Mr. Stals comments on financial sector reforms in Africa Contribution by the Governor of the South African Reserve Bank, Dr. C. Stals, at the Sixth Session of the Conference of African Ministers of Finance and Governors of Central Banks arranged by the United Nations Economic Commission for Africa and held in Addis Ababa on 31/3/97.

I INTRODUCTION

1. Background to the South African financial sector reform process

Unlike many other countries on the African continent, South Africa has a well-established financial structure which includes a relatively independent central bank, sophisticated modern banking institutions and competitive financial markets. There developed, nevertheless, a need for far-reaching financial reforms in recent years. The experience of South Africa in this regard provides an interesting case study from which some lessons can be learned.

The South African financial sector and, for that matter, its total economy, was isolated to a high degree from the rest of the world for more than a decade because of unacceptable internal political and social policies, and international punitive actions taken against the country. In the circumstances, developments in the financial sector did not keep abreast with the evolutionary international changes of the past twenty years. With a lack of external competition and economic concentration in a few powerful corporate conglomerates, a stagnating economy, and a comprehensive protective exchange control system, a "hot-house" climate was created that contributed to a retarded adjustment process of the financial sector.

Major political and social reforms in South Africa culminated in the democratic election of the Government of National Unity in April 1994. The scene was then set for major changes, also in the economy of the country. Indeed, not only was the scene set, but the expectations of the people of the country demanded major reforms that would, as a minimum, provide a better economic performance and an increase in the standard of living of millions of previously disadvantaged members of the community.

Over the past five years, South Africa was therefore not only challenged with the need for reintegrating the South African economy, and more in particular, the financial sector in a rapidly changing global financial environment, but also with the challenge of adapting to a new domestic socio-political structure. These adjustments in the financial sector, which are still in progress, were facilitated by the existence of a sophisticated, albeit marginally retarded, financial system with a long history of more than a century.

The Government's policy approach to the needed reforms is based on a gradual but resolved transformation of the financial sector, mainly by exposing domestic institutions more to international competition, by integrating policy measures, the institutional framework, and the financial markets gradually into the global village, and by adapting at the same time to the changing needs of the local community. In the next part of this paper, the attention is focused on the reform process of the financial system to meet these policy objectives.

The new South Africa was also confronted with a daunting further challenge, and that is to become, and to be part of, Africa. With the admission of South Africa during the second half of 1994 to the Southern African Development Community (SADC), comprising twelve countries in the Southern African region, new challenges were offered for the expansion of financial co-operation on a regional basis. The third part of this presentation will provide a brief summary of the progress so far made with co-operation amongst the central banks of the members of SADC in the implementation of financial reforms in the region.

II FINANCIAL SECTOR REFORMS IN SOUTH AFRICA

2.1 Macroeconomic policy implications

The integration of the South African financial system in the global economy obviously holds major implications for macroeconomic policies. A country that exposes itself to the whims and the fickleness of fund managers and financial traders operating in a technologically integrated global market system can no longer ignore the international norms and standards set for financial disciplines, prudent management, sound government and internal stability and security. Integration into the world financial system brings the advantage of access to a massive pool of excess saving in the mature economies of the world, but also demands from the individual participating country adherence to the disciplines of a global market economy. This presentation will, however not cover the consequences for macroeconomic policies of the financial reforms, but will rather concentrate on major institutional adjustments. Aspects of economic policy, such as exchange rate policies have been, or will be, covered in other sessions of this Conference.

2.2 The role and functions of the central bank

The South African Reserve Bank was founded in 1921 as one of the first central banks to be established in the new world outside of Europe. The Bank therefore has a long history and experience, and has always operated with some autonomy from Government. Even today, the South African Reserve Bank is privately owned, with important restrictions on the rights of shareholders, for example that no individual shareholder may hold more than one-half per cent of the capital of the Bank, and that the Bank may not pay a dividend of more than 10 per cent per annum on the paid-up share capital of the Bank.

Without going into the details of the functions and responsibilities of the South African Reserve Bank, the new South African Government recognised a few basic principles for the role of the central bank in the development of the economy. These can be summarised as follows:

Monetary policy is part of overall macroeconomic policy for which Government takes final responsibility. There must therefore be good co-operation between the central bank and Government, and regular consultation must take place between the Governor of the Reserve Bank and the Minister of Finance. The task of the central bank must be clearly defined and must be restricted to the objective of creating a stable financial environment that will be conducive for optimum real economic development. The central bank must protect the value of the currency. For the implementation of monetary policy, the central bank must be given sufficient autonomy to enable it to make objective decisions on sensitive monetary policy issues, such as the level of interest rates, money supply guidelines, financial liquidity management and bank credit extension policies. The central bank must be accountable to Parliament.

To give effect to this policy approach, the South African Government included the following mandate for the South African Reserve Bank in the new Constitution of the Republic of South Africa:

"The primary object of the South African Reserve Bank is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic.

"The South African Reserve Bank, in pursuit of its primary object, must perform its functions independently and without fear, favour or prejudice, but there must be regular consultation between the Bank and the Cabinet member responsible for national financial matters".

2.3 The development of the banking system

South Africa has always had a private sector banking system, based on private sector ownership and on effective competition in a free market environment. The major reforms introduced in recent years to adapt the banking system to the needs of the country's changed philosophies, macroeconomic policy objectives and international relationships, were therefore concentrated on improving the existing structure.

Firstly, recognition was given in the banking legislation to the existence and role of "informal" banking business that developed mostly in the less developed communities over many years. The Banks Act was therefore amended to provide for the continuation of numerous informal savings clubs ("stokvels") outside the normal constraints of bank regulation and supervision, but also then, of course, without access to central bank accommodation at the discount window.

New legislation to provide for communal ownership of a banking institution was introduced in the form of the Mutual Banks Act.

Secondly, banking institutions adapted their own internal policies to provide for greater participation in the social upliftment programmes of the country, for example by entering into an agreement with Government to provide a minimum amount per year for low-cost housing. On the other end of the spectrum, banks also introduced new electronic data processing systems, for example automated teller machines, and "smart card" facilities for a gradual introduction of electronic money.

Thirdly, bank regulation and supervision underwent major changes over the past ten years to apply the world-wide supported directives of the Basle Committee. At this stage, bank regulation and supervision is based primarily on risk identification and management, with clearly defined roles for shareholders, boards of directors, senior management and internal and external auditors.

Fourthly, the South African banking scene was opened up for foreign banks, and South African banks, in turn, were allowed to establish branch offices, subsidiaries and representative offices in many countries around the world. Today, in addition to about 35 domestic banks, there are more than 10 established branches and subsidiaries of foreign banks operative in South Africa, and about 60 international banks with representative offices in the country. South African banks have opened up 29 branches/subsidiaries in 13 other African countries.

It is still too early to judge the effect of this wider competition on the South African banking system. There are signs, however, that it is beginning to squeeze the margins of banking business. In particular, the share of foreign banks in wholesale banking, foreign exchange business and financial market activity increased significantly. This was accompanied, however, by an almost explosive increase in the total volumes of business in these markets, which provided for continued growth in existing and newly-established institutions.

2.4 The development of financial markets

Once again, the new South Africa had the advantage of inheriting well-established and relatively sophisticated financial markets. This did not mean, however, that no reforms were required in these markets. The most striking adjustments occurred in the capital market. A “big-bang” revolution took place in the Johannesburg Stock Exchange last year when: the market for trading in equities was separated from the bond market; an electronic screen trading system replaced the traditional open-floor outcry system; corporates and non-residents were allowed for the first time to become broker-members of the Exchanges; provision was made for negotiated commissions and principal versus broking trade by members of the Exchange.

Over the past few years, a market in derivatives also developed, originally as an over-the-counter market, but since the establishment of the South African Futures Exchange (SAFEX) in 1990, on a more formal basis.

These reforms, together with the other socio-politico-economic changes in the country, boosted turnovers in the financial markets. In 1996, the total turnover in equities on the Johannesburg Stock Exchange exceeded US $27 billion; total turnover in the Bond Market amounted to US $703 billion, and 4.1 million contracts were traded through SAFEX.

Major changes also took place in the South African market for foreign exchange, particularly in the light of the gradual removal of exchange controls. South Africa has a floating exchange rate system in which about 30 authorised dealers in foreign exchange (banking institutions) make prices on a competitive basis, for foreign currencies (mostly US dollar). The exchange rate is therefore determined by underlying forces of demand and supply, influenced to a diminishing extent by Reserve Bank intervention (through exchange controls and direct active participation). The Reserve Bank is gradually reducing its participation in the market, and is now in the process of encouraging the development of a more active market in forward foreign exchange outside of the central bank. The average daily turnover in the South African market for foreign exchange over the past six months amounted to US $6.1 billion.

The policy of the Reserve Bank is to continue to encourage the development of the financial markets, and to monitor these markets on a regular basis. The central bank itself, however, is reducing its own direct participation in the market-making processes. This applies to the market for foreign exchange and also the capital market. Negotiations for the transfer to the private sector of responsibility for the primary funding of government and for market-making in government bonds have reached an advanced stage. The Reserve Bank will eventually confine its participation in these markets to transactions (such as open-market operations) aimed at the achievement of defined monetary policy objectives.

2.5 The national payment, clearing and settlement system

Up to now, the national payment, clearing and settlement system was vested in a joint venture between the Reserve Bank and the major commercial banks in the country. Clearing takes place on a daily basis through an electronic data process in a communal banking service facility known as the Automated Clearing Bureau (ACB). The ACB is, however, no longer able to stand up to the emerging pressures of the expanded activity in the financial markets. The Reserve Bank has therefore taken the initiative to introduce a major reform to the national payments, clearing and settlement system. In April 1998, a new integrated system will be introduced to provide for real-time on-line settlement on a gross basis of large transactions, and for a daily netting-process and final settlement of smaller transactions.

The intention with this major reform project is to reduce the risk exposure of possible default by any individual institution that could lead to the collapse of the whole system. At the same time, the new system must be compatible with global network systems for payments and clearing operations, and must provide a framework for an integrated cross-border settlement system for the SADC region.

2.6 The gradual removal of exchange controls

At the centre of the South African programme for financial reform is the gradual phasing-out of exchange controls. Comprehensive exchange controls were introduced in South Africa over an extended period of time, ranging from 1961 to 1993. These direct control measures were intended to provide some protection to the domestic economy against the adverse effects of non-economic factors that afflicted South Africa over a long period of time.

When the Government of National Unity came into power in April 1994, it was accepted as a policy objective to remove the exchange controls. At that time, however, South Africa had virtually no official foreign reserves at its disposal for this purpose. The pragmatic solution was therefore adopted to embark on a process of a gradual phasing-out of the exchange controls.

Good progress has been made over the past three years with this programme. So far all effective exchange controls on current account transactions have been lifted; exchange controls applicable to non-residents have been fully removed; the two-tier exchange rate system for certain capital account transactions was formally terminated in 1995; South African resident corporates were given permission to make certain direct investments in branches and subsidiaries in foreign countries; South African resident institutional investors (insurers, pension funds and mutual funds) may now diversify up to 10 per cent of the total assets managed by them in foreign currency denominated assets; and South African resident private individuals will shortly be allowed to transfer limited amounts of capital from South Africa for foreign investment.

The removal of the exchange controls is a process that has far-reaching effects for the financial sector and the development of the financial markets in South Africa. It is a process that must be applied with caution, and must be supported by other macroeconomic policy measures aimed at improving the international competitiveness of the South African economy. In the area of the financial sector, the authorities must make sure that level playing fields are created for all domestic and non-resident participants in the market.

III REGIONAL FINANCIAL CO-OPERATION WITHIN SADC

When it formally joined the Southern African Development Community in the second half of 1994, South Africa was given the task of managing the Financial and Investment Protocol for the region. A Sectoral Committee of Ministers of Finance was established within the institutional framework of SADC, and two sub-committees were created, one for Heads of Finance Departments, and a second for Governors of Central Banks.

The Committee of Governors of the Central Banks of SADC met four times during the past eighteen months, finalised a Terms of Reference for its activities, established a Secretariat and Research Unit within the South African Reserve Bank, and agreed on a number of projects and programmes to be implemented. The basic approach of the Committee of Governors has been described as a “bottom-up” approach, where the attention is focused at this stage on financial co-operation amongst, and not integration of, the financial systems of the twelve independent members of SADC. Furthermore, the attention is focused on the development of the internal financial systems of members within a consistent and compatible framework that will pave the way for the co-ordination of macroeconomic monetary policies at some later stage, and perhaps some integration of systems further downstream.

The programme of the Governors’ Committee therefore provides for an exchange of information on, and regular discussion of, macroeconomic structures and economic changes in member countries. To facilitate this programme, the Secretariat of the Committee has established within the South African Reserve Bank a computerised data bank for basic financial and economic statistics of each one of the members of SADC. All members will at some stage have direct real-time access to this data base; an exchange of information on the structure, the functions, the responsibilities and the relationships with the government of each one of the twelve participating central banks. For this purpose, the Secretariat of the Committee is busy with the compilation of an information data bank on the participating central banks; a co-ordinated training programme for central bank officials. The South African Reserve Bank Training Institute will this year offer three three-week specialised courses on central banking for officials from SADC central banks; co-ordination of the exchange control policies applied by members of SADC. At least two countries in the region have removed all exchange controls, and many others are in the process of gradually removing remaining controls; a work study on Information Technology (IT) develop-ments within each central bank. The exercise involved in by South Africa to revise is national payment, clearing and settlement system provides an opportunity to plan ahead and consider ways and means of introducing compatible and inter-changeable systems in the region; a concerted approach on efforts to reduce or avoid money laundering and illegal banking activities in the region; and a major initiative to improve the quality of bank supervision and regulation in the region, and to co-ordinate policies on the licensing of banking institutions. This work is undertaken jointly with the East and Southern Africa Banking Supervisors Group (ESAF), which includes a few more countries than just the SADC configuration.

Whilst the work of the Governors’ Committee up to now was more institutionally-centred, more attention will be given in the next phase to the development of the financial markets in the region. There are obviously opportunities for a better utilisation of existing markets in a number of the participating countries in the interest of the whole region. In the third phase, the Committee of Governors will address the macroeconomic needs for the harmonisation of monetary policies such as inflation and interest and exchange rate policies of the member countries.

The broad strategy of the SADC Committee of Governors is based on the premise that a sound financial basis must first be laid within the participating countries before it can be extended to the region as a whole. At this stage, the main objective is therefore to learn from each other and to help each other to create appropriate structures for the central bank, the private banking sector and the financial markets in each one of the twelve members of SADC. The domestic financial sector reforms introduced in each country must, however, even at this early stage, take cognisance of the development needs of the region, and the longer-term objective of a more co-ordinated and integrated regional financial sector. This will be the contribution of the central banks to the expansion of trade and investment, and to improved living conditions for the approximately 130 million people of the region.

Finally, the Committee of Governors of SADC as a regional body has a great interest in establishing extended relationships with similar regional central banking forums in the rest of Africa, and other similar initiatives in the Southern African region.

IV CONCLUSION

The nature of current South African financial sector reforms is dictated by the special circumstances of the country. They may therefore differ substantially from those introduced in other countries. The South African reforms are needed to adapt the financial sector to major internal socio-political reforms, and to accommodate the challenges presented by an enhanced participation in the global financial markets.

As far as regional developments are concerned, South Africa welcomes the opportunity of participating more actively through the Southern African Development Community in the development of the financial sector of the African continent.

There is a growing need for some closer contact between the various regional financial sector arrangements on the African continent. From the level of financial reforms applied within each one of the more than fifty African countries, through the second tier of regional financial cooperation, the ultimate objective must be to establish a sound, stable and well-functioning financial system in support of economic development in the whole of Africa. Co-ordination on a continental basis of the financial reforms applied within the regions can, perhaps, become an important function of the Economic Commission for Africa, working under the auspices of the Economic and Social Council of the United Nations.