Dr. Stals assesses the new opportunities for South African investors in an environment of no exchange controls Address by the Governor of the South African Reserve Bank, Dr. C. Stals, at a Business Breakfast Forum hosted by Marriott Merchant Bank and Deloitte & Touche in Durban on 17/3/97.

1. Background

The announcement on the further relaxation of exchange controls by the Minister of Finance, Mr. Trevor Manuel, on Wednesday last week received as much, if not more, attention as his announcements on fiscal policy for the 1997/98 fiscal year.

For more than 35 years, South African residents were not permitted, at least within the rules of the law, to make investments outside of the country without prior approval from the exchange control authorities. Approval was seldom given, particularly not before 1994 when the besieged South African economy had to contend with international sanctions, boycotts and disinvestment campaigns.

Following upon the political and social reforms in the country and the withdrawal of punitive international economic actions, the Reserve Bank and the Department of Finance started with a gradual phasing out of the exchange controls. A major constraint remained an acute shortage of foreign exchange reserves which were completely depleted by the time the Government of National Unity came into power in April 1994.

Looking back over the past three years, good progress has nevertheless been made with the gradual phasing-out of the exchange controls. As a first priority, all restrictions on non-residents to repatriate their investment funds from South Africa were removed. Various ways and means were introduced to enable South African corporates to acquire foreign investments in branches or subsidiaries controlled by them. They were, for example, allowed to use the proceeds of foreign equity or convertible debenture issues to finance foreign investments. The Reserve Bank has approved a cumulative amount of more than R18 billion for this purpose.

In June 1995, a scheme was introduced to enable South African insurers and pension and mutual funds to diversify part of their existing asset portfolios into foreign currency denominated investments. Approval has been given for more than R30 billion of asset swap transactions in terms of which institutional investors could exchange South African assets for foreign assets in this process. According to information available to the Reserve Bank, more than R17 billion of these transactions have been executed.

A number of internal arrangements were introduced to reduce the administrative burden of exchange controls, for example to grant the authorised dealers in foreign exchange more scope for discretionary decisions on exchange control applications, without prior reference to the Reserve Bank. In the process, virtually all exchange controls on current account transactions in the balance of payments (i.e. payments for goods and services) were removed.

The announcement made by the Minister of Finance last week extended the exchange control relaxation programme now also to foreign investments by private individuals. A basis has been established for a continuation of the gradual removal of the exchange controls through the periodic lifting of limits and other administrative measures over a wide front to cover the corporate sector, institutional investors and private individuals. There remains but the blocked assets of emigrants (former South African residents) that need to be addressed at some stage.

2. The relaxations announced last week

The announcement of some further exchange control relaxations last week by the Minister of Finance was very important, not only for the substance of the relaxations but also for the clear policy direction indicated. This was the first major relaxation of the exchange controls announced by Mr Manuel since he became Minister of Finance in April 1996 and confirmed his endorsement of the policy of the gradual removal of the exchange controls.

Secondly, the Minister himself regarded the announced relaxations as an important change in the underlying philosophy held by the Government on exchange controls. In his Budget Speech the Minister said:

"The package of exchange control reforms placed before this House today moves South Africa to a system with a positive rather than a negative bias .... The objective is to reach a point where there is equality of treatment between non-residents and residents in relation to inflows and outflows of capital."

The Minister, in other words wants to indicate that South Africa now has a free foreign exchange system with a number of temporary exceptions, instead of a controlled system with a few special concessions.

The wide-ranging concessions now made give South African corporates more freedom to make direct investments outside of South Africa, with some special dispensation for investments in other members of the Southern Africa Development Community (SADC); increase the scope for institutional investors to diversify part of their portfolios into foreign assets and for the first time enable South African private individuals to make foreign investments, either directly or through South African authorised dealers in foreign exchange. Some of the details of these relaxations must still be worked out, but the Minister indicated that all the relaxations announced will be implemented by 1 July 1997.

3. New options for the investor

In the past, many South Africans wanted to invest part of their savings outside of the country for non-financial reasons, and this may still be so in future. The more rational investor, however, may think twice before making an investment in a foreign currency, in a foreign country and perhaps also in the shares of a foreign company. In considering such a possibility, a few important macroeconomic realities will have to be taken into account.

The first is that markets, the more free they become and the more efficient they function, also work more effectively as a catalyst for equalisation. For example, if the average rate of inflation in South Africa over time is 10 per cent per annum and the average rate of inflation in the rest of the world is 3 per cent, nominal interest rates in South Africa will on average be about 7 per cent above the level of nominal interest rates in other countries. Differences in real rates of interest will reflect differences in the risk factor attached to investment in different countries.

In the same example, the exchange rate of the South African rand will depreciate over time by about 7 per cent per annum. The depreciation in the exchange rate will therefore make sure that the converted rand value of a foreign investment will keep up with the value of a similar South African investment, adjusted for inflation. There are therefore no special gains to be made from the investment in a foreign currency.

Thirdly, taxation in South Africa will be levied on income earned on foreign investments on the same basis as income earned in South Africa. (The taxation on “passive income” earned in foreign countries as referred to by the Minister in his Budget Speech.)

Foreign investments will, however, hold new risk exposures for South African investors, particularly in an environment of volatile international exchange rates. The timing of the transfer of an investment into a foreign currency can be detrimental. A South African investor who may have transferred his savings into a sterling investment earlier this year when the exchange rate between the rand and the pound was R8.00 = £1.00 could have lost 10 per cent of his investment within a very short period of time. Last Friday the exchange rate was back to R7.10 = £1.00. This brings into any foreign investment a new speculative element that does not exist in the local investment market.

Finally, very few private individuals in South Africa have the knowledge and the expertise to manage foreign investment portfolios, and to assess the alien risk exposures that are connected to such investments. We should not, just because of sentimental reasons, make use of a new freedom to invest funds abroad when a local investment will serve our needs better and more effectively.

4. Monetary policy in an environment of no exchange controls

The new situation brings new challenges also for monetary policy. The depreciation of the rand last year, and the appreciation of almost 10 per cent since November 1996, gave us a taste of the new exposures of our financial system to the global markets. If South Africa wants to be part of the global village, we shall have to abide by the rules of the international markets.

Without exchange controls, capital in and outflows will be dictated by market forces, and markets are inclined to put heavy penalties on errors made by governments and central banks in their macroeconomic policy decisions. It will be fatal for a country to liberalise its financial systems and to encourage the integration of its domestic financial markets into the global system, and then to balk at the disciplines of these markets.

5. Financial institutions without exchange controls

Many South African financial institutions have already taken up the challenge of becoming part of the international financial community. Such institutions will also have to consider carefully how this new venture will affect their own security, liquidity and solvability. There are numerous examples in the world of the collapse and failure of major financial institutions because of international exposure.

Governments or financial regulators and supervisors cannot protect multinational institutions against the many risks involved in being global. South African institutions were protected from these international risk exposures through the isolation of our country from the international markets. Now that the opportunities are being opened up for an outward movement, they have to tread with care and with caution.

6. Conclusion

The removal of exchange controls opens up new opportunities for South African corporates, institutional investors and private individuals. All of them, however, must not be overwhelmed by emotional considerations inspired by a new freedom, but must give careful consideration before any decision is taken to invest hard earned savings in a foreign country, in a foreign currency and in a foreign institution.