Daniel Mminele: "Does the investment case for emerging markets still hold?"

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the Old Mutual Investor and Analyst Showcase Dinner, Cape Town, 4 December 2013.

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1. Introduction

Good evening ladies and gentlemen and thank you to Old Mutual for inviting me to say a few words tonight, just as another year with its share of uncertainties and challenges is drawing to a close. The topic chosen for our discussion, namely whether or not there is still a case for investing in emerging markets (including South Africa) may have sounded incongruous two or three years ago, when emerging countries were at the forefront of the global economic recovery, and capital flows into the emerging world had resumed at a strong pace following the 2008–09 financial crisis. However, the last twelve months in particular have proved more challenging for securities markets in the emerging world, and it is the seriousness and durability of these challenges which I will try to assess tonight.

2. The changing role of emerging markets in global growth

The historical case for portfolio diversification into emerging market assets has long been based on the growth outperformance of emerging market countries. As these countries grew faster than their developed counterparts, reflecting either favourable demographics, large investments in human and physical capital, strong productivity gains, better governance or a mix of these, returns on invested financial capital were expected to be elevated. In turn, this justified faster growth in prices of emerging market equities. Furthermore, as income levels converged towards those of more developed economies, support for stability-oriented policies – and, consequently, lower and more stable inflation – increasingly became the norm, enabling a reduction in the risk premium embedded in these countries' fixed-income markets. Finally, stronger productivity gains called for an appreciation of emerging market currencies, at least in real terms, over the long run. For most of the past decade, empirical evidence supported this paradigm: For example, between 2002 and 2012, the Morgan Stanley Capital International (MSCI) index for emerging market equities outperformed its global counterpart by 300 per cent, while returns on local currency emerging market bonds were 40 per cent higher than those on US Treasuries over the period.

Yet, something seems to be changing. Emerging market economic growth is still outpacing that of the developed world, but the gap is narrowing. In its October 2013 World Economic Outlook, the International Monetary Fund (IMF) projected that growth in emerging markets would slow from 4,9 per cent in 2012 to 4,5 per cent this year and pick up to 5,1 per cent next year, whereas at the same time, developed economies would accelerate from 1,2 per cent this year to 2,0 per cent in 2014. Such a narrowing, albeit a mild one, in the "growth gap" is nonetheless surprising as in the past decade or two, recoveries in the developed world generally saw the emerging economies outpace advanced economies. In a word, global recoveries used to leverage the emerging market performance, rather than undermine it.

Why is this happening? It is hard to pinpoint a single cause. But, among others, the performance of exports in many emerging economies has been poor, by historical standards, over the past eighteen months, suggesting (at least in some sectors) a loss of world market share. Also, in the current year, the co-existence of strong rates of credit growth and slowing real GDP growth in several large emerging market economies has raised concerns about a declining efficiency of invested capital. Separately, efforts by Chinese authorities to rebalance economic growth towards a more consumer-oriented model has prompted expectations that growth in China will in future be less intensive in industrial commodities, with negative implications for the major exporters of these commodities.

The big question is how much of the recent developments represent underlying structural changes, or whether some of these factors will prove cyclical – for instance, that exports will revive once the developed world's recovery is more solidly entrenched. There are some issues that point to a structural component. Firstly, one tool through which developed economies are fostering economic improvement is by restoring competitiveness, be it via cost and price disinflation (as in the case of the euro zone's periphery) or by allowing currency depreciation (like in Japan). Secondly, a difference between the current situation and the early 2000s – when the recovery saw emerging market growth outpace global benchmarks – is that the real effective exchange rates of emerging market currencies are not, on balance, as depreciated as they were at the time. Thirdly, there are increasing indications that the moderation in economic growth in the emerging world has some lasting causes, for example less favourable demographic patterns. It is significant that the IMF's estimates for *potential* economic growth in all the five BRICS countries are lower, in 2013, than similar estimates made in 2011.

3. The likely impact of declining global liquidity

The impact of somewhat less favourable fundamentals has, of course, been compounded by concerns that the ample liquidity made available in recent years to fight the global crisis will gradually be withdrawn, perhaps in the not-too-distant future. The announcement by the US Federal Reserve in May that conditions would probably soon warrant a tapering of its asset purchase programme – which incidentally does not equate to a reduction in global liquidity, merely to a phasing down of additional injections – quickly resulted in a sharp rise in the risk premium embedded in most emerging market assets. Since Chairman Bernanke first talked about tapering on 22 May 2013, the JP Morgan index of emerging market currencies has lost 7.5 per cent of its value versus the US dollar; the Emerging Market Bond Index (EMBI) local currency index has fallen by around 2.4 per cent at the same time as the EMBI-plus sovereign spread of US dollar-denominated debt over US Treasuries increased by close to 100 basis points; and the MSCI Emerging Market equity index has fallen by 4.0 per cent, even as the MSCI World index of global equities continued to power ahead, gaining 6.0 per cent over the period.

What will happen, then, when global central bank liquidity starts declining in earnest? Admittedly, the response to tapering talk since May need not necessarily be a guide to future market moves, as the reduction in the Federal Reserve's asset purchases is probably by now discounted to a much larger extent than it was before Chairman Bernanke spoke to Congress in May. To the extent that the Fed does not again surprise markets, but instead manages to stabilize expectations embedded in the longer part of the US yield curve, for example via the continued and effective use of its forward guidance, the impact on the global asset price constellation could be more benign than it has been so far this year. But how much is priced-in, nobody really knows.

Nonetheless, the strong correlation seen since the second quarter of 2013 between the exchange rates and bond yields of emerging countries (especially those seen as the most vulnerable to a reversal of capital inflows, because of more fragile domestic growth or external account fundamentals) and US Treasury yields, does highlight the vulnerability of the former to a further backup in the latter. Notwithstanding central bank efforts at anchoring long-term rate expectations, it seems difficult to imagine that a reduction in global liquidity – at a time when non-resident demand for US bonds, in particular, has been waning – would have no significant impact on US or core European yields. International estimates of "term premiums" embedded in longer-term bond yields did suggest that quantitative easing policies had compressed these premiums to unusually low levels; in turn, as prospects for an unwinding of quantitative easing emerged, they started to normalize. Furthermore, term premiums have shown some correlation across both developed and emerging bond markets, in particular since they began to rise from May 2013 onwards.

4. The case for (still) investing in emerging markets

Risks hanging over emerging market assets, however, do not mean that the case for investing in such assets is closed. First of all, while the growth out-performance of emerging countries relative to the developed world has been dwindling, this should not obscure the fact that the gap, while narrowing, remains positive, and that emerging markets remain the biggest contributors to global growth. Demographic trends, productivity gains, increases in the stock of capital remain conducive to a stronger growth performance of emerging market countries in the medium to long term. Even countries that have shown a relatively strong degree of convergence with living standards of the developed world can still out-perform the latter, as the case of Korea and Taiwan shows.

Similarly, emerging countries continue to display, on balance, better fiscal or external metrics than their developed world counterparts, whether one looks at current account balances, public deficits or ratios of public and private debt to GDP. Rather than the developments following Mr Bernanke's comments in May 2013 representing an "emerging market crisis", as some may want us to believe, what is probably a more correct characterization of the developments is a correction or re-pricing in the wake of expected normalization of global monetary policy and uncertainty around the speed of such normalization. What seems to further underpin the emerging markets investment case is much stronger fundamentals when compared to previous episodes of emerging markets coming under pressure, such as in the late 1990s, or even more recently in 2008. Substantial progress has been made in the last two decades towards more flexible exchange rates, reserves have been accumulated on a grand scale, fiscal positions are healthier than in many advanced economies, all of these making emerging markets overall more resilient. With regard to the more cyclical component of the recent developments, without underplaying the need for structural reform in some cases, one could even draw a more constructive conclusion of current developments, namely that depreciating exchange rates, and moderation in growth patterns may actually be testimony to how responsive these economies have become, and can adjust to changes in the underlying fundamentals.

Furthermore, global investors may at present be relatively under-weight in emerging-market securities, strengthening the case for out-performance of the latter over the medium term. Private surveys of US and EU pension funds do suggest that their allocation to emerging-market debt has remained stable and relatively low, as a share of total assets under management, in recent years, even as the share of emerging market bonds in world market capitalisation continued to grow. In particular, global investor allocations to local-currency bonds of emerging market economies remain low, in part because of historical reasons of liquidity which nonetheless fade over time as emerging economies increasingly expand the size and maturity of their local bond market.

That said, not all emerging countries retain sustainably stronger fundamentals than their developed world counterparts, and growing divergences within the broad emerging market bloc, coupled with the likelihood of less abundant liquidity over the next few years, suggest that differentiation between respective emerging markets could increasingly become the norm in coming years. Whereas the immediate post-recession years had seen a strong cross-correlation between the performances of different emerging market assets, as they shared common drivers in the form of liquidity injections and interest rate expectations in the world's major economies, such correlations have already started to wane in 2013. Country differentiation gradually began to replace the proverbial "risk on, risk off" trading patterns of the earlier period. Countries with relatively weaker growth, inflation and external account metrics saw their currency, bond and equity markets under-perform those with more solid fundamentals. Therefore, it may not be helpful to lump together countries and call them "the fragile five", when underlying dynamics in these countries could be quite different, even if they present similarities when one looks at budget deficits and current account deficits.

5. South African assets under this new paradigm

This allows me to conclude with a few words on our domestic situation. Domestic financial markets have faced significant challenges since the second quarter of this year. The rand has extended a depreciating trend that began in the latter half of 2011, and lost about 12 per cent on a trade-weighted basis since early March, declining to levels last seen in late 2008, at the height of the global financial crisis. The yield on the benchmark R186 long-term bond has risen by more than 100 basis points, even as domestic short-term rates remained anchored by the absence of a change in the Reserve Bank's repurchase rate, while the CDS spread on five-year sovereign South African debt also widened, generally by a larger amount than those of countries enjoying a similar rating to South Africa. The domestic equity market has been the exception to this rule, although this partly reflects the "rand hedge" qualities of certain sectors or stocks which, because of the dollar pricing of their outputs or the international diversification of their operations, tend to benefit from a depreciation of the currency.

We cannot be under the illusion that the poor performance of domestic financial markets since the beginning of this year is a mere consequence of a less favourable international backdrop. Domestic socio-economic fundamentals also play a part in investment decisions of global buyers of South African securities. Phases of rand under-performance relative to other large emerging market or commodity-linked currencies have frequently coincided, of late, with disappointing foreign trade or current account data releases; similarly, episodes of labour disputes are often accompanied by a poor performance of the local currency and credit spreads. More generally, investors seem to query whether the growth prospects of South Africa will be sufficient to meet, over time, the economic aspirations of its citizens and, in so doing, cement public support for the stability-oriented macroeconomic policies which investors have long regarded as a "constant" of the political landscape since the advent of democracy in 1994.

However, one should not so easily forget the great many strides South Africa has made on the macroeconomic front, reflected by greater macroeconomic stability and longer upswings in the business cycle since the advent of democracy. The adoption of an inflation-targeting monetary policy framework in 2000 came with many benefits – contributing to a decline in the level and volatility of inflation and nominal interest rates, improving the transparency and accountability of the central bank, and therefore also its credibility. South Africa became increasingly integrated into international financial markets, contributing to the growth and development of its own domestic financial markets and financial infrastructures in terms of sophistication, depth and liquidity, thereby helping to boost growth and improve the country's resilience against external shocks. The policy and institutional framework similarly remain strong. It is also as a result of this underpinning for the South African investment case that, over the years, South Africa has been included in a number of bond indices tracked by international investors, such as the JP Morgan Emerging Market Bond Indices and the Citi World Government Bond Index.

The strides we have made as a country are borne out by favourable rankings in a number of competitiveness reports. Overall, South Africa is ranked 53 out of 148 in the 2013/14 World Economic Forum Global competitiveness report; ranked in the top 15 worldwide in the 2012 Emerging Markets Opportunity Index; first in economic competitiveness in the Africa Competitiveness Report (taking the lead in financial market development, technological readiness, market size, business sophistication and innovation); and 39 out of 185 countries in the World Bank's Report on Doing Business.

South Africa is respected for its good corporate governance – ranking first for ethical behaviour of firms; efficacy of corporate boards and protection of minority shareholders in the

Global Competitiveness Index. We perform particularly well in a number of areas: quality of institutions; intellectual property protection; property rights; efficiency of legal framework; and accountability of private institutions. These rankings are a clear indication of South Africa's economic and financial potential.

That said, there are no doubt challenges that we confront today as a country and those challenges are reflected in the somewhat weaker investor sentiment. There is an urgent need for action on structural reforms, focus on quality education and skills development; infrastructure investment; to name a few. The National Development Plan sets out a good framework for dealing with these issues and the implementation thereof would help place the country on a faster and more sustainable growth path. Tackling these challenges requires a collective effort by players inside and outside government and a realisation that trade-offs will be necessary, and that the more difficult challenges cannot be addressed in a manner that is entirely painless for everybody.

What role can, and should monetary policy play in supporting investor confidence in South Africa's fundamentals? Admittedly, it is the nature of financial markets that perceptions of risk evolve over time, resulting in at least some degree of price volatility, even in those markets perceived as among the safest. Policymakers cannot completely eliminate financial market volatility. Yet in the recent past, some emerging countries have used specific tools to try and limit the extent of such volatility. One should however remember that the structures of financial markets differ across countries, and hence a policy tool that appears appropriate in some jurisdiction may not necessarily be the most desirable one in a different country. Furthermore, empirical evidence does not, so far, suggest that the volatility of South African financial assets has meaningfully diverged from those of markets in countries where such policy tools have been implemented.

It is, however, important that investors remain assured and convinced of the firm commitment of South African authorities to price stability and sustainable public finances, irrespective of the challenges that the country faces in the pursuit of sustained economic growth and development. In that respect, the Bank's commitment to flexible inflation targeting, monetary policy transparency and predictable implementation, remain crucial to limiting any rise in financial market uncertainty and volatility.

The Monetary Policy Committee at its November meeting judged that an unchanged policy rate was consistent with its mandate at this stage. In order to maintain the integrity of the inflation targeting framework, however, it would not hesitate to take appropriate action, should the medium-term inflation outlook deteriorate significantly. At the same time, a reduction in public deficits as per the framework laid out in the October 2013 Medium-Term Budget Policy Statement, together with the implementation of measures agreed upon in the National Development Plan, aimed at unlocking the country's longer-term growth potential, would substantially assist the Bank in carrying out its mandate of price and financial stability, in the interest of sustained economic growth and development.

6. Conclusion

Let me then finish by answering the question of whether there is still a case for investing in emerging markets with a "yes". While challenges remain and headwinds in the form of uncertainties around Fed tapering, lower growth in key emerging market economies, and continued volatility are likely to be with us for some time, and the need to address certain structural challenges by emerging economies is beyond question, the much better fundamental backdrop of emerging markets and continued prospects of higher growth than in advanced economies, especially in regions such as Sub-Saharan Africa, appear to suggest that it would be a mistake to write off emerging markets. By rather adopting a somewhat medium to longer-term investment horizon with appropriate diversification strategies, and looking through some of the temporary turbulence, investors that maintain their loyalty to this asset class are likely to reap the benefits. Emerging markets appear to be adjusting both cyclically and structurally from spectacular levels of growth observed previously to more sustainable levels. This should continue to support a steady investment case.

Thank you.

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