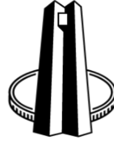

An address by Fundi Tshazibana,

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at the Central Bank of Eswatini,

Mbabane, 17 November 2023

Global shifts and regional spillovers – how are we performing?

Introduction

Ladies and gentlemen, thank you for the opportunity to address you today at this event hosted by our colleagues at the Central Bank of Eswatini. The relationships between our respective central banks go back a long way – after all, the Common Monetary Area (CMA) of Southern Africa is the oldest existing currency union in the world, dating back to the beginning of the 20th century. The deep economic ties between the economies in the CMA, and our pegged exchange rates, underscore a high synchronisation in our economic cycles, especially in responding to the impact from global shocks, trends and spillovers to the African region – a central theme of my talk today.

The past three to four years have seen many global shocks, and their ramifications continue to reverberate. In fact, we are still uncertain about the long-term effects these shocks will have on the world economy, trade and capital flows. While the COVID-19 pandemic may no longer be a major health concern, we still face a world of relative price shifts, high inflation, re-organisation of supply chains and increasing geopolitical risks. Encouragingly, both the global economy and our regional context have shown some resilience to these shocks. But some effects might come with a lag and complicate the task we, as central banks, face in maintaining price stability and financial stability. These are some of the issues I will try to address today.

Some encouraging global developments

We are all well aware of the inflation surge experienced globally in 2021 and 2022, driven by supply and demand mismatches that emerged as economies reopened in a staggered manner after the COVID-19-related lockdowns. During this period, advanced economies experienced inflation levels not seen since the early 1980s. To limit the permanent release of the inflation genie out of the bottle, advanced economy central banks had to act decisively by raising rates to levels last seen before the 2008 Global Financial Crisis.[1] In emerging market and developing countries, most central banks had to tighten too, though the degree of the policy response varied considerably based on idiosyncratic factors.

The good news is that in the past year or so, inflation rates have declined around the world. However, core inflation has remained rather sticky. This is the case with labour-intensive services in advanced economies, against a background of still-tight labour markets. Nonetheless, services inflation is now falling in most countries. Favourable base effects in energy, food and the unwinding of supply chain bottlenecks have also tempered price increases in other consumer price index (CPI) components. Furthermore, longer-term inflation expectations, at least in major advanced economies, have remained reasonably well anchored, a testimony to central banks retaining their credibility.

As a result, the monetary policy tightening episode appears largely complete. While central banks maintain vigilance against persistently high inflation, they demonstrate rising evidence of the transmission of earlier rate hikes to financial conditions and credit demand. Consequently, financial markets now see no probability of an additional hike in the United States (US) or eurozone. In the emerging economies, some of those central banks which had acted early and proactively to deal with inflation now have the flexibility to consider rate cuts.

Another encouraging development is that disinflation is occurring alongside the surprising resilience of the global economy. The IMF's October World Economic Outlook estimates that global growth will only slow to 3.0% this year, from 3.5% in 2022. In addition, Bloomberg consensus of economists now also expects world growth

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[1] See 'Inflation: A look under the hood', Bank of International Settlements, *Annual Economic Report 2022*.

of 2.8% in 2023, up from only 2.1% projected at the beginning of the year. In advanced economies, most private sector balance sheets were solid at the time when monetary policy was tightened. Cash buffers supported private spending, while in the US, corporate borrowers had 'locked in' low-cost medium-term financing when interest rates were at historic lows. This delayed the impact of higher rates on demand.

Cross-border capital flows, while weak by historical standards over the past few quarters, have nonetheless displayed equal resilience in 2022–23, considering the size of the repricing in advanced economies' bond markets, usually a "bellwether" for global investor risk appetite. Over the past 12 months, portfolio flows to emerging markets over the past 12 months are only a 0.3 standard deviation below their average of the past 10 years.[2] This is good news, considering that the 10-year US Treasury yields have risen by about 300 basis points since the beginning of 2022.

Some of this better-than-expected news appears to have spilled over to the sub-Saharan Africa (SSA) region. In its October 2023 *Regional Economic Outlook*, the International Monetary Fund (IMF) projected a rebound in regional growth from 3.3% this year to 4.0% next year. Similarly, the IMF noted that median inflation for the region fell by 3 percentage points between March and July, and that most governments have started to consolidate fiscal policies, thus helping to stabilise debt-to-GDP ratios. In response to this improved environment, most SSA central banks have also paused their tightening cycles.

We have also observed moderating inflation rates, as well as some resilience in economic activity, in CMA counties. In South Africa, inflation stood at 5.4% year on year in September, down from a peak of 7.9% in July last year. A similar pattern has been observed in other CMA countries, and indeed, my colleagues at the Central Bank of Eswatini recently revised down their 2023 inflation forecast from 5.55% to 4.93%.[3] Inflation also fell faster than expected in Lesotho, and in Namibia, with expectations of a further decline in 2024.

[2] The portfolio tracker data from the Institute of International Finance is used.
[3] See Monetary Policy Statement, Central Bank of Eswatini, 22 September 2023.

At the same time, the South African economy performed better than expected in the first half of the year, leading the South African Reserve Bank (SARB) to revise its 2023 growth forecast upwards to 0.7%, from a low of 0.2% in March.

Risks of negative spillovers remain elevated

Despite these recent improvements, the global environment remains challenging. In the shorter term, higher advanced economy bond yields can still undermine, with a lag, cross-border capital flows. These are key to the funding of countries with external and public deficits, like most of us in the SSA region. History suggests that capital flows are more vulnerable, not only when nominal yields but also real yields are rising – as the latter typically reflect a re-pricing of the future path for policy rates, or higher term premiums for longer-dated maturities.[4] This has been the case in the US these past two years, where the real 10-year yield rose from -1.0% at the beginning of 2022 to a peak of 2.5% by the end of October.

Bloomberg columnist John Authers recently drew a parallel between 2023 and 1987, a year when rising real yields in the US co-existed with resilience in 'riskier' assets, especially equities, until the stock market crashed in October of that year.[5] We do not want to be 'prophets of doom' and predict market corrections that may or may not happen, but in recent months, we have already seen declines in equity prices, as well as emerging market currencies and bond markets. Higher yields may still translate, with a lag, into a further correction in riskier assets, especially if economic activity in the US eventually slows, as most economists expect.

The tragic events unfolding at present in the Middle East, less than two years after the start of the conflict in Ukraine which shows no sign of an immediate resolution, highlight the importance of geo-political risks. These can negatively affect the global economy via trade, commodity prices – especially oil – and higher asset price volatility. Beyond geo-political issues, climate change, and the potential it has to generate greater volatility in agricultural commodities and changes in resource allocation,

[4] The Federal Reserve Bank of New York, using the Adrian, Crump and Moench (2013) model, calculates that the term premium on the 10-year US Treasury yield has risen from -0.74% at the end of April 2023 to +0.42% at the end of October (https://www.newyorkfed.org/research/data_indicators/term-premia-tabs#/overview).
[5] J Authers, "No one wants to remember 1987. Then there's 1916.", Bloomberg, 4 October 2023.

presents another risk to global inflation. In fact, as Christine Lagarde recently remarked, the world may have entered a period where supply shocks will become durably larger, and more frequent than in the past.[6]

These non-financial factors can have a direct impact on financial markets and capital flows, as investors may require a higher risk premium for holding riskier assets. They can also have an indirect impact, as more frequent and larger supply shocks have a larger probability of de-anchoring inflation expectations, forcing central banks to be more cautious and resulting in tighter policy over the economic cycle.

This can enhance financial stability risk. Expectations that the era of low and stable interest rates would last influenced both the funding and investment models of many financial institutions, leading them to increase their exposure to interest risk. If higher yields for longer become the norm, many investment positions may be liquidated simultaneously, adding to asset price volatility.[7]

Negative spillovers from the global environment to our regional economies are not limited to financial flows. Merchandise trade flows also pose a risk to emerging market and developing country growth. Global trade in merchandise goods – after the post-COVID-19 rebound – appears to be in a recession phase.[8] China's shift away from infrastructure and property investment, towards more household consumption and away from infrastructure and property investment poses a challenge for commodity exporters. As a result, African exports have been contracting since the second quarter of 2023.

Beyond the current weakness in global export and import flows, the international trade system could suffer from geo-economic fragmentation in the medium term if geo-political rivalries unravel the multilateral, rules-based system. Rival trade blocs that engage less which each other, be it with respect to trade, foreign direct investment or technology transfers. Recent research from the IMF suggests that the SSA region,

[6] See 'Policymaking in an age of shifts and breaks', speech by Christine Lagarde, President of the European Central Bank, at the annual Economic Policy Symposium 'Structural Shifts in the Global Economy' organised by the Federal Reserve Bank of Kansas City in Jackson Hole, 25 August 2023.

[7] International Monetary Fund, *Global Financial Stability Report*, October 2023.

[8] Data from the Netherlands Bureau for Economic Policy Analysis show that the volume of global trade contracted by 1.9% year on year, on average, in the first eight months of 2023.

with its broad spectrum of export destimations, could experience the most significant output losses from such fragmentation.[9]

Regional vulnerabilities to global challenges

Although the SSA region has displayed resilience to global shocks, these improvements are still fragile and insufficient to bolster the region's attractiveness for external investment. First of all, inflation remains too high in many SSA economies. Among the 10 largest economies in the region, six still had double-digit year-on-year inflation rates as of September. Recent currency depreciation in many SSA countries (where a large part of the consumer goods basket is imported, and where inflation expectations are often poorly anchored) risks perpetuating high inflation, in terms triggering addition foreign exchange losses.

Many countries in the SSA region tend to suffer from 'twin deficits' (fiscal and external) which raise the cost of debt servicing and refinancing at a time when global investors are more risk-averse, and more sensitive to deteriorating fiscal dynamics. According to the IMF, over half of the SSA countries are either at a high risk of debt distress or already in debt distress.[10] No country in the region has been issuing Eurobonds since April 2022, suggesting that the refinancing of external debt could be particularly challenging in the next few years.

Finally, economic performance in the SSA region remains uneven, and generally falls short of the performance seen two decades ago– a period when investment in the region increased steadily. South Africa is one of the laggards in the region – the SARB only expects growth to accelerate to 1.0% in 2024 amid continued constraints from insufficient electricity production and inefficient transport networks. Other CMA countries also look set to fall short of the regional average. More generally, the IMF notes a tendency for resource-intensive economies to underperform, highlighting the lingering problem of the SSA's insufficient downstream integration into value chains.

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[9] See International Monetary Fund, 'Geoeconomic fragmentation: sub-Saharan Africa caught between the fault lines', *Regional Economic Outlook: sub-Saharan Africa Analytical Note*, April 2023.

[10] International Monetary Fund, *Regional Economic Outlook: sub-Saharan Africa*, October 2023.

How policy can best respond

In response to these global challenges and regional vulnerabilities I have described, policymakers in our region, including us central bankers, still have work to do.

Here is a list of the issues we should consider:

- Policy response is not for central banks alone
- Structural reforms are unavoidable
- Controlling inflation is not negotiable
- Close supervision of banks and non-banks is a must
- And a credibility fiscal path is not only a necessary for fiscal sustainability but to bolster confidence, ensure financial stability to give some breathing room to monetary authorities

High and volatile inflation discourages external capital inflows. It also discourages domestic fixed investment, erodes the purchasing power of the more vulnerable in society, and generally leads to a sup-optimal allocation of resources. This makes it essential for central banks to ensure that inflation returns swiftly to target, even when the causes of deviation are due to external factors, domestic supply shocks or necessary exchange rate adjustments.

Market-determined exchange rates support foreign investment and enhance the allocation of resources in the longer run. Within the CMA, the rand is able to play its role of ‘shock absorber’ in episodes of capital outflows, and this helps reduce the length and size of such episodes. In the near term though, currency realignment is typically associated with an inflationary shock, and it is a central bank’s task to ensure that the shock does not become permanent. Credible monetary policy frameworks are required to help facilitate the eventual return to lower inflation rates.

Arguably, both the spillovers from global shocks and the policy response required to deal with the inflationary consequences can increase the vulnerability of a country’s financial institutions. To avoid conflict between price and financial stability goals, central banks should act pre-emptively by monitoring the evolution of financial institutions’ balance sheets and take appropriate action in the case of excess risk concentration or growing forex or duration mismatches. In the context of escalating public debt levels, heightened exposures of both banks and non-bank financial intermediaries to the sovereign require close supervision.

Fiscal policy can play a crucial role in limiting both price and financial stability risks, especially in those SSA countries which, like South Africa, have seen elevated deficits and rising debt ratios in recent years. A credible fiscal consolidation path can boost investor confidence, stabilise the currency and reduce the risk premia on government debt. Reforms that help in broadening the tax base, prioritising productive public investment and reducing wasteful expenditure, can all assist in fiscal consolidation, without causing significant real income losses.

More generally, structural reforms that help foster stronger and more inclusive growth would facilitate the task of both monetary and fiscal policymakers. These can include the deepening of domestic capital markets to reduce reliance on external funding at a time when the cost and availability thereof have become more challenging. They can also entail steps that facilitate the diversification of African economies, the broadening of their export base, and their stronger integration into global supply chains. Reforming network industries, fostering skills development and training, and reducing barriers to entrepreneurships would all assist in that diversification.

Concluding remarks

As the year draws to a close, we can take comfort in the relative resilience of the global economy and financial systems. The global economy continued to expand in 2023, despite being buffeted by high inflation, rising interest rates and heightened geo-political tensions. Credit continued to flow, albeit at a more moderate pace, and any corrections in asset prices occurred in an orderly fashion. Closer to home, we are encouraged by signs of declining inflation and improving growth prospects.

Nevertheless, the road back to price stability remains lengthy and one that is likely to be fraught with more uncertainties than we were accustomed to before the pandemic. Consequently, global interest rates may become structurally more volatile, at a time when cross-border trade and financial linkages potentially realign alongside geostrategic considerations. It is our task as central bankers to be ready to respond to how these patterns affect price formation. We remain committed to fulfilling our mandate of price stability.

Thank you.