South African Reserve Bank

Remarks by Daniel Mminele,
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at the Managing Capital Flows: Challenges for Developing Economies Conference

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Good afternoon, ladies and gentlemen.

Let me start by thanking the International Monetary Fund (IMF) for inviting the South African Reserve Bank to be a part of this conference – and in these rather spectacular and splendid surroundings. As many of you will know, the Victoria Falls next to us were declared one of the seven natural wonders of the world. Luckily, the issues we have been asked to address today do not leave us at the mercy of nature, but are rather about the choices we need to make to ensure that we harness the good that comes with international capital flows while managing the risk of damage that they admittedly may cause under certain circumstances.

1. Introduction

In this session, we have been asked to provide some concrete advice to policymakers in light of what has been discussed during the course of the day. When I read this, I was reminded of an old Zambian saying: "One who enters the forest does not listen to the breaking of twigs in the bush." This speaks to remaining focused on one's particular task despite what one may see or hear in the process of the quest. Unfortunately, when it comes to providing advice on managing capital flows, one tends to hear many twigs breaking. This is a complicated task. Any piece of advice cannot be based on generalisations or extrapolations as country-specific factors and features of the financial system, as well as the time at which measures are considered, are of critical importance.

In my remarks today, rather than dispensing concrete advice on liberalisation and volatility management, I will restrict myself to making some general observations on capital flow management, followed by sharing experiences from South Africa. I will leave it to you to judge which of our experiences could be useful in certain environments and which should rather be avoided. What will be successful or effective will be highly dependent on country-specific circumstances, although we should always be cognisant of the potential spillover effects of our individual and collective actions.

2. Views on the liberalisation of capital flows

It is an undisputed fact that most countries have made impressive progress in the liberalisation of their capital flows in order to reap the benefits of capital inflows while remaining mindful of the unintended consequences of these inflows. According to the IMF publication titled *Capital flows: review of experience with the institutional view*, published in December 2016, the average number of easing measures introduced between 2013 and 2016 amounted to 851, with almost 60% representing easing by emerging market economies. China, Colombia, India, Indonesia, Malaysia, South Africa and Thailand introduced about 127 easing measures. During the same period, only 233 tightening measures were introduced, with more than half representing emerging market economies. In order to rationalise this behaviour, it is perhaps at this point worth recapping some benefits of capital flows.

Countries with a liberalised capital account tend to be able to tap into foreign savings to invest in infrastructural projects that contribute to sustainable domestic employment creation and generate income to service the underlying debt. The other benefit relates to the typically ensuing technology transfer and financial market development and innovation that assist countries in increasing the absorption capacity of flows without distorting the macroeconomic fundamentals. Needless to say, opening a country’s capital account also increases its vulnerability to the changing conditions in global financial markets.

The most fundamental and intricate rule about the liberalisation of the capital account is that the process has to be well thought through in terms of timing and sequencing in order to minimise costs and unintended consequences. The manner in which these controls are eased should be tailored to a country’s specific circumstances and economic objectives.

Careful planning ensures that macroeconomic stability is maintained over time and that the benefits outweigh the costs.

The IMF has recommended a phased approach to capital flow liberalisation, prioritising the liberalisation of stable flows such as foreign direct investment, which are closely correlated with growth, before more volatile and short-term portfolio flows. It further recommends that the relaxation of controls on capital inflows be prioritised before capital outflows.

As Napoleon Bonaparte once said: “Forethought we may have, undoubtedly, but not foresight.” Some countries which may have planned the process of capital account liberalisation and subsequently met some macroeconomic preconditions to liberalisation (like strong and stable growth, low inflation, and high levels of foreign reserves) might in retrospect discover that they have liberalised prematurely or too rapidly. While the liberalisation of the capital account is generally associated with the abolishing of capital flows measures that confine capital mobility, the reimposition of temporary controls in instances where the openness was prematurely or too rapidly undertaken or posed a risk to macroeconomic and/or financial stability may be justified. If a country has liberalised at too fast a pace than its economy was able to handle, temporary and limited measures may be effective in providing some stability until macroeconomic adjustments and policies have created, once again, a more suitable environment that can support the free movement of capital.

As stated earlier and according to the institutional view of the IMF, it is permissible to reimpose capital flow measures on a temporary basis when the excessive flows pose a risk to the macroeconomic and/or financial stability of the country. More so, the Code of Liberalisation of Capital Movements of the Organisation for Economic Co-operation and Development (OECD), established in 1961 and currently under review, provides an established process of international dialogue and cooperation with regard to the management of capital flows. In addition, the Code serves as the platform for countries adhering to it to explain their policies on capital controls and raise questions about the policies of others.

Ideally, one would prefer to avoid a situation where capital flow measures are reimposed. However, it would be important to accept the burden of explaining rather than putting financial systems and economies at risk for fear of being accused of having committed policy mistakes. Ongoing engagement and collaboration to stay abreast of the developments in the capital liberalisation of other countries, including exchanging views and sharing experiences at conferences such as this one, is necessary to both avoid the need to possibly reimpose capital flow measures and be better prepared should the need to reimpose arise. To further the international debate on understanding and managing capital flows better, including the macroprudential tools that have a capital flow intent, the G20[1] re-established in 2016 the International Financial Architecture Working Group which is in the process of compiling a report on its work for the G20 Hamburg Summit scheduled for July this year.

3. The case of South Africa

The administration of exchange controls is a function delegated to the South African Reserve Bank by the Minister of Finance. South Africa has progressively liberalised its exchange control framework since 1994, removing all restrictions on the capital flows of non-residents. These initiatives were undertaken with the explicit objective of attracting investment into South Africa. As a result of this predetermined approach, South Africa has thus far never found itself having to reimpose capital controls but has instead endeavoured to minimise the barriers on residents, enabling domestic firms to expand internationally, particularly into Africa.

In South Africa, the sequencing of liberalising controls by type of flow was generally broad-based for both inward and outward flows. The country does not have restrictions on inward capital flows and these inflows have thus far been effective in adequately financing the deficit on the current account of the balance of payments. The country's reliance on portfolio inflows makes it difficult to impose measures that may dry up this source of funding.

Regarding outward capital flows, a phased as opposed to a 'big bang' approach was adopted to ensure that financial stability was maintained. The sequencing started with current account transactions, followed by removing controls on non-residents capital flow, direct foreign investments by South African corporates, and finally allowing for the diversification of the portfolios of institutional investors. This approach was followed also because of the large amount of domestic savings after years of tightening. Although prudential limits to regulate the foreign exposure of domestic institutional investors still exist,

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they have a built-in stabilising effect, such that as the rand depreciates, the institutions closer to their limit will breach the threshold and will over time be required to repatriate the funds.

As the only source of knowledge is experience, allow me at this point to share our use of the policy toolkit for managing capital flows. The policy response to capital flows is embedded in maintaining macroeconomic policy discipline and strengthening the depth and regulation of financial markets. The flexible exchange rate continues to act as a shock absorber, where the currency is allowed to strengthen if it is not deemed overvalued relative to the fundamentals or to weaken if it is not deemed undervalued. In a nutshell, South Africa has a relatively hands-off approach to managing capital inflows while monetary policy is not focused on the exchange rate but rather on the possible inflationary implications of exchange rate changes. However, during periods of sustained inflows, the authorities accumulated foreign exchange reserves, without in any way seeking to influence the exchange rate towards a particular level or range.

During periods of large capital outflows, such as in the final quarter of 2008, the South African Reserve authorities deemed it inappropriate to impose capital control measures on outflows, for the following reasons:

- According to the 2016 results of the triennial survey conducted by the Bank for International Settlements, about two thirds of rand trading occurs in offshore markets. Any domestic capital flow restrictions will therefore have little to no impact on this trading but could rather lead to an increase in offshore trading.

- The risk of the prevailing domestic financial stability being disturbed if the exchange rate were to depreciate is limited by the fact that both the private sector and government borrow mainly in the local currency.

- There is no major mismatch between South African banks' foreign assets and liabilities, which are both moderate relative to the size of their total balance sheets.

- The low level of foreign currency-denominated indebtedness protects balance sheets as it limits the impact of sudden stops on the accessibility of foreign liabilities. Large corporates also adopt strategies, such as hedging, to manage exchange rate volatility.

- South Africa recorded a positive net international investment position in September 2015, the first time on record (since 1956). The national balance sheet acts as a stabilising mechanism as a weaker exchange rate increases the value of South Africa's foreign assets.

South Africa's view on capital account liberalisation and capital flow management is aligned with the institutional view of the IMF. As an enhanced engagement member of the OECD Advisory Task Force Committee (ATFC) with no voting rights, the country has been fully engaged in the ongoing review of the OECD Code. Continued cooperation between the IMF and the OECD remains crucial for addressing any perception that countries might receive seemingly conflicting signals regarding the appropriateness of capital flow measures, and is helpful in enhancing the consistency between the IMF's institutional view and OECD approaches with the G20 Coherent Conclusions for the Management of Capital Flows. This cooperation is also crucial for ensuring that the approaches by various international organisations do not give rise to any conflicting policy advice. Participation in the ATFC affords South Africa an opportunity to learn about the effective use of capital flow measures from a full description of the experiences of other countries.

The work on capital flow management by the IMF and the OECD is also crucial for the macroprudential framework and the policy tools that are being developed by the South African Reserve Bank. The constant updating on the developmental work on capital flow management, which forms part of the G20 agenda on the reform of the international monetary system, under the International Financial Architecture Working Group, is crucial in the construction of a macroprudential framework and policy tools currently under consideration by the South African Reserve Bank.

In addition to reviewing its capital flow measures framework, South Africa is continuously pursuing efforts to further modernise its regulatory framework through reforms in its financial regulatory and supervisory architecture. In 2016, the South African Reserve Bank published, as part of its financial stability mandate, a proposed macroprudential policy framework for the South African financial system and its regulated entities. Although this macroprudential framework is currently silent on capital flow measures that have a macroprudential intent, the inclusion of capital flow measures in South Africa's macroprudential framework is an integral part of the South African Reserve Bank's current research agenda. While acknowledging the role of foreign savings in financing domestic demand, it is of utmost importance to develop a toolkit of macroprudential measures required to deal with credit and asset price cycles driven by global capital flows. I must, however, stress that the prudent way of dealing with volatile capital flows is to maintain disciplined macroeconomic and countercyclical policies during periods of inflows to ensure that the economy is resilient should outflows occur.

In a broader context, it is important for source countries of capital flows to be cognisant of the role and effect of their measures on the policies of recipient countries. Improved global policy coordination will help to mitigate the unintended spillovers from country-specific policies and will add stability to and improve efficiency in the global financial system.

In summary, South Africa has made remarkable strides in liberalising capital controls since 1994, especially on non-resident investors. Exchange control restrictions on foreign investment by private individual residents in South Africa have been progressively relaxed since 1997, such that the current limits are no longer a constraint. It is estimated that by now less than 3% of individuals are ‘somewhat constrained’ by the remaining exchange controls. Limits on outward foreign direct investments for corporates have also been abolished. And as a step towards prudential regulations, institutional investors are permitted to invest abroad, subject to a foreign exposure asset limit (currently 25% or 35% depending on the type of institutional investor).

With every experience there is a lesson to be learnt; the progressive liberalisation of the exchange controls came at the cost of losing key information on cross-border flows that is crucial for macroeconomic policy decisions. It was at this point that the authorities strengthened the cross-border system for monitoring and reporting. As the process of applying for approval of foreign exchange was largely eliminated, authorities were also required to strengthen regulatory, supervisory, inspection and monitoring roles to prevent the illegal export of capital. The illicit flow of capital is currently a big challenge for most countries that have liberalised capital control measures, but that is a topic for another day.

4. Conclusion

In conclusion, I would like to reiterate the IMF's views on the importance of maintaining sound policies and strong frameworks, including monetary policy and exchange rate flexibility, as the first line of defence against excessive capital flows. Robust macroprudential measures as well as capital flow management measures can serve as a supplementary defence mechanism, where warranted. The macroeconomic environment should encourage domestic savings and the deepening of financial markets so that capital flows can be effectively absorbed and channelled towards productive investment.

The work on capital flow management by the IMF and the OECD, which forms part of the G20 agenda on the reform of the international monetary system, under the International Financial Architecture Working Group, is crucial in the construction of a macroprudential framework and policy tools currently under consideration by various countries. Therefore, a more consistent global approach to capital flow management issues among various international frameworks and agreements should be facilitated, including addressing data gaps. We therefore welcome and support the current collaboration between the IMF, the OECD, the G20 and the Bank for International Settlements in this area.

Thank you.