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A South African perspective on global imbalances

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Financial inflows into South African financial markets have resumed in 2009 and gained momentum in 2010, largely as a result of low interest rates and an oversupply of liquidity in advanced economies. As an emerging-market country with a current-account deficit, South Africa is to some extent reliant on these inflows to fund its own external imbalance. However, financial inflows have exerted significant upward pressure on the exchange rate of the rand, with negative effects on the exporting sectors of the economy. Prices of South African bonds and equities have also increased significantly, raising possible concerns about their sustainability and possible sudden reversals. There are, however, also characteristics of the South African economy and financial system that improves its resilience to shocks and the side-effects of global imbalances.

To date, South Africa has not implemented direct measures to stem capital controls, for various reasons. Its policy reactions to global imbalances comprised mainly countercyclical monetary and fiscal policy, a further accumulation of foreign exchange reserves to moderate the exchange rate appreciation and further relaxations of controls on capital outflows.

Global imbalances have been a characteristic of the world economy for many years, with different aspects thereof receiving varying degrees of attention as the global economy proceeds through its boom and bust cycles. Before the most recent global financial and economic crisis, concerns about global imbalances centred on the causes and effects of the US current account and fiscal deficits – the so-called 'twin deficits'. While these remain relevant, the focus has now shifted to the risks of a much broader concept of global imbalances, with all countries being affected or threatened in some way and contemplating appropriate policy responses.

This brief note discusses some of the financial stability risks of global imbalances for emerging-markets in general, and for South Africa specifically. It also describes the South African scenario and South Africa's policy responses to the effects of global imbalances on its economy.[1]

1| Financial stability risks of global imbalances

It is sometimes useful to classify financial stability risks according to their cross-sectional (or structural) dimension and their time (or cyclical) dimension.[2] These dimensions also apply to the risks associated with global imbalances, and such a classification helps to put risks into context and guide appropriate policy actions.

1|1 Cross-sectional dimension

The cross-sectional dimension of global imbalances relates to divergences in savings, investment and consumption patterns among countries, and groups of countries. Some of these imbalances had been embedded in the structure of the world economy as it developed over centuries, such as the income gaps between developed, underdeveloped and emerging-market countries. These structural divergences have manifested themselves in persistent trade, fiscal and international investment imbalances.

Since the onset of the 21st century, emerging and developing economies as a group became net exporters of goods and services to the rest of the world. The current account balance of emerging markets as a group changed from a deficit of USD 13 billion in 1999 to a surplus of USD 723 billion by 2008. In aggregate, the advanced economies recorded a net current account deficit of USD 495 billion in 2008, compared with a surplus of USD 12 billion in 1999. The current account deficit of the United States alone amounted to over USD 700 billion in 2008. The crisis has subsequently reduced the magnitude of current-account deficits and surpluses as household consumption, business investment and international trade declined. However, external imbalances remain indicative of internal demand imbalances in both the surplus and deficit economies, with the former suffering from insufficient and the latter from excessive domestic demand.[3]

In general, emerging-market economies have built up significant reserves, in some cases from their current account surpluses and in other cases from financial account inflows. In certain instances, the build-up of reserves resulted from attempts to keep their exchange rates from appreciating. Between the first quarter of 2000 and the end of 2009, emerging-market reserves increased by just more than USD 3 trillion, with half of that amount attributable to China. In 2000, emerging-market reserves amounted to 36 per cent of total global reserves. By 2009, this percentage has increased to 64 per cent.

Emerging-market reserves have been invested predominantly in the reserve currencies of advanced economies. Consequently, as a group they recorded net financial outflows of close to USD 600 billion in 2008 if reserves flows are included, while the advanced economies recorded inflows of USD 289 billion. The United States remained the main recipient of foreign investment flows during the crisis, recording net inflows of just over USD 500 billion in 2008. This circular flow of funds has been a structural feature of the global economy for the past ten years and contributed to growing imbalances in the international investment positions of countries. At the end of 2008, advanced economies' net liabilities to the rest of the world amounted to

1 *Date of writing : November 2010.*
2 *As explained by Borio (2010): "Implementing a macroprudential framework: Blending boldness and realism", prepared as a keynote address for the BIS-HKMA research conference on financial stability, Hong Kong, 5-6 July 2010.*
3 *Statistics quoted in this section have been sourced from the IMF's regular publications on Balance of Payments Statistics and International Financial Statistics.*

USD 943 billion, up from USD 178 billion in 2000.[4] By contrast, developing and emerging market economies as a group had a net asset position of USD 750 billion, compared with a net liability position of USD 1.15 trillion in 2000.[5]

These growing imbalances have been a topic of intense debate, eliciting concern about their sustainability, speculation about possible events that could impact on these imbalances and the consequences of such events. Nevertheless, even throughout the crisis, the pattern seems to remain in place as emerging-market economies outperformed advanced economies and continued to channel their reserve assets back to safe-haven assets, mainly US Treasury bills. However, tension among key players seems to be escalating and the risks to the financial system and the imposition of protectionist measures, or threats thereof, are increasing. These tendencies pose a real danger to global financial stability, trade and growth.

1|2 Time dimension

The time dimension of global imbalances refers to their cyclical elements, and mostly stem from the collective behaviour of economic agents to changes in economic conditions and policies in various stages of the business cycle. This behaviour tends to be procyclical in nature. It exacerbates the business cycle and becomes an endogenous source of systemic risk as market participants adapt their risk appetite, pricing policies and required rates of return in reaction to changes in the cycle. The crisis and related interventions by authorities to stabilise the financial system introduced a number of cyclical imbalances which, unless they are addressed within a reasonable time, run the risk of becoming structural in nature. Because of the amplitude of the crisis cycle, these imbalances are also much more severe than 'normal' cyclical imbalances. They are also, in many instances, amplifying the structural imbalances that had been in place before the crisis. A few examples of current cyclical imbalances are:

- High amounts of liquidity and historically low interest rates in (mostly) advanced economies. With abundant liquidity available in advanced economies, and lending rates almost certain to stay low for some time, investors have an incentive to borrow in these markets and invest in higher yielding, riskier markets, thereby potentially building up to a renewed round of asset price bubbles.

- Various advanced countries suffered from rising fiscal deficits before the crisis. However, large fiscal stimulus and support packages by governments have pushed these imbalances to much higher levels. The United States, various European Union members, the United Kingdom and Japan are now under pressure to consolidate their public finances, at a time when the global economic recovery is still fragile.

- While the amount of government debt has exploded in many countries, private debt issuances have dwindled during the crisis. This has resulted in an imbalance of public debt relative to private debt, which will have to be restored as the pricing of private debt normalises and appetite for private debt instruments increases.

- Emerging-market economies have generally emerged from the crisis in better shape than most advanced economies and with much less direct damage to their financial systems. As a result, they represent attractive destinations for international investment flows. However, there is a risk that these flows could become motivated by 'spread trading' rather than the fundamental attractiveness of the investment destination, which could cause distortions in the pricing and risk assessment of financial assets.

- As a result of large foreign financial inflows, combined with dollar weakness, free-floating emerging-market currencies have appreciated substantially against the US dollar in the first ten months of 2010, posing a serious threat to both their export sectors and economic growth. Various countries have retaliated by introducing taxes, capital controls and penalties on foreign inflows, the effectiveness of which still remains to be seen. However, further currency misalignments and volatility represent another cyclical imbalance stemming from the crisis.

4 *Within this group, there are individual countries with significant net asset positions.*
5 *This change was dominated by China, who recorded a net asset position of USD 1.5 trillion in 2008.*

2| The south african scenario

South Africa has also been affected by the cyclical flows of funds to emerging markets. Financial flows to South Africa have increased significantly during 2010 and, contrary to previous periods of large capital inflows, these flows constitute purchases of South African bonds rather than equities. This supports indications that the interest rate differential, rather than growth expectations, may be the main driver of these flows. In the year to the end of October 2010, net purchases of South African bonds by foreigners totalled ZAR 74 billion (about USD 11 billion), while net purchases of equities totalled ZAR 22 billion (about USD 3 billion). Evidence suggests that a significant portion of these funds originate from foreign pension funds and asset managers in search of yield. These inflows, combined with some foreign direct investment flows, have caused the nominal trade-weighted value of the rand to appreciate by about 7 per cent in the year to end-October and by 31 per cent since the beginning of 2009, putting severe pressure on South Africa's exporting manufacturers and the agricultural sectors.

Financial inflows have also put upward pressure on South African bond and equity prices. Yields on all maturities of South African government bonds are now at or close to record low levels and the All-bond index, a total-return index calculated by the Johannesburg Stock Exchange (JSE Limited), is at a record-high level. The JSE's All-share index is now only about 3 per cent below its peak level reached in May 2008, even though the economy has subsequently been through a recession and is still operating significantly below potential. There is little evidence that increases in bond and equity prices have been fuelled by domestic credit extension as private sector credit extension by the banks is still weak. Financial inflows are regarded as the main reason for the rallies in bond and equity prices and, although asset prices are not yet seen to be at a 'bubble' level, they have the potential to become destabilising should these trends continue for an extended period, in particular in the event of sudden reversals of financial flows and demand for emerging-market securities.

In addition to being subject to the effects of global imbalances, South Africa struggles with a number of internal imbalances, such as imbalances in the distribution of income, imbalances between production and consumption, between saving and consumption, between productivity growth and wage increases and between the supply and demand of specific categories of skills in the economy. South Africa's unemployment rate in the formal non-agricultural sector stands at just more than 25 per cent, and more than a million jobs have been lost between the fourth quarter of 2008 and the second quarter of 2010. Promoting job-creating economic growth is a policy priority for the government and a condition for sustained financial stability over the long term. The internal imbalances are often in conflict with one another, but nevertheless should be addressed by the various arms of government and the central bank through appropriate policies and strategies.

There are, however, also characteristics of the South African economy and financial system that make the country relatively more resilient to shocks and the side-effects of global imbalances than many of its peers. The capital ratio in the banking system averages over 14 per cent, with tier one capital at around 10 per cent. Throughout the crisis, South Africa's banking system and financial markets continued to function smoothly without any special support required. Economic growth turned positive in the third quarter of 2009 and averaged about 4 per cent in the first half of 2010. Household indebtedness, although still high at 78 per cent of gross domestic product (GDP), seems to have peaked and historically record low interest rates are supporting the deleveraging of balance sheets. The inflation rate decreased to 3.2 per cent in September 2010, close to the lower end of the target band of 3 to 6 per cent. An accommodative monetary policy provides some relief to sectors of the economy that are negatively affected by the strong currency, and facilitates a faster deleveraging of household balance sheets. South Africa's foreign debt ratios are moderate, with total foreign debt amounting to 28 per cent of GDP, and short-term foreign debt is more-than-adequately covered by foreign reserves. Lastly, although the fiscal deficit has increased to 6.7 per cent of GDP during the economic downturn, in line with the government's countercyclical fiscal policy stance, it is still at moderate levels compared to those of most advanced and many emerging-market economies. The fiscal deficit is forecast to decline to 3.2 per cent of GDP by 2013/14 as economic growth accelerates, without the need to introduce austerity measures.

3| Policy responses to the effects of global imbalances

The policy options available to emerging-markets to counter the effects of global imbalances on their domestic economies are not uniform. Emerging markets with current-account surpluses have a different set of options available to counter the effects of capital inflows than those with current-account deficits. If a country depends on financial inflows to fund its current account, it can hardly afford to discourage these inflows too aggressively, or to become too selective about the types of inflows that would be preferred. Contrary to most emerging-market countries, South Africa has consistently recorded a deficit on its current account since mid-2003, although this deficit has been reduced from its peak of 8.5 per cent of GDP in the first quarter of 2008 to an estimated 4.2 per cent of GDP in 2010.[6] Inflows on the financial account are therefore needed to fund the current-account deficit, and have kept South Africa's overall balance of payments position positive over the years.

The likely success of direct controls or taxes on financial inflows is uncertain in the South African context. The rand is freely convertible and has a higher trading liquidity than many other emerging-market currencies. Consequently, foreign investors are able to enter and exit rand positions relatively quickly and with low transaction cost. Because of its relative liquidity, the rand is also more volatile than most emerging-market currencies and is often used by foreign investors to adjust the overall exposure of their portfolios to emerging markets. Past experience has shown that foreign portfolio investment can be reversed very quickly if global investment sentiment and risk appetite changes, resulting in sharp and sudden adjustments to the rand exchange rate. Applying direct controls in such an environment becomes very risky and unintentional consequences can easily follow. South African policymakers have to date preferred to adopt countercyclical, accommodative monetary and fiscal policies in order to reduce the impact of a strong exchange rate on the real economy.

The South African Reserve Bank has also leaned against the appreciation of the rand exchange rate by moderately increasing its foreign exchange reserves. However, the success of lower interest rates and reserve accumulation in preventing a significant appreciation of the rand has been limited, for a number of reasons. First, although the policy rate of the Bank has been reduced to a record-low level of 6.0 per cent, interest rate differentials remain attractively wide even at that level. Second, lower interest rates have mixed empirical effects on the nominal exchange rate of the rand. Expectations of further possible interest rate cuts and currency appreciation raise the probability of capital gains on bonds, thus making them even more attractive to foreign investors. Lower interest rates also increase the attractiveness of the South African equity market, as growth prospects become more optimistic. Third, the interest rate differentials make it costly to drain the domestic liquidity that is created in the process of absorbing capital inflows into official reserves. Fourth, the amounts of reserves that will have to be accumulated to make a meaningful difference to the exchange rate are very large: the average daily turnover in the South African foreign exchange market is around USD 10 billion, of which spot transactions constitute about a quarter.

The government in its October 2010 Medium-Term Budget Statement announced further liberalisation of controls on capital outflows that are intended to enable international firms to make investments through South Africa to the rest of Africa and to further enhance opportunities for offshore portfolio diversification for resident investors. Among others, proposals have been made to increase the annual limits on the amounts that South African individuals can invest offshore, and the existing exit levy on emigrant outflows has been abolished. These initiatives form part of the government's macroprudential risk-based approach to the management of foreign exposure.

However, there are limits to what monetary, fiscal, regulatory or macroprudential policies can achieve. Economic agents in the public and private sectors also have to adapt their behaviour to a changing environment. South African importers currently benefit from the rand's appreciation. They should exploit this opportunity by importing capital goods and expanding production capacity at much lower costs than budgeted, in preparation for the next upward phase of the economy. Expediting the import

6 *National Treasury Medium-Term Budget Statement, October 2010.*

of capital goods will at the same time take some of the pressure off the exchange rate.

The competitiveness of the export sector should not be based only on the exchange value of the rand, but should be achieved by improving companies' overall competitiveness in international markets. In the current global environment, a relatively strong exchange rate may be a feature of the South African scenario for some time. In such an environment, there should also be more emphasis and incentives to improve competitiveness through innovation, higher productivity, lower production costs, greater efficiencies and improved quality.

Global imbalances pose a threat to global financial stability as well as to the financial stability of individual countries. There is a limit to which individual countries can respond to these imbalances and a coordinated multilateral approach is required to unwind them in an orderly manner over time, in the interest of all. However, there is also a responsibility on individual countries to address their own internal, structural imbalances and to try and avoid passing on the consequences thereof onto their neighbours or trading partners.