



EMERGING MARKET PERSPECTIVES

A Road Well Traveled

In an era of high inflation, emerging markets have lessons to share

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In the ongoing public dialogue about economic policy, the challenges faced by advanced economies usually dominate those of the developing world. In monetary policy, for instance, the defining issues of the past decade were the zero lower bound on interest rates and inflation that was too low. But neither of these problems affected emerging markets much. Our challenges had much more to do with textbook issues, such as keeping inflation from drifting above our targets, resisting demands for lower interest rates to lift short-term economic growth, and financing unsustainable fiscal positions.

Now, as the economic conversation in advanced economies changes to address higher inflation, emerging markets have something to offer. Emerging market central banks have ample

experience dealing with these conditions, including the political pressure that often follows policy tightening. Three areas of experience stand out.

The first has to do with managing supply shocks. These are as hard to explain from a monetary policy perspective as they are routine. In my 12 years on the South African Reserve Bank's Monetary Policy Committee (MPC) I have spent more time trying to gauge the impact of supply shocks, and communicating how we distinguish between transitory and persistent effects, than I have managing demand-side pressures. Many emerging markets have had similar experiences.

Part of the problem is that even with moderate rates of inflation, price and wage setters learn to track inflation and to index their prices. This means that if central banks don't respond to shocks in a timely way, price pressures expand and inflation expectations shift. This leaves policy further behind the curve, so that temporary shocks end up having lasting effects.

For many years, the optimal response to supply shocks was the advanced economy textbook version: Don't respond, because the shock will dissipate. But emerging market economies exhibit more indexation and less tolerance for real income losses. Inflation today is more likely to propagate into the future. For that reason, policy responses to supply shocks are required more often. Many emerging market economies have introduced robust inflation-targeting frameworks to better shape inflation expectations, and these have generally worked well, creating policy flexibility.

This need for a more distinctive emerging market approach may be grounded in generally higher inflation rates, which give people a strong incentive to track the consumer price index rather than assuming price stability. Our inflation rates matter for day-to-day decision-making by households and firms.

Fiscal sustainability

The second area is related to our mandate. It is often assumed that fiscal and monetary policy don't overlap. This is more abstract than real. Monetary policy can be distorted by fiscal policy, as any emerging market policymaker will tell you. The increase in concerns about fiscal dominance bears this out, not least as major central banks increasingly focus on the legacy of quantitative easing and other policies that boosted their holdings of government debt. Because of balance sheet concerns, it is even more critical that central bank mandates remain simple and direct.

To achieve good outcomes, countries need a broader macroeconomic strategy that delivers other key outcomes, especially fiscal sustainability. Without such a strategy, central banks cannot, by themselves, ensure a growth-friendly environment.

South Africa is a case in point. In the 1990s, the newly elected democratic government instituted a series of reforms that underpinned the longest period of unbroken growth in South Africa's history. The three main building blocks of these reforms were a floating exchange rate, which liberated the country from costly and unsuccessful exchange rate interventions; inflation targeting, which led to lower interest rates and more stable prices; and perhaps most important, fiscal restraint.

Together, these reforms helped steer the country through the emerging market crises of 1998 and 2001. But because they involved discipline and caution, they were not widely popular. In turn, this contributed to a more spendthrift approach over the past decade, with much less concern about either the volume or the quality of spending. A severe macroeconomic deterioration ensued, along with some of the lowest growth rates in South Africa's history.

Monetary policy held the line, but monetary policy is not everything. Again, other emerging markets have had similar experiences.

A balancing act

This brings me to the third area of emerging market experience: how to maneuver when making policy and, specifically, how to strike a balance between acting resolutely and remaining open to new ideas and information.

In advanced economies, particularly in recent years, groupthink has perhaps been a major policy problem. But I am not sure that is the emerging market experience. In the case of South African monetary policy, we have seldom had unanimous agreement on whether to raise rates. Even in the few cases when all MPC members agreed to tighten, we disagreed on how much to raise rates. And in our broader society, I can assure you that we suffer no lack of diversity of opinion.

My experience suggests that what emerging market policymakers really need is divergent views on tactical questions but consensus on the grand strategy.

In South Africa, our central bank mandate, laid out in the constitution, is to protect the value of the currency in the interest of balanced and sustainable growth. Much as I admire open discussion, it isn't

helpful to question and criticize the role of the central bank. Diversity of opinion is important, but not everything needs to be pulled apart.

As advanced economies face inflation dynamics that more closely resemble patterns in emerging markets, this distinction—between the things that require conviction and those that need debate—could be helpful. Monetary policymakers are making tough decisions, with inadequate information and high stakes. Critics will ignore the complexity and just assert that central banks can't see the facts. Central banks should reiterate their strategic goals—clearly, patiently, and backed by good evidence. What consensus you can muster should be nurtured, not feared as a sign of groupthink. By contrast, when it comes to tactics, you need to be open and willing to change your mind.

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The year 2023 could well be when the trends of 2022 reverse and some advanced economies return to lower inflation. If so, this will offer emerging markets some welcome respite. But we should not take anything for granted. Unfortunately, it is less clear that more benign inflation trends in advanced economies will ease economic conditions for emerging market and developing economies. A renewed commitment to addressing high debt levels is needed, keeping in mind the cost of the transition to low-carbon economies. Emerging market economies must make better use of the financing they can attract to re-achieve higher economic growth with more sustainable capital.

With lower economic growth and undiminished need for financial resources, the high-inflation environment in much of the world is likely to persist. Better coordination between sustainable fiscal policy and monetary policy would create important synergies, reducing the impact of supply shocks, keeping the cost of financing governments low, and taking inflation off the list of concerns of households and firms throughout the emerging world. **FD**

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