Mr. Stals addresses the topic "Implications for the South African financial sector of the process of financial globalisation" Speech by the Governor of the South African Reserve Bank, Dr. C. Stals, at the Tenth Annual "Beeld" Economist of the Year Banquet, held in Johannesburg on 8/5/98.

1. Lessons from the East Asian crisis

Recent developments in certain East Asian countries focused attention on the many pitfalls for the smaller economies of the world on the road to financial globalisation. The reasons for the collapse of financial markets in East Asia may differ from country to country, but a few common shortcomings in the economies of the afflicted countries were identified:

Firstly, in many countries, inappropriate macroeconomic policies were applied to defend artificial exchange rates, and/or to maintain interest rates at untenable low levels. These countries were highly successful for many years and they achieved remarkably high average economic growth rates over an extended period of time. Based mainly on an industrious and frugal labour force, they were able to remain competitive, despite the emergence of underlying weaknesses in the economic fundamentals.

Secondly, the financial systems did not keep pace with the changing macroeconomic environment. Banking institutions were not properly regulated and monitored, and financial markets were distorted by undue governmental intervention. In some cases, there were insufficient disclosure of basic information that could have enabled investors to make a better assessment of the deteriorating situation at an earlier stage.

Thirdly, the countries became overly exposed to foreign capital flows, and vulnerable balance of payments positions developed that could not be managed once confidence faded. Large current account deficits were no longer covered by total capital inflows, and the withdrawal of short-term funds from some countries exacerbated the situation.

Fourthly, bad governance in public and private sector institutions did not realise the seriousness of the underlying adverse developments, and did not take timely corrective action. When the bubble finally burst, the situation had already advanced to a stage where only costly and painful macroeconomic restructuring could salvage these economies.

The experience of the afflicted East Asian countries provides ample evidence of the vulnerability of the smaller, emerging market economies in the environment of financial globalisation. Other countries, including South Africa, can also be subjected by the global financial markets to similar painful corrections, although it might be for completely different reasons. The lesson for South Africa from the East Asian crisis is therefore to be alert, to be cautious, and to be aware of the harsh but not unreasonable disciplines of the global markets.

2. South Africa and financial globalisation

Over the past few years, the South African financial sector has moved quite fast on the road of globalisation. In the Annual Report for 1997 of the Bank Supervision Department of the Reserve Bank, interesting information has been made available about developments in the South African banking sector in 1997.

There are now more than 20 foreign banks operating in South Africa through locally-established branches or subsidiaries, and more than 60 foreign banks with representative offices in South Africa. South African banks are also extending their activities to the rest of the world and during 1997 obtained permission from the Registrar's Office to establish more than 45 branches, subsidiaries, and representative offices in other countries around the world.

At the end of 1997, the total South African banking sector utilised more than R35 billion in foreign funding, and carried loans extended by them in foreign currencies of about R17½ billion. The foreign liabilities and foreign assets of the South African banking sector, respectively, represented but small percentages of the total assets (or total liabilities) of the banking sector, estimated at about R440 billion as at 31st December 1997. Foreign funds as a source of financing of the activities of South African banking institutions are, however, still increasing.

It is well-known that non-resident investors have become very important participants in the South African financial markets. Over the past 16 months, that is since the beginning of 1997, non-resident investors increased their holdings of South African equities by R45.6 billion, and their holdings of South African bonds by R31.1 billion.

The South African Government raised a total amount of approximately R11.3 billion in seven public loan issues made in international capital markets since December 1994. At the same time, many South African public and private sector borrowers also made use of the foreign financial markets to fund the expansion of their activities in South Africa, and in the rest of the world. The gradual relaxation of exchange controls has indeed enabled South African residents to acquire large foreign assets abroad. The following estimates provide some indication of the extent of these investments since the beginning of 1994:

Direct foreign investment by South African corporates	R44.3 billion
Portfolio foreign investment by South African institutional investors	R37.4 billion
Portfolio foreign investment by South African private individuals	R1.1 billion

Volumes in the South African foreign exchange market increased substantially in recent times. At this juncture, it is not unusual to have a daily turnover in excess of US$ 10 billion in this market.

One further indication of the extent to which South Africa has already become part of the global financial markets can be found in the expansion of the Euro-rand market. The total amount outstanding in this market, where non-resident borrowers raise funds in rand-denominated loan issues made to non-resident (mainly European) investors, now exceeds R37 billion.

3. Consequences for the South African economy

This process of the globalisation of the South African markets has important consequences for the South African economy. The major advantage for South Africa is, of course, that the scarce sources of finance for economic development can be supplemented with increasing amounts of foreign funds. Savings of more developed countries are therefore transferred to South Africa to supplement domestic saving.

The large inflow of funds over the past four years enabled the Reserve Bank to increase the country's official foreign reserves from a small to a more acceptable amount of R33 billion, which is sufficient to cover about three month's imports of goods. This increase also made it possible to substantially relax exchange controls in order to create a more free market, which should eventually contribute to a higher economic growth rate.

It is necessary that foreign investments make a more purposeful direct contribution to real economic development in South Africa, and not only to the restructuring of the financial system.

To achieve this, South Africa must ensure that attractive and competitive investment projects are available for this purpose.

The globalisation of South Africa's financial markets, however, have important consequences for the analysis of South African financial conditions, and in particular for the forecasting of possible future developments in South African financial aggregates. The exchange rate of the rand is consequently more subject to the inclinations and whims of foreign investors, as well as to developments in the foreign exchange markets of nearly all the other parts of the world. How well the South African financial authorities may plan and manage, developments over which they have no control can change the exchange rate of the rand, especially against individual currencies, in a direction which was not expected or could not be forecasted. These kinds of changes can be very disruptive over the short term.

This also applies to South African interest rates. A sudden inflow of funds from the rest of the world can lead to a decline of South African interest rates against the run of events in the South African economy or the objectives of the monetary authorities. Similarly, an outflow of funds arising from developments in a distant country, such as for example Indonesia, can very easily lead to an increase in South African interest rates when we would have liked to have seen a decline.

South African share prices are also affected by the views of foreign investors and do not always truly reflect the actual potential of South African companies. Developments in the prices in London, New York, Paris and Tokyo often have a greater influence on these prices than developments in South Africa.

Even the South African inflation rate tends to move to lower levels in accordance with the inflation rates in the rest of the world. Inflationary errors that are made with domestic macroeconomic policy under these circumstances, will often have a detrimental effect on the South African balance of payments, or aggregate domestic economic activity, before leading to an increase in prices.

4. Economic forecasting: a difficult task

Against the background of the international integration of financial markets it becomes much more difficult to predict developments in financial aggregates, such as interest rates, exchange rates and the inflation rate. It does not only depend on what happens in the better known own national economy, but requires a broader cosmopolitan knowledge. Mr. Alan Greenspan's decisions often can have a greater influence on the developments of these aggregates in South Africa than decisions of the Governor of the South African Reserve Bank.

Unfortunately, businessmen, investors and economic policy makers often have to take a view about possible future developments in these financial aggregates. The decisions they have to take are mainly concerned about the future, and not about the past or present situation. It is therefore essential that forecasts be made, even if it is done in a framework of greater uncertainty and unforeseeable future developments. With all the modern electronic technology which is available to facilitate forecasts, the world of the actual economy remains too uncertain to be always correct.

There are a few basic principles which must be kept in mind when making forecasts of financial aggregates:

1. Do not believe too much in your own forecasts. There are good reasons why you will often be wrong.

2. Do not accuse someone else - for example, the Governor of the Reserve Bank - if your forecasts are wrong. He also has only little control over developments in these macroeconomic aggregates.
3. Make regular forecasts. The data on which forecasts are usually based change often and therefore justify regular revisions of forecasts.
4. Be willing to acknowledge a wrong forecast and produce a new one. Most people who take note of your forecasts have in any case already forgotten the last one that you made.
5. Remember the assumptions which form the basis of every forecast. They are often so unrealistic that the forecast is also nearly worthless.
6. Make forecasts on the basis of objective analyses, and not on what suits your book or the book of your clients. It doesn't help to be popular but wrong.
7. Be grateful if you are sometimes right in this difficult game of trial and error - it may not happen again.

5. Concluding remarks

The integration of South Africa in the world financial markets is an on-going process that is linking developments in the major financial aggregates in this country more and more to developments in the rest of the world.

Because of this process, economic forecasting has become much more complex. Not only changes in the South African situation influence developments in important financial aggregates, such as interest and exchange rates, but also events in remote places such as Indonesia.

Economic forecasters have great responsibility, not only to provide consistent and sensible forecasts, but also to understand and explain the shortcomings of even their best efforts - and to remember that even bad forecasts can sometimes become self-fulfilling.