South Africa’s experience with capital flows since the financial crisis

From measurement to analysis

Barend de Beer

IFC-BCB-CEMLA Satellite Meeting
24 July 2015
Rio de Janeiro
Brazil
South Africa’s capital flows within an international context;

- Methodological improvements and reducing data gaps;

- Conclusion
South Africa’s capital flow developments within an international context

- Since the 1990s – South Africa generally experienced net capital inflows to finance a persistent current account deficit (currently around 5 per cent of GDP).

- In part due to relatively low domestic savings rate – between 2003 and 2014 South Africa’s average domestic savings rate as a percentage of GDP amounted to 16,1 per cent which was significantly below the global average of 21, 2 per cent.
South Africa’s capital flow developments within an international context

- Over the same period South Africa’s public sector debt as a ratio of GDP increased substantially from 31.6 per cent to 43.9 per cent – a significant increase, but still much lower than many other developed and developing economies.
- These developments have meant that South Africa’s domestic gross fixed capital formation (a key requirement for future growth sustainment) - has become increasingly reliant on international capital inflows.
South Africa’s capital flow developments within an international context

- The balance on the financial account as a ratio of GDP indicates there were only two periods since 1994 (2001 and 2003) where this ratio moved into negative territory.
South Africa’s capital flow developments within an international context

- So what has the composition of the capital flows to South Africa been since 2000?

  ![Graph showing South African net financial flows by functional type]
  
  - Except for 2008, portfolio investment (PI) has been the major anchor in South Africa’s international capital attraction;
  - The 2008 PI capital reversal coincided with SA’s record attraction of FDI which cushioned the sudden capital flow reversal to some extent;
  - However, the reality of EME exposure to sudden reversals became very clear.
South Africa’s capital flow developments within an international context

Composition of liability portfolio investment flows has changed significantly

<table>
<thead>
<tr>
<th>Period</th>
<th>Liabilities</th>
<th>Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Equity</td>
<td>Debt</td>
</tr>
<tr>
<td>R millions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009 - current</td>
<td>147,638</td>
<td>454,063</td>
</tr>
<tr>
<td>Per cent</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000 - 2008</td>
<td>90%</td>
<td>10%</td>
</tr>
<tr>
<td>2009 - current</td>
<td>25%</td>
<td>75%</td>
</tr>
</tbody>
</table>

Source: SARB
South Africa’s capital flow developments within an international context

- For first part of 2000’s, mainly flows into the equity markets.
- Net flows into the bond market were small and often funded domestically;
- Since 2009, large inflows into the debt (bond) market by pension funds and long-term investors;
- South Africa constitutes 10 per cent of the Global Markets Local Currency Bond index (GEMEX), and since end Sept 2012 included in the Citibank World Government Bond index (WGBI);
- Low government foreign currency borrowing (around 10 per cent of GDP);
- Foreign ownership of rand denominated SA government bonds increased from just below 14 per cent in 2009 to around 36 per cent in 2014.
- What does this imply for vulnerability to capital flow reversals?
In general, South Africa has a relatively low foreign currency exposure on balance sheets of government, households, banks, etc.;

Banks are relatively less reliant on external funding – and net exposure limited as a result of prudential regulations;

The country’s net investment position is slightly negative.

Foreign debt ratio of just above 40 per cent of GDP

Rand denominated component = approximately 56 per cent
South Africa’s capital flow developments within an international context

How does South Africa compare with other EME’s?

- **FDI:** South Africa’s attraction of FDI relative to a panel of peer countries seems to indicate that it has fared less well in attracting FDI despite having a high potential to attract FDI – resulting in increased reliance on PI capital flows;

- **PI:** As a ratio to emerging market GDP, the sizeable post-crisis period flows to EME’s could not emulate the level seen in 2007 - close to 8 per cent of EME GDP, oscillating between three and six per cent between 2009 and 2014.

The experience in South Africa was similar to that of the other EME’s with net portfolio flows to South Africa as a ratio of GDP peaking at 8 per cent in 2006, reversing to negative 6 per cent in 2008, and thereafter it has not pierced levels above 4 per cent yet.
South Africa’s capital flow developments within an international context

What about the currency and foreign reserve asset position?

- Developments in the rand foreign exchange market since the financial crisis have also increased the focus on cross-border capital flows and the implications it has for a country’s ability to deal with surges and reversals in cross-border capital flows.

- South Africa’s exchange rate regime is one of the most flexible among EME’s and foreign exchange intervention is rare;
South Africa’s capital flow developments within an international context

- Since the sharp depreciation that accompanied the financial crisis, the rand initially strengthened by 45 per cent against the US dollar between October 2008 and April 2011;

- Partially in response to low global interest rates and quantitative easing;

- Since April 2011, the rand has however experienced sharp periods of depreciation with only occasional appreciation - on average depreciating by 44 per cent between April 2011 and May 2015 (35 per cent against a trade-weighted basket of currencies).
South Africa’s capital flow developments within an international context

- During periods of volatility, South Africa resisted increasing capital control measures;
- Instead it gradually built its gross international reserve asset position and international liquidity position - US$ 46.4 billion and US$ 41.5 billion at end of May 2015, respectively;
- Reserves cover almost 5 months of imports and close to 80 per cent of gross external financing needs;
- This is in line with developments in various EMEs - increased reserves, taking advantage of renewed capital inflows; and
- BRICS’ Contingency Reserve Arrangement would also enable South Africa to draw US$ 10 billion to further bolster the buffer.

Concerns:
- Loss of competitiveness in periods of real appreciation;
- Consequences of excessive volatility;
- Asset price bubbles and credit booms during periods of strong inflows; and
- Vulnerability to sudden stops and reversals associated with balance sheet effects.
South Africa’s capital flow developments within an international context

- South African FX market increased by US$7 billion between 2010 and 2013, reaching US$21 billion in April 2013, a 50 per cent increase between 2010 and 2013 (deep and liquid market by EME standards);

- Daily average turnover in the South African FX market was far exceeded by the global daily average turnover in the USD/ZAR currency pairing which reached US$51 billion, implying an increased rand market outside the borders of South Africa;

- Implications for currency volatility and management during periods of capital reversals?
South Africa’s capital flow developments within an international context

Summary of post-crisis capital flows

- Relatively hands-off approach (no direct controls put in place) because of difficulty to predict usefulness in South African market (difficult to discriminate between good and bad capital);
- In fact, further relaxation of controls on resident outflows (prudential limits act as natural stabiliser);
- No new controls on banks – prudential requirements effective, low foreign funding and strict rules on open position exposure;
- Future stance on intervention will be based on circumstances;
- Deep and liquid FX market – the flexible exchange rate has helped South Africa manage volatile capital flows, and furthermore the gradual increase in pace of foreign reserve asset accumulation is also aimed at buffering against surges in market volatility - foreign reserve assets still below IMF metric;
- Openness, currency volatility and relatively low foreign reserves exposes South Africa;
- Reality - low FDI attraction means reliance on PI;
- Policy has been very vigilant of exchange rate pass-through to inflation;
- Difficult to predict ER movements and inflation impact (challenge for policy);
- During strong inflows – little real sign of credit or asset market bubbles.
Methodological improvements and reducing data gaps

- The processes, methodologies and structures used to compile international capital flow data and economic statistics in general, form the bedrock upon which analysis and ultimately policy decisions are based.

- There has been continual improvement and development with regards to the measurement of South Africa's capital flows, which have come about due to:
  - Adherence to international developments in guidelines and reporting requirements;
  - Internal statistical quality control improvements (quality and cross-checking); and
  - Continually improving analysis of measured data and providing feedback to the compilation process.
**Methodological improvements and reducing data gaps**

<table>
<thead>
<tr>
<th>Component</th>
<th>Development</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Foreign Direct Investment</td>
<td>Improved measurement of FDI and creation of International Transaction Database on FDI</td>
<td>1) More accurate measurement of FDI; 2) Richer sectoral and geographical analysis; 3) Improved analysis with other areas – e.g. Capital Account (dividend flows)</td>
</tr>
<tr>
<td>2. Portfolio Investment</td>
<td>Closer alignment between portfolio stock positions and flows through targeted measurement intervention with data suppliers</td>
<td>1) Improved data accuracy; 2) Increased awareness of PI importance; and 3) Reduction in unrecorded transactions</td>
</tr>
<tr>
<td>3. Derivatives</td>
<td>Comprehensive measurement of SA OTC derivative market (banking sector)</td>
<td>1) Closing data gaps; 2) International alignment; 3) Reduction in unrecorded transactions; and 4) Cross-pollination of other intl. datasets (BIS triennial survey)</td>
</tr>
</tbody>
</table>
## Methodological improvements and reducing data gaps

<table>
<thead>
<tr>
<th>Component</th>
<th>Development</th>
<th>Implication</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>4. Locational Banking Statistics (LBS) Data</strong></td>
<td>Increasing the analytical usefulness of the LBS data by developing an analytical suite</td>
<td>1) Extension of monetary and credit aggregate data analysis; and 2) Developing indicators of vulnerability - Currency breakdowns and mismatches; - Structural vulnerabilities; - Financial interconnectedness and implications for systemic risk (network analysis); 3) Improved analysis of “Other investment“ category of Balance of Payments</td>
</tr>
<tr>
<td><strong>5. Integrated Economic Accounts (IEA's)</strong></td>
<td>SA is in the process of constructing a full set of IEA's based on the guidelines provided in SNA 2008 and in fulfilment of G20 requirements</td>
<td>1) Development of balance sheet approach for SA BoP/IIP - closer alignment of stocks and flows; 2) Harmonisation between ROW and other economic sectors (BPM6 and SNA2008 alignment); and 3) Improved analysis (WTW, FOF)</td>
</tr>
</tbody>
</table>
Methodological improvements and reducing data gaps

Ultimate purpose?

- Reduced unrecorded transactions
- More refined classification of identified capital flows
- Enhanced policy usefulness of capital flow statistics and analysis

For all of the years since 2005, the adjustments were positive, with the unrecorded transactions decreasing as a ratio of GDP due to improvements in methodology and measurement techniques in various sub-components of the capital flows.
Conclusion

In summary our view is that...

Accurate analysis based on sound statistics should provide policy focused output.

Only useful if based on sound data and development of analysis needs must feed back to required statistics.

Process of continual rejuvenation and improvement.

Capital flow statistics should be:

1) based on sound statistical techniques and methodology;
2) which is aligned with international guidelines but also;
3) Addresses national requirements and conventions.

In summary our view is that...