Mr Stals discusses the impact of the international financial crisis on the South African economy

Speech by the Governor of the South African Reserve Bank, Dr Chris Stals, at the 52nd Congress of the South African Nurserymen's Association in Johannesburg on 17 May 1999.

The process of financial globalisation

The financial markets of the world are progressively becoming more integrated in a process that has become known as "financial globalisation". National stock and bond exchanges and money and foreign exchange markets are being opened up for international participation. Fund managers located in the major financial centres of the world operate across borders in many countries at the same time, dealing in securities, funds and foreign currencies.

The process of financial globalisation, or the integration of world financial markets, was made possible and is being driven mainly by the following four developments of the past two decades:

Firstly, the vast improvement of communication systems that has made it possible for markets throughout the world to be linked through satellite communication on a 24-hour basis and on real-time with each other.

Secondly, the astounding developments in electronic data processing techniques that make it possible to store, analyse and transmit a massive amount of information on financial markets, financial assets and financial results of individual institutions to all destinations around the globe.

Thirdly, a growing amount of saving, surplus to the investment needs of the major developed and fully industrialised countries. This development enticed investment fund managers in these countries to look for alternative places for investment. At the same time, there is a huge recognised need for, and big shortages of, investment funds in the developing countries of the world.

Fourthly, there is a world-wide tendency towards economic liberalisation, particularly after the collapse of the communist systems of Eastern Europe, and of the self-sufficiency strategies of countries in East Asia.

The process of globalisation is not restricted to the financial markets. Trade in goods and services is also being liberalised at the same time, and cross-border labour mobility is increasing, albeit at a much slower pace. The world-wide web network provides not only for the introduction of electronic financial transactions and of e-mail, e-funds, and e-money, but also for e-trade or e-commerce. Globalisation is indeed a process of overall economic integration, and not only the integration of financial markets. However, in the financial markets, the process of globalisation is, at this stage, a few steps ahead and perhaps much more advanced than in the markets for goods, services and labour.

South Africa's position in the globalisation process

Particularly since 1994, South Africa has adopted a clearly defined policy of actively participating in the process of financial globalisation. Recognising the low level of saving (or high level of consumption) in this country, combined with the massive need of funds for financing of economic development, South Africa must obviously encourage the inflow of foreign investment capital into the country. The low level of domestic saving must be supplemented with funds from the excess saving of the industrial countries, otherwise it will not be possible to create sufficient jobs for the relatively large number of new work-seekers that come to the market on a regular basis. The alternative solution, that is to reduce total consumption in the country, will not be easy to accomplish.

South Africa has therefore over the past five years implemented a number of economic policies to facilitate the process of its participation in globalisation. These efforts were particularly effective in the area of financial integration. The measures introduced included:

- The gradual phasing out of exchange controls. At this stage, non-residents are completely free to bring funds into South Africa, and to take funds out of the country, for whatever purpose. Residents may invest limited amounts of their own funds outside of the country. These limits now apply to private individuals, corporates and institutional investors.

- The restructuring of the capital market to provide for more specialised trading in equities (shares), bonds and derivatives. The Johannesburg Stock Exchange changed its total character by providing for corporate ownership, foreign participation, screen trading, paper dematerialisation, and for an electronically controlled centralised securities depository. The volume of transactions on the Johannesburg Stock Exchange increased from R117 billion in 1996 to R319 billion in 1998. In the Bond Exchange, the volume of transactions increased from R3 trillion in 1996 to R8.5 trillion in 1998. Non-residents now account for about 20 per cent of all these transactions.

- The upgrading of the national payment, clearing and settlement system to provide for much faster settlement of claims between banking institutions, and a more efficient transfer of funds between the clients of the banks. The upgraded system has also been linked to international payment and settlement systems (such as SWIFT) to provide for easier cross-border or foreign currency payments.

- Finally, the more active participation by South Africa in multinational economic co-operation arrangements, such as the International Monetary fund, the World Bank, the Bank for International Settlements and the African Development Bank.

All these actions paid off, and South Africa is at this stage already integrated to an important extent in the global financial markets.

The consequences of globalisation for South Africa

As already mentioned, the main advantage for South Africa in financial globalisation lies in the opportunity it affords of attracting more foreign investment funds into the country. From this point of view, South Africa was relatively successful and attracted more than R200 billion in foreign investment funds over the five-year period from 1994 to 1998. This enabled the country to:

- relax exchange controls and allow South African residents to invest about R130 billion outside of the country;
- finance an accumulated deficit on the current account of the balance of payments of about R40 billion; and
- add about R30 billion to the country's official foreign reserves.

These statistical aggregates, however, disguise one important weakness in the capital inflows into South Africa, and that is the fact that about 80 per cent of the total foreign funds invested in South Africa came in the form of portfolio investments, that is investment in paper assets, and not in bricks and mortar. The disadvantage of this type of investment is that it can be very volatile. Funds can flow out of the country as easily as it flows into the country, and both in- and outflows can at times be very disrupting for the domestic economy.

The global financial crisis of 1998

South Africa, and many other countries of the world, experienced the adverse consequences of such sudden capital outflows back to the industrial countries of its origin last year. The 1998—problem for the globalised financial markets started in East Asia where a number of countries such as Japan, Korea, Thailand, the Philippines, Indonesia and Malaysia, experienced problems with their domestic economies. These problems led to a decline in the confidence of foreign investors in emerging markets which led to the large-scale withdrawal of investment funds from these countries back to the countries of origin, that is back to the major industrial countries of the West. There was a flight from more risky investments in the emerging markets into higher quality but lower yielding financial assets of the industrial countries, in this case, mainly of the United States of America.

Although South Africa did not experience the same economic problems as the East Asian countries, the contagion effect spilled over into the South African economy in May 1998 when foreign fund managers were withdrawing portfolio investments from all the emerging markets of the world, and not only from the East Asian countries. South Africa, with its well-developed capital markets with large turnovers and unrestricted convertibility for non-residents, provided an easy source of liquidity for the fund managers who needed to transfer funds back to their countries of origin.

During the first four months of 1998, non-residents increased their holdings of South African bonds by no less than R16 billion. From May up to December 1998, however, non-residents reduced their holdings of South African bonds again by R26 billion. It was indeed difficult for the South African economy to absorb the effect of this switch-around of R42 billion within the same calendar year of the in and outflows of non-resident portfolio investment capital.

The large outflow of non-resident funds from May to December 1998 had the following adverse consequences for the South African economy:

- The yield on long-term government bonds increased from below 13 per cent in April 1998 to over 20 per cent in September 1998.

- The outflow of capital forced a depreciation of the rand against foreign currencies of about 20 per cent.

- Liquidity was drained from the South African banking sector to such an extent that the banks had to borrow large amounts from the Reserve Bank on a daily basis, and also had to curtail their credit extension to the private sector.

- The shortage of funds in the markets pushed up short-term interest rates, including the prime overdraft and mortgage lending rates of the banks by about 7 full percentage points to levels of about 25 per cent.

- The rate of inflation in South Africa increased from 5 per cent in April 1998 to 9.3 per cent in November last year.

These adverse developments in the financial markets gradually depressed real economic activity in the country. In both the third and fourth quarters of last year, South Africa accordingly experienced declines in total economic activity (that is, experienced negative economic growth rates). On a temporary basis, the financial globalisation and South Africa's participation in the process, therefore had a negative or adverse effect on the South African economy.

Recovery of global financial conditions

The deterioration in the South African economy in the second half of last year found its origin in the problems of the international financial markets. Nothing changed in the South African domestic situation in May 1998 to justify the sudden switch-around in the non-resident capital inflows to outflows from the South African Bond Exchange.

The adverse conditions in world financial markets continued into the fourth quarter of last year. It was only after some stabilisation was reintroduced in East Asia and after the collapse of the Russian economy was discounted in the financial markets, and after a credible international financial rescue package was put together for Brazil, that markets calmed down again. The South African financial markets were quick to follow. Since about November last year, the outflow of capital through the Bond Exchange came to an end; the exchange rate of the rand stabilised and even appreciated slightly; liquidity of the banking sector increased again; the yield on government bonds declined, and short-term interest rates declined. Most of the banking institutions now quote prime and mortgage lending rates at the level of 19 per cent. The rate of inflation also peaked in November 1998 at 9.3 per cent and has since declined to 7.9 per cent in March 1999.

In line with the rest of the world, the improved conditions in the financial markets have not succeeded in improving real economic activity up to this stage. There is a growing optimism, however, that a recovery in overall economic conditions will commence before the end of this year, and that next year will, on a world-wide basis, be a better year than 1999 — that is, provided that no further major shocks will occur in the global financial markets in the near future.