positive. Risk indicators declined markedly from December 2011 to March 2012, with the VIX index in particular falling to a level of 15, which was more or less around the lows recorded at the beginning of the financial crisis. Intra-euro zone sovereign spreads underwent a sharp compression, as did bank CDS spreads, while the reduction in risk-aversion spurred a marked rally in equities. Yet many questions remained unanswered. For example, will vulnerable sovereign states take advantage of this "window of opportunity" to implement the necessary strengthening of their public finances and to improve their competitiveness? Will credit to non-financial entities start flowing more strongly again now that banks have been able to secure more solid financing? Will authorities manage to implement fiscal austerity measures without unduly damaging growth prospects in Europe? And then there is the issue of whether geopolitics will push oil to levels that threaten the fragile global recovery. Let me briefly add that Europe is not the only source of risk, as there are, e.g., major fiscal challenges in US, which could come to a head early next year. The jury is still out on these questions, but investor concerns seem to be rising again, especially with respect to the credibility of fiscal consolidation plans in Europe. At the most recent meeting of G20 finance ministers and central bank governors last month, there was some optimism that tail risks faced by the global economy had started to recede. However, the persistence of downside growth risks and the need for on-going structural reform and global rebalancing were also highlighted as needing to be kept firmly on the G20 agenda.

3. Implications for South Africa

As has been the case since the beginning of the financial crisis, South Africa has not been immune to these fluctuations in international markets. Our banking system is solid and well-capitalized, our financial markets (including the interbank market) have not experienced any problems that required official intervention, and our external and public finance situation looks far more manageable than in many developed economies. Yet the country's strong trade links with the European Union; its reliance on commodity exports; and its liquid and sophisticated financial markets provide as many channels for the transmission of external shocks. The past year's fluctuations in domestic equities, bonds and the exchange rate, as well as the sensitivity of local GDP to the global cycle, bear testimony to this relationship.

Supply-side problems undermined South African growth in 2011. Some of these were external, including disruptions to the automobile sector's supply chain following the devastation in Japan. Others were internal – and I refer here to safety-related interruptions in mining and industrial action in both the mining and manufacturing sectors. The consequence, however, was that GDP growth only averaged 3,1 per cent in 2011, a lesser increase than what the Reserve Bank had been projecting this time last year. Admittedly, the latter half of the year brought some good news on the domestic demand front. Thus, real GDP accelerated to 3,2 per cent (quarter-on-quarter annualized) in the fourth quarter, driven by sustained solid expansion in consumer spending and an acceleration in both private and public fixed investment. Yet, many factors justify caution – above all the uncertain global environment – and the Reserve Bank's latest projection for 2012 growth at 3,0 per cent still falls marginally short of the growth rate achieved last year, and of the rate of growth required to put a serious dent into unemployment. In this regard, latest figures show an unfortunate rise in unemployment in the first quarter of 2012.

The past twelve months also saw a mild breach of the Reserve Bank's 3-6 per cent inflation target, with the headline CPI rate increasing to 6,3 per cent in January before retreating to 6,0 per cent in March. Price pressures over the past year have remained essentially of a cost-push nature. The moderate pace of "core" inflation (4,4 per cent in March when excluding food, petrol and energy) shows that despite some evidence of price pressures becoming more broad-based, these are still expected to remain contained by the relatively subdued state of the domestic economy. In fact, as highlighted by the MPC on March 29, the Reserve Bank expects that CPI inflation will gradually decline from the second quarter of this year onwards, with a projected average of 5,2 per cent by the end of the forecast period at the end of 2013.

The behaviour of domestic fixed-income markets over the past twelve months would suggest that investors by and large agree with the Reserve Bank's interpretation of the inflation acceleration as temporary and largely supply-driven in nature. Despite volatile global markets, rand-denominated bond yields declined over the past year, testing post-recession lows, while breakeven inflation expectations are not markedly different from where they were a year ago. Both the government bond and swap yield curves are flatter up to the ten-year maturity. And while the performance of longer-term bonds appears in part to be dictated by investor expectations of subdued growth both globally and locally, the planned faster reduction in the government budget deficit compared with initial National Treasury targets may also have reassured investors. Activity in the domestic bond market by non-resident investors illustrates their relatively constructive approach towards emerging market debt in general, and South African bonds in particular. Statistics show that net foreign purchases of local bonds were positive in ten of the twelve months to April 2012, and despite a hefty sell-off in September 2011, the cumulated net purchases amounted to R74,5 billion. In comparison, the previous calendar-year record in 2006 stood at R34,3 billion. In recent weeks, the announcement of the possible inclusion of South Africa into the World Government Bond Index later this year, has provided some impetus to the local currency bond market and non-resident inflows. This is a positive development as the criteria for inclusion is based on the level of sophistication of our bond markets with regard to size, credit quality and lack of barriers to entry, as well as on its liquidity and a transparent price discovery process. This represents another endorsement of South Africa's financial markets as being world-class.

Other financial assets, however, have experienced a more volatile environment over the past year. Equity prices, as measured by the JSE all-share index, failed to post any gain over the whole of 2011 despite a recovery in the latter part of the year. Furthermore, a continuation of the late 2011 rally into early 2012 quickly lost steam, bearing testimony to continued investor concerns about any speedy return to solid economic growth. In contrast to positive inflows into bonds, net non-resident activity into local equities has resulted in net sales of R25,4 billion in the twelve months to April 2012.

The exchange rate of the rand, while not repeating the wild gyrations of earlier financial crises, has remained vulnerable to shifts in global risk appetite and swings in commodity prices. Following relative stability in the first half of 2011, the currency weakened beyond R8.00/US$ in September as foreign investors sold domestic bonds, and even the resumption of bond purchases in the ensuing months failed to bring the rand back to its previous range. The past few months have again been a period of moderate volatility, with the rand seemingly driven – as with other so-called "commodity currencies" and emerging market currencies – by the countervailing forces of abundant global central bank liquidity, fledgling investor appetite for risk and movements in the EUR/USD exchange rate.

4. Financial market operations

The management of overall money-market liquidity continues to be one of the most important functions of the Financial Markets Department (FMD) as part of the implementation of the monetary policy decisions of the MPC. The Bank continuously reviews its monetary policy operational procedures for appropriateness and effectiveness, and changes are implemented when deemed necessary. As you are aware, various changes were implemented in August 2010 and March 2011 following research conducted within the Bank as well consultations with market participants through the Financial Markets Liaison Group (FMLG). As a result of the changes, the actual daily liquidity requirement increased markedly from a daily average of R10,3 billion in the twelve months before August 2010 to an average of R15 billion in the next twelve months, and further to an average of R16,8 billion from September 2011 to 30 April 2012. The number of banks participating in the main repo auctions has increased from four to a total of six and at times, seven banks, with the combined bid amounts tending to be higher than the announced average weekly liquidity requirement.

The introduction of longer-term foreign exchange swaps with maturities of up to twelve months has improved the Reserve Bank's open market operations and has led to the more effective management of money-market liquidity. The discontinuation of the practice of announcing the estimated weekly liquidity ranges to the market has significantly reduced the Reserve Bank's activity in the money-market. Participation in SARB debenture auctions has also improved.

Following further consultations with market participants, another set of enhancements to the Reserve Bank's monetary policy operational procedures was implemented on 01 March 2012:

- When the auction is oversubscribed, the amounts tendered for by commercial banks in the weekly main repo auctions are now allocated on a pro rata basis, up to the announced average daily liquidity requirement for the week;
- The Bank now conducts 2- and 5 day main repo auctions during the week of the MPC meetings; and
- SARB debentures and reverse repos are now issued with maturities of 7- and 14 days, in addition to the usual 28- and 56 days maturities.

These enhancements have further improved the functioning of the money market, especially the interbank market, have also increased the level of flexibility in the Reserve Bank's liquidity management operations, and have eliminated the lack of synchronisation between the Reserve Bank's main repo auctions and the MPC interest rate announcements. This lack of synchronisation had previously led to discrepancies in the market, as interest rates in the interbank market changed when the repo rate was changed, while the interest rate for the main repo remained unchanged for the rest of the week.

Financial market development initiatives remain an important strategic focus area of the Financial Markets Department in cooperation with members of the FMLG, its various working groups and other market participants. The focus for the next period will be on completing projects such as the pricing of the floating rate notes (FRNs) in the secondary market, gaining a better understanding of high-frequency trading in the foreign exchange market and developments in over-the-counter (OTC) market in foreign exchange derivatives and reviewing the calculation reference rates in the money-market.

5. Reserves management

In line with stated policy of not targeting a specific level of the exchange rate, the Reserve Bank continues its activities in the foreign exchange market for purposes of building reserves when market conditions are conducive and to execute client transactions. The official gross gold and foreign-exchange reserves increased from US$49,3 billion on 31 March 2011 to US$50,7 billion on 31 March 2012. The change reflected a combination of valuation adjustments, maturing forward transactions, and proceeds of a government foreign bond issue. The international liquidity position improved from US$44,7 billion to US$48,9 billion during this period.

The reserves accumulation strategy continued to be implemented in close consultation with the National Treasury. During the 2011/12 financial year, the Reserve Bank purchased approximately US$4,0 billion for reserve accumulation purposes. These purchases were swapped into the forward market by means of FX swaps in order to sterilise rand liquidity injected into the money market. By end-2011, foreign exchange reserves could comfortably cover a year’s worth of South Africa’s external funding requirements (consisting of the current account deficit and short-term external debt, as per the so called augmented Guidotti Ratio definition).

The Reserve Bank has continued to manage official reserves following prudent risk management and governance principles. The strategic asset allocation is reviewed regularly, compiled in accordance with the Reserve Bank’s investment objectives and determines the structure of the foreign-exchange reserves in terms of currency composition, asset allocation and market risk.

6. Conclusion

It is now time for me to conclude, by thanking you for your co-operation over the past financial year as many of you are counterparties in our transactions, participate in information exchanges bilaterally and in fora such as the FMLG, and readily make your research available to us. No doubt, future challenges lie ahead in what remains an unusually uncertain global financial environment. Yet I trust that the spirit of co-operation that we have developed in our financial markets over the years will help us to successfully meet these challenges. I also would like to extend thanks to my own colleagues, the management and staff of the Financial Markets Department. Their hard work and dedication during a rather challenging year for the department has been exemplary. They continue to make the Reserve Bank and the country proud. I would also like to thank colleagues from other departments within the SARB, many of which are present tonight, who work closely with the Financial Markets Department on a daily basis.

Thank you also to the staff of the Reserve Bank’s Conference Centre for once again arranging this function for us.

Thank you.

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