Mr. Stals reviews the position of South Africa against the background of the global financial crisis Address by the Governor of the South African Reserve Bank, Dr. C. Stals, at the Fifth Annual General Meeting of the South Africa - Canada Chamber of Business in Johannesburg on 22/10/98.

1. Background

As could have been expected, this year's Annual Meetings of the International Monetary Fund and the World Bank held in Washington D.C. during the first week of October, were dominated by a discussion of the global financial crisis.

What started off more than a year ago as an East Asian crisis gradually extended to other emerging market countries and eventually also affected a number of smaller well-developed economies. The most recent extension was an infliction on the financial systems of some of the industrial countries, such as the United States of America. What started off as a more regional problem of the countries surrounding the depressed economy of Japan, indeed became a global problem that is now demanding the serious attention of the entire international community. This may be a depressing thought, but it is nevertheless one of the more encouraging outcomes of this year's annual meetings of the IMF and the World Bank. Now that so many countries, and also major industrial countries, are more directly involved in the financial crisis, there is a greater urgency for finding a solution.

2. The causes of the problem

Many reasons have been advanced for the world financial debacle. Apart from the adverse effects of a protracted recession in the Japanese economy, East Asian countries were blamed for lax macroeconomic financial policies, for insufficient disclosure of information on foreign capital movements and debt positions, for bad governance at government and private sector levels and for crony capitalism.

Private international investors were blamed for irresponsible speculative attacks on the foreign exchange rates of countries, destabilizing activity in the financial markets and a reluctance to share in the burden of eventual collapse and adjustment.

The International Monetary Fund has been criticized and is still under attack from many quarters for not diagnosing the problem at an earlier stage, and for the way the Fund eventually handled the crisis situation in individual countries. The medicine prescribed by the Fund (the Fund's "conditionalities") is blamed for killing the patient, rather than curing the illness.

Recent developments added a further dimension and exposed a possibly more important basic cause for the global financial dilemma, and that is the excessive leverage positions that certain financial institutions were allowed to create in funding international capital flows, including speculative investments in emerging markets. The near-collapse of the hedge fund Long-Term Capital Management (LTCM) in the United States of America in September exposed an astonishing balance sheet position for an important operator in the world financial markets - a balance sheet for a non-bank financial intermediary that used more than $50 of borrowed funds (mostly bank funds) for every one dollar of own capital!

Finally, the nature and functioning of the present international financial system of floating exchange rates, unrestricted capital movements and liberalised financial markets is also now

being questioned. This system, which gradually developed through an evolutionary process over the past two decades after the final demise of the system of fixed par values in the 1970s, has some built-in elements that encourage periodic occurrences of international financial instability. Particularly the smaller economies of the world find it increasingly difficult to maintain orderly domestic financial conditions in an environment of financial globalisation, financial market integration and exchange control liberalisation.

The truth is perhaps that no solitary cause can be singled out as the only reason for the development of the present international financial crisis. The erosion in the quality of the system took place over a long period of time and the possible causes identified above most probably all contributed to the weakening and eventual foundering of the system. The restoration of greater stability in the international financial markets is therefore a cumbersome and complex process that will take some time to achieve. The seriousness of the problem, however, demands a worldwide concerted effort that can best be accomplished by working through the available existing infrastructure of the IMF and the World Bank.

3. Implications of more recent developments in the crisis

Three important events over the past few months contributed to a deepening of the crisis, but at the same time also to a better understanding of the situation.

Firstly, the decision of Malaysia to reintroduce rather restrictive and comprehensive exchange controls on international capital movements focused attention on the real danger of a new movement towards national protectionist and economic isolation policies. It is true that Malaysia is traditionally a country with a high domestic savings rate and is therefore less dependant on foreign investment for the financing of its own internal economic development. It is also true that the presence of serious internal political division in Malaysia to some extent discredited Mr Mahathir's recent economic policy measures. International investors, however, could not ignore the signals of the danger of a wider and more general recourse to direct governmental controls over international capital movements, particularly over the more volatile short-term capital flows that recently disrupted the economies of so many of the emerging and developing countries of the world.

Secondly, the default by Russia in respect of the redemption of its short-term domestic and foreign sovereign debt caught many investors by surprise. A huge overnight decline in the discounted value of Russian government bonds that was previously regarded as secure collateral for large banking loans extended to Russian borrowers forced massive losses on investors, and led to large provisions for bad debts from international banking institutions. The Russian debacle more than anything else exposed the vulnerability of the world's banking system in the current situation of global financial turmoil. It also partly exposed the role of hedge funds and short-term speculators in this evolving global drama. More than one short-term non-banking financial intermediary and quite a few banks were caught with their pants down in the Russian debacle, and were forced to absorb huge losses. The clear warning was for greater caution in the games they play in this high-risk environment of the global financial markets.

Thirdly, the near collapse of Long-Term Capital Management and the decision of the American Federal Reserve Bank System to get involved in the subsequent rescue operation of this non-bank financial institution, exposed a new dimension of the emerging world financial crisis. It remains a highly debatable issue of why the Federal Reserve was prepared to attach its name, albeit not its funds, to the rescue of LTCM. The only reason can be that the Fed was gravely concerned about possible adverse implications for the American banking system of a liquidation of LTCM. As

it turned out to be, LTCM managed about $5 billion of selected clients funds, but had invested in the financial markets more than $250 billion of borrowed funds, mostly raised on a short-term basis from American banking institutions.

Both the American authorities and representatives of the hedge fund movement recently went out of their way to explain that LTCM was not representative of the industry and that most other hedge funds maintained much more reasonable leverage positions on their balance sheets. The vulnerability of the world's financial system, and of many reputable multinational banking institutions, was nevertheless rudely exposed by the LTCM affair. The real explanation that should at this stage be demanded from the American financial supervisory authorities is therefore not why the Fed got involved in the rescue operation of LTCM, but rather why such excessive gearing was permitted by a financial institution that in the end turned out to hold a major systemic threat for the American banking system, and indeed for the emerging global financial system as a whole.

The moment that the Fed decided to support the rescue operation for LTCM, the whole ball game changed as far as the future role of hedge funds is concerned. The fact that it has become necessary for the monetary authorities of the most important financial structure in the world to lend their support to the rescue of an institution such as LTCM, surely recognises the importance of this type of institution for monetary policy in general, and for the protection of overall financial stability in particular. But then it also demands financial disciplines and the adherence to minimum requirements of financial prudency, capital adequacy and risk-aversion policies from such institutions.

The epicentre of risk exposure in the present global financial crisis has therefore partly shifted from the East Asian or emerging and smaller developed economies of the world to some of the world's major financial centres. Important international banking institutions have become so involved in the problem of excessive leverage and speculative investments in the global financial markets that they now also have to implement major and painful internal restructuring programmes. A few examples of such forced financial reform programmes already surfaced in recent weeks and more will most probably follow. Maybe we are now much closer to finding a solution for the international financial crisis of the past year, which can surely no longer be blamed only on macroeconomic mismanagement in the smaller economies of the world. LTCM exposed one of the major sources of global financial instability.

4. In search of a solution

The causes of the current world financial crisis are complex and widespread. The solution therefore is not a simple one. In particular no quick solution is available.

It must firstly, be taken into account that the adverse developments in the financial markets will continue to have secondary effects that will, for some time to come, exert a negative influence on global real economic activity. Forecasts for world economic growth in 1998 have systematically been scaled down from a rather ambitious 4 per cent made towards the end of last year to only about 2 per cent at this stage. In a number of East Asian economies, growth will indeed be negative this year.

Secondly, the restructuring of the banking systems in a number of the affected countries will take some time before normality will be restored. As is known, the Japanese Government has just recently provided an amount of more than Yen 60 trillion to recapitalise the

Japanese banking system. In the meantime only modest amounts of new bank loans will be available for the financing of consumption and investment.

Thirdly, the deleveraging process to reduce the absurd excessive gearing ratios of some mega-sized financial institutions can only be accomplished by a reduction in world liquidity. Taking account of the magnitude of the problem of over-leveraging as evidenced by the balance sheet information recently released for LTCM, this can become a major constraint on the availability of new funds in the global financial market over the next year.

Against this background, the world can only extricate itself from this complex problem by a coordinated effort applied from three different levels:

Firstly, many macroeconomic deficiencies were exposed in a number of countries that in the end suffered most from the global financial crisis. It is dangerous to generalise the shortcomings as they would obviously differ from country to country and would therefore also require specialised treatment suitable to the underlying situation in each one of the affected economies. A number of countries such as Thailand, Korea and the Philippines have already addressed their problems with appropriate adjustment programmes, and are beginning to reap benefits from often painful corrective measures. These adjustments provide for more disclosure and transparency, enhanced financial regulation and supervision, recapitalising of banking institutions, more restrictive monetary and fiscal policies, exchange rate adjustments and improved governance in macroeconomic management in general.

Secondly , all the criticism against the multinational institutions, and particularly against the IMF, is not without foundation. These institutions did not keep up with the accelerating process of financial globalisation in recent years, and with the rapid integration of world financial markets. Economic policy models that may have been appropriate in the old system where central banks and governments could still exert strong influences on the direction of major financial aggregates such as interest and exchange rates and could effectively control changes in the money supply and in bank credit extension cannot be applied without adjustment in the new world where market forces now dominate the scene. Some changes in the global financial system have become necessary and urgent. These institutions are now concentrating on increasing their resources, e.g. IMF quotas, on improving their surveillance functions and on revising the “architecture” of their existing infrastructural frameworks.

Thirdly , after the LTCM affair, there is an urgent need for multinational banking and other financial institutions to revise their own internal risk control models. The action taken by Malaysia recently to reintroduce exchange controls on international capital movements and the de facto default by Russia in its inability to redeem its public debt eroded almost overnight the value of what was regarded as secure collateral in terms of normal banking practices. The development of more suitable risk management models cannot be left entirely to the official financial supervisors of the world - private sector financial institutions should on their own initiative improve their internal financial disciplines and controls.

5. South Africa’s position in the international financial crisis

The South African economy was also badly affected over the past six months by the deteriorating international financial situation. As non-resident investors reduced their holdings of South African bonds, we had to ride with the storms. Although the authorities “leaned against the wind”, South Africa ended up with:

- a decline in the value of the rand. Changes in the exchange rate of the rand after some turbulent fluctuations resulted in a currency that is now about 18 per cent weaker than at the beginning of this year;
- higher interest rates. The level of interest rates also moved up and down but now stands at about 7 full percentage points above the level of six months ago;
- some decline in overall liquidity in the banking sector which, however, eased again in recent weeks;
- a depressed real domestic economy. Growth in real gross domestic product slowed down already last year and was further restrained by the recent adverse developments in the financial markets.

During this testing period, some structural weaknesses in the South African economy were once again exposed, but also some inherent strengths for which we should be grateful. These include a sound and well-managed domestic banking sector and financial markets that provided the liquidity, the mechanisms and the resilience to adapt to the rapidly changing international environment.

South Africa's approach to this worldwide financial market problem is to remain part of the system and to lend our support for a global initiative to solve the problem.

Action at the level of national governments, the multinational financial institutions and private sector financial market operators is necessary to restore stability in the global financial system:

- Governments must recognise, analyze and define deficiencies in their macroeconomic policies and identify weaknesses in their financial structures, and must take the necessary steps on a case by case basis to strengthen the system at the national level. Problems are different from country to country and no standard macroeconomic module can be prescribed on a global basis for universal application.
- The multinational institutions should concentrate on the obvious shortcomings of the present infrastructure for international payments, international capital flows and the determination of exchange rates. The process of financial globalisation, worldwide financial market integration and liberalisation of financial institutions moved faster than the global authorities themselves did with their control and surveillance systems. The approach now should not be for the markets to be stopped in their progress, but rather for the authorities to catch up.
- Private sector financial market operators, including multinational banking institutions, hedge funds and institutional fund managers, must in their own interest reconsider and review their modus operandi in the markets. In particular, risk management models must provide for the volatile global financial environment in which they now operate.

Many encouraging signs emerged from the discussion in Washington D.C. to indicate that progress is now being made at all three levels, and that greater stability is gradually returning to the world financial system. South Africa, like many other countries in a similar situation, is watching these signs of hope with great interest.