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RECENT DEVELOPMENTS IN INTERNATIONAL FINANCIAL MARKETS

Keynote Address

by

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Introduction

It is indeed an honour and pleasure to have the opportunity to speak to this gathering this morning. I wish to start by thanking the organisers and, in particular, the Chairman, former Deputy Governor at the Bank of Botswana, Mr Oduetse Motshidisi, for the invitation to this Conference held in this beautiful city of Cape Town.

As many of you would be aware, while it is true that the primary mandate of any central bank is price stability, Governors have a myriad of responsibilities on a daily basis. Beyond the pre-occupation with the core mandate of monetary and financial stability, many central banks, including my own, the Bank of Botswana, have responsibility for the regulation and supervision of the banking sector; promotion of an efficient payments system; currency management; and, also, the management of foreign exchange reserves, as well as the closely related roles of economic and financial adviser to Government. Equally important are considerations such as broader financial sector development issues including financial inclusion, consumer protection and financial literacy. My comments today will reflect these mixed perspectives.

This Conference is being held in the shadow of the tenth anniversary of the onset of the Global Financial Crisis and subsequent "Great Recession". Unsurprisingly, the causes and lessons of the Crisis have been a major topic of discussion in recent months. This meeting is, therefore, taking place at possibly the most opportune time in the history of global finance. In the aftermath of this difficult episode, the world should come out the wiser.

At its recent meeting in Berlin, Germany, the Financial Stability Board Plenary observed that the international post-crisis policy reform agenda was nearly complete and that, going forward, the priority will be placed on monitoring and publicly reporting on its 24 member jurisdictions' implementation of the agreed reforms. Similarly, the recently-concluded annual Meetings of the IMF and World Bank Group noted signs of sustained global recovery, albeit not yet complete, with below-target inflation and weak wage growth in several advanced countries, while output growth remains below potential in many cases.

At the same time, it is important not to lose sight of some megatrends, in demography and technology, for example, that also have a profound impact on economic developments and, more specifically, global and domestic financial markets. In this regard, I note that 2017 is also the tenth anniversary of the iPhone, and we all know the profound impact of that development. What I wish to emphasise here is not only the importance of technological progress, but also the inherent unpredictability associated with such developments. I am informed that when the iPhone was introduced it was envisaged as little more than a combination of the mobile phone and the iPod, with a camera added. As a reflection of the random path of technological developments, the world of apps on which we increasingly depend was not central to the original concept. Also, among today's generation of "new ideas", it seems to be the potential impact of blockchain or Distributed Ledger Technology that is attracting most attention. However, as the example of the iPhone demonstrates, the future path of its development is far from clear.

The coincidence of these two tenth anniversaries is of particular relevance for global financial markets. The vulnerabilities exposed by the Crisis, and the responses they engendered, must be viewed in the context of dynamic developments in information technology. This is in terms of both emerging opportunities and accompanying threats. Here, Distributed Ledger Technology is a prominent example, not least because the technology has become intertwined with the controversial issue of cryptocurrencies. This is unfortunate, given that central banks and regulators, rightly in my view, are increasingly circumspect about digital currencies. It would be regrettable, however, if this stifled development of the underlying technology. Distributed Ledger Technology has already demonstrated sufficient potential, albeit still lacking in maturity, as the basis for more secure and efficient payments systems to attract the interest of several central banks.

Another matter of serious concern in today's financial world and markets is cybercrime. Cybercrime is not the focus for this discussion; it is, however, a major challenge of the modern age and should never be far from our thoughts. I would like to take this opportunity to appeal for concerted cooperative and collective action in meeting this challenge. In this respect, it is welcome that more than 70 percent of members of the Financial Stability Board intend to introduce new initiatives to boost cyber security in the coming year. It is to be hoped that others will follow their example.

Distinguished Ladies and Gentleman, I now wish to focus my remarks on three broad areas. First, a brief look at the domestic economy of Botswana, including the capacity to generate external foreign exchange reserves. This will highlight the growth of the domestic financial sector and the impact of the global financial crisis on the economy.

Second, from the global perspective, I will consider recent developments in financial markets and the associated policy challenges; in particular, the extended period of low yields together with heightened risks, including geopolitical risks. Again, this has major implications for effective asset/liability management.

Before concluding, I will give some consideration to the emerging challenges, where the increasingly optimistic outlook for the global economy has encouraged talk of policy "normalisation".

The Botswana Economy

In the five decades since Independence, in 1966, Botswana's economy has grown rapidly, from one of the poorest in the world to an upper-middle-income country with a per capita income of approximately seven thousand US dollars. Central to this growth has been relatively strong institutions and governance, healthy fiscal position and external balance sheet, low public debt burden and the prudent management of mineral revenues. From the mid-eighties, persistent twin fiscal and balance of payments surpluses led to rapid growth of foreign exchange reserves that, at their peak, were equivalent to almost three years of import cover. In turn, this allowed the authorities to move relatively quickly to open the economy, including the abolition of foreign exchange controls by 1999. Since 2001, both S&P Global Ratings and Moody's Investors Service have consistently assigned Botswana the highest, investment grade, sovereign ratings in Africa. On October 27, 2017, S&P Global Ratings affirmed the country's ratings of A-/A-2 for short- and long-term foreign and domestic-currency denominated debt, while revising the outlook from negative to stable. The revision of the outlook is significant as it reflects expected stable economic growth at a time when many Sub-Saharan African countries face relatively weak growth and shrinking fiscal space.

This has been a remarkably resilient development model, in combination with the Government's consistently prudent approach to fiscal management and sustainable budgeting. However, beginning in the 2000s and, in particular, since the global financial crisis, the twin surpluses have not been so reliable, with recurring fiscal and external deficits. This has implications for the management of the Government's net asset position, including balancing options for taking on more public debt vis-à-vis drawing on the accumulated national savings.

The structural transformation of the economy is also an important consideration. In the past, the model whereby foreign exchange reserves were held pending opportunities for their productive deployment in funding public infrastructure was clearly appropriate. But now, with relatively low returns on such investments, the holding of financial reserves as a sustainable source of income for both current and future generations is increasingly important.

The financial sector, too, has expanded rapidly, both in size and the range of services. In 2016, the financial and business services sector accounted for 13.6 percent of GDP, dwarfing most other non-mining private sector activity; for example, manufacturing accounted for only 5.2 percent. Over the past ten years, cumulative growth of the financial sector, in real terms, has been almost exactly 100 percent, compared to 52 percent for the economy as a whole. A major driving force in this development has been the rapid growth of the domestic pension fund industry. In the early 2000s, the Government took a decision to effectively privatise a large portion of the foreign exchange reserves through the establishment of a defined contribution pension fund scheme for the public service.

Despite its openness, the impact of the global financial crisis on the Botswana economy was relatively mild. The main negative shock was to the mining sector, but the transmission to the rest of the economy was muted, helped by government drawing on its financial savings to maintain public spending. For the financial sector, the predominantly "plain vanilla" characteristics and limited international linkages provided a shield against the worst effects, buttressed further by effective regulation and prudential supervision.

There is no room for complacency, however, as the interconnectedness of Africa with global financial markets continues to develop, encouraged by the search for yield and ample market liquidity resulting from an extended period of ultra-loose monetary policy. More generally, for the "Africa Rising" narrative to regain the much-needed momentum requires sustained recovery in global commodities markets. At the same time, increasingly stringent global regulatory requirements, especially on market conduct and financial crimes, notably the anti-money laundering and combatting of the financing of terrorism regimes, have created challenges. In this regard, a number of countries in the region have been subjected to enhanced due diligence by correspondent banks and, in general, negative perceptions among counterparties towards doing business with African banks. In response to the latter, it is clearly necessary for countries to do everything in their power to ensure that the Know Your Customer, and the Anti-Money Laundering and Combatting of the Financing of Terrorism regulations in their jurisdictions are of the highest possible standards. Adoption and effective implementation of such standards is also supportive of development of the regional markets.

Developments in Global Markets and Economic Policy Uncertainty

The extended low interest rate environment, resulting in meagre returns on international investments, was in large part the consequence of central banks' use of "unconventional" policies, such as quantitative easing and negative interest rates. But a long-term trend decline in the "neutral" rate of interest that balances economic activity also appears to have contributed.

The resulting "search for yield" has driven important developments in the asset management industry. Traditionally conservative funds (including those under the custody of central banks) have had to face up to the need to balance a cautious approach to taking on more risk with moving away from comfort zones based on high-quality fixed income debt instruments and listed equities in liquid major markets. In such circumstances, the traditional guiding mantra of "safety, liquidity, return" needs recalibration in order to retain its operational relevance.

It appears that the greatest challenge has been to balance the increasingly positive signs of global economic recovery, with uncertainty driven by geopolitical event risks. It is perhaps tempting to suggest that this has receded somewhat after a series of elections across Europe where the rise of populist parties appeared to have been halted, if not fully rebuffed. This may be too optimistic, however, as indicated by the recent Austrian elections or, perhaps, the unfolding consequences of events in Spain; the direction of Brexit or the Trump administration are also still very much unknown. The cumulative chances of a highly-unpleasant surprise from further “Black Swan” events are surely not negligible. The question would be how do investors position themselves against these risks?

Looking more closely at equities markets, in particular in the United States, there could be a legitimate concern that the current optimism is bordering on irrational exuberance shutting out evident political risk. It is of course not difficult to cite plausible reasons why equities markets should be buoyant: earnings growth, good exposure to emerging markets, low bond market yields and the prospects of tax reform, among others. However, on their own, these factors do not seem to justify market valuations where cyclically adjusted price-to-earnings ratios are at levels that fall short only of the peaks before the dotcom bubble burst in 2000 and the Great Crash in 1929.

Interest in the next market crash has been heightened by another recent anniversary: Black Monday, on October 19, 1987. Technological developments over the intervening years are, once again, a key factor and a cause for both concern and comfort. For example, there is uncertainty about how markets increasingly driven by passive funds would respond in times of stress. When investors are increasingly hard-wired into follow-ing the herd, the risk of herd-mentality sweeping the markets is likely to be amplified. On the other hand, it can be reasonably argued that improved information flows, increased diversity of investors and interconnectedness of global markets will help prevent market drift and misalignment leading to a crash. Overall, we simply do not know the likely balance of risks.

In terms of major developments in recent years that impact on financial markets, I cannot fail to note the relentless rise of China, now surely a major global player, and with the power of the current leadership amply demonstrated at the just-ended congress of the ruling Communist Party. Beyond the raw strength of the world's second largest economy, with its growth still close to 7 percent per annum, China is the technological leader in key emerging fields such as cashless payments. On the other hand, risks remain pronounced, reflecting issues of transparency, the challenging transition to a consumption-led economy based on inclusive growth and its financial system.

Its emerging status as both a source of and destination for investment is also well known. But China remains something of an enigma to investors, who must aim to chart a prudent path between the opportunities and challenges. Moreover, with its currency now included in the Special Drawing Rights of the IMF, and as Renminbi assets increasingly gain acceptance as part of mainstream benchmark indices, this is a challenge that is increasingly difficult to avoid.

The Emerging Challenges of "Policy" Normalisation

As I mentioned earlier, the recent IMF and World Bank Annual Meetings noted improved global growth, spread broadly over both developed and emerging economies, as well as reduced market turbulence. Importantly, growth in world trade has also resumed after a period of stagnation. Moreover, it was pleasing that this optimism was tempered by realism, including warnings of continuing underlying risk from several quarters. Equally important was the call to use this window of opportunity, of the relatively benign prevailing conditions, to "fix the roof", including undertaking the much-needed structural reforms. In particular, in many countries debt remains at worrying high levels, with potentially negative consequences for continued financial stability. Nonetheless, this "recovery" phase poses a new range of challenges to policymakers, with significant implications for developments in the global financial markets. Here I shall briefly mention a few.

First, what will constitute the new normal for monetary policy is far from obvious. Recent pronouncements by leading central bankers have hardly provided much light in this respect, reflecting, in part, the fear that clarity will result in further market "tantrums". More fundamentally, although I would stop short at labelling this, like the Financial Times, a "crisis of confidence" for central banks, there is a need for a frank discussion on the robustness of the models used to guide monetary policy decisions. In particular, whether the long-standing reliance on the Philips Curve paradigm is still justified; but also the need to effectively integrate financial indicators into the modeling process.

Second, the role of fiscal policy requires careful consideration. At least with hindsight, it does seem that there is a strong case that the retreat to unswerving fiscal austerity added to the negative impact of the 2007-08 global crisis. However, the underlying reasons for fiscal caution still resonate. This dilemma was well summarised in the recent communique from the IMF, which noted that "Fiscal policy should be used flexibly and be growth-friendly, while enhancing resilience, avoiding pro-cyclicality, and ensuring that public debt as a share of Gross Domestic Product is on a sustainable path". This is a tricky combination of requirements to meet simultaneously.

In terms of major policy issues, the need for financial sector reforms and smart regulation is also significant. At the epicentre of the global financial crisis were deregulation, weaknesses in banking system governance structures and erosion of fiduciary responsibility and trust. The lesson to be learned, in this regard, is that strong micro-foundations of a financial system, especially banks, are of crucial importance at both national and international levels. That is why, for example, the Financial Stability Board was established; banking supervisory and regulatory regimes strengthened in many jurisdictions; and capital adequacy and liquidity requirements extensively reviewed. But, as I indicated earlier, the Financial Stability Board recognises that, while the policy design is nearly complete and the new rule books are in place, this is not sufficient. Hence, it is necessary to now turn towards effective implementation. In the context of an integrated and globalised financial system, this requires effective coordination, collaboration and communication, not only among the 24 member jurisdictions of the Financial Stability Board, but also by including more effectively countries such as ours in Sub-Saharan Africa. For example, the unintended consequences of the global reform agenda, such as the global de-risking and withdrawal of correspondent banking relationships, requires urgent attention. I should mention that, in my capacity as Co-Chairperson of the Financial Stability Board Regional Consultative Group for Sub-Saharan Africa, I hope to have greater focus on these issues.

Conclusion

Distinguished Ladies and Gentlemen, in concluding, I remind you that the saying "may you live in interesting times" is reputedly an old Chinese curse. To the extent that the past decade has certainly been "interesting", the continued challenge to policymakers is to make life at least a little bit boring, while not repeating the mistakes of the past.

On a more positive note, despite the recent pushback by the supporters of economic nationalism, the fundamental driving forces of globalisation are not reversible. Nor is it desirable that they should be, given the extent to which they have contributed to global poverty reduction. However, the globalised economy is a source of not just tremendous opportunities, even for conservative investors, but additional risks and associated costs of mitigation. These include the potential for various levels of contagion, as indicated by both the experience of the global financial crisis and the rise of cybercrime which, as I indicated my remarks, is an increasingly global phenomenon. No central bank Governor, wealth or fund manager can afford to act as if they are immune from such risks.

Distinguished Ladies and Gentlemen, I thank you for your kind attention.