South African Reserve Bank

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Financial Markets Department's Annual Cocktail Function, Pretoria, 24 June 2014

Good evening,

It is a great pleasure for me to welcome you all to the Financial Markets Department's Annual Cocktail function. As has become tradition for this event, we would like to take stock of the major developments in global and domestic financial markets over the past year, before updating you on matters relating to the Financial Markets Department and initiatives undertaken over the past year. Tonight we will adopt a different approach, namely that I will cover the first section, and then hand over to Leon Myburgh, Head of the Financial Markets Department, to update you on departmental activities.

Given recent releases of the Monetary Policy Review, the Quarterly Bulletin and speeches, I shall not comment in any detail on recent economic developments.

Re-pricing of risks in international and local financial markets

Those of you who were able to attend our function last year will recall that the assessment at the time was that of increasing confidence about the gradual "healing" of the global economy and financial system, and the reduction in "tail risks" that had unsettled markets for the previous two years. These improvements were at the time largely attributable to the drastic policy actions undertaken on an on-going basis by the world's major central banks. Yet at the same time, it was already becoming evident that there was a build-up of risks, and that the impact

on financial markets of the timing, as well as the pace, of the eventual and unavoidable reversal of these extraordinary measures, could be substantial.

Looking back over the past twelve months, these factors became the dominant drivers of market movements, as was anticipated at the time. The gradual improvement in the major economies that was expected a year ago has continued, by and large, to materialise. Global economic growth has picked up, albeit unevenly. The underlying strength of the recovery has been confirmed in the United States, the Euro zone has emerged from recession, and there are indications that a prolonged period of deflation could be ending in Japan. The extent of the slowdown in emerging market economies appears to have been one of the main surprise developments over the last year as emerging markets were not spared the negative consequences of global risk realignment while expectations of lesser liquidity provision by the US Federal Reserve led to increasing differentiation by investors across emerging-market assets. As you know, currencies and bonds of those countries experiencing relatively wide current account deficits, sluggish economic expansion and inflationary pressures under-performed assets of emerging markets who performed better on these metrics. Concerns about a deceleration in Chinese economic growth also affected financial assets in commodity-exporting countries, like South Africa, which had benefitted from China's surging industrial demand in earlier years.

While the global economic recovery remains broadly on track, high levels of uncertainty, vulnerabilities and fragilities remain, and the global growth outlook continues to harbour downside risks, as the first quarter of 2014 has shown.

As indicated above, global financial markets developments have been mainly driven by changing expectations around asset purchase tapering by the Fed and the eventual normalisation in US policy rates. Consequently, the latter part of 2013 saw long-term bond yields increase in all major developed and emerging economies, and yield curves steepened as investors required a higher "term premium" across a broad range of fixed-income assets, while currencies of emerging market countries at times adjusted abruptly and sharply, leading to a general tightening of financing conditions.

More recently we have observed an easing of financing conditions, based on expectations that monetary policy in the US will only adjust gradually. These developments are underpinned by improved communication by major central banks and further policy measures such as the ones recently announced by the ECB. This has resulted in increased risk taking in financial markets and made carry trades more attractive given reduced levels of volatility. Emerging markets have been benefiting from these developments by way of better performance of their currencies and capital inflows.

Unfortunately, the increased risk taking in financial markets is not matched by increased risk taking in the real sector of the economy. In addition concerns are emerging that the extraordinarily low levels of volatility (e.g. the VIX index is below pre-crisis levels) may be providing incentives to misprice risk and thus increase financial stability risks. A further hazard going forward is the increasing divergence in monetary policy in advanced economies, with the US Fed and the Bank of England moving towards lifting policy rates as part of normalisation, when on the other hand the ECB and Bank of Japan are expected to ease monetary conditions further.

Thus the current situation in global financial markets does not allow for complacency and requires policy makers and market participants to remain alert and carefully manage risks.

Domestic markets within the global context

Given the high level of integration with international financial markets, domestic financial market developments reflected these developments, but were also significantly influenced by South Africa intrinsic factors. The under-performance of the rand relative to other emerging-market currencies was particularly noticeable over three specific periods. The first one occurred in May and June 2013, when the Federal Reserve first talked of “tapering” its Quantitative Easing programme. The second one, in August 2013, coincided with a rise in risk aversion towards countries with large current-account deficits and deteriorating growth fundamentals. In the third phase, from mid-December to late January this year, in addition, investors appeared to be differentiating against countries that were seen

to have been slow in their policy responses to tapering and normalisation risks. This period was characterised by significant net sales of domestic securities held by non-resident investors. Of course it was not only global developments that influenced local markets, as on-going labour market disruptions added to negative sentiment, underperformance in the real economy, and a worsening Balance of Payments situation.

As mentioned earlier, the last few months have brought some signs of greater stability to both global and domestic financial markets: The rand has recovered since its late January trough; the yield on the R186 benchmark government bond has declined by 64 basis points; and the JSE's All-Share Index has climbed to new highs, gaining 10.4 per cent on a year-to-date basis, and net non-resident flows into the local currency bond market stabilised in February to April, before posting a net positive inflow of R10,6 billion in May and R8,2 billion for June (until 23 June).

The levels of development, sophistication and depth of our financial markets have allowed South Africa to weather the turbulence of the past year reasonably well. However, we have to acknowledge that there are still some risks in the system, even if they are difficult to quantify. Bond yields are low relative to the averages of the past decade, and the non-resident share of government bond holdings remains very high by historical standards. Carry trade activity, which seemed to support the domestic bond market in May, is by its own nature a temporary phenomenon, even though its timing is unpredictable. These factors suggest that local yields could be vulnerable to risks of a renewed global bond selloff or a sudden spurt in risk aversion. By several metrics, finally, South African equities appear increasingly expensive.

But it is important to accept that the transition period on the path of policy normalisation will not always be smooth, and not to confuse the bouts of *volatility* that we have experienced, and which are likely to be with us for a while, with *instability* in our markets.

Monetary Policy Challenges

Monetary policy in South Africa is currently facing an increasingly challenging situation, as the domestic economic growth outlook has deteriorated markedly even as inflation broke out of its target range. This deterioration is heavily influenced by supply side factors and final domestic demand has slowed in recent quarters, indicating a continued lack of demand-driven price pressures in the economy. This suggests that the current rate cycle need not match the speed and magnitude of earlier cycles. As you are aware, we entered the present rate hiking cycle in January this year when the repo rate was increased by 50 basis points to 5.5 per cent per annum in reaction to a deteriorating inflation profile, with the Bank's inflation forecast suggesting that the upper band of the inflation target would be exceeded for an extended period. The most recent CPI print at 6.6 per cent came out above expectations, which followed recent consumer and producer price data releases signalling a growing pass-through of previous rand depreciation to prices of durable and semi-durable goods.

Such a risky environment continues to call for vigilance by the Monetary Policy Committee, to ensure that any pass-through of previous rand depreciation to inflation does not become permanent, that inflation expectations do not become unanchored from current levels, but in fact improve as they are uncomfortably close to the upper range of the inflation target. As indicated by the Monetary Policy Committee, the current rate hiking cycle will need to be responsive to incoming data and information in relation to, among other factors, exchange rate developments, food price developments, labour market data and Balance of Payments dynamics. But the fact remains that inflation is uncomfortably high, and that risks continue to be tilted to the upside, and that interest rates will have to normalise in due course.

In this complex environment communicating with the financial markets, which provide an important link in the transmission of monetary policy, becomes particularly important. Central banks implement monetary policy decisions mainly by transacting in the financial markets. While the past year has clearly shown the benefits of an improved level of central bank communication about likely future action, it also needs to be recognised that while policy makers in certain instances

may have more data at their disposal than market participants, the information available is by no means perfect or conclusive enough to allow an analysis that could result in undertakings or even promises of future action. It is also important for market participants to realise that while feedback mechanisms between the market and policy makers are invaluable, central banks will always be careful not to allocate a disproportionate weight to market information that may be embedded in market prices such as FRA rates, and will always cross-check with other information and relevant economic variables. While at times policy makers may feel the need to correct certain impressions that may exist and are influencing market prices at particular times, or give appropriate guidance, it should not be expected of policy makers to keep commenting directly on short-run market movements, as has been suggested by some. 'Running commentary' in this regard could unnecessarily add to volatility.

5 Concluding remarks

Let me conclude by once again thanking you for attending our event today, and also thank you for the cooperation we have enjoyed with you over the past year as both policy makers and market participants were navigating choppy waters within an increasingly complex environment. Our consultative structure in the form of the Financial Markets Liaison Group (FMLG) has matured, and I would like to thank many of you present today, who participate in the various sub-committees of the FMLG and provide us with valuable inputs to inform our work here at the central bank. The FMLG will continue to play an important role as we further develop our markets and ensure their efficiency, transparency and integrity. In this regard, we also continue to monitor global investigations around reference rates. Furthermore, we have noted with concern the recent reports from abroad regarding the investigations around alleged foreign exchange manipulations. We will continue to monitor and consult developments in this regard and consult when necessary to ensure that practices in our financial markets continue to be characterised by appropriate levels of transparency and integrity.

Let me now hand over to Leon Myburgh to share with you initiatives that the Financial Markets Department has been busy with.

Thank you.