Daniel Mminele: The impact of diverging monetary policies on emerging markets

Address by Mr Daniel Mminele, Deputy Governor of the South African Reserve Bank, at the National Asset-Liability Management Africa Symposium, Johannesburg, 29 October 2015.

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Good morning, ladies and gentlemen.

It is a pleasure and privilege to have been invited to deliver the keynote address at this sixth Annual National Asset-Liability Management Africa symposium, which judging from the topics, promises to be an exciting event. Unfortunately, other commitments will not allow me to spend more time with you as I will have to leave immediately after this address. There is, however, strong representation from the South African Reserve Bank, and my colleagues will be able to share with me later some of the insights I am going to miss.

As financial market participants, we all realise the challenges and risks stemming from a low growth and low interest rate economic environment amid a changing financial landscape and turbulence in financial markets.

My remarks this morning will focus on the years since the global financial crisis (GFC), specifically in relation to monetary policy in advanced economies (AEs) and resulting spill-overs and policy implications for emerging market economies (EMEs), with particular reference to South Africa. I will touch on how these monetary policy developments have impacted capital flows and investment positions in EMEs.

Monetary policy developments after the global financial crisis

Although the "taper tantrum" is behind us and the Fed's QE programme came to an end in September 2014, vast uncertainties have re-emerged.

Firstly, the timing and pace of Fed's rate hikes became more uncertain as we moved deeper into 2015, following the soft patch in the US economy, and as inflation kept falling short of expectations.

Secondly, the global environment and specifically financial markets began experiencing some renewed turbulences due to a possible Greek exit and country specific developments in EMEs. One example of such country specific events were the mounting concerns regarding the slowdown in the Chinese economy and its impact on commodity prices, commodity-exporting countries as well as global growth. The unease about the slowdown in China appears to have been further fuelled by various policy measures implemented by Chinese authorities to restore confidence during the sharp sell-off in their equity market, as well as the unexpected devaluation of their currency, which at the time seemed to have created even more policy uncertainty.

Thirdly, in contrast to the Fed's expected monetary policy tightening path, some other major central banks have embarked on further policy easing, exacerbating the so-called monetary policy divergence. In the early part of this year, the European Central Bank (ECB) announced their long awaited QE programme of approximately EUR1,1 trillion, while the dovish stance at last week's policy meeting reinforced expectations for further easing. In Japan, the recent economic contraction and renewed deflation fears fuelled speculation that the Bank of Japan (BoJ) could announce more QE. In addition, various central banks in AEs reduced their policy rates in 2015, for example Canada, Australia (both by 50 bps), New Zealand (75 bps) while Sweden and Switzerland moved further into the territory of negative interest rates. China also started easing monetary policy since November 2014, reducing their benchmark policy rates on six occasions and the reserve requirement ratio four times. The latest easing by China happened as recently as last week, reflecting the Chinese authorities' concern about future

growth expectations and the overall health of the economy. Surprisingly, this resulted in broad EM weakness with losses being registered on both equity and currency markets. Perhaps this reaction is a reflection of increased risks to the Chinese economic outlook.

The GFC set the tone for monetary policy implementation and liquidity provision to significantly influence balance sheet dynamics in AEs (and in order to restore dysfunctional interbank markets). In EMEs, however, this phenomenon was less apparent, with only the PBOC active in this regard. This was because, as EM central banks did not face the "zero lower bound" constraint, they could still use traditional policy tools (such as policy rates) to respond to external shocks. In addition, many EM countries recovered more quickly from the GFC than their AE counterparts, further reducing the need for exceptional policy measures.

Nonetheless, the expansion of the balance sheets of major central banks has not been without effect on emerging markets, and has at times complicated the task of the latter's central banks. Ample global liquidity triggered capital flows into EM countries, in many cases encouraging public and private leveraging and fuelling credit growth. Such developments would typically prompt a policy response in the form of higher interest rates. However, with interest rates differentials with AEs a key driver of portfolio flows and currency appreciation, some EM central banks found themselves facing increasingly complex challenges.

Despite the current delay in the Fed's expected monetary policy normalisation path, the Fed and the Bank of England (BoE) are expected to be the first AEs to increase their policy rates. Against this background, it still appears that monetary policy paths will differ amongst major central banks, in terms of the trend, timing and pace, adding to the uncertainty in global financial markets.

These diverging monetary policy paths create a challenging environment in which central banks have to operate in order to attain a balance between macroeconomic challenges and policy choices. One of these possible choices could be a revision of monetary policy mandates due to changes in inflation trends. Over the past few decades, inflation targets in AEs have steadily fallen to an average of around 2 per cent. In EMEs, inflation fell at a faster pace to an average of around 4,0 per cent, however, with a fair degree of dispersion. This fall in average inflation targets has mirrored the fall in inflation itself. Yet, at present inflation is undershooting those targets, on average by around 1,5 percentage points, in an environment of the zero lower bound constraint. Some economists feel that a way of loosening this constraint would be to revise inflation targets upwards. For example, raising inflation targets to 4,0 per cent from 2,0 per cent would provide 2 extra percentage points of "room to manoeuvre". That is roughly the order of magnitude some researchers[1] have suggested might be desirable.

For EMEs, however, the picture is somewhat more challenging, as domestic developments, in particular currency depreciation, have been key to inflation developments and outlook.

US monetary policy normalisation and treasury yields

Despite the positive growth impact of monetary policy accommodation over the past seven years, considerable vulnerabilities have also emerged during this period, especially for those EMEs that did not introduce the appropriate policy adjustments. Those economies could be vulnerable in the wake of tighter financial conditions.

Although the spill-overs or intensity of the transmission channels of monetary policy normalisation will, amongst others, depend on country-specific factors, the global environment has also become more integrated and complex. In addition, the last couple of months have brought more issues to the fore, for example the impact of lower commodity prices on commodity exporting countries and heightened market volatility, which could make the

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[1] Ball, L (2014), "The Case for a Long-Run Inflation Target of Four Percent", IMF Working Paper 14/92, and Blanchard, O, Dell'Ariccia, G, and Mauro, P (2010), "Rethinking Macroeconomic Policy", IMF Staff Position.

monetary policy adjustment process even more complicated and painful. Against this background, domestic imbalances or weak policies could aggravate risks and challenges in the adjustment process.

Given that the Fed, as alluded to earlier, is expected to tighten policy first amongst the major central banks, let me spend some time on the impact of the imminent US monetary policy normalisation on EMEs. Monetary policy normalisation implies the removal of extraordinary policy measures that had been implemented to deal with a particular economic episode. In this sense, it refers to a path taken to return to a more “normal” monetary policy setting, although no qualification is made as to what exactly constitutes “normal” in the post-GFC world.

During rate-hiking cycles, a key concern for global markets is the path of US bond yields, as these tend to have knock-on effects on other markets, and this is one of the three financial channels of spill-overs to EMEs. Before I discuss the possible effects of US monetary policy tightening on EMEs, I would like to mention some factors which could constrain and/or prevent abrupt and unexpected increases in US Treasury yields. These are important to note as they may influence expectations about the extent of the impact of US tightening on EME economies.

Firstly, some central banks like the Fed initially adopted a form of forward guidance as part of their normal monetary policy toolkit. Although this could have at times contributed to volatility in markets because of the highly uncertain and changing environment in which communication takes place, the aim remained for central banks to be as transparent as possible in terms of the policy outlook. The FOMC is also clear on the gradual normalisation path, as also alluded to by the previous Fed officials like Ben Bernanke ahead of the 2004 tightening cycle[2]. Gradualism in monetary policy also reflects the Fed’s desire to keep bond-market volatility in check – in Greenspan’s words, to “not create discontinuous problems with respect to balance sheets and asset values”.

The second important dynamic is that the longer end of the US yield curve is also interrelated with the Fed’s balance-sheet dynamics. The FOMC has indicated that it will consider the cessation of reinvestments of maturing securities only after it commences hiking the policy rate. In the meantime, it will not sell any securities. Until such time as the Fed has signalled that it will cease to reinvest bond maturities, the Fed will have no direct impact on the stock of bonds in the market.

Thirdly, there is debate on how much the “equilibrium” interest rate has declined structurally in the US, contributing to the downward pressure on the long end of the yield curve.

Lastly, monetary policy in other AEs can also influence the demand and supply for core sovereign assets and therefore the global trend in long-term interest rates. For example, the declining trend in Eurozone bond yields has in the past also played a significant role in driving US Treasury yields lower. This could help explain the observation that US bond yields have not increased significantly along with expected future increases in US policy rates during 2014, a phenomenon reminiscent of the 2004–2006 US tightening cycle. This was also evident during the Eurozone crisis of 2011/12 and again in 2014, when the ECB stepped up liquidity-provision measures and ultimately implemented QE. As a result, the 10-year Bund traded below 1,0 per cent in late 2014 and even closer to 0 per cent earlier this year. This pulled US Treasury yields lower as investors switched out of low-yielding Eurozone bonds into more attractive yielding US Treasuries.

Although some economists/analysts still believe that a Fed lift-off is possible before year-end, there remains considerable uncertainty in the broader market space regarding the timing and extent thereof. This was reinforced by the FOMC decision not to hike at the September meeting amid concerns about global developments and their impact on the US, as well as the likelihood

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[2] Bernanke Ben, Gradualism, Remarks at an economics luncheon co-sponsored by the Federal Reserve Bank of San Francisco and the University of Washington, 2004.

that inflation could dip even lower in the near future. The Fed, however, reserved the option of raising rates by year end and some FOMC members have indicated a belief that such a hike will be necessary. Therefore, the debate continues as to when conditions will warrant a lift-off. The statement from the FOMC after the conclusion of its most recent meeting yesterday suggested that the committee has downgraded its assessment of global risks and has left the door wide open for a possible move at its next meeting in December.

Monetary spill-overs to emerging-market economies

As financial markets and systems became more integrated in recent years, the monetary policy cycles of major economies also became increasingly important for EMEs. The impact from US monetary policy normalisation could transpire through two types of channels: firstly the real channel (trade), and secondly the financial channel. The real/trade channel occurs when US policy tightening is associated with an acceleration in US economic growth, with subsequent spill-overs for EMEs. However, the US economy is not expected to accelerate meaningfully; rather, US policy normalisation will consist of reducing an unusually large, and eventually no longer necessary, degree of stimulus.

In contrast to the trade channel, the much more dynamic financial channel is very important for countries like South Africa, whereby spill-overs function through three sub-channels, i.e. changes in interest rates (or yields), exchange rates and portfolio flows, which could also influence domestic credit conditions as well as other asset prices.

In terms of the interest rate channel, it is well known that South African bonds – and those of countries such as Brazil, India, and Mexico – have a strong correlation with US Treasuries, albeit inconsistent at times. This correlation was clearly evident during the “taper tantrum” when the 10-year US Treasury yield increased from 1,63 to almost 3,0 per cent and the South African 10-year benchmark bond increased from 6,58 to almost 8,0 per cent between May and August 2013. In 2014, South African bond yields also adjusted (downwards) in line with US Treasuries despite various negative domestic developments, including credit rating downgrades and the depreciation of the rand, which under normal conditions would have driven yields higher. In 2015, however, as the initial US policy rate hike was believed to be getting closer, 10-year US Treasury yields increased to around 2,50 per cent, which was mirrored by a 160 bps increase in the comparable R186 domestic bond yield. Earlier this month, however, following disappointing US payrolls data for September and other international data, the 10-year US Treasury dipped to below 2,0 per cent again, followed by a 40 bps decline in domestic bond yields.

The importance of the US interest-rate cycle for South Africa is also apparent in terms of funding costs for both the sovereign and domestic corporates. With reference to the former, the external funding costs – as reflected by JP Morgan’s Emerging Market Bond Index (or EMBI) – the spread for South African bonds over US Treasuries peaked around 460 bps by late September due to domestic factors but also in anticipation of US tightening and general risk aversion, from 350 bps a year ago. EMEs in general have experienced varying degrees of vulnerability during 2015, largely owing to negative country-specific factors, which include political uncertainty in Turkey and increasing concerns about the economic outlook for Brazil. Standard and Poor’s (S&P) downgraded Brazil’s sovereign credit rating to sub-investment grade in September 2015.

Domestic funding costs for banks in South Africa have, on the other hand, been negatively influenced by a further dynamic in the aftermath of the GFC, namely more stringent global financial regulations which are being implemented locally. With the upcoming introduction of the Net Stable Funding Ratio, the spread to Jibar of floating-rate NCDs issued by commercial banks increased significantly across all maturities, in some cases more than double the levels seen around mid-2013, as banks are forced to issue longer-term instruments.

There is a general view that financial regulatory reform, while necessary, may have had certain unintended consequences, such as limitations on banks’ proprietary trading, reducing the

willingness and ability of Primary Dealers to hold sizeable inventories of securities, which have contributed to less liquidity in the markets. This lower level of liquidity introduces new risks through an increase in market volatility that could amplify negative spill-over effects in stress situations.

Another frequently discussed challenge is that of EMEs' foreign-currency corporate borrowing in US dollars and the impact of the stronger dollar and higher yields on debt-servicing and refinancing risks. The total US dollar exposure from both bank loans and debt securities has been growing rapidly over recent years to approximately USD3,3 trillion, according to the BIS. For South Africa, this does not present a significant risk, given relatively low level of foreign liabilities of local companies and banks. However, excessive US dollar appreciation could have ramifications for highly indebted emerging markets, resulting in increased volatility and a sell-off in EM assets. This might very well spill over to other EMEs, including South Africa.

The second sub-channel, the foreign-exchange market, is probably the market that may suffer a more pronounced impact from global monetary policy normalisation. This risk was illustrated during the 2013 "taper tantrum" when the rand – together with the currencies of certain other EMEs perceived at the time to be most vulnerable (such as Brazil, India, Indonesia, and Turkey) – depreciated by more than 10 per cent against the US dollar[3]. The period that followed was characterised by increased differentiation between EMEs. During recent months, however, correlations across markets in EMEs have increased, perhaps suggesting a lower degree of investor differentiation. Against this background, currency-market volatility has increased to levels that prevailed during the Eurozone sovereign debt crisis, while EM currencies on average depreciated by 14 per cent[4].

The popular narrative tends to focus on the rand-dollar exchange rate. Given the outlook for the normalisation of monetary policy in the US, the US dollar has surprised with the magnitude and speed of its appreciation since mid-2014. This was initially triggered by the ECB's announcement of the Targeted Long-term Refinancing Operations in June 2014, amid heightened speculation of full-scale QE, which implied increased monetary policy divergence. In the meantime, expectations of the Fed's hiking cycle were also escalating, and by March 2015, the US currency had appreciated by 26 per cent on a trade-weighted basis[5] and reached US$1,05 against the euro, a level that was only expected amid actual US tightening[6]. This was the largest appreciation ever in the run-up to an interest-rate tightening cycle in the US.

The outlook for the US dollar will, to a large extent, depend on two fundamental factors: the pace of widening interest-rate differentials and the performance of the US economy relative to its major trading partners, although other factors – such as portfolio reallocation – can at times temporarily dampen the importance of these two factors, as occurred in 2014.

Therefore, actual US policy normalisation could result in further weakness in the rand against the dollar, and could also negatively impact portfolio flows by reducing the willingness of fund managers (a large share of them having US dollar liabilities) to hold unhedged positions in South African bonds and equities. This speaks to the third sub-channel, namely portfolio flows. Similar to other EMEs, portfolio inflows into South Africa declined in the aftermath of the "taper tantrum". Reserve Bank statistics show that total portfolio inflows slowed from R85 billion in 2012 to R50 billion in 2014, comprising mostly bond inflows of around R37 billion. More recent

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[3] 3 May to August 2013.

[4] According to the JP Morgan EM currency index, comprising Brazil, Chile, China, Singapore India, Hungary, Mexico, Russia, Turkey and South Africa.

[5] Mid-2014 to mid-March 2015 (Since then, however, the US dollar has depreciated marginally, but traded generally sideways.).

[6] Market analysts' models were showing that the US dollar performance was consistent with an actual 100 bps increase in the US policy rate.

data from the Central Securities Depository[7] reveals that, in the year-to-date, non-residents bought R20,1 billion worth of equities and R861 million worth of bonds, amounting to total inflows of R21,0 billion. South Africa's vulnerability to US policy tightening is augmented by our dependence on external financing to deal with the current-account deficit. South Africa is, however, not alone in this episode of asset reallocation away from EMEs, whereby portfolio inflows in 2015 are expected to fall below 2008 levels, according to the Institute of International Finance[8]. This, however, reflects a "lengthening drought" in capital flows, rather than a sudden stop.

Has divergence in monetary policy impacted investment positions in EMEs?

In the wake of the GFC, investors piled into EM equities and debt amid abundant liquidity, low interest rates and low growth in AEs. These inflows, however, did not always reflect domestic economic fundamentals, whilst the EM outlook also became increasingly uncertain over the past four years. As a result, a major concern with the Fed's upcoming tightening cycle is that global investors will further reallocate portfolios away from EM assets and back towards the US given better growth prospects, rising yields and the perception of a more secure investment environment.

A weaker exchange rate for South Africa would probably raise implied rand volatility, adding to overall risk aversion and weak sentiment towards rand-denominated assets. Although the nominal effective exchange rate of the rand was reasonably stable during 2014, relative to baskets of commodity-exporting or large EMEs, it depreciated by about 10 per cent on a trade-weighted basis during 2015 to date due to the combination of domestic and global developments already discussed.

For South Africa, the favourable impact of a weaker currency on the trade account have not been forthcoming for a few years now which is rather problematic in an international environment of volatile capital flows. While there has been some narrowing in the current-account deficit since the third quarter of 2014, it remains to be seen to what extent this represents the beginning of a sustained compression of the current account after a long period of real exchange-rate depreciation. Furthermore, a stronger US dollar tends to dampen commodity prices, with adverse implications for commodity producers like South Africa. In the second quarter of this year, however, the current-account deficit narrowed to 3,1 per cent of GDP from 6,2 per cent in the same period last year. While this narrowing is attributed in part to temporary factors, there appears to be some evidence that both export and import volumes are responding to the depreciation of the rand and the weaker economy. I have to add though that larger service receipts contributed to a narrowing of the current account. However, the Bank expects this process of adjustment to remain slow, with the export response inhibited by a number of factors including, *inter alia*, headwinds from the slowing global economy and electricity supply constraints.

Although a number of EMEs have been able to reduce their policy rates in response to the favourable impact from oil prices on inflation, this could be thwarted by developments in currency markets. This, in an environment where economic growth for emerging markets has slipped to its slowest pace since 2009 as countries battle to deal with the combined impact of a stronger dollar and weaker commodity prices. In this regard, the domestic economic outlook has also deteriorated even further as reflected by the surprise economic contraction in the second quarter of the year. Although domestic developments contributed, the downside risks to the global economic outlook have also increased on the back of a slowing Chinese economy.

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[7] Strate data up to 20 October 2015.

[8] Capital flows to emerging markets, October 2015.

On the positive side, we should remember that the beginning of the US monetary policy tightening cycle will not necessarily be bad for the world, in particular for South Africa and other EMEs, as it would indicate that the US economy is in better shape and therefore supports the global recovery. In addition, both the consensus and FOMC projections suggest that the Fed will not move to a restrictive stance anytime soon, but rather that it will merely reduce the degree of policy looseness. Finally, while policy normalisation in the US may well reduce the flow of US-based capital to EM assets, prospects for additional stimulus in the Eurozone and Japan, as well as capital outflows from China, could result in greater investments into EM from these regions, counter-balancing to some extent the impact of US tightening.

In summary, recent experience makes it quite clear that changes in AEs' monetary policies have been a key driver of developments and sentiment towards EMEs and market volatility, as the years of low interest rates and unconventional monetary policy have seen increased international exposures to EMEs.

Conclusion

In conclusion, it would appear that policy challenges and, specifically, the "divergence" between the major central banks will continue to have major bearings on emerging economies in the foreseeable future. Market strains have eased over the past few weeks, in part because of growing indications that the Federal Reserve would take the risk of a further deterioration in financial conditions in consideration before any policy decision. Nonetheless, the consensus view remains that while lift-off has been delayed, it will still happen in the not-too-distant future; and its impact on global portfolio flows and EM assets remain highly uncertain. So does the impact on the world economy and global financial markets from current or potential stimulus in the Eurozone, Japan and China.

Against, this background, it is clear that central banks cannot afford to be complacent, as the risks related to global monetary policy and macroeconomic developments remain high given the globalised nature of the world economy. This is unchartered territory, and the risks of further market turbulence are tilted to the upside. In light of possible implications for financial stability and resilience, and for domestic price developments, central banks – and the South African Reserve Bank among them – will have to exert continued and utmost vigilance.

Thank you.