South African Reserve Bank

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Emerging market economies in a new global cycle

1. Introduction

Ladies and gentlemen, good afternoon.

Let me start by thanking the Central Reserve Bank of Peru and the Reinventing Bretton Woods Committee for the opportunity to participate in this conference on the highly relevant topic of how a changing global economic cycle might impact emerging market economies.

The near-decade since the global financial crisis has brought with it an unprecedented financial environment for emerging countries. The financial characteristics of this evolving cycle of globalisation as well as the challenges and benefits it poses to emerging market economies indeed deserve our attention, especially against the background of an environment in which the benefits of multilateralism are being questioned by some, when in fact the role of international institutions and regional financial cooperation should be intensified.

2. The financial characteristics of a new global cycle

Policy rates in the United States (US) remained at around zero from late 2008 to late 2015, and even today they are 1.7 percentage points below their average of the past 25 years. In Japan, the eurozone and several other European economies, the policy rates remain near or below zero. Following several phases of quantitative easing, the balance sheets of the US Federal Reserve, the European Central Bank, the Bank of Japan and the Bank of England currently account for almost 38% of their respective country's gross domestic product (GDP), versus 10% in June 2007. Such accommodative policies have compressed long-term interest rates and financial risk premiums, with spillover effects of strong portfolio inflows and downward pressure on domestic real yields enjoyed by emerging market economies. South Africa was no exception; in the period between 2009 and 2016, non-resident portfolio inflows averaged 3.9% of GDP, versus 2.4% in the previous 20 years, fully funding a wider current account deficit and contributing to a compression of average real yields on government debt.[1]

Yet this environment may be about to change. The gradual fading of economic slack in the advanced economies raises legitimate questions about whether the current degree of global monetary stimulus remains appropriate, and indeed a number of central banks in advanced economies have signalled intentions to move from their current highly accommodative monetary policy stances. Policy rates in most of the advanced economies could eventually follow the US path towards gradual normalisation, and central bank balance sheets could probably decline to levels more consistent with 'normal' central banking operations. Such steps may well raise the real long-term interest rates to levels more in line with economic fundamentals, especially as budget austerity has faded in most of these economies.

Should this happen, emerging countries may start finding easy and cheap external financing less forthcoming. Currently, cross-border bank flows from advanced economies into the emerging world are already experiencing headwinds from a

[1] Deflated by CPI inflation, South African 10-year government bond yields in the past five years averaged 2.55%, about 35 basis points less than the average of the previous 10 years – this is despite the gradual deterioration in South Africa's sovereign credit rating in recent years.

tighter regulatory environment, which has generally led banks to reduce risk exposure and place greater focus on the domestic business.[2] A situation where emerging countries have to compete harder for international capital could be another element in the broader picture of 'reduced globalisation'.

3. Another step towards lesser globalisation?

According to the World Bank, trade in goods and services as a share of GDP has generally been declining post-crisis. For sub-Saharan Africa, in particular, it had fallen as low as 55% of GDP in 2015 from 74% in 2008. While cyclical weakness in import-intensive fixed investment growth accounts, to some extent, for this partial reversal of earlier trends, other – more structural – factors are also at play. These include the sharp slowdown in the expansion of global value chains (GVCs) as the number of trade protection measures put in place across the world now tends to exceed that of liberalising measures.[3] At the same time, current political trends in some advanced economies make the imposition of restrictions on migratory flows more likely.

To some extent, the challenges of attracting capital from advanced economies could be compared to the slowing growth in GVCs. In the late 1990s and early 2000s, the growing development of securities markets in emerging countries, the further deregulation of the insurance and pension fund industries in advanced economies as well as a reduced 'home bias' by international investors all contributed to a structural rise in the global portfolio allocation to emerging market assets. The monetary policies implemented after the global financial crisis exacerbated that trend, but this structural shift appears to have now run its course.

4. Potential challenges and benefits

A slower pace of globalisation, let alone the reversal of some of its aspects, will no doubt bring challenges to many emerging countries. In an environment where

[2] According to Bank for International Settlements data, cross-border claims of all reporting banks to emerging and developing economies rose from US$1.65 trillion (4.9% of world GDP) in 2000 to a peak of US$4.0 trillion (6.3% of GDP) at the start of 2008, but then fell back to US$3.7 trillion (4.9% of GDP) at the end of 2016.

[3] See 'The future of globalisation', Barclays *Economic Research* 2 March 2017.

international trade may no longer grow as a share of GDP, countries which had followed an export-orientated development model are probably most exposed. Also exposed are countries which had benefitted from strong integration in GVCs. At the same time, countries that run structural current account deficits, and hence rely on capital inflows to finance their investment growth, are exposed to reduced financial globalisation.

Sub-Saharan African countries, including South Africa, partly ‘missed out’ on the inclusion in GVCs, with their exports still largely dominated by raw or less-transformed commodities. This may leave them relatively sheltered from protectionist measures, especially as they do not run large external imbalances with advanced economies, the US in particular. Yet this is no cause for complacency: growth models are also changing in some large emerging economies, potentially reducing their relative demand for commodities.

For example, South Africa’s exports to Asia grew by an average of 13% per annum in the past 15 years, a move mostly driven by these countries’ surging appetite for commodities, which is likely to ease as they reach higher levels of development. Against such a challenging global backdrop, many of South Africa’s structural issues – notably its poor competitiveness in non-commodity exports, its inability to absorb a large part of the workforce, and its dependency on high value-added imports – stress the need for an increased focus on implementing structural reforms.

However, it need not all be gloom and doom for emerging economies. A new global growth model could also bring opportunities to emerging countries – provided that they are properly exploited. Monetary policy normalisation in advanced economies could end up reducing the elevated sensitivity of financial conditions in specific emerging economies to their global counterparts.[4] In market parlance this is often referred to as ‘risk on, risk off’ behaviour – and while this facilitates external financing in periods of elevated risk appetite, it can also reduce domestic policy autonomy. In fact, in a world where more conventional monetary policies are in place, financial risk may be priced more accurately, resulting in proper market rewards for good policies

[4] See ‘Are countries losing control of domestic financial conditions?’ in the *Global Financial Stability Report,* published by the International Monetary Fund in April 2017.

– an incentive for policymakers to implement prudent policies. A reduced role for cross-border capital flows, or a lower level of dependency, could also provide more protection for emerging markets in periods of a global crisis, as it would reduce the risk that advanced economies' fund managers and banks would withdraw their investments or loans in a rush. In fact, this might greatly reduce the risk of financial crises, as international financial exposure is managed in a more risk-conscious manner.

At the same time, a lesser degree of financial globalisation could help to reduce global imbalances. Sizeable cross-border reallocation of capital allowed the persistence of large current account deficits or surpluses in some countries which posed threats to global financial stability. In some countries, capital inflows have exceeded financing needs, and are either being recycled into excessive domestic credit growth or forcing authorities to accumulate sizeable and costly foreign exchange reserves. In other countries, large deficits fuelled strong increases in external liabilities, endangering macroeconomic stability and putting sovereign ratings at risk.

5. Role of international organisations and regional financial cooperation

It is important, however, to recognise that the optimal economic development of emerging countries is still likely to require access to international financial markets. However, these countries may increasingly have to seek such opportunities within the emerging region itself. With regard to financial coordination, there are two issues that have a strong bearing on vulnerabilities in the international financial architecture that require global action from international organisations such as the International Monetary Fund (IMF) and forums such as the G20.

The first issue relates to the management of capital flows. The gradual liberalisation of capital flows in countries with large external surpluses provides additional scope for the foreign financing of emerging economies. However, excessively volatile capital flows and the related spillover effects remain key concerns for many emerging market economies. In instances where these are accompanied by increased credit extension and posing a threat of increased financial stability risk, a sharp focus on the management of systemic risks is of importance. In assisting countries to deal with the unintended consequences of these excessive capital flows in a manner that promotes sound policies and strong frameworks – including monetary policy and exchange rate flexibility – as the first line of defence against excessive capital flows, the IMF published a guidance paper titled "The liberalization and management of capital flows: An institutional view [5]". South Africa's approach to capital flow management has been broadly in line with the IMF's institutional view. We have adopted a relatively hands-off approach to managing capital inflows, allowing the exchange rate to act at as a shock-absorber, while monetary policy is not focused on the exchange rate but rather on the possible inflationary implications of exchange rate movements.

As you know, the Organisation for Economic Co-operation and Development (OECD) is currently reviewing its Code of Liberalisation of Capital Movements (Code). The IMF is also participating in the review of the OECD Code. Continued cooperation between the IMF and the OECD remains crucial for addressing any perception that countries might receive seemingly conflicting signals, or policy advice, regarding the appropriateness of capital flow measures. Additionally, the support from the IMF through the establishment of the Data Gaps Initiative framework, aimed at supporting enhanced policy analysis of risk in the financial sector as well as an analysis of vulnerabilities, interconnections and spillovers, including cross-border risks, promises to be of great use.

Let me now address the second issue, which has to do with the adequacy of the global financial safety net (GFSN) at national, bilateral, regional and global level. Members of the G20 have agreed to collaborate closely to advance cooperation and form consistent policy stances with the aim of advancing structural reforms, fostering economic resilience, promoting infrastructure investment, and promoting the stability of the international financial architecture – all to enforce stronger, more sustainable, more balanced, and more inclusive growth.

[5] IMF Policy Paper, 14 November 2012. "The liberalization and management of capital flows: An institutional view"

In this regard, the IMF could assist by applying a consistent approach to the monitoring and surveillance of countries to help identify potential risks and shocks that could emanate from the global financial system. The G20 Hamburg Action plan called on “the IMF to further enhance the effectiveness of its lending toolkit in line with its mandate, including considerations on a new short-term liquidity instrument and a new non-financial policy cooperation instrument”, and I understand that this work is receiving attention at the highest level in the IMF. An improvement in the IMF policy toolkit and financing instruments would assist in closing the gaps in the financial system and, in so doing, assist with improving the resilience of economies to exogenous shocks.

The IMF and regional institutions in Africa should further explore ways to improve access for African countries to the GFSN beyond what is available at multilateral financial institutions.

The importance of regional financing arrangements (RFAs) remains key to strengthening the GFSN, and they provide multilateral insurance properties of a different nature to the safety net. However, there is a need for African countries to work together with the IMF in developing RFA facilities in the region.

6. Conclusion

In conclusion, the new global cycle, partly characterised by normalisation in the global financial markets after a prolonged period of a low interest rate environment and reforms in the banking sector, harbours both challenges and opportunities for emerging market economies. The interconnectedness and interdependencies of our economies makes international cooperation indispensable, and the rhetoric around trade protectionism and pushback against multilateralism is occurring at a time when we can least afford it. However, any success in international cooperation will only be achieved if it is built on maintaining macroeconomic policy discipline and strengthening the depth and regulation of financial markets at individual county level.

Thank you for your attention.