South African Reserve Bank

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The global backdrop and monetary policy in emerging markets

Introduction

Ladies and gentlemen, good afternoon.

Thank you to BNP Paribas for allowing me the honour to deliver the opening keynote address at this prestigious gathering of global official institutions.

Also allow me to commend the organisers of this event for their foresight in coming up with diverse and well-balanced topics that have risen to the top of the global agenda.

There is no doubt in my mind that, at the present moment, uncertainty in the global macroeconomic environment, including rising geopolitical uncertainties, elevated trade tensions and rising debt levels, dominate the discussions of most global investors and policymakers.

In my remarks today, I will discuss the implications of these developments for emerging market economies and the possibility of further risk from market volatility, before I conclude by touching on the policy options at our disposal to navigate through these rather turbulent times.

An uncertain global economic environment

Investors and policymakers alike have had a nervous last few months. It is often said that expansions do not die of old age. Yet, as they lengthen in duration, reaching near-record periods in some cases, observers increasingly worry about whether the trigger of the eventual downturn is already there. Are we in such a case at present?

In his foreword to *Global Economic Prospects* published earlier this month, World Bank President David Malpass writes that 'global growth has continued to weaken and momentum remains fragile'[1]. Compared to its January forecast, the World Bank has this month downgraded its forecast for global growth in 2019 by 0.3 percentage points to 2.6%. Furthermore, it sees only a mild recovery ahead, to 2.8% by 2021. Revisions to this year's forecasts are broad-based, across both advanced and emerging economies. Private sector consensus forecasts have similarly been scaled down in recent months.

In some countries, a moderation was expected after the strong momentum observed in late 2017 and early 2018. In the United States (US), for instance, economists anticipated that the boost to private spending from the fiscal stimulus of the first half of 2018 would eventually fade. This has indeed happened, although the US economy remained dynamic at the start of 2019, rising by a surprisingly strong 3.1% when annualised, despite a temporary shutdown of government services.

But the deceleration in other countries, amid a slowdown in global trade flows, surprised many by its magnitude. The eurozone slowed from 2.4% in 2017 to 1.8% last year, as weakening exports to Asia, the United Kingdom (UK) and Eastern Europe took a toll on business confidence. The World Bank now only expects a 1.2% increase in the eurozone's gross domestic product (GDP) this year. China has also lost momentum, as earlier policy tightening curtailed lending by the non-bank financial sector and the tariff increases of 2018 weighed on exports.

By late 2018, these negative economic surprises had reached levels ample enough to trigger a bout of risk aversion in financial markets, which particularly affected equities

[1] Media Call on the June 2019 Global Economic Prospects Report, World Bank Group, Washington DC, United States

and corporate bonds (although emerging market currencies and fixed-income markets were relatively sheltered). Global financial conditions tightened. This tightening, however, proved short-lived, as the continuation of benign (and, in some cases, soft) inflation developments allowed major central banks to pause, or delay, the start of their normalisation process. In the US, in particular, indications by the Federal Reserve (Fed) that it could be patient before making any policy decisions helped equities and corporate bonds to recover their earlier losses.

Nonetheless, many threats to global expansion remain unresolved, and in some cases risks previously identified have begun to materialise. First and foremost among these are the trade tensions between some of the world's major economies. In the wake of the recent increases in US tariffs on selected Chinese imports, and in light of the potential for broader tariff increases, analysts are already anticipating a bigger drag on global growth from what increasingly looks like a protracted trade conflict. In its most recent Surveillance Note for the G20 Finance Ministers and Central Bank Governors, for the meetings in Fukuoka, Japan, 10 days ago, the IMF noted these additional tariffs would "dampen trade and weigh on confidence and financial sentiment, adversely impacting investment and productivity and growth."

Separately, the UK's Parliament is struggling to agree on the terms for leaving the European Union, with negative consequences for growth and investment and some spillovers to continental Europe. Financial markets have displayed sensitivity to these developments.

At the same time, a number of geopolitical tensions continue to simmer, especially between Iran, the US and its Middle East allies.

While the G20 observed that global growth appears to be stabilising more recently and may pick up into 2020, downside risks overall are still perceived to be tilted to the downside.

What does this backdrop imply for emerging markets?

Against such a global backdrop, emerging countries are facing conflicting pressures. And the experience of the past 15 months shows that it is not just the monetary policy path in the major economies, but also the divergences (or not) between these policies, that can have major consequences for emerging markets.

At first, and for a large part of 2018, an ever-widening growth gap between the US economy and its major partners, coupled with budding trade tensions, boosted the US dollar. The Fed continued to normalise policy rate levels while other major central banks stayed put. The resulting widening in the interest rate divergence in favour of the US contributed to dollar appreciation.

The mix of rising US interest rates, a stronger dollar and overweight investor positions (at the time) in the so-called ‘risky assets’ weighed on the currencies and bonds of those emerging markets that exhibited frail external and fiscal balances. Specifically, financial stress in Argentina and Turkey, amid the need to roll over a large amount of short-term debts and a de-anchoring of inflation expectations, precipitated a sell-off in emerging market assets, although with important differentiation across countries.

The situation changed in the fourth quarter of 2018, when indications of slowing economic activity in the US led financial markets to anticipate lesser tightening by the Fed, resulting in some downward pressure on the dollar and a decline in US Treasury yields. The prevailing mix allowed for some recovery in emerging market assets and a resumption of capital flows to these countries. Additional factors also helped, including the decline in oil prices, the tightening of monetary policy in a large number of emerging countries that had restored wider rate differentials with the advanced economies, and, in several countries, a lesser-than-feared pickup in inflation in response to currency depreciation.

During the early stages of this year, we have seen a significant change in monetary policy forward guidance given by major central banks, the Fed and ECB in particular, which delivered some easing of financial conditions, particularly in advanced economies, but in emerging markets as well, although to a lesser degree.

Yet the situation remains fluid, as illustrated by the recent downward pressure on emerging currencies in response to the renewed flare-up in trade tensions – even if, again, rising market expectations of lower US interest rates are cushioning the blow.

In summary, the last few years have continued to teach us that, in a world of open capital accounts and elevated debt levels, global capital flows display cycles that remain heavily influenced by the monetary policy of the advanced economies. Furthermore, the Fed retains its key role in driving these flows, owing to the dollar's role as a funding currency for both portfolio flows and bank loans. Indeed, the desynchronisation of policy cycles between the Fed and other major central banks can accentuate the capital flow cycle, especially if it leads to dollar appreciation.

That said, cross-border investors and lenders continue to differentiate between specific emerging markets. Those with elevated foreign exchange (FX) liabilities, twin deficits and poorly anchored inflation expectations remain the most vulnerable.

Looking ahead, the relative synchronisation of major economies' central banks, insofar as they all experience a lack of inflation pressures, provides some reason for optimism, as does the success of these central banks in reversing the undue tightening of financial conditions in late 2018. However, any indications that the advanced economies are slowing faster than expected as risks materialise could trigger renewed capital outflows from the emerging markets.

Additional risks from geopolitical uncertainties and trade tensions

Allow me to briefly discuss, albeit in more detail, how trade tensions, and more generally geopolitical uncertainties, can affect the environment for emerging markets.

Countries with open capital markets and floating currencies are exposed to swings in the international perceptions of risk – and the factors I have mentioned influence these perceptions. Hence, even if a specific emerging country is not directly exposed to higher tariffs, or if it is not in the region where a geopolitical issue is flaring up, it can experience capital outflows as investors will require a higher premium on its assets.

There are more direct channels through which emerging markets can be affected by geopolitical issues. These include, of course, upward pressure in oil prices. We saw, up to a few weeks ago, that tensions in the Persian Gulf were keeping the price of crude elevated, even as global growth showed signs of slowing.

In addition, business confidence will typically suffer if the geopolitical tension affects prospects for trade with the region concerned. If the endgame is military conflict and infrastructure destruction, a consequence will be migratory flows. These, if uncontrolled, can cause both fiscal pressures and socio-political tensions in the country receiving the displaced populations.

Finally, conflict can also increase the cost of, and the potential restrictions to, international merchandise trade, for instance if it affects an area that is important for maritime traffic.

Of course, we talk here of linkages that relate to ‘severe’ geopolitical events like conflicts – and there is thankfully no certainty that these will happen. Nonetheless, emerging countries have also in the past been affected by ‘milder’ events that weigh on global demand and make investors less willing to increase exposure to the ‘riskier’ emerging market assets.

As far as trade tensions are concerned, negative consequences for emerging markets will emerge if these countries are involved in specific stages of the affected global value chains, or if they export commodities that are used at the beginning of these value chains.

The IMF G20 Surveillance note mentioned earlier indicated that based on simulations conducted by the IMF, recently announced tariffs, together with previously announced ones, could reduce global GDP by 0.5 per cent in 2020.

Are emerging economies at risk of further market volatility?

This leads me to addressing the issue of how emerging countries can navigate the current turbulent waters, and in particular how they can deal with potential financial market volatility.

As I have argued earlier: the experience of the last year shows that portfolio investors and other lenders, including banks, do differentiate between emerging markets, largely according to the strength of their macroeconomic and policy fundamentals. For instance, while currencies like the Argentinian peso and the Turkish lira depreciated by 48% and 32% versus the US dollar in the first 10 months of 2018 respectively, others barely depreciated, losing less than 5% over the same period (such Thai baht, Malaysian ringgit or Peruvian sol). These discrepancies illustrate the major influence of external and fiscal imbalances (the proverbial 'twin deficits'), as well as the degree of endogenous inflation dynamics in response to external shocks.

Does this mean that emerging market assets will again experience widespread differences in performance this year and the next? While such a risk is indeed elevated, several factors should nonetheless help to insulate these markets better than in earlier crises.

First, most emerging countries enjoy better coverage ratios from their FX reserves, even if historical experience reveals that, when other fundamentals are weak, high reserves may not offer much protection against market volatility.

Second, inflation expectations now appear better anchored in a broad range of emerging countries, as a direct consequence of the growing credibility of inflation-targeting regimes. In several cases, public debt is also better managed than in the past, with countries extending the average maturity of their debt and increasingly relying on local currency-denominated issues.

Finally, the real effective exchange rates appear to be mostly fairly valued or even undervalued after their widespread depreciation in 2018.

This said, endogenous sources of vulnerability to future global market turbulence still exist in emerging countries. They need to be addressed if future bouts of local market volatility are to reduce in both size and duration. I would like to mention, in particular, the growing indebtedness of the corporate sector and, to a lesser extent, also of the household and government sectors, which means that, for most of the emerging countries, total debt (public plus private) is now well in excess of the levels that prevailed before the global financial crisis.

Similarly, an increase in FX liabilities (mostly by the private sector) and, in several cases, growing mismatches between FX-denominated assets and liabilities poses risks in some countries. Indeed, even if there is no such mismatch at present, the levels of both FX assets and liabilities are often large relative to GDP, which means that any changes in valuations can quickly generate important swings in a country's net international investment position.

Finally, the experience of South Africa also highlights the dangers linked to an increased financial fragility of state-owned enterprises (SOEs), as the hard-currency liabilities of SOEs can rise quickly, eventually turning into additional credit risks for the sovereign.

Policy options to deal with turbulent times

In the beginning of these remarks, I pointed to the support which emerging market currencies and fixed-income assets have received from the rising expectations of US interest rate declines and the fall in long-term bond yields, both in the US and in other advanced economies. Such developments ensure that the yield differentials between emerging countries and their advanced counterparts remain relatively wide, offering some buffer against capital outflows. However, this equilibrium is fragile. If the world economy proves more resilient than expected, bond yields can easily reverse part of their recent decline, especially if the recent US inflation softness proves transitory, as most economists indeed anticipate. Conversely, if global growth data surprise on the downside, emerging markets could suffer from a 'flight to safety' and renewed appreciation of the US dollar.

Last year's events, just like the 'taper tantrum' of 2013 or the 'investment recession' of 2016, show that if global financial conditions become less favourable, all the emerging countries will be affected to some extent, although those with stronger fundamentals will show greater resilience. Building resilience thus appears to be a necessary task for governments and central banks alike. In particular, it is important to ensure that inflation expectations remain well anchored and that, as a consequence, the lower exchange rate pass-through to inflation observed in the recent cycle remains the norm.

But authorities should also keep the growth in FX-denominated liabilities under control, so as to allow exchange rate depreciation to play its role as an ‘adjustment variable’ and minimise any impacts from external currency and asset price shifts onto private sector balance sheets. They also have the option of using the available macroprudential tools should conflicts emerge between the respective goals of price and financial stability, including risks to these balance sheets.

Resilience also depends on limiting dependence on foreign capital to meet domestic funding needs. It is therefore important for governments to ensure, through a mix of prudent fiscal policies and an environment that is conducive for private savings, the absence of any major mismatches between the domestic supply and demand of debt securities. Hence, when non-residents eventually reduce their bond holdings, these net sales will be more easily absorbed by domestic investors, and the domestic market for securities will remain liquid. Appropriate, sophisticated market tools to hedge against currency and interest rate risk can only help in the deepening of domestic markets.

These tools I have just mentioned deal more specifically with currency- and capital flow-related risks. Nonetheless, the list is not exhaustive. Resilience also depends on the way in which investors perceive the institutional and governance quality of the recipient country, the existence of checks and balances, and the depth and quality of its political debate. And, as South Africa’s experience shows, financial resilience also depends on real economic resilience. South Africa’s inflation expectations may be better anchored than they were in the past, its FX liabilities may be relatively low, its banking sector may be solid, and its domestic capital markets may be deep and liquid. Yet it’s domestic GDP growth performance has been weak, contributing to relatively high fiscal and current account deficits and a relative vulnerability of South African assets.

Consequently, emerging market policymakers should also focus on measures that increase the ability of domestic private agents to adjust to external shocks, including the mobility of labour and capital across sectors. These measures include lowering the constraints to doing business, creating opportunities for laid-off workers to 'retrain' and find jobs in alternative industries, ensuring that infrastructure is appropriate for business to respond to relative price shifts, and allowing for sufficient economic and export diversification. This way, heavy reliance on specific commodities, markets or segments of value chains will not become a major risk if those particular sectors face global shocks.

Conclusion

In conclusion, let me again point out that while the global environment remains challenging for investors and policymakers alike, much progress has been made over the years to better insulate the emerging economies from unavoidable global shocks, and authorities have additional tools at their disposal to increase that resilience over the medium to long term.

Central banks can also play their part in the build-up of that resilience, both through the execution of their price and financial stability mandate, and through their management of official reserves – even though the current low-yield environment makes it difficult to earn good returns on their financial assets.

But central banks also face limitations in what they can achieve.

Strengthening a country's economic and financial architecture is everybody's task.

Thank you.