“Charting a Course through Rough Seas: How Emerging Markets Can Navigate Tougher External Conditions”

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I. Introduction

Thank you, Deputy Governor Tshazibana, for the warm welcome. It’s an honor to join you all today. It was also an honor to recently host Governor Kganyago at the IMF to deliver an excellent Camdessus Lecture, in which he spoke in depth about the role of capital flows in emerging market growth and shared several important lessons for policymakers and for international institutions. I greatly enjoyed the lecture and am very glad to now be here in South Africa. [1]

We are near the Cape of Good Hope, where the Indian and Atlantic oceans meet. For centuries, sailors in these parts have known that success in charting a course through one ocean doesn't guarantee success when the turn is made toward the other. The clash of seas and turning of the winds can bring fierce new challenges to even the most experienced and resilient of seafarers.

This reminds me of the past three turbulent years of the COVID-19 pandemic, Russia's war in Ukraine, and a series of extreme weather events. Emerging markets have demonstrated that they are skilled sailors in choppy waters, but we see more waves ahead. It is only appropriate that this conference is focused on drawing out post-crisis lessons and examining new policy challenges.

Today, I will focus on emerging markets (EMs) like South Africa and discuss three important ways in which the external conditions they face have changed since before the pandemic. *First, global financial conditions are tougher. Second, geoeconomic fragmentation is rising. Third, climate change is inflicting growing costs.* Together, these changes are transforming the economic landscape and making the world more volatile and uncertain.

To respond to it, I will also discuss three broad actions that policymakers in emerging markets can take. These actions come on top of the significant steps already taken over the last two decades to strengthen EM policy frameworks. It is important to underline that these steps helped many of them prove resilient over the past three years, despite facing unprecedented shocks.

II. A daunting external landscape for EMs.

II.1. Global financial conditions are tougher.

Let's begin with tougher global financial conditions. As the fight to bring inflation back to target continues, we expect global interest rates to remain high for quite some time. Furthermore, there are reasons to think that rates may never return to the era of 'low for long'. This possibility is reflected in U.S. 10-year treasury bond yields, which have surged to over four percent in nominal terms, the highest level since the global financial crisis (slide 4).

In this environment, financing conditions for EMs can be expected to remain challenging. In the 18 months since the U.S. started its aggressive tightening cycle, average long-term yields for EM dollar bonds have increased by about 200 basis points (slide 5), sovereign and corporate bond issuance (in foreign currency) has dropped by half and two-thirds, respectively, and portfolio flows to major EMs have decreased sharply (slide 5).

Down the road, the long-term natural real interest rate—or r*—could return to lower levels. As our research shows, this is because people are living longer, wealth remains highly concentrated, and productivity growth is weak. However, a return to a low global r* is far from certain. Already-high global debt levels—combined with the significant public spending needed to support aging societies,

climate change mitigation, and possibly AI-driven productivity growth—could put upward pressure on global r*. [2]

But even if global r* is lower, we may not revert to the “old times” of “low for long” policy rates that prevailed after the Global Financial Crisis (GFC). Why? We learned from the last two years that the Phillips curve may not be reliably flat, and adverse supply shocks may occur more frequently. Both lessons point to a more difficult inflation-output tradeoff for central banks. Compared to before the pandemic, central banks could react more aggressively to broad-based supply shocks and shy away from over-easy policies when inflation is only modestly below target and labor markets are close to full employment. [3]

II.2. Geoeconomic fragmentation is rising.

A second important development in the external landscape is the rise of geoeconomic fragmentation, or GEF. The pandemic and Russia’s war in Ukraine have raised legitimate concerns about supply chain security and broader national security. And indeed, policymakers should act to improve their economic and financial resilience. However, it must be acknowledged that increased resilience comes with a cost. More disturbingly, we are seeing an increase in policy actions around the world that, if continued, pose a serious threat to global prosperity.

Here I am talking about trade restrictions, which have picked up sharply since the pandemic and the war. Almost 3,000 restrictions were imposed just last year—*nearly 3 times* the number imposed in 2019 (slide 8). Foreign direct investment is now increasingly driven by geopolitical preference rather than geographic distance (slide 9). All of this points to an increasingly fragmented world. [4]

The effects of fragmentation will vary across countries. Our simulations of the impact of trade fragmentation find that while a few EMs could benefit, most will lose—including South Africa, with a hit of 5 percent of GDP. Other EMs could face output losses of over 10 percent of GDP. FDI fragmentation would add to these costs, and because FDI from advanced economies offers access to better technologies and know-how, EMs would be hit hardest. [5]

Fragmentation also makes the world more vulnerable to shocks, as it leaves countries with fewer trading partners. For example, our simulations find that in a fragmented world, a negative supply shock in the U.S. production of wheat would raise its price by about twice as much as it would in an integrated world (slide 10). Such a price increase could seriously hurt millions of people who already face high food insecurity. [6]

In this fragmenting world, countries are also turning inwards and engaging in large-scale industrial policies. In 2023 alone, the

number of such measures that also restrict trade has increased nearly sixfold. Most of that increase is in AEs (slide 11). EMs have also increased the use of protectionist industrial policies though with less reliance on subsidies. Recent examples of large-scale industrial policies include the US CHIPS and Science Act and the Inflation Reduction Act, the EU Green Deal Industrial Plan, and China's longstanding industrial policies in strategic sectors. Such policies can heavily influence the direction and volatility of global trade and capital flows.

II.3. Climate change is also inflicting growing costs.

The third change in external conditions is climate change. Extreme weather events like hurricanes, droughts, floods, and fires are becoming more frequent, and more costly (slide 13). To build resilience, EMs are investing in climate adaptation and mitigation. The cost of this will be enormous. The International Energy Agency estimates that mitigation-related investment needs in emerging markets and developing economies will reach about $2 trillion annually by 2030—or 40 percent of global needs. For South Africa, the World Bank estimates climate financing needs of 4.4 percent of GDP per year between 2022 and 2050 (slide 14). This scale of costs—when many emerging markets have limited fiscal space,

global financial conditions are tougher, and the world is fragmenting—poses an exceptional challenge. [7] [8]

III. How can EMs succeed in this difficult new environment?

The three challenges I've outlined—tougher global financial conditions, rising geoeconomic fragmentation, and costly climate change—are interconnected. And, as I mentioned, they are making the world more volatile and uncertain. So how can EMs succeed in this difficult new environment?

Before I speak to this, I would like to recognize the resilience many emerging markets have demonstrated to the turbulent shocks of Covid and the war. In major EMs, despite sharply rising rates, spreads have stayed stable and there have been no systemic financial crises. And though inflation rose quite dramatically in several EMs, long-term inflation expectations remain mostly anchored.

These outcomes owe much to the improvements many EMs made to their policy frameworks and financial sectors over the last two decades. Advances in central bank independence, inflation targeting frameworks, exchange rate flexibility, and macroprudential regulation of their financial sectors have all played critical roles. [9]

While many EM central banks were ahead of the curve in raising rates to help bring down inflation, they can seek to avoid premature easing of policy, given the lingering uncertainty about inflation. This will buttress their hard-earned credibility. We may yet see greater tumult in EMs given the risks ahead, including from the structural rebalancing taking place in China. It is therefore essential to further strengthen monetary policy frameworks and enhance the prudential framework of the financial sector, including by incorporating climate-related financial risks. Central banks should also stand ready to act if global financial conditions deteriorate markedly. Traditional measures include relying on exchange rate flexibility and selective liquidity provision. In some *exceptional* cases, foreign exchange intervention could also be useful—for example, to address frictions in shallow FX markets, help counter financial stability risks from FX mismatches, or help preserve price stability when large exchange rate changes risk de-anchoring inflation expectations. [10]

However, FXI should *not* be used to target a particular level of the exchange rate, or as a substitute for warranted macroeconomic adjustment. In this regard, SARB's approach of maintaining exchange rate flexibility—even in episodes of stress—has acted as an important buffer.

But the three challenges I've laid out today require action beyond traditional monetary policy and financial sector enhancements. Let me now focus on three broad actions emerging markets can take to address these challenges.

III.1. Accelerate domestic resource mobilization and rebuild fiscal buffers.

The first is to accelerate domestic resource mobilization and rebuild fiscal buffers. This will help pay for development priorities and strengthen resilience to shocks in an environment of tougher global financial conditions.

Interest payments on public debt owed by EMs are set to rise significantly from around 11% of revenue in 2019 to around 14% by 2028 (slide 17). This will reduce fiscal space for critical spending needs and put pressure on debt sustainability. In South Africa, for example, the interest bill is forecast to increase from about 19 percent of revenue this fiscal year to 27 percent of revenue by FY28/29—about twice this year's budget allocation for health.

Every EM can do more to mobilize domestic revenue and increase spending efficiency. Even countries with the highest collection rates have room to improve. We estimate that, absent any change to institutions and economic structures, EMs can, on average, still raise their tax-to-GDP ratio by nearly 5 percentage points (an increase of 30%). [11]

Revenues can be boosted by streamlining tax expenditures, such as VAT exemptions. Empirical evidence suggests that such measures that broaden the tax base have a smaller effect on output and unemployment than tax rate increases of the same magnitude during fiscal consolidations. [12]

Personal income taxes in EMs yield only 3% of GDP on average, suggesting that many EMs can take advantage of more progressive personal income tax rates and increased compliance. Real property taxes also remain largely untapped in most EMs. These are efficient taxes that can be designed to be progressive—with appropriate relief for low-income households. Finally, better tax administration—including by advancing digitalization—can improve revenue mobilization in EMs.

But mobilizing that revenue is only part of the story: EMs can also increase spending efficiency. They can eliminate inefficient programs—like broad-based fuel subsidies that are expensive, regressive, and undermine efforts to mitigate climate change—and replace them with better designed programs, such as cash transfers targeted to the most vulnerable. There is also scope to strengthen social protection systems—for example, in half of all Latin American countries, less than 40 percent of social safety-net transfers accrue to the poorest 20 percent of the population. In addition, improving performance of state-owned enterprises in critical sectors and allowing for private sector participation can help both save substantial fiscal resources and enhance the provision of the public services. In South Africa, for example, the budgetary cost of the state-owned energy company, Eskom, has exceeded nine percent of GDP (in total) over the last fifteen years. Fixing the power sector is essential for supporting faster economic growth: the SARB estimates that growth this year could have been 2 percentage points higher with more energy availability. [13] [14]

III.2. Enhance resilience to fragmentation through diversification and reforms.

The second action is to enhance resilience to geo-economic fragmentation through diversification and reforms. While firm-level

decisions should predominantly shape the future resilience of supply chains, government policies can help. Upgrading and modernizing critical infrastructure can help firms grow their trade with multiple partners. Stress testing supply chains of critical inputs and outputs can also help prepare for future shocks. [15]

Countries can take advantage of the re-direction of FDI by accelerating reforms that make them an attractive investment destination. This includes improving infrastructure, reducing red tape, and reforming labor and product markets. These same measures will help boost domestic private investment that will play a critical role in raising growth and building resilience.

As for industrial policies to support domestic industry, our advice is to tread carefully. History is replete with examples of IPs that were not only costly, but also hindered the emergence of more dynamic and efficient companies.

But if industrial policies are pursued, what are some important features to consider? Because rent-seeking and misallocation of resources is a major risk, a pre-requisite for IP is strong governance and administrative capacity. Another pre-requisite is that the externality or market failure these policies address should be easy to identify and target, such as carbon emissions. IPs are also more successful when complemented by economy-wide structural

reforms. If IPs must be used, governments should ensure they are time-bound and cost-effective to limit fiscal burdens. Moreover, to prevent a protectionist race where all countries lose, these policies must be consistent with countries' international obligations, including WTO rules. [16] [17]

While EMs must adapt to fragmentation, they can also help prevent it from getting worse. By championing global integration, from which they have substantially benefitted, EMs can help reverse a troubling trend.

III.3. Implement a fiscally and socially sustainable climate strategy.

The third action is to address the challenge of climate change by implementing a strategy that is both fiscally and socially sustainable. To ensure fiscal sustainability it will be critical not to rely mostly on spending measures such as green public investment and subsidies to reach net-zero targets. Forthcoming research in the IMF's Fiscal Monitor shows that such an approach would lead to a sharp rise in the debt-to-GDP ratio—over 50 percentage points by 2050 relative to current paths. Clearly, this is not feasible. [18]

Carbon pricing should therefore be an integral part of the policy package as it can raise revenues and catalyze much needed private investment. Given the frequency of climate shocks and their impact

on public finances, countries could consider incorporating climate actions in debt sustainability analysis.

Climate policies will also need to be nested in a broader just transition strategy that explains how climate action will be compatible with promoting jobs and sustaining growth. While green transition policies can create jobs and boost growth in some areas, other sectors and regions that are particularly exposed to high-carbon activities may lose out. Ensuring an inclusive transition will therefore require compensating measures, including education and re-skilling to help workers match to green jobs. By addressing distribution concerns, climate strategies can be socially sustainable.

Promising country examples include Chile and South Africa. Chile introduced green taxes in 2014 as part of a broader tax reform package that also included increasing education and healthcare spending. And South Africa has put in place carbon taxes that are easy to administer and are scalable over time. Such reforms are supported by the country's Just Transition Framework, which clearly outlines the measures needed to minimize the social and economic impacts of the climate transition and improve the livelihoods of those most vulnerable to climate change.

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IV. The role of the IMF

I've laid out three major challenges facing EMs. These come on top of a sobering global outlook, with the lowest medium-term growth forecast since 1990—only 3.1 percent.

But EMs do not have to tackle these challenges alone. At the IMF, we are supporting all our members—including EMs—as they navigate this difficult new environment.

IV.1. Making tough global financial conditions easier

While shocks like the pandemic have made global financing conditions tougher, the IMF has stepped up to help countries deal with them. Since the pandemic, the Fund has extended substantial financial assistance through precautionary arrangements, including $148.3 billion to eight EMs. And an additional $97 billion has been provided to 22 other EMs through disbursing arrangements. Moreover, we help our members reduce their debt vulnerability amid difficult funding conditions by assisting them in strengthening their public finances and public financial and debt management.

IV.2. Analyzing fragmentation

The IMF is also closely watching the disturbing fragmentation trend I have described. Through our surveillance mandate, we have

conducted analytical work that clearly highlights the costs of worsening fragmentation.

IV.3. Confronting climate change

Finally, we are helping our members confront climate change. The IMF's Climate-Public Investment Management Assessment, or C-PIMA, helps governments identify improvements in public investment institutions and processes to build low-carbon and climate-resilient infrastructure. India, Senegal, and the UK are amongst the 40 countries that have already benefitted from a C-PIMA.

In addition, our new Resilience and Sustainability Trust provides financing for adaptation and mitigation reforms that will help boost private investment in climate projects. This is complemented by technical assistance to support countries as they enhance their framework for managing climate change and attracting private investment. So far, programs have been approved for ten countries, including Kenya, Rwanda, and Seychelles.

V. Conclusion

Let me conclude. The shocks of the past few years have left behind a world that is harsher and hotter. Tighter global financial conditions,

increasing geoeconomic fragmentation, and the ongoing effects of climate change will create new challenges for EMs.

It goes without saying that strengthening macro-fundamentals is critical to address any challenge, old or new. Re-invigorating structural reforms can help strengthen governance, labor markets, and product markets, and develop human capital, all of which are crucial. But contending with these new challenges requires going a step further. Mobilizing domestic resources, enhancing resilience to fragmentation, and implementing a fiscally and socially sustainable climate strategy can help.

The challenges may be daunting. But the opportunities are vast. EMs have shown considerable resilience over these past few years, and their potential to accelerate growth and raise living standards remains promising. South Africa embodies this potential. With its abundant natural endowments and strong institutions, this country is poised for a growth take-off—if reforms that resolutely and courageously tackle structural obstacles are implemented. As in other EMs, success in South Africa will require difficult reforms now that may not pay off until later. But it is an investment well worth making—and one that the IMF stands ready to support.

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