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INVESTMENT MANAGEMENT

RESERVE BANK COULD HAVE BEEN EVEN BOLDER IN ADDRESSING LOCAL LIQUIDITY CONSTRAINTS

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The Reserve Bank followed up its larger-than-expected repo rate cut with a separate, unanticipated announcement the next day that it would bolster bank liquidity by reducing the rate at which banks borrow from the central bank by a percentage point too.

We welcome the decision by the central bank but question whether this will be enough to ease the tight liquidity conditions that have contributed to unprecedented moves in short-term credit and bond yields. Bid-offer spreads are blowing out, and price discovery has become extremely difficult.

The Bank did acknowledge the pressure on liquidity in various funding markets and the fact that it needed to review liquidity management strategy, reduce the Standard Facilities Borrowing Rate and increase repo lending facilities.

What is unusual about the decision is that it came so soon after the Bank had issued its formal MPC statement, which we viewed as disappointing. But the decision does go some way towards meeting the monetary policy measures we thought were necessary to calm fixed income markets and address the funding pressures being experienced.

The Reserve Bank's more tempered monetary policy moves are at odds with the central banks in the major developed markets like the US and Europe. There they have committed to doing what it takes to meet the demand for dollar-based short-term funding and have announced a sequence of emergency measures, using all the tools at their disposal.

We would have liked to see the Reserve Bank follow in their footsteps by announcing a package of monetary policy measures, including reducing the bank reserve ratio requirements, increasing repo facilities and introducing quantitative easing for the first time in South Africa.

We believe the bold moves taken by the Fed and ECB have created the room to introduce some of these measures without impacting on our status as a higher-yielding emerging market. As such, the Bank may have missed a significant opportunity to take even more action.

The financial market response to the MPC announcement highlights the volatility prevalent in the fixed income markets right now. The Bank's decision to cut the repo rate to 5.25% was initially well-received. But the rally in the rand and bond yields was short-lived. Soon after, the rand ran back up to almost R17.50 a dollar from R17.10 ahead of the statement. Local bonds yields fell immediately after the rate cut announcement, with the R186 declining to 9.77% from 10.38% before the meeting, but then they gave up the ground to close at 10.33%.

The response to the Reserve Bank's decision to lower the standing facilities borrowing rate on Friday morning was also extreme, with the most liquid R186 five-year bond yield falling more than a percentage point before rising again to wiping out all of the gains again. In my 12-year career, I have never seen moves like this before.

The extreme volatility is indicative of the extent of the credit squeeze that has taken hold of local money markets. The high levels of demand for cash, which is putting liquidity under such pressure, is prompted by two things: investors panicking and moving into cash and safer money market instruments to reduce risk, and investors urgently needing cash to fund margin calls.

Global financial markets have been experiencing similar liquidity pressures. As banks have struggled to meet the extremely high levels of demand for dollars from corporates running into short-term funding issues and investors forced to fund margin calls, the Federal Reserve has been called on to act as the “central bank for the world”.

At home, we are concerned that the Reserve Bank's downwardly adjusted economic growth forecasts are still too optimistic. The Bank foresees negative economic growth of -0.2% this year and then sees growth returning to positive territory for the following two years.

These forecasts are in stark comparison with the estimates that are coming through in Europe and the US, where economists are expecting these developed markets to fall deeply into negative territory during the second quarter. For instance, JPMorgan Chase is predicting a 14% decline in US economic growth and a 24% decrease in European growth in the second quarter, and Deutsche Bank -12.9% in the US. At a global level, there is increasing consensus that the world economy may already be in recession.

Given these challenging economic and financial conditions, we are still not convinced that the Bank’s decisions taken this week are sufficiently expansionary. Markets are negotiating the fallout from two black swan events that have brought us into unprecedented market territory, and only time will tell if it will be enough.

Ends.

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