T T Mboweni: Global competitiveness - is South Africa ready?

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Black Management Forum Conference 2000 in Gauteng on 13 October 2000.

* * *

1. Introduction

Financial markets around the world are being integrated into a single global market and, whether we like it or not, emerging and developing countries are being drawn into this process. The growing economic interdependence of countries worldwide can be seen in the greater volume and variety of cross-border transactions and in the faster and more widespread diffusion of technology. Technological progress has improved transportation and communications, enhanced information awareness and information processing, and set the stage for new products and innovations.

Although these markets still do not form a single global village, they are already so interdependent that they have altered the environment in which the provision of financial services takes place. One of the most important results of globalisation has been the huge upsurge in cross-border financial transactions. This, in turn, has meant that shocks in one "national" market are quickly transmitted to other "national" markets with the speed never thought of decades ago. The contagion effect of the recent crisis in East Asia is a good example.

Another consequence of globalisation, is increased competition. Financial liberalisation, the removal of controls and the breakdown of international barriers, make it possible for new entrants to participate in markets which were previously closed to them. In view of the size of these enterprises and their involvement in many countries in the world, they are usually well-placed to provide specialised services to clients at relatively low costs. The increased competition makes new demands on old established enterprises and they must either adapt or die.

2. Globalisation and financial institutions

Financial institutions all over the world have responded to these changes in different ways. Some entered into strategic alliances with foreign or domestic enterprises. Others positioned themselves by specialising in the provision of certain specific services. Yet others chose to consolidate and form large groups. This approach led to takeovers and amalgamations of financial activity in new companies that provide a broad spectrum of financial services to consumers.

In South Africa the financial system has also been undergoing major modernisation and strengthening. The impetus for this change came after 1994 when foreign financial institutions began to participate directly in the South African market. The policy followed by the authorities of gradually removing exchange controls, opened up new opportunities for the diversification of investments. As a result, foreign financial institutions set up large numbers of subsidiaries, branches or representative offices in South Africa. At first the domestic financial institutions felt the impact of increased competition, but they now seem to have adapted well to the changed circumstances and have introduced various measures to improve their efficiency.

The depth, breadth and stature of South Africa's financial markets has been increased by a number of important developments in recent years. The development of a eurorand bond market, the introduction of primary dealers in bond auctions and the successful launching of a domestic medium-term note programme deepened the South African bond market. Financial instruments have also been diversified and aligned more closely with developments in international capital markets.

The Johannesburg Stock Exchange has been restructured to provide for electronic screen trading, corporate and non-resident participation, negotiated commissions and dual capacity trading by brokers. The stock exchange has also successfully forged links with other exchanges in Southern

Africa, and now shares with the Namibian Stock Exchange a system for trading, clearing and settlement. Electronic clearing and settlement, the phased dematerialisation of shares and their registration in a central securities depository, are currently being introduced. The objective is to reduce settlement risk through delivery against payments linked to the National Payment, Clearing and Settlement System.

It is important to realise that institutions that have greater international distribution and delivery capacity can compete better on a global basis. While merger and acquisition activity continues to grow rapidly in the world, the South African market has been relatively quiet in this regard since the market crash of September 1998. Although the past years have seen high-profile listings on the London Stock Exchange of South African Breweries, Old Mutual, Anglo American and Didata, there have been relatively few new listings or rights issues on the Johannesburg Stock Exchange. Moderate growth in share prices has tended to slow merger and acquisition activity, but cross-border acquisitions by South African companies have entrenched South Africa as part of the global economy and highlighted the need to be globally competitive.

The world of competitive global finance clearly favours players with a global scale and reach. This means that financial institutions must have research facilities to keep them up to date with international developments, they must have access to global markets and they must have products that can be marketed internationally. For many South African institutions, this implies a complete change in culture and in the behaviour of their staff, and probably also a realignment of their organisational structures.

Financial institutions in a global environment will, in particular, rely heavily on information to target potential clients, assess their needs and objectives, manage their portfolios, construct investment strategies and allocate assets. In this regard the Internet has emerged as a key competitive arena for the future of financial services. Web-based commerce has added new complexity and unpredictability to the world of commercial and retail banking, mutual funds and brokers, back-office processors and financial software providers.

Institutions that do not have a clear strategic focus will find it increasingly difficult to maintain their positions as competition gets tougher. They will have to identify a specific focus for their business, because it may become difficult to compete successfully in all the various fields and instruments. Careful planning and organisation are needed in this integrated world to ensure that the needs of clients are well served. Clients have become increasingly performance sensitive. This makes it essential to monitor structures and products to keep performance inconsistencies to a minimum.

3. Globalisation and financial regulation

Greater global competitiveness also poses new challenges to financial regulation for ensuring financial stability. The recent experience in a number of countries has clearly indicated that there is a real danger of financial instability from globalised financial markets and large and volatile international capital flows. The Asian crisis was magnified by bad loans, weak balance sheets and lack of transparency in financial reporting. Research shows clearly that emerging markets with sound financial systems are better able to manage the effects of international financial crises.

Partially in response to some negative effects of globalisation, several international institutions such as the Basel Committee on Banking Supervision, the Bank for International Settlements (BIS), the World Bank and the International Monetary Fund (IMF) have done studies on reforming the international financial architecture.

The cooperative global efforts on reform have been concentrating on five major areas. The first area is to make timely, reliable statistical data available to the market and the public, as well as information about economic and financial policies, practices and decision-making. Important progress in this area includes the establishment of the Special Data Dissemination Standard of the IMF and the release of Public Information Notices following the conclusion of the Article IV consultation process between the IMF and member countries. It is agreed that greater transparency will enhance the understanding by the public of economic policy measures of government, strengthen credibility and make market participants less uncertain in their decision-making.

The second area is the creation of internationally accepted practices. Key progress in this area includes the development of the Code of Good Practices on Fiscal Transparency, the Code of Good Practices on Transparency in Monetary and Financial Policies and guidelines concerning financial sector soundness. Adherence to these international best practices and codes should help to ensure that economies function properly.

The third area is the strengthening of the financial sector. The assumption is that banks and other financial institutions need to improve internal practices, including risk assessment and risk management. At the same time the official sector needs to upgrade the supervision and regulation of the financial sector to keep pace with the modern global economy. To achieve these objectives, the Basel Committee has developed the Core Principles for Effective Banking Supervision, while the Committee on Payments and Settlement Systems has drawn up the Core Principles for Systemically Important Payment Systems. Universal principles for insurance as well as security market regulation have also been developed.

The fourth area of financial sector reform concerns involving the private sector in crisis prevention. The involvement of the private sector should limit moral hazard, strengthen market discipline and improve the repayment of loans.

The fifth area of reform concentrates on the prevention of systemic instability. Most of the international best practices and codes have been established to minimise the effects that the insolvency of a financial institution may have on other institutions. In addition, the IMF has created a Contingent Credit Line facility as a precautionary defence for countries with strong economic policies. This facility has been designed to prevent the balance of payments problems that could arise from international financial contagion.

South Africa has been actively involved in discussions on the new international financial architecture. We recently also participated in a Financial System Stability Assessment undertaken by the IMF and the World Bank. The report on South Africa has not been published, but found that the South African financial system is robust and that the financial sector's legal framework is impressive. The assessment was further that South Africa is in broad compliance with recognised best practice in the fields of security, insurance and banking regulation and that we are making substantial efforts to ensure transparency. Despite this favourable assessment, we must nevertheless continue to strive for sufficiently accountable, transparent and effective cooperation between the various agencies for the smooth running of South Africa's financial markets. This should instil public confidence in the financial system.

The Banks Act and the regulations governing the activities of the banks have been amended to bring them into line with international developments. In addition, the Reserve Bank has established a Financial Stability Unit (FSU) to focus on the overall stability of the financial sector and its preparedness for global competition. One of the functions of the FSU is to keep abreast of international developments as far as stability issues are concerned. The unit should ensure that the South African financial system remains resilient in an environment of global competition. It has also been created to ensure effective cooperation with the Financial Services Board.

The Reserve Bank's Financial Stability Unit will continuously assess developments in the domestic financial system to ensure that we obtain early warnings of any signs of a potential crisis. The FSU will also investigate the overall design of the financial regulatory regime, with special emphasis on aspects of regulation that are difficult to implement. Its aim will be to strengthen structures, ensure better management of risk in financial institutions and improve corporate governance. The work of the unit will cut across a number of other areas, including the need for improved disclosure and how to foster more effective cooperation among players in the financial system.

The establishment of the Financial Stability Unit further demonstrates that South Africa is increasingly being equipped to become an international financial centre. A large part of the unit's work since its establishment has consisted mostly of information gathering and follow-up work arising from the agenda of the Financial Stability Forum of the Group of Seven industrial countries. The Financial Stability Forum aims to bring together the regulators from the Group of Seven countries to exchange ideas on how to achieve greater soundness in financial systems. It has produced guidelines on deposit insurance and key standards for sound financial systems, as well as on implementing these guidelines and standards. Although South Africa is not a member of the G7, representatives of our country have participated in meetings of the Forum's working groups.

4. Globalisation and monetary policy

Globalisation and increased competitiveness have also created additional challenges for monetary policy. The internationalisation of investment decisions has made South Africa more prone to volatile capital movements. This was clearly illustrated by the behaviour of portfolio investments by non-residents in recent years. For example, the net purchases of South African bonds by non-residents amounted to R16 billion in the first four months of 1998. This was followed by a reduction in their holdings of R26 billion in the last eight months of 1998. From the beginning of 1999 until the end of January 2000 they again became net investors in South African bonds to the amount of R16.5 billion. Subsequently, from February to August, they again sold domestic bonds on a net basis totalling R12.5 billion.

In seeking to ensure stability in the overall balance of payments position of South Africa, volatile capital movements are making it imperative for South Africa to reduce inflation. The pursuit of price stability and the success achieved by many countries in bringing their inflation rates down to low levels have left South Africa with no other alternative than to bring our inflation in step with that of the rest of the world and to keep it there. If this is not achieved in the coming years, market adjustments will take place to compensate for the inflation differential. Such adjustments could include large disruptive capital outflows, a depreciation in the external value of the rand and high interest rates.

The thrust of monetary policy in the new globalised financial environment must therefore be the pursuance of price stability. Fortunately the Reserve Bank has already chosen to follow this course and success in bringing inflation down is within our grasp. Unfortunately such a policy stance does not provide unconditional protection against speculative capital outflows. The decisions of international investors are based on international interest rates, exchange rates and such factors as political stability. These factors are beyond the control of the central bank. The only approach that the Reserve Bank can follow is to do its important bit for stability, growth and employment creation, and that means establishing and maintaining financial stability.

However, the way in which this objective is pursued, is in the hands of the Reserve Bank. Recently an inflation-targeting monetary policy framework was adopted for this purpose. Inflation targeting has been used in many other countries with great success. With the adoption of this approach to monetary policy in South Africa, the authorities attempted to create greater certainty about what monetary policy wants to achieve. No one is left in the dark any longer. Everyone should know by now that the Reserve Bank's ultimate objective is an annual average inflation target range of 3 to 6% for the year 2002. This new framework has helped to focus monetary policy, has promoted transparency and has led to a clearer public accountability of the Reserve Bank.

Globalisation and increased international competition have made it important for the Reserve Bank to adopt inflation targeting as its policy approach. International capital flows and liberalised financial markets obscure the relationship between money supply, interest rates and inflation. In an integrated world economy the money supply becomes a less reliable anchor for monetary policy, forcing the authorities to take a different approach.

A fixed exchange rate system would also be a difficult monetary policy framework to pursue in a world experiencing large and volatile capital movements. This was clear from the developments in Mexico during the tequila crisis and in Thailand, Malaysia and Indonesia during 1998 when large amounts of capital were withdrawn from emerging-market economies. However, some countries, such as Hong Kong and Argentina, have applied a system of fixed exchange rates with some success, while maintaining price stability. Their success was due to consistent monetary policies and well-regulated financial systems. Flexible exchange rate regimes nevertheless seem to shelter countries more effectively from the exogenous shocks that are typical of greater economic integration.

Trying to maintain an exchange rate target may be costly in terms of less activity in the domestic economy. In an inflation-targeting framework, exchange rates are generally allowed to reflect the supply of and demand for currency in foreign exchange markets. By allowing the exchange rate to be flexible, interest rates become more stable and reversals in international capital flows do not disrupt domestic economic activity as much. This does not mean that large exchange rate changes do not have serious effects on production. Naturally they have a direct impact on the country's international economic activity. Depending on the importance of the external sector they could also have a serious impact on domestic production growth, job creation and inflation. However, large changes in interest rates generally have a larger impact on domestic activity than exchange rate adjustments. The art of central banking is to make these essential adjustments to the economy with the least harm to domestic economic activity and job creation.

5. Conclusion

Globalisation and greater competition pose interesting challenges on a micro and macro level for enterprises and the public authorities. Financial institutions and markets need to make many adjustments to cope with this changed environment. Similarly, public authorities face new problems without easy answers. These issues have led to a considerable effort by international organisations to improve the world's financial architecture. At the same time, national public authorities had to apply their minds to the policy approaches that the integrated world economy require. Financial institutions, financial markets and the monetary authorities in South Africa have adapted in a flexible and well-considered manner to changes in the world economy. We seem to have made the correct changes under the circumstances, and these changes should contribute to sustainable high economic growth and job creation in the medium to long term.