South African Reserve Bank

Remarks by Deputy Governor Naidoo, at the AFRITAC South, International Monetary Fund & South African Reserve Bank Seminar on Monetary Policy Implementation and Financial Market Development

26 August 2019

1. Introduction

Good morning and thank you to AFRITAC South for the opportunity to make a few remarks this morning. You are about to embark on a week-long seminar on "Monetary Policy implementation and financial market development", a very pertinent topic, particularly since the global financial crisis (GFC) and the disruptions caused to an otherwise boring central banking world. I have no doubt that the course content will be stimulating and the South African Reserve Bank (SARB) is privileged to share with you our experiences. Like many other central banks, we are also in the throes of change, re-evaluating frameworks, determining if they remain fit-for-purpose and contemplating various enhancements including to the toolkit and reference rates.

I would like to share just a few thoughts with you this morning, firstly around the changing nature of central banking, the importance of well-developed financial markets, and South Africa's monetary policy implementation framework. I will end off with a few comments on current global economic conditions.

2. The changing nature of central banking post the Global Financial Crisis

The Bank for International Settlements (BIS) rightly pointed out that the global financial crisis has shaken the foundations of the deceptively comfortable pre-crisis central banking world. Indeed, the nature of central banking has changed considerably. Before the Global Financial Crisis, central banks had only to keep inflation within a tight range (in most cases through control of a short-term interest rate). Some would suggest that it was because central banks carried out this mandate so well, that the seeds of the Global Financial Crisis were sown.

However, as the crisis erupted and economic activity weakened, policy rates quickly reached the zero lower bound, and central banks had to become innovative. As such, central banks deployed their balance sheets quite aggressively, to implement "unconventional" monetary policies and bolster liquidity in financial markets through quantitative easing. No longer was the game about arresting rising inflation, but rather avoiding deflation, and finding novel ways to do this.

It became clear that price stability in itself is no guarantee against major financial and macroeconomic instability. Thus, there came an increased emphasis and expansion of central bank mandates, to include financial stability. In a similar manner to price stability, financial stability is considered an important prerequisite for sustainable economic growth and development. While South Africa's banking system remained sound during the 2008-2009 period, like many of our global counterparts, we also became more explicitly responsible for contributing towards financial stability. The South African Reserve Bank monitors and reviews the strengths and weaknesses of the financial system as well as any risks to financial stability, in line with internationally agreed upon standards and principles for regulators.

Another area in which thinking has undergone transformation since the global financial crisis is that of intervention in the foreign exchange market. The interconnectedness of the global economy and financial globalisation means that many countries, emerging ones in particular, have at times witnessed sharp volatility in the value of their currency, creating distortion in financial markets and the real economy. Post the crisis, there is a greater acceptance of the role of foreign exchange intervention as an additional monetary policy tool. The impossible trilemma[1] in that a central bank cannot cannot achieve all three of the following at one time, i.e. managing the exchange rate; allowing the free flow of capital; and monetary policy autonomy. has since come in for some criticism, as it is felt that it depicts too restrictive a view of the world. The corners of the triangle representing the trilemma can be rounded with intermediate policies such as temporary capital controls. The International Monetary Fund also updated its Institutional View on capital controls in 2012, noting that more financially open

[1] The impossible trilemma posits that a central bank cannot achieve all three of the following at one time: managing the exchange rate; allowing the free flow of capital; and monetary policy autonomy.

economies did worse in the global financial crisis and that limited, coordinated policies to temper flows could be acceptable, especially in economies with relatively underdeveloped markets.

Many emerging market central banks have adjusted their foreign exchange market operations as large and volatile capital flows and widening currency mismatches seem to have added weight to support policies aimed at containing exchange rate volatility. Several have thus increasingly intervened in the foreign exchange market, as foreign exchange intervention has become much more acceptable and been complemented by more active use of other instruments to manage capital flows, such as capital controls. While many emerging market economies have improved their economic performance and resilience through a flexible exchange rate system combined with inflation targeting frameworks in the past two decades, strictly free-floating currency regimes have become rarer.

The South African Reserve Bank's involvement in the foreign exchange market is mainly related to reserve accumulation and for managing money market liquidity. We remain committed to the principle of the exchange rate being determined by market forces of demand and supply. However, the South African Reserve Bank is not indifferent to the challenges posed by significant exchange rate volatility, and any intervention would have to be considered alongside the need to smooth out abrupt exchange rate movements, in the interest of financial stability.

3. The importance of well-developed financial markets

There is much greater acceptance post the global financial crisis, of the importance of financial market development for stability and economic development. Developed financial markets can facilitate access to foreign savings and mobilise accumulated savings within the economy, and allocate these toward productive uses such as investment. In turn, productivity growth in the economy is enabled, household wealth is improved, and the cost of economic activities as well as other frictions that exist due to inefficient markets, is reduced.

The World Bank's Global Financial Development[2] Report highlights that financial markets that are well-developed are of sufficient size relative to the economy they serve; allow access by different economic agents such that both small and larger players are able to obtain financial services; are efficient such that they are able to successfully intermediate financial resources; and are stable and resilient to shocks.

The enhanced stability that developed financial markets provide is particularly important given the highly interconnected nature of modern markets. As cross-border flows between countries grow and exposure to macroeconomic conditions in other countries increases, economies (particularly small and emerging or frontier economies) become increasingly vulnerable to external shocks and crisis episodes. We have witnessed on numerous occasions how monetary policy tightening in the United States led to capital outflows from emerging markets while raising the foreign currency liabilities of many borrowers in the developing world.

Underdeveloped local-currency bond markets expose borrowers to external shocks as well as potential currency mismatches between their liabilities and revenue streams. Deep local-currency bond markets are an important part of an established market, in that they reduce the exposure of borrowers to exchange rate volatility and volatile capital flows by leveraging domestic savings and reducing the reliance on foreign savings. A deep and liquid local-currency bond market relative to its emerging-market peers allowed the South African financial sector to absorb the capital outflows during the rout of emerging markets last year and at the height of the global financial crisis.

In recognition of the critical role that well developed financial markets play in safeguarding financial stability, various initiatives are ongoing to support the development of financial markets, and indeed seminars such as this become increasingly important. In 2011, the G20 endorsed an action plan to support the development of local-currency bond markets and several international institutions such as the World Bank, the International Monetary Fund and the OECD produced a diagnostic framework underpinning this work. This diagnostic framework enables the analysis of different components of local financial markets such as money markets and government and corporate bond markets in order to understand the necessary reforms.

---

[2] World Bank. 2018. *Global Financial Development Report 2017/2018: Bankers without Borders*.

The G20's work on local-currency bond markets includes efforts towards financial development in Africa, through the Compact with Africa (CWA) initiative, which was introduced in 2017 and is governed through the Africa Advisory Group. The Compact with Africa initiative provides a framework for increasing private investment and the provision of infrastructure in Africa. It includes a Financing Framework that aims to support the development of domestic debt markets among participating countries in the region by identifying commitments that countries can make toward reforms that support financial market development. South Africa co-chairs the Africa Advisory Group along with Germany.

4. South Africa's monetary policy implementation framework

Central banks rely on smooth functioning and efficient financial markets to implement monetary policy decisions and ensure effective transmission to the rest of the economy. As the Director-General of market operations at the European Central Bank noted, central bank financial market operations have been the central banks' portal to reality ever since the creation of central banks in the 17th century. Operational frameworks, which encompass the financial instruments and related rules and practices for monetary policy implementation, if poorly designed, not only risk the achievement of a central bank's monetary policy objectives, but undermine the efficiency and stability of the financial system[3].

A large portion of this week's course is focussed on the implementation of monetary policy. The Bank for International Settlements notes that monetary policy implementation consists of three key elements: (i) a 'policy signal' to formally express the stance of policy, such as an overnight interbank interest rate or the policy rate; (ii) an 'operational target' that can be used as a gauge to ensure that the intended monetary policy stance is being attained. A short-term money market rate is typically the choice, however, in most cases the policy signal and the operational target are the same; and (iii) 'instruments' to achieve the operational target, namely the open market operations, standing facilities, reserve requirements, and the rate of remuneration on reserves.

[3] Evaluating monetary policy operational frameworks, U. Bindseil, August 2016

The global financial crisis required a rethink of monetary policy implementation frameworks. Conventional monetary policy measures and tools aimed at the control of the standard operational target, i.e. short term interest rates, were no longer sufficient and central banks had to look at unconventional measures aimed at for example term spreads, and liquidity and credit spreads.

The Financial Markets Department of the South African Reserve Bank is responsible for implementing monetary policy. This is achieved through a liquidity deficit or classical cash reserve system, where banks are kept short of cash, through the levying of a cash reserve requirement and various other open market operations. Commercial banks refinance this shortage at the South African Reserve Bank once a week at the repo rate, and in this manner, the marginal cost of banks' funding is affected and the repo rate is transmitted to the rest of the economy. The South African Reserve Bank lends funds to the banks against eligible collateral, which comprises assets that qualify as liquid assets in terms of the prudential liquid asset requirement. In addition, a range of end-of-day facilities are offered to the commercial banks to square-off the daily positions on their settlement accounts, e.g. access to their cash reserve balances held with the Bank, supplementary repos/ reverse repos (at repo) and an automated standing (at repo plus or minus 100 basis points).

The South African Reserve Bank has utilised this framework since the introduction of inflation targeting and has had no need for adjusting it during the crisis. However, as economic conditions have changed and financial markets have become more developed and sophisticated, there is a need to review its effectiveness. We are currently studying the possibility of moving to an interest rate focussed system with the policy signal still the repo rate and the operational target the overnight interest rate. We are also currently considering amending and enhancing the toolkit.

5. Current global economic conditions

Let me conclude with just a few remarks on global economic conditions, currently once again on a precarious footing. Just as growth was starting to pick up, and developed market started to unwind unconventional monetary policies and zero interest rates - trade tensions and the imposition of tariffs have led to a decline in economic activity. The threat of a no-deal Brexit has further caused instability, as it is expected that such an outcome would plunge Britain into a recession. Geopolitical risks have amplified,

while central banks are facing increased political pressure. The threat of a currency war is gaining ground, as China allowed its renminbi to slide below the symbolic level of Rmb7 to the dollar, resulting in the US labelling China a currency manipulator. Confidence by consumers and business have dropped, purchasing managers' indices have trended lower, while corporate bankruptcies and lay-offs have increased…all suggesting that the global downturn has already begun.

Safe haven assets are rallying on the back of these developments. Gold has risen over 16% since the start of the year, while safe haven currencies such as the Japanese Yen and the Swiss Franc are also gaining ground. The Federal Reserve which had begun to raise interest rates and to shrink its balance sheet, has reversed course and delivered its first rate cut since 2008. Recent events have led to expectations of a potentially deeper easing cycle.

Consequently, the amount of negative yielding debt has reached over US$16 trillion, its highest level ever, as investors seek the safety of government bonds. German 30-year sovereign bonds have rallied sharply and the entire yield curve is below 0% for the first time. Traders have brought forward pricing of Fed policy rate cuts, expecting 50 basis points of cuts by the end of October, compared to expectations not too long ago that these cuts would happen by January 2020.

Emerging markets are feeling the brunt of trade and currency wars… currencies have weakened and non-residents have been pulling out of bond and equity markets.

Indeed we are living in volatile and uncertain times, and it has become increasingly difficult for central banks to navigate our way through the chaos.

With that, let me wish you the best for a productive and enlightening seminar.