T T Mboweni: Annual conference on global imbalances, competitiveness and emerging markets

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the CEPR/ESI 11th Annual Conference on Global Imbalances, Competitiveness and Emerging Markets, Pretoria, 28 September 2007.

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Distinguished delegates

This is the eleventh year that representatives from the academic world and central banks across the world meet to discuss topics that are very relevant in the prevailing macroeconomic environment. On this occasion, the organisers have selected the issues of global imbalances, competitiveness and emerging markets. From the programme, it is clear that we can look forward to some interesting views and insights into these issues. In my keynote address, I will focus on a few aspects relating to central banks, in particular in emerging-market countries, and the challenges faced in formulating and implementing monetary policy in a globalised financial system characterised by imbalances.

When referring to global imbalances, the most obvious ones that spring to mind are the US twin deficits and global trade imbalances, which have probably been the most publicised imbalances over recent years. Yet the world is characterised by many other imbalances. Some of these are embedded in the structure of the world economy as it has developed over the centuries, such as the income gaps between developed, underdeveloped and emerging-market countries. Others are more cyclical in nature. The current fallout in the US sub-prime market is an example of a reaction to a more cyclical imbalance caused by low interest rates, high liquidity and a general under-pricing of risk over recent years. Cyclical balances are normally restored through a combination of policy adjustments and market forces. However, this can be a painful process, as many financial institutions, investors and sub-prime mortgage lenders and borrowers that were directly affected by the recent events in global credit markets can bear witness to.

Another example of a current cyclical imbalance is the extent of carry trades and build-up of long/short investment positions globally, which resulted from loose monetary policy in some countries and tighter policy in other countries, mostly emerging-market countries. This has enticed investors to borrow in the low-interest-rate currencies and invest in the high-yield currencies.

Most cyclical imbalances result from the boom and bust characteristics of the global economy and financial markets. In his last speech, read on his behalf at the Jackson Hole Conference on 31 August 2007, the late Edward Gramlich had some interesting things to say about booms and busts. Essentially, he argued, American history showed that boom periods followed a pattern of initial discoveries, breakthroughs, widespread adoption, widespread investment, and then a collapse where prices cannot keep up and many investors lose a lot of money. In the bust that follows the boom, there is generally an overreaction, but after the dust clears investors emerge a little bit wiser and some of the benefits that led to the boom in the first place remain.

The challenge to central banks, as well as to academic researchers, is to be able to see through the dust and noise of market talk, commentary, newspaper and television reports, speeches and comments by politicians and trade unions and many others with the interest of particular individuals or groups in mind. Instead, central banks need to make an effort to understand the processes that are underway and to apply the appropriate dose of policy measures, at the right time, for the longer-term benefit of the economy as a whole. This is much easier said than done.

When considering the issue of global imbalances, one can imagine the world economy as a giant pendulum swinging to and fro. A stationary state of balance (what economists like to call equilibrium) never exists for very long, if at all. Indeed, Newton's laws of motion, that for every action there is an equal an opposite reaction, can be equally well applied to the world of economics. A trend or event that pushes the economic pendulum to one side is usually corrected by a counter action, which can be brought about by means of countercyclical policies, or merely through the self-correcting nature of markets.

However, while these booms and busts can be fascinating to analyse with the benefit of hindsight, they make the lives of policy makers considerably more difficult. Referring back to the analogy of a pendulum: it is easy to see from the side whether a pendulum is swinging to the left or to the right, but if you sit right on top of it, it becomes much more difficult to know exactly where the balancing point is. Central bankers are part of the global economy as it unfolds day by day, yet they have to judge the balancing point of policies that can affect the global economy and financial markets for many years to come. This is not an easy task, and policies can easily under or overreact to boom and bust cycles.

Many of the global imbalances in the world today can be related to the process of globalisation, which facilitated almost unlimited cross-border flows of funds. The wave of financial globalisation and innovation that has flooded over financial markets during the past two decades has also complicated the formulation and implementation of monetary policy. I would like to also make a few comments in this regard.

Globalisation has been brought about by a number of factors, including:

- the increasing free flow of capital across national borders;
- the emergence of global financial institutions;
- a technological revolution that made geographical location almost irrelevant;
- an explosion of new financial instruments; and
- new insights and developments in the areas of asset management and risk management.

These developments facilitated the significant cross border flows that emanated from global savings imbalances and a search for higher yields at a time when interest rates in developed markets were low.

Emerging markets have been affected by these changes in very particular ways. Emerging-market assets have increasingly become an acceptable and desired asset class in diversified global portfolios, recognised as both yield-enhancers and risk-reducers through diversification. This is partly attributable to the improved macroeconomic and financial profiles of many emerging markets. On the one hand, this appetite for emerging market assets has contributed to a steadier and more sustainable flow of funds to emerging markets: once accepted as part of an investment mandate, certain portions of portfolios are allocated to these assets for longer periods. On the other hand, large inflows of capital relative to the size of domestic financial markets have a significant impact on domestic asset prices, volatility, liquidity and external vulnerability. Domestic asset prices become very sensitive to changes in sentiment or risk appetite among global investors.

Significant foreign investment flows to emerging markets have also to some extent contributed to imbalances between domestic and foreign assets and liabilities. Countries that have received large amounts of inflows, while enjoying the benefits of these, should always keep in mind that they are also building up increasing foreign liabilities, which are likely to affect future outflows of dividends and interest payments. This holds equally true for foreign direct investment and portfolio investment. There is also an ever-present risk that foreign investors could withdraw again if the global environment changes. South Africa is a classic example of a country with such an exposure, and it is precisely for this reason that the South

African Reserve Bank has used the opportunity of increased flows to emerging markets to strengthen its foreign reserves position.

These developments have complicated the formulation and implementation of monetary policy by central banks, in particular in emerging markets. Globalisation of financial markets has to some extent blurred the conventional ways in which markets react to monetary policy. As a result, the extent and direction of changes in asset prices in response to changes in monetary policy are becoming increasingly uncertain. For example, while conventional unhedged interest-rate parity theory predicts that exchange rates should strengthen when interest rates are increased, the South African experience of late showed that the opposite is just as likely. During the current tightening cycle, the South African rand on more than one occasion weakened when interest rates were increased, and appreciated when interest rates remained on hold. Clearly, in these instances global investors' views about the impact of rates on the growth trajectory overruled other influences and conventional relationships.

The build-up of carry trades globally has been mentioned earlier in this address as a current example of imbalances caused by different monetary policy stances among countries, within the context of globalised financial markets. The extents to which carry trades are conducted globally amplify the effects of relative changes in asset prices – not only for the high-yielding investment destinations, but also for the relatively low-yield origins of funding. Carry trades in their broadest sense comprise any investment made with borrowed funds. Short positions in low-yielding financial markets or instruments are typically used to fund long positions in high yielding markets or instruments. In practice, such funding can take numerous forms in the money, capital and derivatives markets across the world, making it very difficult for an individual government agency or central bank to obtain an exact indication of the extent of these trades in the domestic market. There is also much uncertainty about the triggers that could reverse carry trades, and the speed with which they could be reversed. These are all factors that add to the uncertainty of central bankers about the likely effects of their policies on financial markets and asset prices.

A similar "black box" of uncertainty that can have an impact on monetary policy is the activities of hedge funds in global financial markets. We know that hedge funds influence markets in significant ways, but find it very difficult to determine exactly to what extent. Although the term is loosely used, it is not always clear which institutions should be referred to as hedge funds: traditional fund managers and so-called hedge funds seem to be moving closer together in their strategies and activities. Also, the complex structures of some derivative instruments and investment conduits make it almost impossible to determine who is exposed to whom, and to what extent. The current turmoil and illiquidity in the major financial markets is largely attributable to this uncertainty and lack of trust.

Emerging markets, in particular, are vulnerable to the contagion effect, which is regularly illustrated. This has affected South Africa on a number of occasions during the past year and contributed to volatility in domestic financial markets. In times where risk aversion increases and investors pull out of riskier assets, the rand tends to be in the basket of currencies that suffers the most. This can be related to some extent to the liquid nature of the rand market.

Nevertheless, despite the risks and complexities associated with financial globalisation, there are also clear benefits. Speaking from a South African perspective, the central bank's inflation targeting framework has been well supported by the benign global inflation outlook over recent years, as well as by conditions in global financial markets that led to increased foreign capital inflows to emerging markets. The combination of global liquidity, combined with favourable conditions in the domestic economy, caused demand for South African equities by non-residents to increase at an exceptional pace, recording net purchases of R33 billion in 2004, R50 billion in 2005, R74 billion in 2006 and a record R66 billion in the year to 20 September 2007. In the bond market, activity has been a little more volatile, with non-residents purchasing a net R365 million in 2004, selling a net R10,7 billion in 2005 and purchasing a net R34 billion in 2006. Partly supported by these activities, but also in line with global trends, the JSE's All-share index recorded a succession of record highs, while domestic bonds hardly interrupted their five-year rally, despite a cumulative increase of 300 basis points in the Reserve Bank's repo rate since June 2006.

To date, the significant foreign portfolio inflows, combined with a favourable outlook for the domestic economy, have enabled the country to finance a relatively large current account deficit, which, in turn, was to a large extent driven by investment expenditure and infrastructural developments – hopefully efforts from which the country would benefit in years to come. Capital inflows have also enabled the South African Reserve Bank to increase official reserves to a much healthier level, contributing to a series of upgrades in the sovereign risk ratings, while the exchange rate of the rand has become much more stable compared to a few years ago.

My comments have highlighted some of the uncertainties that central banks have to deal with in their policy making. I would like to also focus a bit on how these challenges should be approached.

Good central bankers and good academics have a number of unique characteristics in common, which distinguish them from other market participants when faced with uncertainty, volatility and imbalances. Firstly, they both have to take a long-term view, focusing on their primary objectives. Investors and politicians often worry more about their next quarterly results or the outcome of the next election than about the shape of the overall economy in five or ten years' time. They can exert significant pressure on central banks to apply policies that are likely to benefit their own positions. By contrast, central bankers and academics should try to focus beyond the prevailing noises of volatility, imbalances and uncertainties and focus on long-term objectives and relationships. This requires independence and the ability to resist pressures to succumb to short-term gains rather than long-term benefits.

A second commonality between central banks and academics is that they should be impartial and objective, acting without self interest: Monetary policy, like academic research, should be based on sound and consistent principles and methodologies.

A third commonality is that, however good a policy or research output may be, it has to be communicated effectively. Even the most brilliant new theory or discovery will be of no value if it cannot be communicated and understood by the target audience. Similarly, monetary policy loses its effectiveness if it is not understood and if the central bank does not have credibility. The uncertainties, complexities and imbalances that exist in the global economy make appropriate communication strategies by central banks all the more important. Clear and regular communication about policy objectives, the policy outlook, risks and objectives becomes an increasingly important policy instrument, in addition to setting interest rates.

It is at conferences such as this one that central banks and academic researchers can meet, exchange views and support each other in their commonalities. Policy makers have an opportunity to learn from new theories that emanate from academic research, while academics have an opportunity to apply their minds to current, relevant and complex problems facing the global economy. I look forward to a stimulating programme.

Thank you.