Mr. Stals comments on the need for greater financial flexibility in a volatile global financial environment Address by the Governor of the South African Reserve Bank, Dr. Chris Stals, at the Annual Dinner of the Institute of Bankers in Cape Town on 5/11/98.

1. Increasing volatility in financial markets

Developments in the global financial markets over the past year focused the attention on the ability of countries to adapt to rapidly changing conditions in an extremely volatile global environment. With a strong trend towards globalisation and the worldwide integration of financial markets that swept through the world economy over the past decade, most countries of the world, big and small, have now become more exposed to volatile capital inflows and outflows. The cross-border (and therefore cross-currency) transfers of huge amounts of investment funds disrupt domestic and foreign currency markets in many countries almost on a regular basis.

From the experience of the past year, it is clear that many of the smaller countries with rapidly expanding domestic economies and emerging financial markets find it increasingly more difficult to maintain domestic financial stability and remain within the unstable environment of an integrated global financial market. The amounts involved in volatile capital transfers are too large for the smaller economies to absorb. Countries find it difficult to adapt internal situations to sudden and unpredictable turnarounds in the flow of funds that may take place from time to time.

A second major problem that surfaced during this year of financial turmoil centred around the diverse economic needs of many countries that find themselves at different stages of economic development, different phases of the business cycle, and pursuing different objectives with their overall economic strategies. The integrated global financial markets set high standards, based on the needs and norms of the more developed economies, being the main source of the supply of funds. Ambitious fund managers, seeking to maximise the yield on investments managed on behalf of demanding clients, have little loyalty to the needs or the circumstances of the countries where they make their investments. There is, indeed, little diversification in their thinking or in their computer programs when they invest in the global markets -- all emerging markets are, for example, treated as just one group of countries.

Given the environment of volatile capital movements, a third deficiency of the present system has been identified, and that is the lack of a global “lender of last resort” or “discount window facility” that can serve to provide temporary assistance in times of sudden outflows of capital from a country. The resources of the International Monetary Fund turned out to be completely inadequate in the present volatile environment. Even after the completion of the current round of increases in the quotas of the Fund, the IMF will not be in a position to supply the needs of its member countries in times of serious global financial crises. Many recipients over the past year of IMF assistance are also of the opinion that the conditionalities attached to IMF loans are no longer appropriate for the present world environment. Disruptions in international financial markets are no longer created by structural or temporary imbalances in international trade, but rather by volatile international capital inflows and outflows. The IMF’s conditionalities are still directed, however, to the restoration of equilibrium in the current account of the balance of payments.

A fourth conclusion from the developments of the past year is that the present international financial system of floating exchange rates and free capital movements provides increasing incentives for speculators and short-term profit explorers to exploit weaknesses of individual countries, often at the cost of the impoverished and the poor people of the world.

2. A Hobson's choice for the emerging markets

Smaller countries such as South Africa can do little to change the world financial system, but may still be able to isolate themselves from the volatility of the world environment. This will, however, require comprehensive restrictive exchange controls on both residents and non-residents in respect of all international capital transactions. In the process, a country that moves in this direction will most probably be excluded from the ongoing process of financial globalisation, and will be barred from access to international capital markets.

A few countries recently nevertheless opted for this alternative and rather preferred the route of isolation to the continued exposure of their economies to fickle foreign fund managers and international currency speculators. In the case of Malaysia, it was judged that the country's high domestic savings rate will generate sufficient funds to provide for its needs for future economic development. In the case of Russia, the government had no other choice but to close its financial markets after a major collapse in the public and private sector financial systems.

South Africa, with its low level of domestic saving and massive needs for future economic development, has no choice. Unless this country can rely on some regular substantial inflow of capital from the rest of the world, its economic growth rate will not create sufficient jobs for the already large number of unemployed and the annual addition to the labour force, or provide the resources needed for the social upliftment of the population. South Africa must therefore remain part of the global financial markets, and must pursue macroeconomic policies and introduce structural adjustments regarded as necessary to make the country attractive for foreign investors.

It is not precluded that some important changes may be introduced to the world financial system over the next few years. South Africa will, to the extent that it participates in this debate in various international fora, press for the introduction of measures that will reduce the volatility of the markets. We know from experience, however, that proposals for change to the global financial architecture can take a long time to find consensus, and changes will most probably only be introduced gradually.

In the meantime, South Africa will be exposed from time to time to volatile capital movements, and the domestic economy will remain vulnerable to external disturbances that may in the short term force macroeconomic policies inconsistent with domestic economic objectives. The question remains, what can, or should, South Africa do to make sure that the domestic economy will, over the medium and longer term, be better protected against the disadvantages of international financial market volatility and still gain maximum advantage from international capital inflows?

3. The need for financial flexibility

Globalisation is about markets. It is markets that are being integrated in a worldwide system of unrestricted capital movements, and markets that are being opened up for participation by investors from all around the world. Acceptance of any country in the global financial markets therefore requires a recognition of the principles of the market economy, and an adherence to the rules of the game.

One of the basic rules of the game in a market economy is that governments must allow market forces of demand and supply to determine prices. Intervention by governments in the markets for whatever purpose, if necessary, must always work through the markets, without suspending or restricting the forces of demand and supply. The price mechanism indeed provides the core discipline of the market economy, and through price changes, markets signal messages and activate automatic adjustment processes intended to hold demand and supply in equilibrium.

In the context of international capital flows, the exchange rate is, of course, the most important price. It is important for the smaller countries therefore to ensure flexible adjustment processes for exchange rate changes in the environment of a volatile global financial environment. It is almost impossible to maintain a fixed exchange rate for any currency once large amounts of capital start flowing out of or into a country. Efforts to maintain a fixed and unrealistic exchange rate in such circumstances will only entice speculative transactions that will eventually exacerbate the problem.

This does not mean, however, that the authorities may never intervene in the foreign exchange market, for example to maintain orderly conditions, to smooth out short-term fluctuations, or to provide liquidity to the market. Such interventions, which must preferably always be conducted through the market system, are often confused with a policy of fixing the exchange rate through more direct means of control.

In South Africa, there is a misguided perception that the Reserve Bank must intervene in the foreign exchange market to prevent any appreciation of the rand, but must refrain from intervention whenever the rand comes under pressure for depreciation. Such a policy will, of course, create a one-way bet for speculators and will encourage short-term investors to take positions against the rand and then force the exchange rate down to generate capital profits for themselves. The Reserve Bank prefers to intervene in the market on a discretionary basis, to work discreetly through the market forces of demand and supply, and to keep speculators guessing on what the Bank’s next step will be.

South Africa adheres to a policy of a floating exchange rate system. As long as we still maintain exchange control restrictions on the foreign assets that South African residents may hold, the Reserve Bank will have to continue to intervene in the foreign exchange market from time to time, both as a buyer and as a seller of foreign exchange. As in the past, the Bank will exercise cautious discretion, will respect the underlying forces of demand and supply, and will accept the need at times for a depreciation and, in different circumstances, also for an appreciation of the rand. In other words, we believe the present South African exchange rate policy has sufficient flexibility built into the system to accommodate the vicissitudes of a globalised financial market system.

Another very important price that must be flexible and adjustable in this new world financial environment is the interest rate. Interest rates are prices: the prices of loanable funds with different maturities and different risk exposures. As is the case with all other prices in a market economy, interest rates are determined by forces of demand and supply. If the authorities do not want to accept interest rates as determined by market forces, they should preferably work through the markets to either reduce the demand for funds (for example by reducing government expenditure), or increase the supply of funds (by creating more money through the central bank). This latter course may reduce interest rates in the short term, but holds the danger of higher inflation, and therefore also higher interest rates, in the longer term.

In March this year, the Reserve Bank moved away from the conventional fixed Bank rate for its loans to banking institutions and introduced the more flexible daily tender system for repurchase transactions, where the effective lending rate of the Reserve Bank is determined on a day-to-day basis through a process of the interaction of demand and supply. The repo rate is now more closely linked to movements in short-term market interest rates as determined by overall demand and supply conditions in the money market. Short-term interest rates can adjust very quickly to changes in underlying conditions. The repo rate can be influenced by the Reserve Bank by changing the amount of central bank funds supplied to the market. In the process, the basic principle of the market mechanism is adhered to.

Here once again there is a misguided perception in South Africa that the Reserve Bank should intervene more actively in the markets to prevent interest rates from rising, even when there is a fundamental shortage of funds, but should not prevent interest rates from declining in times of increases in the supply of funds. Such an asymmetrical approach will, unfortunately, not be tolerated by the disciplines of the global market economy. In the recent turmoil in the international financial markets, a number of smaller countries experienced the vengeance of the international market forces when they tried to keep exchange rates or interest rates fixed at artificial levels not associated with the underlying market fundamentals.

A third area where greater flexibility in the price-fixing process has become of more importance in the situation of global financial integration is in the determination of the prices of financial assets such as share and bond prices. A decision by the Hong Kong Monetary Authority recently to buy shares in the stock exchange when sales by non-residents pushed prices down was exploited by speculators, but nevertheless contributed to some stabilisation as the authorities operated mainly through the market mechanism of demand and supply. As with all other interventions by the authorities in the financial markets, buying or selling of paper in the financial markets should be done with discretion, and should not prevent normal market forces from continuing to function effectively. For a country such as South Africa, it is therefore important to encourage well-functioning, efficient and flexible financial markets where prices can adjust quickly to changes in the underlying demand and supply conditions.

Many other examples of a need for greater flexibility in the process of price determination can be conjectured, for example, prices of commodities, of financial services, and of labour. Without flexible prices in all markets, smaller countries will find it increasingly difficult to survive in an integrated worldwide economy.

4. South Africa's experience with global financial volatility

Over the past six months, South Africa has experienced the full force of the uncontrollable volatility of the international financial markets. A few statistics will illustrate the impact these forces had on the South African economy:

- During the first four months of 1998, non-residents increased their holdings of South African bonds by R16.3 billion. During the next five months, that is from May to September, non-residents reduced their holdings of South African bonds by R22.4 billion.

- The exchange rate of the rand, which was relatively stable throughout 1997 and the first four months of 1998, depreciated by 21.4 per cent from 22 May 1998 to 31 August 1998. Since then, the rand has appreciated slightly but is still, at this stage, on average about 16 per cent down from the beginning of the year.

- The yield on long-term government bonds rose from below 13 per cent in April 1998 to 20.09 per cent on 28 August 1998, and then declined again to below 16 per cent at this stage.

- The prime overdraft rate of banking institutions was raised from 18.25 per cent at the end of April 1998 to 25.5 per cent on 28 August 1998. During the past few weeks, the major banks have reduced their prime overdraft rates again to 23.5 per cent.

- The average prices of all shares listed on the Johannesburg Stock Exchange increased by 32.3 per cent from December 1997 to an all-time high in May 1998, but then declined by 38.7 per cent to the end of September 1998. Since the end of September, the all-shares price index of the Johannesburg Stock Exchange has increased again by about 19 per cent.

These erratic movements in major financial aggregates created many problems for the authorities, financial institutions, businesses, private individuals, and indeed for the total economy. And yet, nobody can be blamed for it. It is part of the globalisation of financial markets, and of South Africa's participation in this process. South Africa went through a similar experience in 1996. On both occasions, that is in 1996 and so far in 1998, we succeeded in restoring financial stability in a relatively short period of time, but not without painful adjustment and a high social cost in terms of low economic growth.

There is no guarantee that somewhere down the road our economy will not be tested again by the increasing volatility of an integrated world financial market system. It is therefore important that we shall all learn from the two experiences of the past three years, and shall prepare our economy to prosper even within the environment of volatile international capital movements.

We have learnt that sound macroeconomic policies at all times make it easier to absorb the fluctuations in the financial markets. Countries that do not apply sound macroeconomic policies are punished more severely during times of international currency turmoil.

We have learnt that flexibility in domestic financial and other markets makes it easier to absorb the shocks of the periodic global financial market disturbances. In particular, we have learnt that prices as determined by market forces must be allowed to respond quickly and decisively to changes in underlying market conditions.

We have learnt that government policies are important, but that government actions alone cannot solve the problem once it has infiltrated into our markets. The disciplines of the market economy must be allowed to function in a flexible way.

We have learnt above all that sound, well-managed, and healthy banking institutions can form a major bastion against total economic collapse in a situation of large capital outflows. In a number of East Asian countries, the economies collapsed completely because weak banking systems could not survive in the adverse climate of sudden large outflows of capital.

South Africa must be grateful for the strength of our banking system, and must protect it to make sure that we shall also be able to withstand the future storms of a volatile global financial market environment. Weak banking systems lead to weak economies.