



South African Reserve Bank

**Keynote address by Daniel Mminele,
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Recent developments in emerging economies' foreign exchange markets

Good afternoon, ladies and gentlemen.

This year has certainly been another challenging one for the foreign exchange (FX) market.

The emerging market (EM) currency complex has just emerged from one of the steepest corrections since the taper tantrum of 2013. Some of the worst-hit currencies have recovered from their year-to-date lows, including the Argentine peso, the Brazilian real, the Turkish lira, and the South African rand. But the broader EM basket, as measured by the JP Morgan Emerging Market Currency Index, remains close to its lowest levels on record.

As we enter the final weeks of this year, it seems apt to reflect, and to share some perspectives on recent developments in EM FX markets, including developments in the local foreign exchange market. I will also touch briefly on some of the initiatives that have been undertaken to improve governance in the domestic FX market. But before I share my pearls of wisdom with you, let me remind you what one Winston Churchill said in the House of Commons, on 29 September 1949:

“There is no sphere of human thought in which it is easier to show superficial cleverness and the appearance of superior wisdom than in discussing questions of currency and exchange.”

Or the famous words of former Fed Chairman, Alan Greenspan, who in 2004 observed that ***“Nonetheless, despite extensive efforts on the part of analysts, to my knowledge, no model projecting directional movements in exchange rates is significantly superior to tossing a coin. I am aware that of the thousands who try, some are quite successful. So are winners of coin-tossing contests”.***

Recent developments in EM FX

So far this year, the JP Morgan EM Currency Index has declined by more than 10%, and losses among the major EM currencies have ranged between a tenth of a per cent (Hong Kong dollar) and 49% (Argentine peso). This is the first year since 2015 that EM currencies as a group have depreciated by this much on a cumulative basis.

A number of factors contributed to the recent sell-off. The most important one was probably the tightening in global financial conditions. Much has already been said about global policy tightening so I will not add to the debate here. But to paraphrase Warren Buffett, the tightening of global financial conditions was synonymous with a tide that receded and revealed who was swimming naked. Without pointing fingers, if you consider who has weak policy and institutional frameworks, and who has not done their homework in the area of structural reform implementation, and enhancing resilience, it will become clear who was found to be swimming naked.

The EM FX weakness in 2018 can also be attributed to the strengthening of the dollar on improved macroeconomic performance in the United States (US), more signs that the synchronised recovery in the global economy was fragmenting, geopolitical events, including sanctions on Iran and Russia, which also contributed to higher oil prices.

Another factor that contributed to the sell-off was the growing trade tensions between the US and its major trading partners, and the subsequent imposition of tariffs, which threaten global economic and financial integration. Besides the possible negative impact on global trade and economic growth, this situation also has negative consequences for business and financial market sentiment. This, in turn, could further undermine investment and international trade, ultimately lowering global productivity

levels by disrupting global supply chains and slowing the development of new technology.

The fact that growth in China, the world's second-largest economy, is already slowing down on the back of structural reforms makes the possible consequences of the trade war particularly concerning for EMs. Signs of an adverse impact on the global economy through a further weakening in demand from China for commodities such as metals and other raw materials could weigh further on commodity prices and therefore on export-oriented countries.

Policymakers need to tackle all these developments through a multilateral, rules-based and coordinated approach. History has shown time and again that there are no winners in trade wars.

The depreciation of EM currencies, which had started in April, worsened during the third quarter of the year. And as it worsened, much of the market commentary claimed that this was a highly correlated sell-off, despite the long-standing realisation that EMs, as an asset class, are not homogeneous.

In times like these, it becomes harder for some investors to ignore the risk of contagion in EMs. In fact, at the height of the sell-off, an opinion piece was published on the Bloomberg platform titled 'We may be facing a textbook emerging market crisis'.¹ The article expressed the view that, given the fundamental problems in EMs in general, EMs as an asset class were likely to come under pressure. Weakening currencies, it was feared, would drive foreign investors away, hurting all assets.² Much to our relief, these fears did not materialise.

Despite this, our conversations with global and local investors reiterated the view that differentiation, informed by a top-down assessment of the overall economic environment in EMs, had increased over the years. This appears to suggest that investors were increasingly reassessing their investments in EMs on a selective basis. We have also found evidence to suggest that the distribution of performance this year across the EM FX complex was one of the most differentiated sell-offs since the global

¹ Bloomberg, 'We may be facing textbook emerging crisis', Satyajit Das, 3 September 2018

² Ibid

financial crisis.³ However, as idiosyncratic and geopolitical risks became more prevalent, market players also started to consider the ‘tail risk’ of a more generalised risk asset sell-off.

Notably, EMs with higher external debt and current account deficits, coupled with high sensitivity to monetary policy normalisation in the US, witnessed severe market losses. By contrast, EMs in Asia showed more resilience to the recent market turmoil, which is being attributed to their relatively sound economic fundamentals as well as solid external balances.

In this volatile environment, policy actions by monetary authorities varied, depending on their mandates, their level of independence, and how their economies were affected by the recent economic and financial developments. The central bank of Argentina increased the benchmark policy rate to 60% and sold significant amounts of FX reserves to stabilise the peso. In addition, the Argentinian government unveiled austerity measures and secured a bailout facility with the International Monetary Fund. The central bank of Turkey, in turn, increased its policy rate to 24% and implemented other measures to stabilise the exchange rate of the lira.

Recent developments in the rand exchange rate

Similar to other EM currencies, the rand depreciated against the US dollar for most of the year. According to Bloomberg, the local currency depreciated by 28% from late February to early September, ‘peaking’ at R15.70 to the dollar on 4 September. Despite the fact that there were no events unique to South Africa that could have triggered weakness of such magnitude, the local unit ranked among the worst-performing EM currencies during that period. Many reasons have been put forward for why this was the case, such as the fact that the rand is a high-beta currency and is used as a proxy hedge for other EM currencies. But attention also needs to be drawn to the starting point of the depreciation, as the rand had appreciated significantly towards the end of last year, and in early 2018, on the back of improved perceptions

³ This view is informed by our study of EM FX return statistics such as skewness of returns, differences between average and median returns, as well as differences in average returns of different quartile ranges.

around domestic political risks. This resulted in portfolio inflows which contributed to the relative strength of the rand.

According to data from the Johannesburg Stock Exchange, non-residents purchased R48.4 billion worth of bonds and equities during the first quarter of this year. However, in the second quarter, non-residents sold R85 billion worth of bonds and equities as expectations for global financial conditions tightening increased and risky assets came under pressure. The vast majority of this selling was in government bonds. The selling of South African financial assets continued in the third quarter, with R62.5 billion worth of bonds and equities being sold. But more recently we have seen some slowdown of outflows and some resumption of inflows. This contributed to the rand recovering some of its losses, to the current level of R13.9 against the US currency, although this still represents an 11.6% depreciation since the beginning of the year.

The rand also weakened on a trade-weighted basis, and its real effective exchange rate declined below its long-term average. According to the SARB's equilibrium exchange rate model, the real effective exchange rate of the rand moved from being overvalued at the beginning of the year to currently finding itself at an undervalued level. The forecast presented to the MPC at its meeting last week showed the implied starting point for the rand against the US Dollar at R14.50. According to the Quarterly Projection Model, this undervaluation is expected to persist through 2019, as the local currency is expected to only gradually revert to its equilibrium level.

2018 has also seen a significant pick up in volatility with the 3-month option implied volatility for the rand rising from 11.8 per cent in April to peak at a level of 23.6 per cent on 5 September before receding to the current level of around 16.7 per cent. This has gone along with reduced turnover in the South African FX markets, which saw the total average daily turnover in the rand market reducing from an average of US\$12.5 billion in 2017 to an average of US\$9.9 billion in the first 10 months of 2018, caused mainly by lesser activity by non-residents and thus partly reflecting risk-aversion towards emerging markets.

What the future holds remains uncertain. The continued tightening in global financial conditions, a change in investor sentiment towards EMs, escalating trade conflicts and geo-political developments, together with some idiosyncratic risks, remain the key

risks to the local currency. As such, it is likely that the rand, along with other EM currencies, will remain volatile.

As a consequence of the recent volatility, exchange rate forecasts remain widely dispersed. Between this quarter and the third quarter of 2019, the exchange rate of the rand is expected to average R14.50 to the US dollar – this is according to Bloomberg median forecasts.⁴ However, the difference between the most optimistic and the most pessimistic survey participants on the exchange rate forecast for the first quarter of 2019 is almost R3.00 – I have little doubt that one of the participants somewhere within that range will be correct! Such a wide dispersion around the median forecast over such a short forecast horizon is representative of the uncertainty that has become an inherent part of our lives. And this uncertainty adds significant complexity to the conduct of monetary policy, the most recent outcome of our monetary policy meeting and the finely balanced decision being a good case in point.

As regards the exchange rate and monetary policy, allow me to reiterate that forward-looking and medium-term oriented monetary policy within a flexible inflation targeting framework, requires us to look through volatility and to focus on macroeconomic fundamentals, as we stated in our most recent Monetary Policy Review. In this vein, we will continue to allow the exchange rate to absorb the initial shocks, and focus our policy actions on addressing second-round price effects, much as at times it can become difficult to distinguish first and second round effects in the wake of extended or multiple supply side shocks. However, it is important that policy decisions should not be informed by short-run market developments in either direction.

Before I conclude, let me briefly touch on some initiatives to strengthen governance issues in the domestic FX market.

The South African Foreign Exchange Committee

During the past year, we have made further progress in promoting high ethical and professional standards in support of fairness, integrity and thus the reputation of our foreign exchange market.

⁴ Bloomberg median forecast as at 12 November 2018

Following the establishment of the Global Foreign Exchange Committee (GFXC) in 2017, of which South Africa is a member, the SARB facilitated the establishment of a stand-alone local foreign exchange committee, the South African Foreign Exchange Committee (SAFXC). This forum consists of a wide range of key professionals involved in the domestic wholesale FX market (including Authorised dealers, the interdealer broker community, the Association of Savings and Investment South Africa, the Banking Association, and others). Its purpose is aligned to that of the GFXC, which is to promote a robust, fair, liquid, open and appropriately transparent FX market, in which a set of diverse participants is able to transact confidently and effectively at competitive prices that reflect available information, and in a manner that conforms to acceptable standards of behaviour.⁵ The key activity in giving effect to this is providing guidance to the local FX market by endorsing and upholding the FX Global Code (Global Code), and encouraging adherence to it.

The SAFXC has launched various outreach programmes aimed at creating public awareness and promoting the Code to the broader FX market community. Members of the SAFXC have been reaching out to their respective constituencies in the FX market (and hopefully to all of you here present), encouraging them to endorse the Global Code and commit to it by publishing a Statement of Commitment. To date, all the SAFXC members have endorsed the Global Code and have published their respective Statements of Commitment. By way of leading by example, since 01 September 2018 in its foreign exchange operations, the SARB only deals with counterparties, both local and offshore, that have endorsed the Global Code through the issuance of Statements of Commitment.

The outreach programmes by the SAFXC should be viewed as a collaborative initiative by the public and the private sectors aimed at strengthening the integrity and effectiveness of the domestic wholesale FX market, and should be supported by all of us. If your institution is an active participant in the FX market but has not endorsed the Global Code yet, I would like to encourage you to review your FX market operation practices and align them with the principles of the Global Code so that you too are able to publish a Statement of Commitment.

⁵ See <https://www.globalfx.org/> for more detail.

In conclusion, the road ahead for EMs remains fraught with risks despite the recent stabilisation in market sentiment. The prospects of further US monetary policy normalisation, financial market volatility and less certain global trade environment coupled with weak economic fundamentals suggest that the EM currencies will remain volatile. This will require vigilance and prudent decisions by policy makers.

Thank you.