Mr Stals' statement on South Africa as an emerging market

Statement by the Govenor of the South African Reserve Bank, Mr Chris Stals, at the Annual Dinner of Ethos Private Equity in Stellenbosch on 29 March 1999.

The emerging financial markets of South Africa

South Africa is well-known in the international financial community for the sophistication of its financial markets. Founded on a good legal and accounting infrastructure, on a long experience of more than one hundred years which started with the need for the financing of the early gold mines of the Witwatersrand, on a good education system, and on transparent and universally recognised macroeconomic fiscal and monetary policies, the country is well placed to be one of the leaders, albeit of the second league of world financial market structures, i.e. after the more established and super-financial markets of the major industrial countries.

For some years, the development of the South African financial markets was shackled by the constraints of the socio-political problems of the country. In the economic field, the restrictive measures of boycotts, sanctions, disinvestment campaigns and isolation placed severe restrictions on the development of the South African financial markets. The socio-political reforms of the early 1990's removed most of these constraints, and new challenges have emerged since 1994 to reintroduce the South African financial markets into the global system, just at a time when the global system underwent one of the most revolutionary changes in its total history, a process which has become known as "the globalisation of financial markets".

South Africans took up these challenges with enthusiasm and the results achieved with, firstly, restoring normal relations with the international markets and, secondly, adapting to the major changes in the global system are often underrated. Progress made in the South African markets is, perhaps, best illustrated by the almost explosive increases in turnovers in the major financial markets:

- Secondary trading in shares on the Johannesburg Stock Exchange increased, in terms of number of shares traded, from 5.1 billion in 1995 to 9 billion in 1996, 17.9 billion in 1997 and 34.4 billion in 1998. The total value of shares traded increased from R63 billion in 1995 to R117 billion in 1996, R207 billion in 1997 and R319 billion in 1998.
- The increase in total turnover in the secondary market for bonds was equally spectacular. The total value of transactions in secondary trading on the Bond Exchange of South Africa increased from just over R2 trillion in 1995 to R4.3 trillion in 1997 and to R8.5 trillion in 1998.
- Activity in the market for derivatives likewise increased quite significantly over the past few years. The number of contracts traded in both futures and options on futures transactions more than doubled from 1995 to 1998.
- The South African market in foreign exchange made its contribution to the development of the overall financial markets. The average daily turnover in this market increased from US $2.7 billion in 1995 to $8.0 billion in 1998. At one stage, in the middle of 1998, the average daily amount exceeded $10 billion.

These developments in the South African financial markets obviously dictated major changes in the official policy approach and in regulatory requirements for the various financial institutions. The "big bang" changes introduced by the Johannesburg Stock Exchange, the changes introduced by the Department of Finance in the primary marketing of government bonds, the switch from a fixed bank rate to a fluctuating rate for repurchase transactions by the Reserve Bank, and the upgrading of the national payment, clearing and settlement system are just a few examples of the flexibility in official policy that supported the developments of the past few years.

The expansion of total activity in the financial markets for obvious reasons also attracted more foreign participation. A great number of foreign banking institutions, for example, established themselves in South Africa. At this stage, almost thirty foreign banks now operate in the South African market through branches or subsidiaries established here, and more than sixty foreign banks have established representative offices in South Africa. Foreign investors have taken active participation in a number of the member stockbroking firms of the Johannesburg Stock Exchange, and participate as authorised dealers for the Department of Finance in primary issues of, and secondary trading in, government bonds.

Last year, non-residents accounted for 28.5 per cent of the total value of transactions in shares on the Johannesburg Stock Exchange, and for 16.2 per cent of the total value of transactions in bonds traded on the South African Bond Exchange. The development of the South African financial markets in recent years was therefore supported to an important extent by the active participation of non-residents. In the process, South Africa not only succeeded in rejoining the world financial markets, but also in keeping abreast of the major developments in the process of globalisation of financial markets.

The phasing-out of exchange controls as a contributing factor

An important precondition for the incorporation of the South African financial markets in the global economy was the lifting of exchange controls. South Africa had to face this daunting challenge in 1994 with the knowledge that the country had no foreign reserves at its disposal at that stage to finance any net outflow of capital. It had to rely, therefore, on inflows of capital to generate the foreign exchange reserves that would be needed for the financing of any outflows, following upon the removal of the controls.

In the beginning, the South African monetary authorities were often criticised for not being more bold, and for following a policy of gradualism instead of a “big bang” approach for the removal of exchange controls. In retrospect, and taking account of the magnitude of the gross flows into and out of South Africa over the past five years, the path followed by the authorities was undoubtedly the correct one.

On balance, and on a gross basis, non-residents increased their claims on South African residents by more than R200 billion over the past five years. This enabled South Africa to finance an accumulated current account deficit of about R40 billion, to increase the net foreign reserves by about R35 billion, and to allow private South African residents to accumulate about R130 billion in foreign assets. This included about R60 billion of foreign direct investment by South African corporates, about R65 billion held by institutional investors in foreign assets, and about R4 billion invested by private individuals outside of the country.

The process of the gradual removal of exchange controls resulted in the effective withdrawal of about 70 per cent, [or even more], of the exchange controls that existed at the beginning of 1994. At this stage, South Africa has no effective exchange controls any more on:

- current account transactions of the balance of payments; or
- the inward or outward transfer of funds owned by non-residents.

In the case of residents, limits were introduced for amounts that can now be invested outside of the country by corporates, institutional investors and private individuals. The further phasing-out of exchange controls requires the gradual raising of these ceilings until they are no longer restrictive.

The only area in which no concessions of any significance were made so far refers to the blocked funds of emigrants or former residents of South Africa. The Government must still take a decision on the implementation of a programme for what will most probably be a gradual release of the blocked funds of former residents.

The globalisation process

The liberalisation of the South African financial sector and concurrent developments in the structure of and volumes in the capital, money and foreign exchange markets supported the absorption of the South African markets in the process of globalisation.

Last week, Mr Andrew Crockett, General Manager and chief executive officer of the Bank for International Settlements in Basle, delivered the annual Gerhard de Kock Memorial Lecture in Pretoria. He gave the following definition of globalisation:

“Globalisation is a term that is widely used, but defies precise definition. I take it to mean a process in which geographic and market barriers are being rapidly eroded. Economic agents are now able to make financial transactions with little hindrance in all major markets of the world. Not only this, they can switch with increasing ease between different types of intermediation, each of which is in increasingly close competition with the others”.

Globalisation holds many advantages for a country such as South Africa. It gives developing countries or emerging markets easier access to the surplus saving of the more mature industrial countries of the world. The advantages in globalisation for South Africa are clearly illustrated by the figures on gross cross-border capital flows over the past five years quoted above. The volatility in these capital flows, however, can also cause many macroeconomic problems for participating countries, particularly in the short-term, when international investment sentiments may change very quickly and often unpredictably.

Last year, South Africa felt the full impact of adverse developments in the global financial markets when large amounts of portfolio funds previously invested in the country were suddenly withdrawn. To illustrate the severeness of this problem, the flows of non-resident portfolio investments into and out of the South African Bond Exchange last year can be quoted. In the first four months of 1998, non-residents increased their holdings of South African bonds by R16 billion. In the subsequent eight months, that is from May to December 1998, they reduced their investments in these bonds by R26 billion, to become net disinvestors of R10 billion for the year as a whole.

These volatile capital flows had serious implications for the South African financial markets. The exchange rate of the rand depreciated by about 20 per cent; liquidity was drained from the domestic banking sector; interest rates rose to extremely high levels, and the rate of inflation increased from 5 per cent in April 1998 to 9.4 per cent in December 1998. These adverse developments in the financial markets had a serious depressing effect on growth in the South African economy.

South Africa was, of course, not the only country that was so hard hit by the adverse developments in the global financial markets that began as a more localised East Asian crisis in the second half of 1997. In the end, emerging markets in Latin America, Central and Eastern Europe and in Africa all suffered from the contagion effect of the East Asian crisis. Even financial markets in the industrial countries were affected, as evidenced by the near-collapse in September 1998 of the Long-Term Capital Management fund in New York.

There are at this stage numerous initiatives in progress at the international level to improve the international financial architecture in an effort to create greater stability in the global financial markets. It is widely accepted, however, that the developments of the past decade cannot be rolled back. In the words of Professor Klaus Schwab of the World Economic Forum:

"The financial globalisation is no longer a process – it is now a situation. We should therefore no longer talk of globalisation, but rather of globality".

The outlook for South Africa as an emerging market

The question can now be asked what the outlook for South Africa is as an emerging market in this unfolding brave new world?

Firstly, what are the prospects for the further expansion of the South African financial markets? It is unlikely that the rate of expansion in the volumes in the various markets experienced over the past few years will be maintained. There are, however, a number of further important structural reforms now in progress that will provide further stimulus, further expansion and more growth in the markets. A few can be mentioned:

- The implementation of the STRATE (Share Transactions Totally Electronic) system of the Johannesburg Stock Exchange to provide a secure electronic settlement environment for share transactions;
- The immobilisation, dematerialisation and concentration in a fully electronic Central Securities Depository of paper scrip and certificates to facilitate immediate payment against delivery of financial asset transactions;
- The further extension of the National Payment, Clearing and Settlement System (SAMOS) to provide for real-time on-line settlement on a gross basis for all large transactions, and same-day settlement for all transactions with and within the banking sector;
- The further extension of international participation at all levels in the South African financial markets.

Secondly, will the remaining exchange controls be removed to provide a further stimulus to the development of the South African financial markets? Here again, the answer must be in the positive. The removal of exchange controls is a one-way process that should not be reversed, not even when international capital flows go against the country, as happened in the past year.

The continued integration of South Africa in the world financial markets will force a greater use of the versatile major driving force of globalisation, and that is electronic communication. The emergence of a global electronic network for trade (e-commerce), financial transactions (e-payments) and money transactions (e-money) makes the retention of exchange controls on current account or capital transactions virtually impossible.

Thirdly, will the process of financial globalisation continue, and will it provide further stimulus to the expansion of financial markets? It is true that globalisation played havoc with the world financial markets last year and created many macroeconomic hardships, particularly in the emerging markets of the world. It is also true that there is some backtracking by certain countries from the process of globalisation.

It is also true that the integration of the world financial markets is a process that is irreversible. South Africa's attitude is therefore not to withdraw from globalisation, but rather to learn from the lessons of the past, and to adapt more effectively to the vicissitudes of this new world financial environment. In the final situation, South Africa with its low domestic savings rate and urgent requirement for the expansion of its production capacity, needs foreign investment to finance economic development in the interest of all the people of this country.

The process of globalisation brings with it growing competition amongst the approximately thirty countries that have now been grouped together as the emerging markets of the world. Investors, mainly from the industrial countries, have many options on where they can invest their funds. South Africa came through the financial turmoil of the past eighteen months relatively well. The banking sector stood up to the strains without any major mishap, the financial markets continued to function effectively, and the macroeconomic adjustments were painful but nevertheless less severe than in most of the other affected countries. Perhaps our fiscal and monetary policies were not as bad as local critics perceived them to be. The final assessment is now being made in the global markets. Some foreign investments are beginning to flow back into South Africa. Since the beginning of this year, non-residents have again increased their holdings of South African bonds by almost R4 billion.

The world financial markets are returning to a situation of more stability. Serious efforts are now being made at the multinational level to improve the architecture of the world financial system. After the turmoil of the past eighteen months, a period of sobering consolidation will at this stage have a salutary effect on this exciting process of the worldwide integration of financial markets. In the longer-term, the process will continue. And South Africa will hopefully continue to be an active participant in the process, and will come out as one of the winners in this very competitive environment.