T T Mboweni: South Africa's integration into the global economy

Address by Mr T T Mboweni, Governor of the South African Reserve Bank, at the Diplomatic Forum, Rand Afrikaans University, Johannesburg, on 25 October 2000.

*   *   *

"Globalisation refers to an evolving pattern of cross-border activities of firms, involving international investment, trade and collaboration for the purposes of product development, production and sourcing, and marketing. It is driven by firm strategies to exploit competitive advantages internationally, use favourable local inputs and infrastructure, and locate in final markets. These strategies are shaped by declining communication and transport costs, and rising R&D costs; macroeconomic trends and exchange rate fluctuations; and liberalisation of trade, investment and capital movements".

OECD Jobs Study. Facts, Analysis, Strategies. 1994.

1. Introduction

Globalisation is not a new phenomenon. There have been many periods of global economic integration, followed by periods of backlash. Despite these occasional disruptions, the degree of economic integration in the world has been rising over time. Especially since the Second World War, the pace of economic integration has become more rapid. Technological progress has improved transportation and communications, enhanced information awareness and information processing, and has set the stage for new products and innovations. These developments make it much easier for national markets to be globally integrated. Although these markets still do not form a global village, they have become so interdependent that they are changing the environment in which economic activity takes place.

This new economic environment has, however, also brought about certain disadvantages, such as the large reversals in international capital flows and resulting economic crises in many countries. Towards the end of last year, these crises led to protests against free trade and "global capitalism". Demonstrations were particularly strong in the City of London and at the World Trade Organisation round of negotiations in Seattle. More recently the meetings of the IMF and World Bank in Washington and Prague during April and September 2000 were also the focus of protests against globalisation and the debt burden of some developing countries. Despite these demonstrations, global economic integration today is greater than it has ever been and is likely to become even stronger in the coming years.

2. Consequences and lessons of globalisation

New technologies will continue to make the world a smaller place. The linkages between stock exchanges in many countries increased significantly in the 1990s. Recent empirical evidence shows that due to the elimination of obstacles to free trade, greater financial market integration has led to greater market efficiency and better risk-and-return combinations for investors. There has been a sharp increase in the weight of foreign assets in the portfolios of some agents, as well as the correlation between the relevant stock indices and the ability of each market return to explain the behaviour of returns in other markets. The disadvantage of the greater integration of financial markets is that it reduces the ability of domestically focused policies to deal with the problems arising in the respective domestic financial markets.

South African share prices are increasingly influenced by the views of international investors. Developments in London, New York, Frankfurt and Tokyo often have a greater influence on domestic share prices than actual developments in South Africa. South Africa has seen major swings in foreign exchange flows, interest and exchange rates in recent years. Under these circumstances, errors of judgement may be easily made with domestic macroeconomic policy that could have a detrimental effect on aggregate domestic economic activity in South Africa. It can be said that the greater the level of integration of the global market, the greater the need for worldwide supervision. One of the important questions in this regard is whether such worldwide supervision should be provided by a single international supervisor or by a closely linked group of supervisors.

South Africa's sophisticated financial system compares favourably with those of most industrialised countries and surpasses those of many emerging-market countries. Although great strides have been made in recent years with global and regional integration, the process of financial integration has had a few setbacks. South Africa has experienced the contagion effects of periodic emerging markets crisis that forced painful adjustments. The Mexican crisis, and more recently the Asian crisis, were unlike any seen before and spread quickly around the world. They quickly took on systemic proportions and could only be addressed through the immediate mobilisation of substantial international effort.

The Asian crisis in 1997 and 1998 was characterised by three important factors. Firstly there were macroeconomic imbalances, along with massive outflows of short-term capital. Secondly there was an acute crisis in the financial sector, reflecting institutional and banking practice weaknesses. Thirdly an economic management model was applied which was not in keeping with the new demands of a globalised economy. Before massive financial assistance could be considered for these countries, a set of measures or rules was required that would lead to greater transparency, better management and anti-corruption efforts. Furthermore, the relationship among corporations, banks and governments needed immediate fundamental changes.

Some analysts believe that the Asian crisis did not stem from so-called "crony capitalism" but from economic liberalisation. They postulate that a flood of speculative capital first caused a real-estate bubble, which affected the rest of the economies when the bubble burst. The problem therefore was not a lack of openness but too much of it, too soon. They also suggest that as capital rushed out of Asia, countries like Taiwan and others still had sound fundamentals - budget surpluses, low inflation, high savings rates. Some critics also maintain that the IMF's actions made a bad situation worse. Draconian prescriptions, such as bank closures, budget cuts, higher interest rates and structural reforms intended to root out everything wrong with the Asian approach to the economic policy, had an excessive deflationary effect.

Whether the IMF's actions were entirely appropriate in all instances during the Asian crisis is a matter for another day, but the important characteristic distinguishing the Asian crisis from other crises was the prominence of private financial institutions and other private enterprises as both creditors and debtors. As Michel Camdessus, former Managing Director of the IMF, pointed out, a number of trends in the integration of capital markets stand out. These trends make the process more complex, and include the following:

(1) The domestic private sector is playing a far more important role in the economy of most countries. Domestic financial and capital markets have sprung up in Beijing and Moscow and a host of other cities in the developing world.

(2) The foreign investment community is far more diverse, comprising direct investors, portfolio investors, banks and bondholders.

(3) The different types of investment have responded to globalisation in different ways and even during crisis periods flows of direct investment have in many instances not fallen steeply.

(4) It is too simple to conceive of nations as belonging to either the debtor or creditor group. There are powerful flows in many directions. The largest source of direct foreign investment in Asia is, for example, Asia itself. Korea, Hong Kong, Thailand and Japan are all important sources of foreign investment within the region, and remain so even though some were at the heart of the Asian crises.

Globalisation accelerates and spreads the international consequences of domestic policies. No country can escape the consequences of globalisation, and all countries are being called upon to ensure "rigour and transparency in overall economic management; banking and financial sector soundness; reform of the institutions of the state in terms of seeking public sector efficiency, appropriate regulation, emphasis on the rule of law, independence of the judiciary (and the central banks), anti-corruption measures, etc.; and growth that is centered on human development".

Whether a country is large or small, a financial crisis can become systemic through contagion on the globalised markets. The domestic economic policies of the major industrialised countries have in recent years increasingly taken into account their potential worldwide impact. This duty of universal responsibility is also becoming important for all countries, large and small. As globalisation progresses, all countries take a measure of responsibility for the stability of the international financial system and the quality of world growth. This adds commitment and responsibility that are required of every government in the management of their economies. Globalisation also concerns the worldwide integration of financial markets. Therefore active participation in this integration process implies that monetary and fiscal policies have to be subjected to the disciplines of the international market. Globalisation mercilessly exposes the shortcomings in national economic policies in countries that do not apply the universal "laws" for prudent macroeconomic management. The process of globalisation accentuates the pressure for change and for greater coordination and harmonisation of economic policies.

The World Bank, IMF, OECD and other international organisations are encouraging countries to discover what the consequences are of the circular relationship between the integrity of monetary and financial management, high-quality growth, and poverty reduction. Without poverty reduction, the first two have little chance of enduring, and without the first two, any efforts to reduce poverty will take longer and be less successful.

3. South Africa's re-entry into the global economy

Since 1994 South Africa has introduced major changes to domestic political, social and economic structures. After years of apartheid-induced isolation from the global economy, countries lifted sanctions and companies ceased disinvesting from South Africa. Profitable opportunities were opened up for South Africa to reintegrate its economy into the global economy.

South Africa's integration into the global economy had important implications for the South African banking sector. The official policy has been to open up the South African banking sector to foreign participation, and to expose South African banking institutions to foreign competition. As a result of this policy, 15 foreign banks have registered branches in South Africa and 60 foreign banks do business in the country through representative offices. The South African banking sector remains sound and well-managed. Some mergers are taking place in line with world trends, and the 35 domestic banks are rationalising their activities to face the challenges of globalisation. The four big banks in South Africa have assets of over R500 billion. The registered banks in our country have an aggregate balance sheet of some R772 billion as at the end of August 2000 with capital and reserves of R71,4 billion. The South African Reserve Bank is responsible for bank regulation and supervision which is based entirely on the recommendations of the Basel Committee. Regulation and supervision concentrates on the management of risk exposures within each banking institution.

Exchange controls were relaxed by removing all restrictions on current account transactions, and on the inward and outward transfer of funds by non-residents, and then by gradually enabling residents to invest specific amounts of capital outside the country. As a step along the indicated path of systematically abolishing exchange controls, all such controls over non-residents were abolished in March 1995 when the dual exchange rate system was terminated. The result was that the financial rand disappeared and the proceeds of local sales of non-resident-owned South African assets were regarded as freely transferable from the Republic and could also be freely used in the Republic for any other purpose. In March 1997, the Minister of Finance also announced that individuals who are tax-payers in good standing would be allowed to invest a specified amount of their savings in any manner abroad and in fixed property in SADC countries. Alternatively, they would be allowed to hold foreign currency deposits, up to a defined limit, with South African authorised foreign-exchange dealers or with foreign banks outside South Africa. In February 1999 the Minister also increased the amount that South African corporates investing abroad could remit from South Africa from up to R30 million per new investment project in foreign countries and R50 million in SADC to R50 million and R250 million respectively.

The large capital inflows over the past few years have enabled the Reserve Bank to increase the country's official foreign reserves from the equivalent of 6½ weeks' worth of imports of goods and services at the end of 1994 to 14½ weeks' worth at the end of June 2000. The increase in the country's official foreign reserves in recent years also made it possible to substantially relax exchange controls over the period.

Government took the lead in reintroducing South Africa gradually to the global markets for public loan issues. A number of issues were made in the global and Yankee US dollar markets, in Sterling, Deutsche Mark and in the Samurai Yen market. South African private corporates were also encouraged to raise funds through equity and bond issues in international capital markets, and were allowed to use part of the proceeds from such issues for financing the expansion of their activities in the rest of the world.

South African institutional investors, such as insurers and pension funds, were allowed to exchange part of their rand-denominated portfolios for foreign-currency denominated assets through swap transactions entered into with foreign counterparts. In accordance with the principle of relaxing exchange controls, permission was granted in June 1995 to South African institutional investors (long-term insurers, pension funds and unit trusts) to exchange, through approved asset swap transactions, part of their South African portfolio for foreign securities. In March 1997 it was announced that institutions that qualified for asset swaps would be broadened to include regulated fund managers registered with the Financial Services Board. With effect from July 1997, portfolio managers registered with the Financial Services Board as well as stockbroking firms which are members of either the Johannesburg Stock Exchange, the Bond Exchange of South Africa or the South African Futures Exchange, could also apply to acquire foreign portfolio investments by way of asset swaps.

Integration into the world financial markets required a major restructuring of the institutional arrangements in the South African capital markets. The Johannesburg Stock Exchange (JSE) introduced changes to provide for corporate ownership, foreign ownership of stockbrokerage firms, dual capacity trading, negotiated commissions, and electronic screen trading. The JSE is continuing to improve its facilities by providing for the immobilisation and dematerialisation of shares, and for improved clearing and settlement arrangements. The total value of shares traded on the JSE increased from R63 billion in 1995 to R448 billion in 1999.

The most spectacular increase in volumes over the past few years took place in the Bond Exchange of South Africa. Total turnover in this market increased from R2 trillion in 1995 to R8,8 trillion in 1999. The relaxation of South African exchange controls made an important contribution to the development of the Bond Exchange and transactions by non-residents in this market have increased significantly.

The adjustments that have occurred in the South African economy, and on South African monetary policies during the past few years, were necessary and timely. These adjustments were needed to restore and maintain overall economic equilibrium. South Africa has increasingly developed robust financial, economic and foreign exchange markets. This latter market is growing rapidly and its daily average turnover now exceeds $9 billion.

Another interesting development following the globalisation process is the emergence of a Euro-rand market. The outstanding nominal amount of rand-denominated loans raised in this market by South African and non-South African borrowers from non-South African investors, is now almost R202 billion. A part of these loan issues is usually hedged by investing in South African bonds.

4. Globalisation and monetary policy

The reintegration of South Africa into the world economy and the liberalisation of financial markets also have important implications for monetary policy. As Bill McDonough, President of the Federal Reserve Bank, pointed out in 1998: "The technology for processing information and making this information widely available has fundamentally altered the way the world channels saving into investment. No longer does the global economy rely primarily on loans from commercial banks to meet its financing and investment needs. Rather, more than even before, the global economy of today looks to funds from the fixed-income and related capital markets to intermediate its credit needs. Because the global capital markets have become so important in the credit intermediation process, the economic well-being of us all depends on the orderly flow of funds in these markets. The flow of these funds, in turn, increasingly relies on price signals generated by trading activity that takes place daily in these markets. The reliance on secondary market trading for price discovery constitutes the fundamental difference between funds from securities markets and loans from banks".

This change in the way that savings are channelled to investments has resulted in greater volatility in international capital movements. Recent non-resident transactions on our Bond Exchange are a clear reflection of this greater volatility in international capital flows. In such a situation, it is more important than ever before to create and maintain a sound environment for foreign investment in a country. This makes it more imperative for monetary policy to pursue clearly stated objectives. Increasingly throughout the world, central banks are pursuing price stability as their basic policy focus. Where countries have high rates of inflation which are out of line with the rest of the world, disruptive capital flows could occur because of fears of currency misalignments.

The closer integration of the world economy has therefore focused the ultimate objective of monetary policy and made it even more important to attain this objective. It should, however, also be realised that such a policy stance does not provide unconditional protection against speculative capital outflows. External economic shocks or perceived poor policy measures can still trigger a reversal in capital movements. Monetary policy cannot prevent these reversals. International investors make their decisions on the basis of a wide variety of developments, including price stability. The best approach that central banks can follow is to pursue financial stability in a transparent and accountable manner so that they can at least forestall any uncertainties in this regard.

Although the objective of monetary policy has been better focussed within the context of globalisation, the integrated world economy has resulted in a more complex mechanism for transmitting monetary policy. The relationship between changes in interest rates, money supply and inflation has become less clear under these new conditions, compared with the period when South Africa was more isolated from external influences. As a result of large international capital flows, the effects of policy changes are being transmitted to a greater extent through critical indicators such as bond yields and exchange rates. There are of course longer time lags between policy changes and their desired impact on the real economy.

These changes in the transmission mechanism of monetary policy have reduced the credibility of the money supply as an intermediate guideline for policy. The integration of financial markets and financial innovations made the demand-for-money function less stable. This was clearly reflected in a consistent decline in the income velocity of circulation of M3 money of nearly 15 per cent from the end of 1994 to the end of 1999. The money supply accordingly became a less reliable anchor for monetary policy.

Volatile capital movements further complicate the transmission mechanism under floating exchange rates, because of the impact that exchange rate changes have on the foreign transactions of a country. In a closed economy, the transmission mechanism runs from increases in the repo rate and other short-term interest rates through to longer-term interest rates and asset prices and then to aggregate demand and prices. The open economy version of the transmission mechanism under floating exchange rates runs from interest rates, to nominal exchange rates, to the absolute and relative prices of tradeable goods and eventually to the prices of non-tradeable goods.

In view of this more complicated transmission mechanism in a reintegrated global economy, the Reserve Bank has had to reconsider the framework that it applied in pursuing price stability. Informal inflation targeting using intermediate money supply guidelines was obviously no longer suitable in the changed international environment. From the beginning of this year, the authorities therefore decided to adopt inflation targeting as the formal monetary policy framework of the South African Reserve Bank. This framework should focus monetary policy, increase transparency and lead to a clearer accountability of the Reserve Bank. Such a framework also allows for exchange rate flexibility. Exchange rates should essentially be determined by the supply of and demand for currency in foreign exchange markets.

5. Conclusion

The Reserve Bank's approach to globalisation has been to adapt our framework as well as the banking structure of the country to comply with the international best practice as understood by international investors and regulators. This approach recognises the important contribution that these investors can make to real economic growth, development and employment creation in South Africa.

I remain optimistic about the benefits our country will derive from engaging in the financial globalisation process and the constructive role that monetary policy will play in this process by ensuring financial stability. What we are seeing in many countries, is an improvement in governance, and the establishment of transparent, arm's length relationships among governments, corporations and financial institutions, that are typical of mature markets. We are also witnessing the global acceptance by political leaders of the independence of central banks as a critical factor for credible monetary policy. I actually have a nice quote from Prime Minister Lionel Jospin of France. He says that: "Independence signifies ignoring pressures, whatever its source. The independence of central banks goes ... beyond independence from political, executive and legislative power. For me it also equates with independence from private or collective economic interests, autonomy versus the short-term, frequently imposed by capital markets and, finally, freedom of action vis-à-vis the monetary policy of other central banks". There are greater responsibilities on all sides. Just as the public sector is being called upon to change and improve codes of good practice, so too the private sector has to follow suit by complying with these international norms and codes of good practice.

Thank you very much.