South African Reserve Bank

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at the National Asset and Liability Management Conference

London
2 March 2018

Challenges for emerging-market central banks

Good morning, ladies and gentlemen, and thank you for the opportunity to address you on some of the challenges facing emerging-market central banks.

Since the most recent global financial crisis, central banks have faced mounting challenges. Not only were they at the forefront of saving the global economy from collapse; they were also seen as 'the only game in town' in restoring economic growth. Central banks also began to play a more pivotal role in ensuring financial stability in general. With these additional responsibilities and expectations, the independence of central banks became increasingly questioned, as financial regulation is considered by some to be primarily political in nature rather than technical.

The economic dimension to independence is also of importance, particularly in emerging-market economies.

My remarks today will focus on these two dimensions of independence and will consider the extent to which emerging markets have increased their resilience in recent years.

Political independence

The case for central-bank independence is based on the time inconsistency argument that politicians promise low inflation but are tempted to go for higher growth through expansionary monetary policies. An independent central bank, with a clear mandate to maintain price stability and without the concerns of the electoral cycle, is better-placed to focus on and achieve price stability.

The problem of ceding enormous power to unelected officials in democratic societies is solved by distinguishing between goal independence and operational independence. In many countries, central banks have been granted the latter form of independence. This distinction accords neatly with an inflation-targeting framework, where the goal of monetary policy – the inflation target – is set by law or by the elected government, and the central bank has to implement monetary policy and achieve the inflation target without political interference.

Pressures on central banks to use monetary policy to stimulate growth are not new. It is generally accepted among central bankers that while monetary policy can affect cyclical growth, its ability to determine longer-term potential output is limited. Since the global financial crisis, we have seen the potential output estimates in many countries being revised downwards. And while the need for structural reforms has been very clear in many countries too, the focus has been on monetary policy to sustain a growth recovery.

Concerted central-bank actions were probably successful in preventing a full-blown global depression, but their ability to bring about a growth recovery was less certain. There were, at times, excessively high expectations as to what monetary policy could achieve with respect to growth, and failure in this respect had the potential to undermine the credibility and legitimacy of monetary policy in general. In the event, recovery has taken some time, and it is only now that we are seeing a return to 'normal' growth rates on a sustainable basis. We have yet to see if the massive expansion of balance sheets and the high levels of liquidity generated by low interest rates and quantitative easing will ultimately lead to the high inflation that some have feared. While this is unlikely, it remains a risk.

The global crisis originated in the financial sector and subsequently required a rethinking of the role of central banks with respect to financial stability. Prior to the crisis, this responsibility was often not explicitly part of central-bank mandates. Since then, much has changed. And while there are differing approaches among countries, the tendency has increasingly been to locate this responsibility within central banks.

A financial-stability mandate becomes more complex when dealing with the issue of independence, as it does not fit neatly into the ‘goal versus operational independence’ dichotomy. What constitutes financial-stability goals is less clear-cut than in the case of monetary policy. In addition, the policies that are available to achieve or maintain financial stability often require cooperation and coordination between various regulatory authorities, including, at times, the fiscal authorities. A challenge for central banks is ensuring that monetary-policy independence is not undermined in the process. This is particularly the case in the event of conflicts between competing objectives.

Furthermore, macroprudential policies – for example caps on loan-to-value and loan-to-income ratios and criteria for loan eligibility – often have a more visible distributional dimension, and financial-sector lobbies and interest groups are usually strong. As a consequence, central banks have unwittingly been thrust more squarely into the political realm. As their responsibility for financial stability increases, central banks could become increasingly politicized, more so than in the case of monetary policy. Macroprudential policies are often likened to taking the punchbowl away just as the party is starting. Such actions are never popular.

If independence is to be maintained, central banks need to foster the political consensus that underpins independence. This requires even greater transparency and accountability than in the case of monetary policy. Central banks also need to have the courage and political backing to make tough calls. There is always the danger that unhappiness with central-bank actions in the financial-stability field could undermine the credibility and legitimacy with respect to their core mandate of price stability.

The issue of independence can also be related to central-bank balance sheets, which were brought under greater scrutiny in the wake of the global financial crisis. The balance sheets in the advanced economies expanded dramatically following the extraordinary monetary-policy measures undertaken in those economies. As I will elaborate on a little later, these actions also had implications for the balance sheets of central banks in the emerging markets.

It is generally agreed that central banks should not be too concerned about incurring losses or making profits on their balance sheets. These should be regarded as part of the broader government budget constraint. Furthermore, central banks do not have a profit motive but act in the broader interest of the economy. However, central banks that incur continuous losses may ultimately require recapitalization by government and may consequently bring themselves under greater political scrutiny. These issues could divert attention from their core mandate.

The South African experience is perhaps instructive – although not unlike the problems faced by other emerging markets. The South African Reserve Bank recorded losses for five consecutive years from 2010, mainly attributable to reserve-accumulation activities. As capital flows to the emerging markets expanded as the search for yield intensified, many central banks attempted to ameliorate the impact on their currencies by buying reserves.

In South Africa's case, we stepped up reserve accumulation – not to influence the currency, but rather to add to what we considered to be a suboptimal level of reserves.

Whatever the motive, the impact on profitability is the same. With interest rates at the lower bound in the advanced economies and typically significantly higher in the emerging markets, sterilization activities were conducted at a loss. Countries differ as to how they treat these losses, and the preferred approach often depends on legal frameworks and institutional structures. It can, however, in some instances raise questions about central-bank activities, as they are often seen as 'losing taxpayers' money' and putting independence at risk.

Monetary-policy independence

While the political dimension of independence remains an ongoing challenge, the issue of monetary-policy independence in the emerging markets has come to the fore again recently. This is against a backdrop of what appears to be a turning point for global financial markets, following an extended period of low volatility and low interest rates in the advanced economies and an absence of inflation pressures. For some time now, the world has been anticipating interest-rate normalization in the United States (US) in particular. To date, this has been happening at a very slow and measured pace, and has been well communicated.

Over the past few weeks, global financial markets have reacted to the prospect of tighter-than-expected monetary-policy settings in the US. There was a widespread market reaction to the sharp drop in US equity prices and a large spike in the VIX. After the initial bout of volatility, the markets appear to have stabilised somewhat, but they remain vulnerable to further changes in sentiment and perceptions of risk. It does seem, however, that the prolonged period of easy money and highly liquid markets may be coming to an end, raising concerns about spillovers to the emerging markets who, as usual, are the innocent bystanders.

The current turbulence in global financial markets coupled with the return of volatility is in some ways reminiscent of the so-called ‘taper tantrum’ of 2013. After a number of years of interest rates at the zero bound and quantitative easing, the world suddenly faced the prospect of a withdrawal of stimulus. The mere suggestion that the Federal Reserve System (Fed) was considering a reduction in quantitative easing hit the financial markets hard. Long bond yields ratcheted up in the US, raising fears that the nascent growth recovery would be reversed. In the event, the Fed had to allay fears of an excessively tight policy cycle and, in reality, what tightening has occurred since then has been very moderate and well communicated.

But while there are similarities to the taper tantrum, there are important differences as well. At that stage, it was only the US that was looking to tighten policy. Today, the cycle is more synchronised. There are expectations for a more aggressive tightening cycle in the US than had previously been priced in, and further interest-rate increases are expected in the United Kingdom. In addition, the European Central Bank is beginning a gradual withdrawal of stimulus. Monetary policy in Japan is, however, expected to remain highly accommodative.

A further important difference between then and now is that, after a number of false starts, the growth recovery in the advanced economies appears to be more entrenched and broad-based. This will be positive for the emerging markets.

There are also tentative signs that inflation may be on the rise as well, and the likely fiscal expansion in the US is also expected to provide some impetus. Wage growth in the US, which has been surprisingly subdued despite the tighter labour-market conditions, recently showed signs of increasing and contributed to much of the recent bout of volatility in the markets.

This time does seem to be different, and monetary-policy tightening appears to be more clearly countercyclical.

The market overreaction at the time of the taper tantrum in 2013 had a marked effect on a number of emerging markets, who had been the main beneficiaries of the capital flows generated by the highly liquid conditions. Long bond yields in the emerging markets increased and currencies depreciated as capital flows began to reverse. Monetary policies were generally tightened, although there were differences in timing and degree.

According to Eichengreen and Gupta[1], the countries hit the hardest were those with wide fiscal and current-account deficits and open capital markets. South Africa fell into this category, along with Brazil, India, Indonesia, and Turkey – together given the dubious title of ‘the fragile five’. Since then, however, most emerging markets have adjusted significantly and are more resilient. But this resilience is currently being put to the test.

[1] Eichengreen, B and Gupta, P. 2013. ‘Tapering talk: the impact of expectations of reduced Federal Reserve security purchases on emerging markets’. World Bank Working Paper No 6754

One of the clear lessons of the 2013 episode was that the emerging markets are not immune to monetary-policy developments in the advanced economies. This raises the question as to whether small open economies (and that is what most emerging markets are) can conduct monetary policy independently of developments in advanced-economy financial markets. The traditional Mundell–Fleming model has taught us that monetary policy cannot be conducted independently where exchange rates are fixed. However, flexible exchange rates were expected to provide insulation against cross-border spillovers. Furthermore, perfect exchange-rate flexibility would obviate the need for reserves. This view of the world has changed since then, and for good reasons. Very few countries allow their exchange rates to float freely nowadays.

In the past few years, the issue of monetary-policy independence and the insulation properties of flexible exchange rates have been reconsidered. There is little doubt that very few countries are immune to spillovers from developments in the major advanced economies. The question is: to what extent, if at all, can emerging markets insulate themselves from external shocks?

The well-known 'trilemma' tells us that, with free capital mobility, independent monetary policies are possible only if exchange rates are floating. However, the sheer scale of financial globalisation in recent years has led to a rethinking of the trilemma. Hélène Rey[2], for example, has posited the existence of a global financial cycle that is strongly related to monetary conditions in the US and to changes in uncertainty and risk aversion. It is argued that, because credit cycles and capital flows respond to global factors, they may be inappropriate for the prevailing cyclical conditions of many economies. This implies that, for some countries, the global cycle can lead to excessive credit growth when the economy is booming and excessive contraction during a downturn. In other words, it is conditions in the advanced economies that determine domestic financial conditions in the smaller economies, and not domestic policy rates.

[2] Rey, H. 2015. 'Dilemma, not trilemma: the global financial cycle and monetary policy independence'. National Bureau of Economic Research Working Paper No. 21162.

As Obstfeld, Ostry, and Qureshi[3] have pointed out, there are a number of reasons why we would expect monetary policy to be constrained where financial integration pertains. For example, the substitutability between domestic and external financing could limit the effectiveness of domestic policy interest-rate changes on credit extension and asset prices. They also note that, even if we observe divergences between short-term rates as an indicator of insulation, there is likely to be greater co-movement of longer-term rates. Much will then depend on the extent to which long-term rates influence real variables.

For Rey, therefore, the trilemma does not exist. Rather, it is a dilemma – or what she calls 'an irreconcilable duo'. That is: independent monetary policies are possible if, and only if, the capital account is managed, directly or indirectly, via macroprudential policies. These could include capital controls if macroprudential policies are insufficient. In other words: flexible exchange rates do not ensure independent monetary policies when capital is highly mobile. This is a rather significant conclusion for emerging markets as it means that, under conditions of free capital mobility, monetary-policy independence is not possible, irrespective of the prevailing exchange-rate regime.

But this view is not without its critics. For example, Obstfeld et al. and Gita Gopinath[4] agree that the dilemma view may be overstated. However, their evidence suggests that although the trilemma lives on, it does not appear to exist in its strong form. They show that countries with exchange-rate flexibility are less sensitive to changes in global risk and less prone to economic boom-bust cycles. And although independence is not absolute, there is less loss of independence than in the case of countries with fixed exchange rates. In other words: the choice of exchange-rate regime does matter, but we should not expect complete independence with flexibility. The trilemma may be weakened, but it still applies.

Furthermore, the extent to which countries can conduct independent monetary policies also depends on their underlying resilience to global spillovers. It is generally accepted

[3] Obstfeld, M, Ostry, J D and Qureshi, M S. 2017. 'A tie that binds: revisiting the trilemma in emerging market economies'. International Monetary Fund Working Paper WP/17/130.
[4] Gopinath, G. 2017. 'Rethinking macroeconomic policy: international economy issues'. A paper presented to the conference on 'Rethinking macroeconomic policy IV' at the Peterson Institute for International Economics.

that most emerging markets have also become more resilient since the taper tantrum: the macroeconomic fundamentals have generally improved and the domestic financial markets have developed further. In particular, real policy rates are generally higher, inflation is within the target range in most of the inflation-targeting emerging markets, and both fiscal and current-account deficits have generally narrowed. For example: for a selected sample of non-oil-exporting emerging markets[5], current-account deficits as a percentage of gross domestic product (GDP) have narrowed significantly since 2012, averaging 0.7% in 2016 compared with 2.2% in 2013.

In South Africa's case, our deficit has narrowed from its widest level of almost 6% of GDP in 2013 to its current level of 2.3% of GDP.

The deficits of the other so-called 'fragile' countries have also shown sizeable contractions. As a group, therefore, they have greater ability to withstand the impact of exogenous shocks, including sudden stops and higher interest rates in the advanced economies.

An indicator of increased resilience is the fact that, since the crisis, a number of emerging markets have made considerable progress in developing deeper and more accessible domestic-currency-denominated bond markets. They no longer suffer from what is often referred to as 'original sin'. South Africa is again a good example of this. Prior to the crisis, although South Africa had a well-developed domestic bond market by emerging-market standards, non-residents held about 9% of total rand-denominated government debt. Today, this stands at around 40%.

This development is seen as reducing emerging-market dependence on foreign-currency debt. It is also seen as a means to reduce exposure to external shocks and increase resilience. However, this does not insulate emerging markets completely. A sudden stop or a reversal of flows would impact on bond yields and the exchange rate. The ability to absorb exchange-rate changes would differ from country to country. Countries with lower levels of foreign-currency indebtedness would be less sensitive

[5] Argentina, Brazil, Egypt, India, Indonesia, Malaysia, Mexico, Pakistan, the Philippines, Poland, South Africa, Thailand, Turkey

to the balance-sheet effects of large exchange-rate changes. Furthermore, it also implies that bond yields become more sensitive to global factors.

Nevertheless, there is evidence that local-currency credit spreads are much less correlated across countries than foreign-currency credit spreads, and global factors explain significantly less variation in local-currency spreads than in foreign-currency spreads.[6] In a similar vein, work by Shakill Hassan[7] at the South African Reserve Bank shows a low correlation between South African short-term rates and global rates, but the correlation increases for longer maturities. Yields at the short end of the South African terms structure are highly responsive to domestic factors which affect the domestic monetary-policy stance. By contrast, long-term yields are highly responsive to changes in global bond-market developments.

A further indicator of increased resilience is the level of foreign-exchange reserves – something that would be close to the heart of the attendees of this conference. As I've mentioned earlier: despite increased exchange-rate flexibility, the need for reserves has not disappeared. We have seen that, over time, foreign-exchange reserve holdings have increased quite markedly in the emerging markets. This is true even if we exclude China, which has the largest holdings of reserves. Since 2005, the reserve holdings in a sample of emerging markets referred to earlier (excluding China) increased by 178% by the year 2017.

It is generally agreed that the primary motive for reserve accumulation is precautionary, as insurance against speculative attacks in times of crisis. According to research conducted by the International Monetary Fund[8], there is strong empirical evidence that reserves reduce the likelihood of balance-of-payments pressures in the emerging markets. Reserves could provide the means to respond to exogenous shocks, and could calm or even prevent disorderly markets. Central banks have, however, tended to accumulate rather than to use reserves – a phenomenon sometimes referred to as 'the fear of losing reserves'.

[6] Du, W and Schregger, J. 2016. 'Local currency sovereign risk'. *Journal of Finance* 71(3).
[7] Hassan, S. 2015. 'Speculative flows, exchange rate volatility and monetary policy: the South African experience'. South African Reserve Bank Working Paper Series WP/15/02.
[8] International Monetary Fund. 2014. *Assessing reserve adequacy – specific proposals*.

While higher levels of reserves may create the perception of resilience, simply having reserves on their own is not an effective buffer against speculative attacks or crises. Reserves do not eliminate vulnerabilities. They are not a substitute for sound policies and strong, well-regulated financial sectors.

Conclusion

In conclusion, it would appear that, at long last, the recovery from the global financial crisis is on track. It has been a difficult path, with a number of false starts and disappointments. No doubt, the road going forward will not be without its difficulties. The recovery itself is expected to bring about new challenges, for the emerging markets in particular. It is inevitable that monetary-policy normalization in the advanced economies will happen, and that the era of high global liquidity will come to an end. The impact on capital flows and global financial markets will create particular challenges for central banks at a time when political independence is being questioned. While vulnerabilities differ from country to country, the emerging markets in general appear to be more resilient in the face of the recent market volatility. Their macroeconomic fundamentals and policies have improved, making them better-placed to weather the storm than was the case five years ago.

Thank you.