

Forex markets at work – central banks keep out

We have witnessed an extraordinary, though by no means unprecedented, boom-and-bust cycle for emerging markets, of which SA is now one of the more important. The scale of the crisis is made nowhere more clear than by an examination of the interest rate spread between dollar-dominated emerging market government debt and US Treasury bonds.

Panic Attack?

Having been satisfied with as little as an extra 3% per year before the first wave of the Asian crisis, investors are now demanding as much as 16% per year or more. SA dollar-denominated sovereign bonds are regarded as much less risky than their peer group, but now yield 4,8% per year over similar US Treasury bonds compared to as little as 1,3% per year in March.

Emerging markets are rather a mixed bag. All they have in common is that their financial markets have “emerged” recently as important sources of demand for, as well as supply of, mobile international capital. SA carries a fairly large weight in most emerging market equity and bond indices of about 10% and 9% respectively.

Recent History

The increase in the flow of funds to and from emerging markets increased dramatically after 1990. According to the IMF, total net flows of about US\$50bn in 1990 had increased to as much as \$222bn by 1996. Almost all of it was private capital. Equity issues accounted for only about 7% of this total, and while the share of bank finance for emerging markets had become much smaller, bond issues grew dramatically. Africa's, largely SA's, share of the flow was a negligible \$8,8bn, but well up from \$2,2bn in 1990. Asia attracted nearly half of the 1996 flows and Latin America accounted for about a quarter of the total. This surge in new issues was accompanied by an equally impressive growth in secondary market activity.

Naturally, when market feast becomes market famine, the case for allowing capital to flow freely is questioned and the arguments for closer government regulation are more easily revived. But government and super-government agencies have been closely involved in this process. It is often asked whether rescue operations by the IMF do not encourage lenders and borrowers to take unnecessary risks in the first place. (Why worry about financially imprudent behaviour if someone will pick up the pieces?)

The role played by emerging market central banks in this episode deserves closer examination. According to the IMF, of the total flows of capital to emerging markets in 1996, as much as 47% was accumulated in foreign exchange reserves by central banks.

Central Banks Delay Adjustments...

Five of the world's 10 largest holders of reserves are or were emerging markets, notably China, Taiwan, Singapore and Hong Kong. Such reserves are held mostly in the form of US Treasury bills. Thus total emerging market reserves were equivalent to over 20% of all US government marketable securities by the end of 1996. Such investment outcomes would seem to defeat the purpose of attracting the capital. Of what starts out as a flow of private capital seeking higher returns, about half ends up as a low-risk, low-return, First-World asset, managed by a government agency.

Such a perverse allocation of international savings must be at the heart of the problem with the markets. Had the central banks not intervened in the foreign exchange markets over this period,

emerging market currencies would have appreciated faster and interest rates and earnings yields would have come down sooner.

Central banks prevent or delay the markets from making the relevant adjustments when they intervene in the foreign exchange markets. And by investing so much expensively raised capital in low-yielding US Treasuries, rather than in productivity-improving real investment, they must make it much harder for optimistic expectations of economic growth and corporate earnings to be fulfilled.

...and Delay Exaggerates...

Financial markets cannot hope to give off the appropriate signals if foreign capital flows easily in both directions while domestic corporations, financial institutions or households are denied the same opportunities. Even without central bank intervention, there would be little sense in describing exchange rates or interest rates as market-determined if controls were placed on the outflow of domestic capital.

Global capital markets allow savers in mature markets to trade off higher returns for more risk in faster-growing economies. The risks of investing in emerging markets are usually most obvious to people who live and work and manage businesses there. They should be encouraged to diversify their own wealth by holding less risky, lower-return, First-World assets. If so, capital flows to emerging markets would be balanced to a greater degree by capital flows from them.

...which Distorts Decisions

It is surely better that financial reserves against misfortune are held in private rather than central bank hands. With greater freedom to move private wealth in all directions and with less interference from government agencies, we could be much more confident that the (net) capital flows to emerging markets were flowing for the right risk and return reasons. We could also be more confident that financial securities were being priced correctly.

SA's recent experience is instructive in this regard. The saving grace of our weak currency and weak financial markets is that SA institutions, corporations and, to a tiny extent, individuals, have made foreign investments as exchange controls were relieved. Our balance sheets would have been weaker still without the extra R100bn that has been invested offshore.

Good News which Might be Better

Is it not comforting to know that such steps kept the Reserve Bank from accumulating larger foreign exchange reserves when the going was good? What if we had complete freedom to invest offshore? Surely the result would have been better protection against economic adversity? We would have had a smoother ride for our currency and financial markets. And, no less important, we would have had much more respect from the international investment community.

Further Reading

Lal, Deepak (1990) *The Limits of International Co-operation*, Institute for Economic Affairs, London.

Grant, Richard (1992) *Exchange Controls Must Go*, FMF Paper, Johannesburg.

*This Briefing Paper was written by Professor Brian Kantor,
Dean of the Faculty of Commerce, UCT.
It first appeared in the Financial Mail in October 1998.*