The changing face of exchange control and its impact on cross-border investment opportunities in South Africa Address by the Governor of the South African Reserve Bank, Dr. Chris Stals, at the Annual Australia/Southern Africa Business Council Meeting held in Sydney on 23/7/98.

1. The history of exchange control in South Africa

The beginning of exchange control dates back to 1939 when South Africa, as a member of the now defunct British Sterling Area, was asked, together with other members of the Sterling Area, to introduce restrictions on the outflow of funds to non-Sterling Area countries. This ensured the free movement of funds, emanating mainly from the United Kingdom, within the Sterling Area.

After World War II, the Sterling Area exchange controls were gradually phased out, but in South Africa in 1961 the controls were extended and given a specific South African function. This followed upon disrupting internal political clashes (the Sharpeville incident), and South Africa's withdrawal from the British Commonwealth. Exchange control in South Africa was now intended to provide some protection to the domestic economy from the adverse effects of large-scale outflows of capital. For the first time, exchange control also restricted the repatriation of non-resident investment funds from the country.

During the period 1961 to 1993, exchange control was extended from time to time, mostly in reaction to a worsening of South Africa's internal political situation, and increasing external pressures in general. For example, in 1976, after the uprising of school children in Soweto, proceeds of the sale of non-resident owned securities in South Africa were blocked and eventually converted into securities rand, tradable only at a substantial discount at a second tier (lower value) exchange rate. After the United Nations introduced world-wide economic and financial sanctions against South Africa in 1986, a standstill on the repayment of a major part of South Africa's foreign indebtedness was introduced, providing for an extended negotiated redemption of the outstanding amount.

By the time that the major social and political reforms were introduced in South Africa in the early nineties, there existed a very comprehensive system of exchange control that covered certain current account transactions and the inflows and outflows of both resident and non-resident investment funds.

2. The phasing out of exchange control

There was general consensus that exchange controls created many distortions in the South African economy. Interest rates, the exchange rate, financial asset and property prices, and even production costs in the domestic economy were affected by the comprehensive exchange controls. The system prevented the important price mechanism of the market economy from functioning properly. This led to the maldistribution of scarce resources and the functioning of the economy at levels below its optimum capacity.

After the democratic election for a new Government of National Unity took place in April 1994, and international punitive actions against the South African economy were removed, there was general consensus within the new Government that exchange controls should also be removed. There was, however, major disagreement on how fast the controls should disappear. At the one extreme were supporters, mostly in the private financial sector, of a "big bang" approach. They pleaded for the immediate removal of all the controls. On the other hand, there was substantial

support for a more gradualist approach and for the dismantling of the exchange controls over an extended period of time.

The Reserve Bank supported the latter approach, mainly for the following reasons:

- Years of economic sanctions, boycotts, disinvestment campaigns and the withdrawal of foreign loan funds from South Africa depleted the country's foreign reserves. At the time of the elections of April 1994, the Reserve Bank owned, on a net basis, zero foreign reserves.

- During the long extended period of exchange controls, backlogs developed, and a huge pent-up demand for an outflow of capital emerged. Overdue loans had to be repaid to non-residents, and no South African residents were allowed to accumulate foreign assets of any significance over a period of more than thirty years.

- Distortions were by that time so much embedded in the South African financial structure that the sudden removal of exchange control would not only have exerted pressure on the country's low level of official foreign exchange reserves, but could also have forced painful immediate structural changes that would have unduly disrupted the domestic economy in the short term.

The South African authorities therefore decided on a gradual phasing-out of the existing exchange controls. Beginning already in 1993, the following relaxations were accordingly introduced over the past five years:

- As a first priority, all exchange controls applicable to current account transactions were removed. South Africa now fully complies with the requirements of Article VIII of the International Monetary Fund.

- Secondly, controls on non-residents were removed. The debt standstill arrangements of 1985 were finally rescheduled towards the end of 1993, and the financial rand system (two-tier exchange rate) was terminated in March 1995. Non-residents are now completely free to introduce funds for any purpose into South Africa, to repatriate such funds and to transfer out of the country current and capital gains earned on their investments without restriction.

- Resident corporates (companies) were gradually enabled to make direct investments in foreign subsidiaries, branches or joint ventures by transferring limited amounts of funds from South Africa, and by raising funds abroad through equity and loan issues. In the process, direct investments of about R50 billion (US $10.7 billion) were acquired by the South African corporate sector over the past four years.

- Resident institutional investors were given permission in June 1995 to diversify part of their total assets into foreign currency denominated investments. At this stage, they may hold up to 15 per cent of their total assets outside of South Africa. In total, the financial sector has now acquired about R55 billion (US $11.8 billion) in the form of portfolio foreign investments.

- Last year, in June 1997, private individuals were given permission to make limited investments in their own names outside of South Africa. At this stage,

individual taxpayers in good standing with the tax authorities may invest up to R400 000 per individual outside of South Africa. A modest amount of foreign exchange equal to less than R2 billion has since then been absorbed under this concession

- Many other smaller exchange control restrictions were either eased or removed, for example on short-term trade financing, inter-bank financing arrangements and the transfer of legacies, donations and emigrants' funds. Administrative procedures were simplified and banks (authorised dealers in foreign exchange) were mandated to approve many transactions without prior reference to the Reserve Bank.

There remains but one major area for relaxation, and that is in respect of the restrictions still applicable to the so-called "blocked" funds of former residents of South Africa. Apart from settling-in allowances, the remainder of the assets of emigrants is blocked in South Africa and becomes non-transferable. Income earned on blocked funds, however, is not subject to the restrictions.

South Africa has therefore now reached a stage where there are no effective exchange controls any more on current account transactions and on the movement of funds of non-residents. Resident corporates, financial institutions and private individuals all have limited scope to make some investments outside of the country and have, on a combined basis, now accumulated more than R100 billion of foreign assets. Backlogs that existed in 1994 for the outflow of non-resident funds have been accommodated in full, and those that existed for the outward investment of resident funds are gradually being absorbed. On balance, South Africa has now removed more than seventy per cent of all the exchange controls of the past.

3. The inflow of capital into South Africa

The macroeconomic argument for the removal of exchange control is based on the assumption that, on balance, in a liberalised economy, over time capital inflows will exceed outflows. Despite the need to accommodate large accumulated backlogs, this philosophy was vindicated by developments in the capital account of the South African balance of payments over the past four years.

Non-resident investors increased their holdings of South African equities by about R63 billion (US $13.5 billion) from 1 January 1995 up to the end of June 1998, and also invested a net amount of about R30 billion (US $6.5 billion) in South African bonds. The total portfolio investment capital inflow of more than R90 billion was mainly used for financing the acquisition of foreign assets by South African residents, as already mentioned above.

Taking account of the relatively large net inflows of portfolio foreign capital, outflows to finance foreign investment by residents, and all other capital movements, the capital account of the South African balance of payments still showed a net inflow of funds from abroad of R53 billion over the period from the beginning of 1995 up to March 1998. The inflows were more than sufficient to cover modest current account deficits and to raise the total gross foreign exchange reserves of the country to a level of R45 billion (US $9.0 billion) at the end of March 1998. At this level, the total foreign reserves were sufficient to cover about three months' imports of goods and services. In terms of international standards, the level of the foreign reserves is still relatively low, but at least much more comfortable than at the end of March 1994, when the gross foreign reserves of the country amounted to only R10.3 billion (US $3.0 billion).

One of the disappointing aspects of the capital inflows into South Africa over the past four years has been the relatively small amount of direct foreign investment made in the country. Not more than 25 per cent of the total inflows represented direct foreign investment, and the rest came in as portfolio investment in securities, loan capital and short-term financing facilities.

4. Restructuring of the financial sector

The gradual removal of exchange controls was accompanied by some major restructuring of the financial sector in South Africa. To encourage competition in the market, more foreign banks were allowed to establish themselves in the country. More than 20 foreign banks opened up branches or subsidiaries in South Africa, and more than 60 foreign banks now do business in the country through representative offices. Together with about 35 domestic banking institutions, the South African banking industry is now providing, on a competitive basis, excellent and modern financial services to the country. The industry is healthy, well-managed and subject to financial regulation and supervision based on the principles of the Basle Committee guidelines and core principles.

While the gradual phasing-out of exchange control continued, the financial markets were also restructured, liberalised and made more flexible to accommodate almost explosive increases in volumes. In the capital market, three separate specialised institutions were created to provide, respectively, for equity trading on the Johannesburg Stock Exchange (JSE), bond trading on the Bond Exchange of South Africa, and trading in derivatives on the South African Futures Exchange.

Two years ago, the JSE introduced major reforms to provide for corporate ownership, foreign ownership (of stock brokers), dual capacity trading, negotiated commissions and electronic screen trading. The JSE is continuing to improve its facilities by providing for the immobilisation and dematerialisation of stock, and for improved clearing and settlement arrangements. With a listing of about 700 different securities, a total market capitalisation of about US $275 billion and a turnover of about US $45 billion last year, the JSE is now classified as one of the major stock exchanges of the world.

The most spectacular increase in the total volume of transactions over the past few years took place in the Bond Exchange of South Africa. Total turnover in this market increased from the equivalent of US $553 billion in 1995, to US $927 billion in 1997, that is an increase of 67.6 per cent over just two years. The relaxation of the exchange controls made an important contribution to the development of the Bond Exchange. Total gross transactions by non-residents in this market last year exceeded the equivalent of US $257 billion, or almost 30 per cent of total turnover.

Interest is also growing in the South African Futures Exchange. The total number of contracts traded in this market increased from 3½ billion in 1995 to more than 5 billion in 1997.

A further important development that flowed from the globalisation process is the emergence of a Euro-rand market where the outstanding amount of rand-denominated loans raised by non-South African borrowers from non-South African investors now amounts to about R36 billion. A substantial part of the proceeds obtained from these loan issues was reinvested in South African bonds.

The market in foreign exchange in South Africa is also growing rapidly. The average daily turnover in this market now exceeds US $10 billion. Of particular importance is the expansion in forward cover operations in this market, where South African banks now carry a fully covered forward sales (or purchases) book of about US $180 billion.

The Reserve Bank recently introduced steps to encourage a more active development of the domestic inter-bank market for funds. It is the objective to ensure that short-term interest rates should be flexible, and should fluctuate to reflect changes in underlying market conditions. The effective rate at which central bank funds are made available to banking institutions is now determined on a daily basis through a tender system for repurchase transactions, entered into between the Reserve Bank and banking institutions. This greater flexibility in short-term interest rates is of particular importance in light of the growing volume of, and greater volatility in, short-term international capital movements.

As a further step in the development of the financial system, the Reserve Bank at the beginning of this year also upgraded the national payment, clearing and settlement system. The new system provides for an electronic on-line real-time link between participating banks, and for secure fund transfers between these banks. It enables the banks to monitor and manage their liquidity positions continuously, and provides for electronically managed end-of-day settlement of interbank transactions. As from the beginning of October, it will become possible to settle transactions on an intra-day basis as and when instructions are received within the system.

The gradual phasing-out of the exchange controls was therefore accompanied by a simultaneous process of liberalising, modernising and upgrading of the domestic financial system. In the process, the removal of the exchange controls did not create any major disruption in the domestic markets, and the health and soundness of the South African financial institutions were protected.

Both processes, however, should be seen as part of the wider movement of international financial globalisation. Without introducing these changes, it would not have been possible for South Africa to participate in the process of world-wide integration of financial markets. The removal of exchange controls and the simultaneous upgrading of the domestic financial system, opened up the way for South Africa’s participation in this process.

5. The Southern African Development Community

A further consequence of the socio/political/economic reforms in South Africa over the past few years was a natural greater involvement for the country in the economic development process of the African continent. Apart from a more active participation in continental initiatives working through the Organisation of African Unity, the United Nations Economic Commission for Africa, and the African Development Bank, South Africa is taking an active part in the activities of the Southern African Development Community (SADC).

Fourteen countries of the Southern African region now belong to this formal agreement for economic co-operation, with the long-term goal of eventual economic integration. South Africa plays a leading role in the development of financial and investment co-operation amongst the participants in SADC.

Within the structured institutional framework of SADC, a Committee of Governors of all the central banks of the region was established. This Committee introduced a number of co-operation projects intended to develop the financial systems and markets of the region. The approach of the Governors Committee at this stage is first to develop the financial infrastructures in each of the countries, before venturing into the more challenging task of macroeconomic co-ordination or integration.

One of the important projects in the work of the SADC Governors Committee is to remove remaining exchange controls within the region. Where practicable, countries are encouraged

to do this even faster than what has been programmed for the overall phasing out of the controls. It is envisaged that there will eventually be a relatively free movement of goods, services and capital in this vast area with a total population of more than 180 million people.

6. The financial globalisation process

The phasing out of exchange control and the restructuring of the financial system are important preconditions for South Africa's greater participation in the financial globalisation process. As can be deducted from some of the statistics quoted in this address, South Africa is now firmly on the road of greater participation in the expanding international financial markets.

Recent events in the wake of the East Asian financial crisis proved once again, however, that the globalisation process is not without risk. The easy movement of large amounts of funds into and out of countries with relatively small economies can at times be very disrupting. During the four months January to April 1998, non-residents increased their holdings of South African bonds, acquired through the Bond Exchange, by more than R16 billion. Over the next ten weeks, that is during May, June and the first half of July 1998, they reduced their holdings again by R12 billion.

Both the inflows and the outflows of capital on this occasion disrupted the South African financial markets and complicated the implementation of monetary policy centred on the medium-term objective of maintaining financial stability in the interest of optimum economic growth. In the situation and against the background of a rather depressed domestic economy, the yield on long-term government bonds increased from 12.7 per cent on 30 April 1998, to 16.4 per cent on 6 July, before it declined again to 15.5 per cent last week.

The Reserve Bank's fluctuating repo rate similarly showed wide fluctuations and increased from 14.8 per cent in early May to a peak of 24.0 per cent on 22 June, before settling down at a level of about 21 per cent. All banking institutions in the country were forced to raise their deposit and lending rates by about 6 percentage points since the end of April. The prime overdraft rate of the major commercial banks now stands at 24 per cent. With the latest measure of inflation at only 5 per cent per annum, real interest rates are at an extremely high level.

The exchange rate of the rand also came under a lot of pressure. After being relatively stable for a period of about 18 months from October 1996 up to the end of April 1998, the rand depreciated from R5.05 against the US dollar in the middle of May to R6.62 = $1 on 6 July 1998. Since then, the exchange rate appreciated again to fluctuate around the R6.00 = $1 level for the last few days. At this level, the rand, measured against a basket of currencies, is still about 18 per cent down from where it was at the beginning of this year.

Some critics do believe that the removal of the exchange controls is partly to be blamed for this greater volatility in financial conditions. They advise South Africa, therefore, to reintroduce some of the controls, for example, the two-tier exchange rate system. This view is not shared by the monetary authorities in South Africa. Despite the gyrations of recent weeks, we still believe that the advantages of participation in the financial globalisation process will, over time, bring more advantages to the South African economy than disadvantages.

7. Concluding remarks

The policies of the phasing out of exchange control, the restructuring and liberalisation of the financial system and the promotion of active participation in the process of financial globalisation, have created many opportunities for cross-border investment in South Africa.

Foreign banks, fund managers, institutional investors and manufacturing concerns are extending their financial business with South Africa in the form of:

- conventional short-term trade financing;
- short-term inter-bank financing facilities;
- loans extended for medium and longer-term periods to South African borrowers in both the private and public sectors;
- portfolio investment in equities, bonds and financial derivatives, acquired through the various capital market exchanges; and
- direct investment in the form of subsidiaries, branches, or joint ventures with South African undertakings.

Developments in recent years also led to the creation of an active Euro-rand market outside of South Africa, and to a greater involvement of South Africa in the economic development process of the Southern African region.

These exciting developments have already created opportunities, also for the expansion of financial relations between South Africa and Australia. I believe many more opportunities exist and are waiting for the financial and other economic entrepreneurs in South Africa and in Australia to be exploited.

Our two countries should not always be regarded as major export competitors in the world markets for base minerals and other commodities. There are also many areas where our economies are complementary and where our policies can be supportive in the global environment. This applies particularly when it comes to our efforts of integrating our financial markets into the world environment.