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The impact of a changing global environment on African economies and policy

Introduction

Ladies and gentlemen, good afternoon.

Thank you to the New York Fed for again inviting me to address this prestigious annual seminar where major topical issues are discussed. This year is no exception. The theme of 'less accommodative policy amid questions about the global order' has been a key focus of investors and policymakers alike for quite a while already, and clear answers are still not forthcoming. Are we just witnessing a temporary correction of financial markets amid an otherwise benign economic environment, or are disruptions large enough to challenge global expansion, especially in emerging economies? If more severe challenges were to occur, would there be sufficient global cooperation to deal with them in a cohesive manner? I certainly will not pretend to have clear answers to these questions, but will try to provide some perspective, looking specifically at how the changing in global environment is affecting South Africa and South African Reserve Bank's (SARB) reaction thereto. I will also pay attention to the challenges facing the rest of Sub-Saharan Africa and what to possibly expect next.

In some aspects, the global outlook does not appear to have changed fundamentally from earlier this year. The International Monetary Fund is yet to release its October 2018 *World Economic Outlook*, but the last time it published an update to its forecasts in July, its 2018 and 2019 global growth projections were unchanged from the previous forecasting exercise, at 3.9% for both years. The Bloomberg consensus of economists delivers a similar message of stability in expectations. The forecast for 2018 gross domestic product (GDP) growth is presently at 3.8%, unchanged from two quarters ago. At the same time, the normalisation of monetary policies in advanced economies from the unusually loose stance that had prevailed since the end of the global financial crisis has proceeded largely along the pace which policymakers had signalled, and investors had expected, at the start of the year.

Yet, a closer look at the details of the global environment suggests that the outlook may be becoming more challenging as some risks previously identified have begun to materialise. First, economic expansion has become less synchronised than in the 'sweet spot' of 2017, when most economies experienced upside growth surprises without too much inflation. While GDP growth in the United States (US) is still strong on the back of a buoyant labour market and fiscal stimulus, activity has slowed since the start of the year in the eurozone, Japan and China. Second, some policy developments have contributed to either increasing such de-synchronisation – such as fiscal stimulus in the US – or raising overall growth uncertainty, as in the case of rising trade conflicts.

One key consequence of such economic and policy developments has been renewed upward pressure on the US dollar, which has benefitted from the further rise in interest rate differentials (nominal and real) between the US and other major advanced economies, and from the outperformance of US equities.

The combination of rising growth and policy uncertainties, weaker commodity prices – with the notable exception of oil – from March to August 2018 and a stronger dollar has hit emerging countries' financial assets particularly hard. Since it peaked in February 2018, and despite some recovery in September, the JPMorgan emerging markets foreign exchange index has declined by 13%. Over the same period, the MSCI index of emerging market equities has shed 13% and the Emerging Markets

Bond Index Plus (EMBI+) sovereign spread over US Treasuries has widened by 60 basis points.

However, performances across the emerging world have been very disparate, ranging from severe financial stress to near-stability. Judging by these different reactions, it appears that the less favourable global backdrop has led investors to refocus on relative country vulnerabilities, specifically with respect to the rising external liabilities of governments and large corporations, fiscal trends, exposure to global trade and value chains and, in some cases, the level of inflation and the degree of anchoring of inflation expectations.

How the changing environment has affected South Africa

If one excludes the most dramatic sell-offs experienced by the Turkish lira and the Argentine peso, the South African rand has been among the most affected emerging market currencies this year – losing 13% on a trade-weighted basis since its 26 February peak. This depreciation, together with the 98 basis point increase in the yield on the R186 benchmark government bond and the 60 basis point widening in the country's five-year credit default swap spread illustrate the vulnerability of South African financial assets to the changing world environment I have just described.

Why has this happened? In contrast to some of its emerging market peers, South Africa has managed to keep its foreign currency-denominated external liabilities relatively under control. While the ratio of external debt to GDP has risen from a low of 18% in the mid-2000s to 46% as at the first quarter of 2018, the majority (about 55%) of that debt is denominated in rand, and includes government bonds held by offshore portfolio managers. Importantly too, the short-term component of foreign currency-denominated external debt did not exceed 8.5% of GDP, and the bulk of these liabilities consists of either trade finance or domestic banks' foreign currency deposits, which in the latter case are more than offset by foreign currency assets.

Inflation patterns do not appear to be the cause of the market sell-off. Over the past 12 months, consumer price readings have been below consensus expectations seven times (including in the past month), and the average inflation rate (of 4.4%) for the second quarter also fell short of what the South African Reserve Bank's (SARB) model

projected 6 or 12 months earlier. The extended period of sub-par growth in demand appears to be limiting the pass-through to prices of higher input costs, including those related to exchange rate depreciation. Indeed, recent survey indicators suggest that companies' pricing power, especially in the retail sector, is increasingly being eroded. At the same time, some modest signs of slower wage and unit labour cost growth have also emerged in the past year or two.

However, some several of South Africa's fundamentals are fragile enough to keep the country at risk of portfolio flow reversals in periods of rising risk aversion. Among those is the persistence of 'twin deficits'. While the current account deficit has declined, on average, in recent years – it stood at 3.3% of GDP in the second quarter of the year, down from a high of 5.8%, on average, in 2013 – it nonetheless appears elevated for an economy with weak demand and a negative output gap. Domestic savings remain low, illustrating the risk of renewed deficit widening if demand, especially much-needed investment demand, picks up. At the same time, the budget deficit has remained in excess of 3% of GDP in the past few years, despite repeated tax increases, resulting in a continued rise in the debt-to-GDP ratio, compounded by an increase in contingent liabilities linked to state-owned enterprises.

Real economic growth has also been disappointing. At a year-on-year growth rate of only 0.5% in the second quarter of 2018, South African GDP growth was one of the weakest among the large emerging countries. In the second quarter, the South African economy entered what is commonly called a 'technical recession', as GDP growth contracted for a second successive quarter. In many ways, hopes that domestic political developments at the start of the year would translate into a quick boost to activity proved to be excessive. Business confidence quickly retraced most of its early 2018 gains, and the South African rand, which had rallied at the time on the back of such hopes, fell back in sympathy with corporate sentiment (but also on account of the factors already mentioned).

Even as domestic financial markets came under pressure, some assets showed relative resilience, in particular long-term domestic bonds that sold off by a lesser amount – relative to the degree of rand depreciation – than in previous episodes of market stress, for example the 2013 'taper tantrum'. Continued and relatively benign inflation readings probably helped limit the upward drift in bond yields, highlighting the

importance for central banks of keeping price expectations solidly anchored, if the impact of market stress is to remain limited – in both length and scope.

How the South African Reserve Bank is reacting

The SARB has had to acknowledge the risks that the changing global environment is posing to the domestic inflation outlook. Earlier this year, a decline in both actual and forecast inflation – relative to what the SARB's models had been projecting – had allowed the Monetary Policy Committee (MPC) to ease policy moderately, by 25 basis points in March, in an environment of weak domestic demand. However, the outlook for inflation has since deteriorated, even though actual inflation readings generally remained benign and the impact of the increase in the value-added tax rate from 14% to 15%, in particular, seemed relatively muted. Exchange rate depreciation as well as the rising trend in world oil prices and uncertainties about future electricity tariff increases pose the main upside risks to the outlook.

While inflation is still expected to remain within the 3–6% target range over the forecasting period, according to the latest forecasts from the SARB's Quarterly Projection Model (QPM), inflation will peak at 5.9% year on year in the second quarter of 2019, before eventually settling at 5.4% in the last few quarters of 2020. Core inflation is expected to follow a relatively similar, though smoother, profile, peaking at 5.6% year on year during the course of 2019. Given the volatile environment, the risk of an overshoot of the target, given the balance of risks, should not be underestimated. Furthermore, an extended and sizable deviation in inflation from the midpoint of the target range would raise the risks of medium-term inflation expectations drifting back to, if not above, the top end of the range.

The SARB's QPM model projects that in order to bring inflation back towards the target midpoint in the long run, five interest rate increases of 25 basis points each will be needed by the end of 2020. It is important to reiterate that the QPM projection is not a pre-commitment to a future rate path. It is a broad policy guideline that can and will evolve as economic conditions change. At its most recent meeting about two weeks ago, the MPC opted to leave the repurchase rate unchanged at 6.50%, cognisant that downside risks to the growth outlook had partly offset the upside risks to the future

inflation profile. The output gap remains negative and unlikely to close until late 2020, suggesting that risks of demand-led price pressures should remain low over the forecasting period. Nonetheless, the MPC will need to remain vigilant and ready to act against any sign of second-round price effects from the recent rand exchange rate and oil price shifts.

The exchange rate of the rand has been the subject of much debate recently, given its depreciation and heightened volatility in reaction to a combination of fundamental drivers, external risk factors and a general reallocation of capital away from emerging markets. A number of emerging markets have more recently resorted to intervention in the foreign exchange market, informed by their own country-specific circumstances. The SARB has allowed the exchange rate to act as a shock absorber and adjustment mechanism, and maintained its policy of not intervening in the foreign exchange market with a view of supporting the currency.

However, as previously stated, this does not mean that we are totally indifferent to exchange rate movements. It also does not mean that there cannot be circumstances where the cost of not intervening to dampen excess volatility or abrupt and disorderly adjustments, could be higher than that of intervening. This suggests that policy flexibility requires that foreign exchange intervention continues to be part of the monetary policy toolkit to support economic and financial stability. As previously stated, our preference has been to deploy this tool if there are signs of the orderly functioning of markets being threatened, rather than to go against the grain of a market, which is realigning and repricing on the back of the factors mentioned above. Recent developments in domestic foreign exchange markets have not been judged to have been of such magnitude and nature that they required any intervention from the SARB.

Challenges in the rest of sub-Saharan Africa

A changing global environment is equally as important for the rest of the African continent. A decade or so ago, the conventional view was that, apart from the demand for exports and the impact of commodity price fluctuations on the terms of trade, African countries were relatively insulated from global financial shocks, as their

economies were less integrated into the world financial system and thus less vulnerable to portfolio outflows or cutbacks in banks' cross-border loan portfolios. This proved true, to some extent, in the global financial crisis, when the sub-Saharan African region experienced a less pronounced growth downturn than other major regions. However, this too is changing. Greater integration of sub-Saharan Africa into global financial flows has brought access to new resources for the financing of investments and economic development. It has also, however, ushered in a greater vulnerability to potential capital outflows.

So far this year, with a few exceptions, currencies in sub-Saharan Africa have depreciated by only a moderate amount against the US dollar. The recovery in oil prices appeared to help energy exporters, while other countries benefitted from continued, relatively stable economic growth. However, other segments of their financial markets have not performed as well. In particular, yields on eurobonds – which have grown in size as a funding instrument in recent years as sovereigns took advantage of the global 'search for yield' – have increased. In most cases, such yields are up by 100 to 150 basis points from early 2018 lows, reversing a significant part of the previous two years' rally. At the same time, 'frontier' equity markets are displaying a stronger correlation with larger emerging markets than before, illustrating the vulnerability of earlier gains in still-small African stock exchanges.

Furthermore, several fundamental economic trends in sub-Saharan Africa are a growing source of vulnerability. Current account imbalances are rising in a majority of the continent's countries, which are largely non-resource exporters, and contributing to a rising trend in external liabilities relative to GDP. Government budget deficits remain fairly high, pushing public debt ratios higher. And while economies continue to grow in real terms, the experience of the past few years – in particular, their abrupt slowdown in 2015 – highlights the region's vulnerability to external developments, such as swings in resource prices or a rebalancing of China's growth path towards less commodity-intensive demand. Finally, while inflation in the first half of 2018 was reasonably benign in the majority of African countries, the sensitivity of consumer price trends to prices of oil and food commodities, and to exchange rate swings – because of the high share of consumer goods that are imported – is a strong reminder that such stability cannot be taken for granted.

What will happen next?

How will the emerging market situation evolve over the next few months and quarters? In the past couple of weeks, pressure on emerging currencies and other assets has abated to some extent, helped by signals from several central banks indicating that they would not tolerate durable upward shifts in inflation. However, it is too early to predict a stabilisation in emerging market assets, and too early to say with confidence whether the recent market correction will, or will not, turn into a more severe adjustment that could severely undermine growth prospects, and possibly strain corporate and bank finances in emerging countries.

At present, many economists are of the opinion that emerging market assets, and especially currencies, are more fairly valued than they were at the start of the year. However, historical experience tells us that ‘overshoots’ can often happen, following adjustments similar to what has just been witnessed, and financial assets can face an extended period of volatility before settling around new ‘equilibrium’ values.

There are, however, some encouraging factors which should limit the risk of a further, severe adjustment. First, as I indicated earlier, growth in advanced economies has remained relatively resilient, much as risks seem tilted to the downside. Even in emerging markets, with the exception of Argentina, Turkey and South Africa , growth forecasts have not significantly changed since early 2018; hence, the risk that financial market stress in emerging countries could negatively ‘spill back’ into the advanced economy growth outlook still appears, for now, to be low.

Importantly, too, much as the risk remains, we are not witnessing the kind of inflation pressures that might force the world’s major central banks into a significantly faster pace of policy tightening – potentially derailing economic expansion. While both headline and core inflation are at present higher in the US, eurozone and Japan than, on average, in the past few years, few economists anticipate a prolonged overshoot of inflation targets – in the event that these targets are reached in the near future, which may not always be the case. And, while tighter labour markets are finally pushing wage growth higher, this is in part offset by some acceleration in productivity, implying limited upward pressure on prices from unit labour costs.

Equally, just like it has not led to a strong build-up of price pressures in advanced economies, the prolonged period of stimulative monetary policies has not led to the kind of broad-based private sector (especially financial sector) leveraging that would threaten an early and abrupt end to what is now an extended period of economic expansion. Admittedly, in some large emerging countries, in particular in China, private sector liabilities have risen sharply in the past decade as a share of GDP, raising the risk of a future adjustment that may, at some stage, have adverse consequences on not just local but also global economic growth. However, in the short term, the steps recently taken by Chinese authorities – including some mild loosening of their monetary, fiscal and regulatory stance – indicate that they do not see the deleveraging of specific segments of the economy as incompatible with a relatively stable pace of economic expansion.

This said, several factors of uncertainty are likely to persist in coming quarters, implying an ongoing strong need for vigilance by central banks, especially in emerging countries such as South Africa that enjoy open and liquid capital markets.

The first factor to mention is the recent escalation in trade conflicts between the US and China, with both nations announcing an increase in tariffs on a broader range of goods than initially targeted. While earlier tariff announcements in the second quarter of 2018 appear to have not yet had major negative effects on economic activity, concerns remain that a broader, longer conflict could undermine global trade flows, corporate investment and, ultimately, economic growth.

More generally, a move away from the multilateral approach to international relations followed in recent decades – not only in trade but also in financial, regulatory and even military matters – could create a more complex environment for emerging countries relying on open markets and stable external relationships for economic development.

Turning to financial matters, one factor of uncertainty is the future path of risk-free, 'neutral' real interest rates in coming years, and how this will continue to affect global investors' appetite for risk and, in turn, the cost and accessibility of foreign funds for emerging economies. In the decade following the global financial crisis, several factors tended to depress these risk-free rates, including low productivity growth, higher precautionary savings, and continued reserve accumulation by emerging countries

with large current account surpluses. However, these factors have started to fade, albeit gradually.

Finally, geopolitical issues remain a concern. In the past few years, commentators and investors have mostly focused on growing voter frustration of low growth and rising job insecurity in advanced economies. However, one should not forget that such challenges persist in emerging economies too, in particular in Africa. Failure to address issues of persistent inequality and poverty, insufficient job and skills development opportunities, and poorly planned urbanisation could easily increase social unrest and reverse earlier gains towards a more stable, rules-based policy environment. And while most of the policy responses fall outside the remit of central banks' mandates, their contribution to price and financial stability remain essential if development goals are to be achieved.

Conclusion

Acknowledging the impact of the downside risks, especially the escalating of trade tensions and the tightening of global financial conditions, to global growth and inflation, it goes without saying that global coordination and cooperation to deal with these challenges is necessary. In part this would mean that authorities should consciously implement policies and reforms that will weather the financial markets volatility as well as protect global expansion. This kind of coordination and cooperation has served the global economy well during the last global financial crisis and we should work hard to improve on that.

Thank you.