Capital Flow Management in South Africa

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Introduction

- South Africa had a long history of controls on capital outflows; (limited controls on inflows)
- 1996: lifted controls on non-residents, maintained restrictions on residents, with objective of a phased liberalisation.
- Currently some quantitative controls on residents. Institutions (insurance companies and pension funds) subject to prudential limits.
- Responses to strong capital inflows generally limited to reserve accumulation, and liberalising resident restrictions on outflows.

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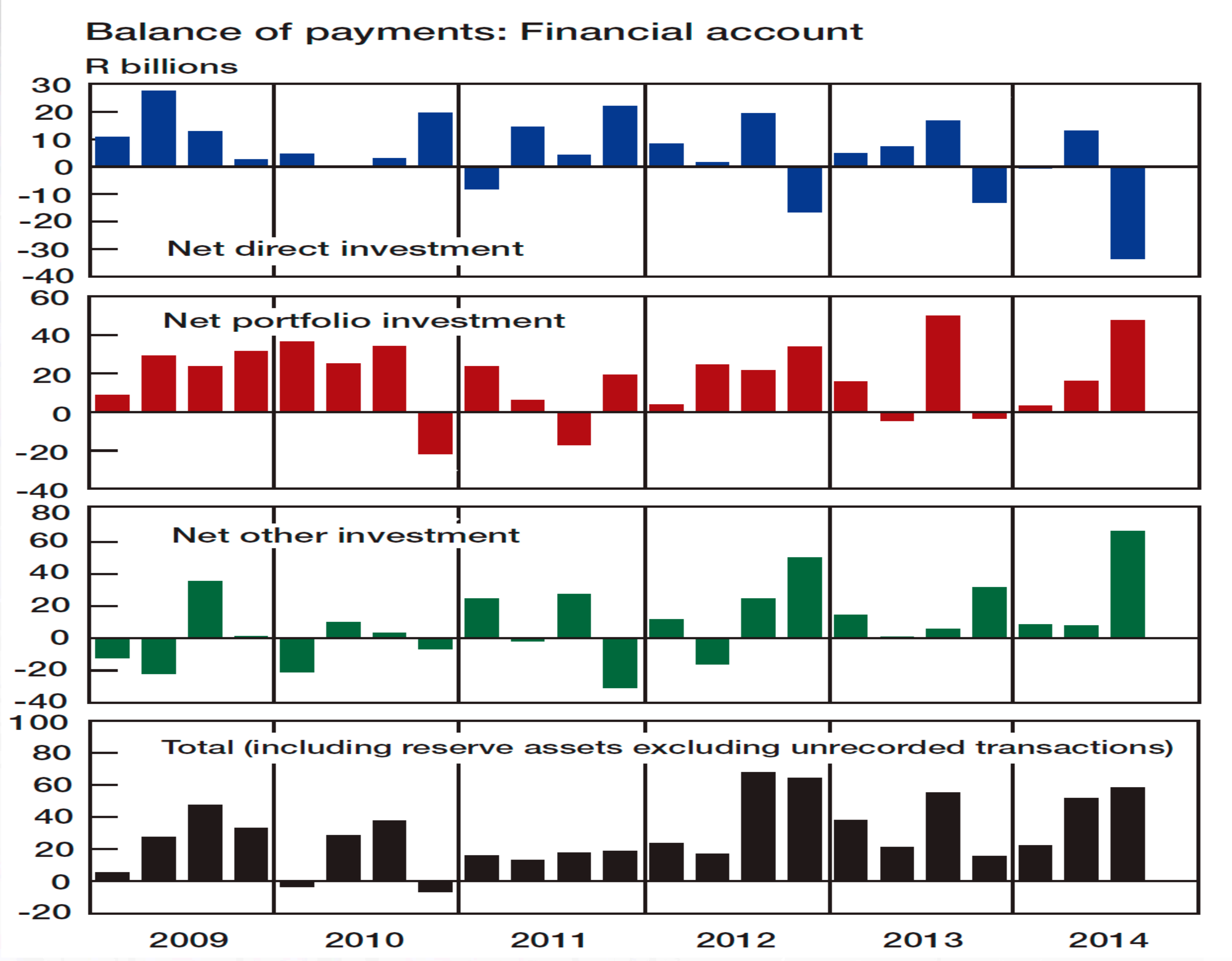
Since the 1990s, generally net capital inflows to finance a persistent current account deficit (currently around 5 per cent of GDP).



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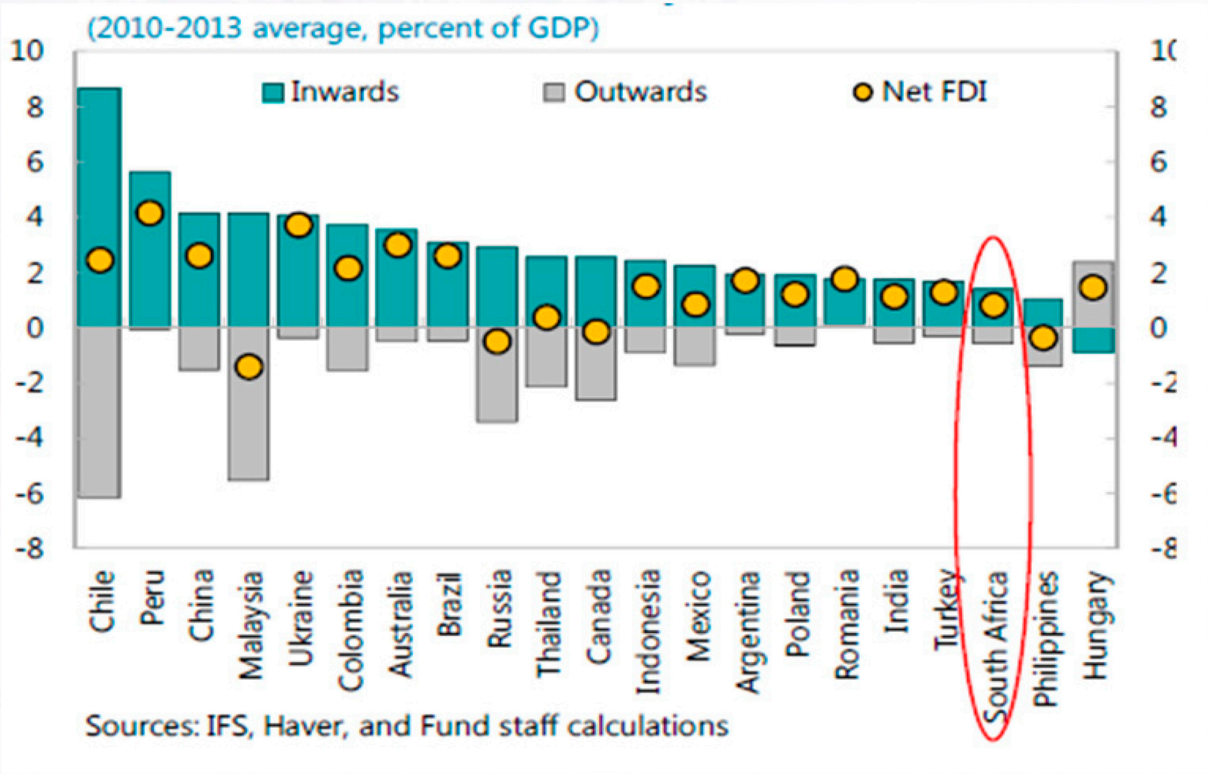
Gross inflows to GDP: FDI portfolio investment

	FDI/gdp	PORT/gdp	Govport/gdp
2007	2,2	4,6	-0,1
2008	3,2	-3,0	-1,0
2009	2,5	4,3	1,1
2010	1,0	3,9	2,2
2011	1,0	2,9	2,9
2012	1,1	3,6	3,6
2013	2,3	2,0	1,7

Nature of capital inflows

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

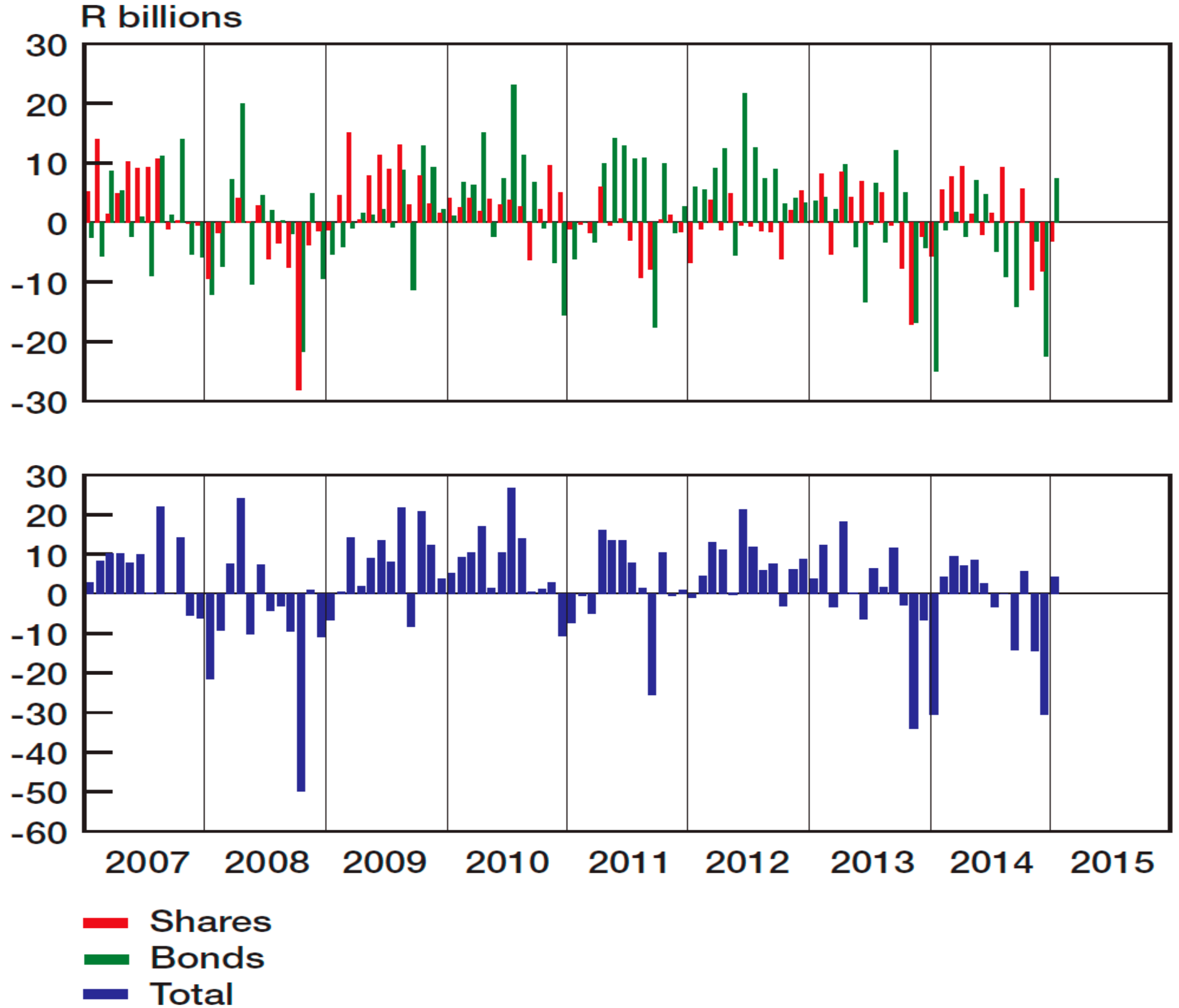
- FDI lumpy, and low relative to other Ems.



Nature of capital inflows

- Government foreign currency borrowing low (around 10 per cent of GDP and 4 per cent on a net basis.
- Portfolio flows predominant. For most of 2000s, mainly flows into the equity markets. Flows into the bond market were small on a net basis and often funded domestically.
- Since 2009, large real money inflows into the bond market, by pension funds and long terms investors.

Monthly net purchases of shares and bonds by non-residents



Source: JSE Limited

Nature of capital inflows

- South Africa is 10 per cent of the Global Markets Local Currency Bond index (GEMEX), and since end Sept 2012 part of the Citibank World Government Bond index (WGBI).
- Foreign ownership of rand denominated SA government bonds increased from about 13,8% in 2009 to around 36% in 2014.
- Greater vulnerability to reversals?
- Banking sector net exposure limited, as result of prudential regulations.
- Banks not reliant on external funding.

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Nature of capital inflows

- Generally low foreign currency exposure on balance sheets (government, households, banks).
- Country net investment position slightly negative.
- Foreign debt ratio 40 per cent of GDP, about half of which is rand denominated debt.

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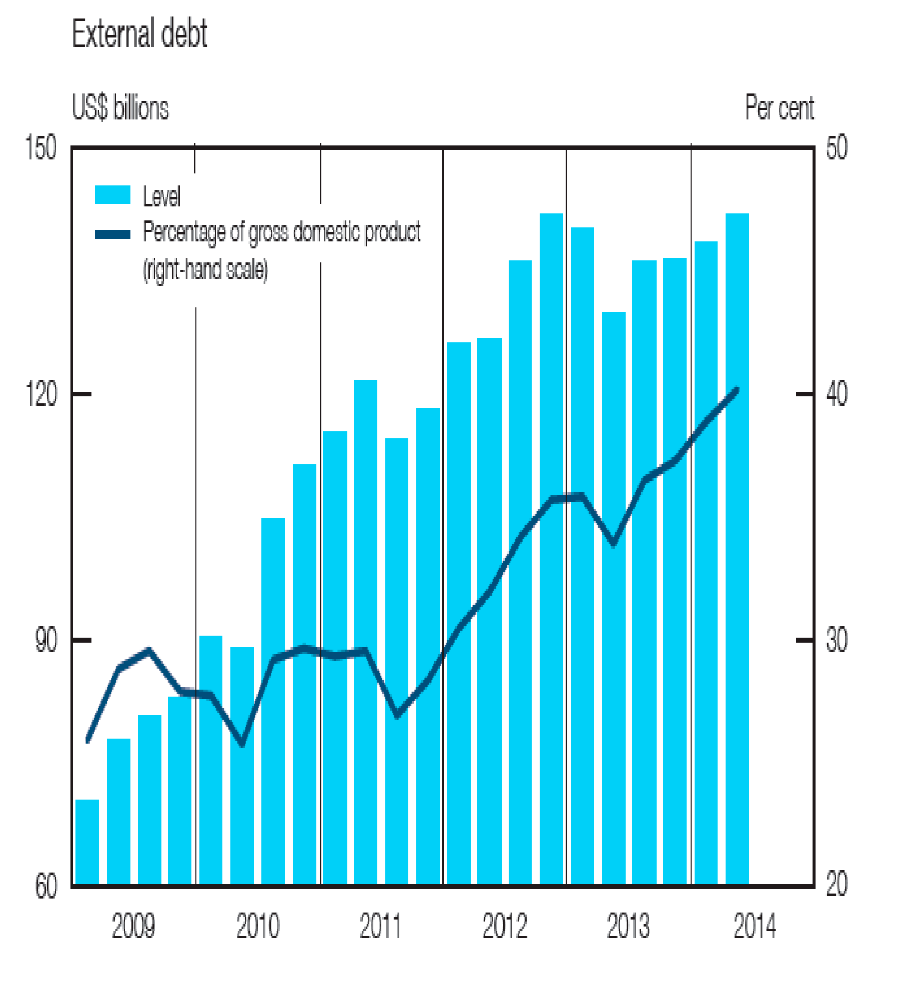
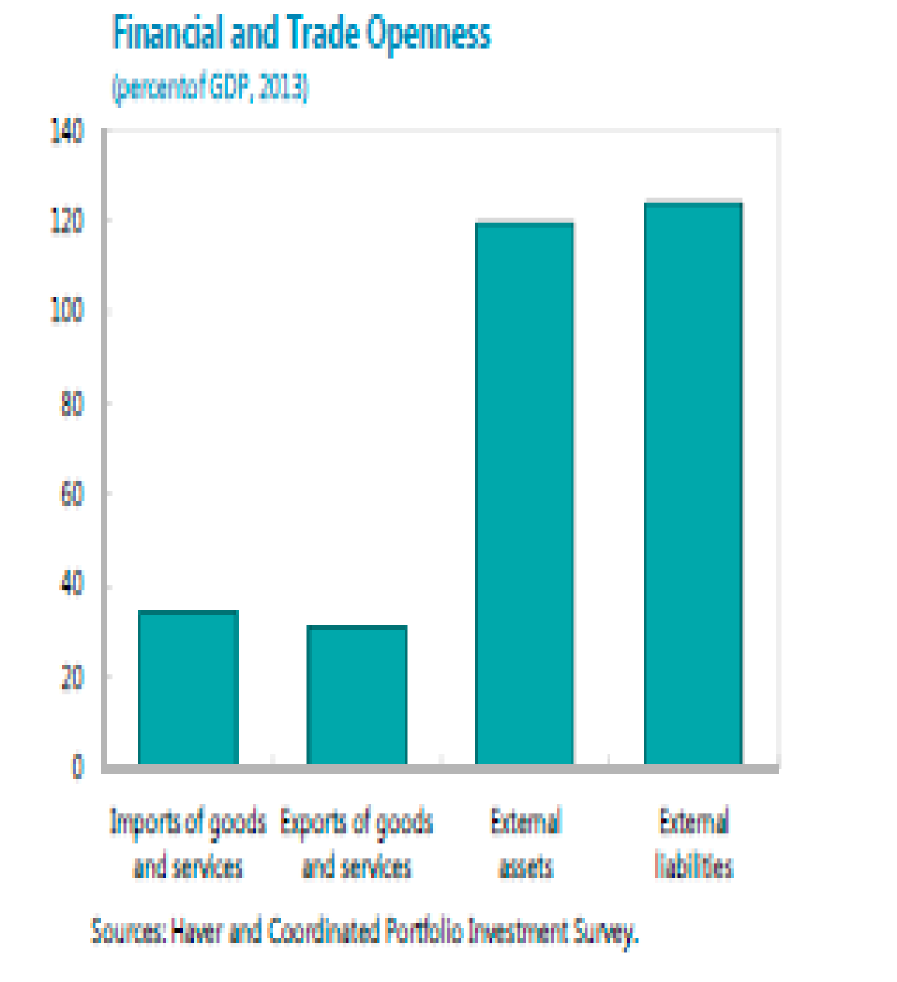
SA foreign debt (incl rand denominated debt) and net external position





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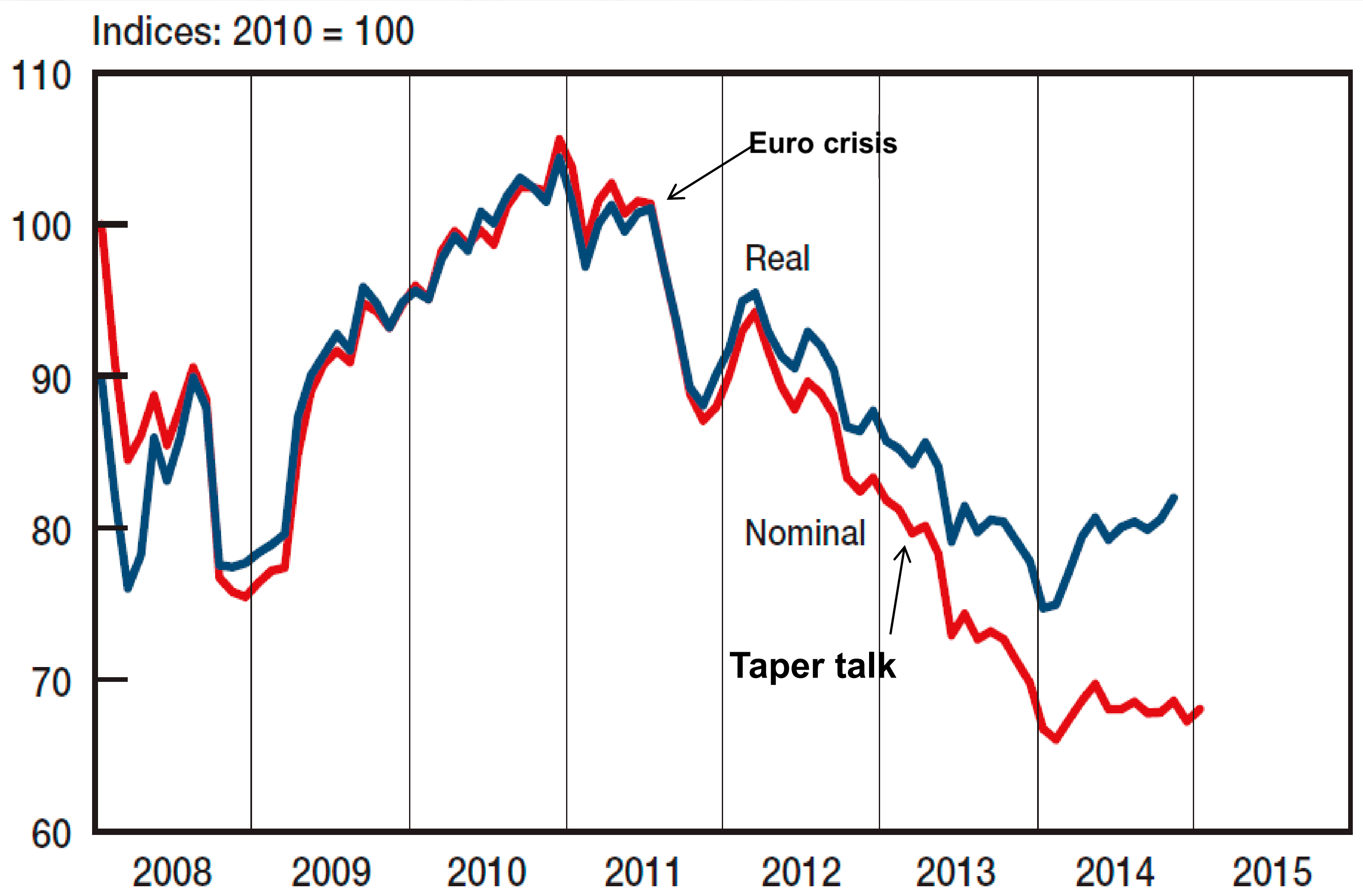
Challenges of capital flows

- Impact on exchange rate:
  - Rand responded to low global interest rates and quantitative easing, and appreciated during 2009-Sept 2011, but weaker since then, for both external and domestic reasons.
- Concern about
  - loss of competitiveness (real appreciation), and consequences of excessive volatility. (rand assessed to be overvalued, particularly in 2009-11);
  - possibility of asset price bubbles and credit booms during strong inflow episodes;
  - and, more recently, vulnerability to sudden stops and reversals, and associated balance sheet effects;

Exchange rate responses

- Main determinants include:
  - Global risk perceptions (esp Europe)
  - Terms of trade (commodity currency)
  - Capital flows
  - Carry trade and interest rate differentials
  - Domestic factors.

Floating exchange rate, with relatively little intervention, particular during periods of currency weakness.
(Real and nominal effective rand exchange rate)



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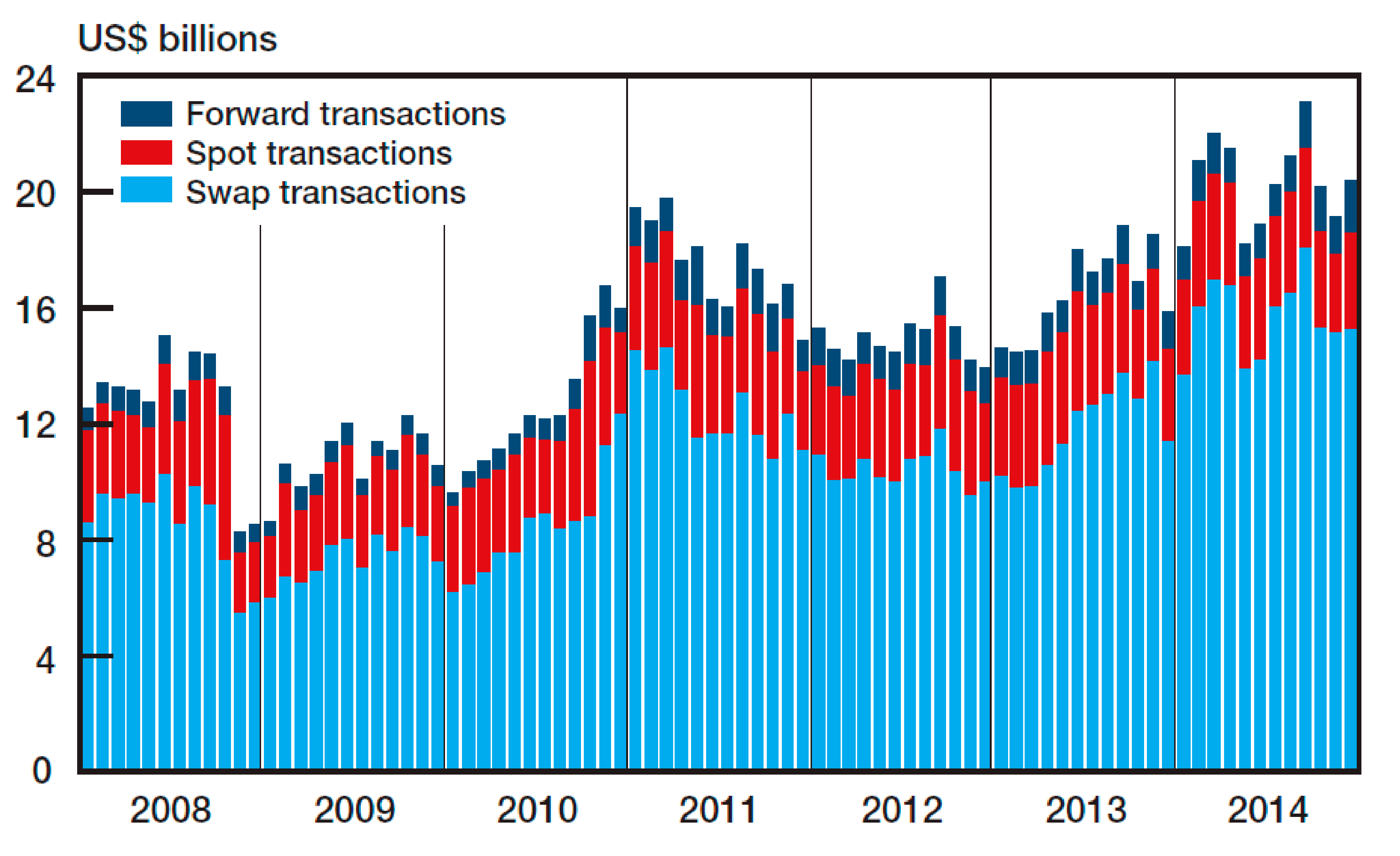
Relatively deep and liquid market by EM standards, high turnover, used to hedge EM exposure.

Average daily net turnover in the SAforeign exchange market



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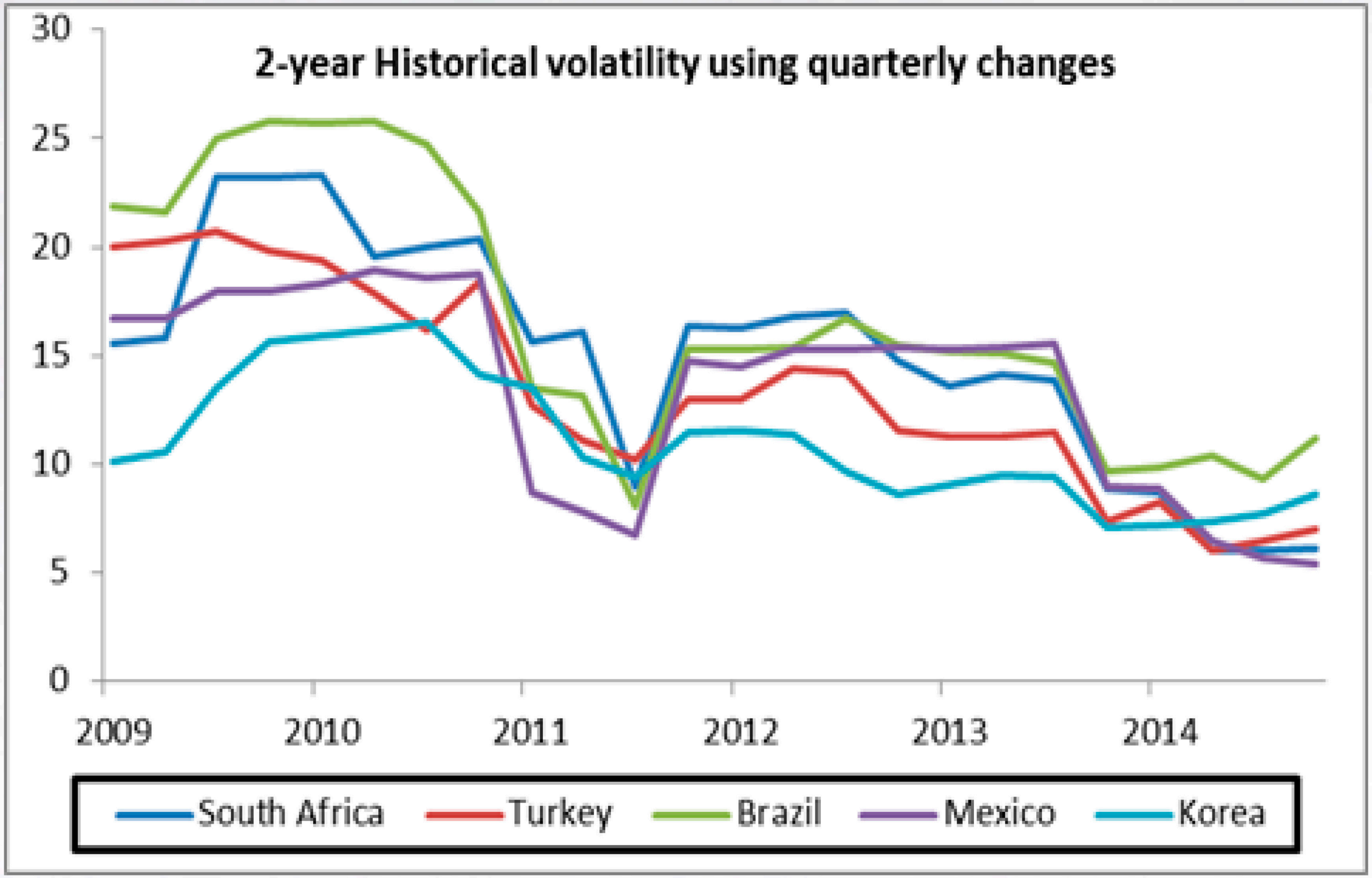
Rand generally a highly volatile currency, high beta, but less volatile at lower frequencies.



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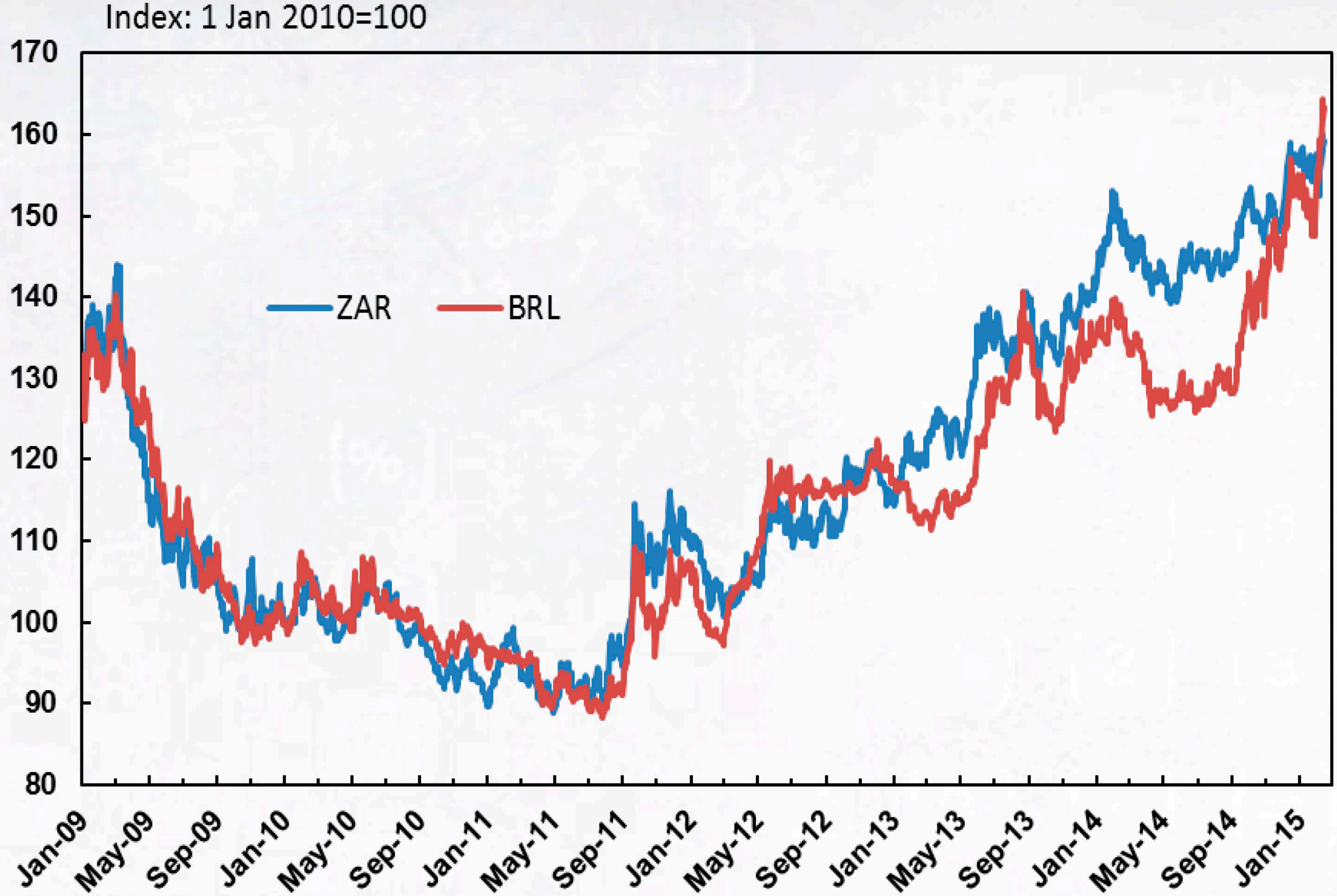
Rand moved in line with other Ems (eg Brazil) despite different approaches to capital controls.

(Rand and Brazilian Real vs the US dollar)



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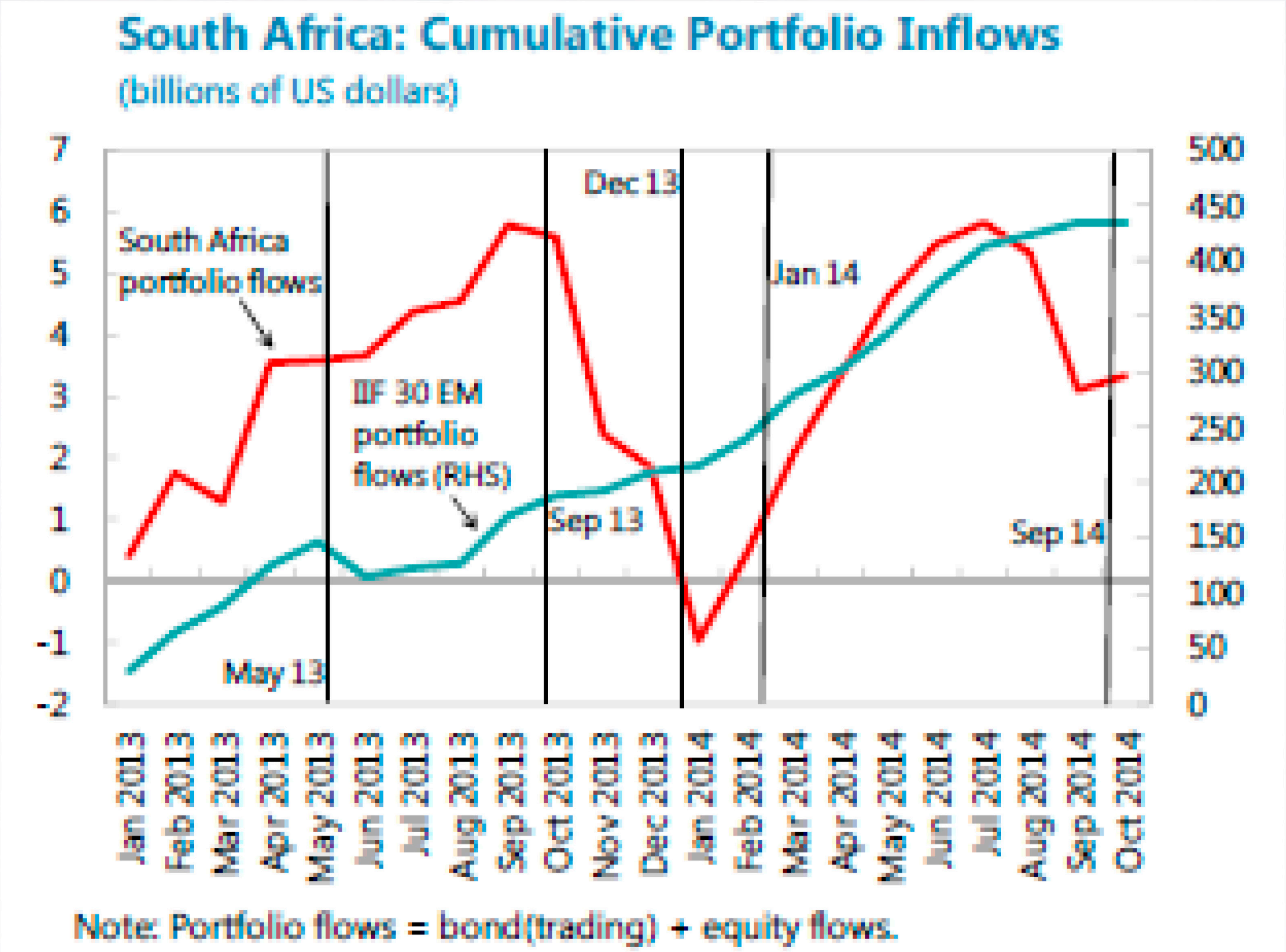
Rand and domestic financial markets strongly impacted by global market volatility



Source: IMF Article IV Report 2014

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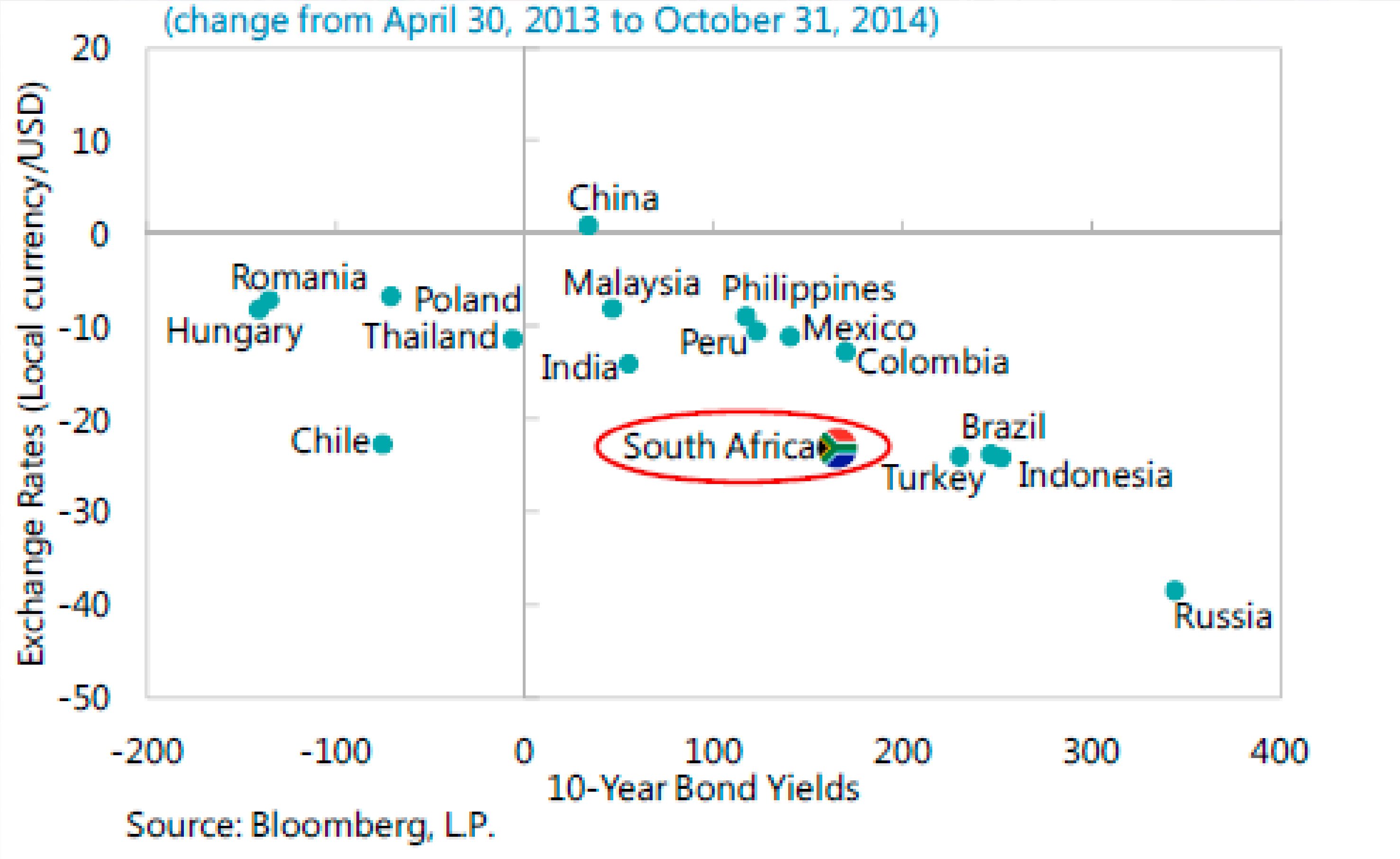

Source: IMF Article IV Report 2014

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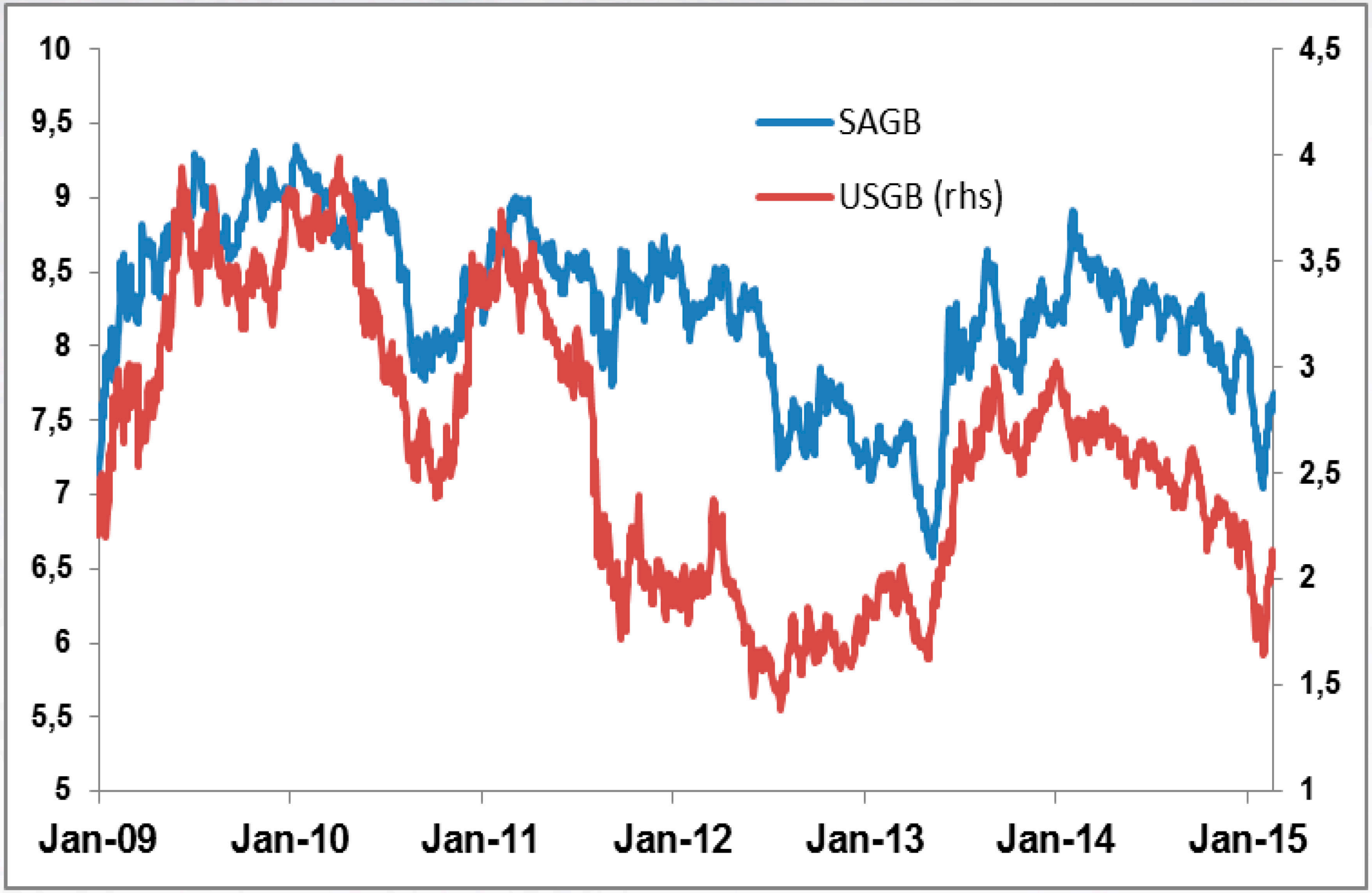
SA and US 10-year government bond yields



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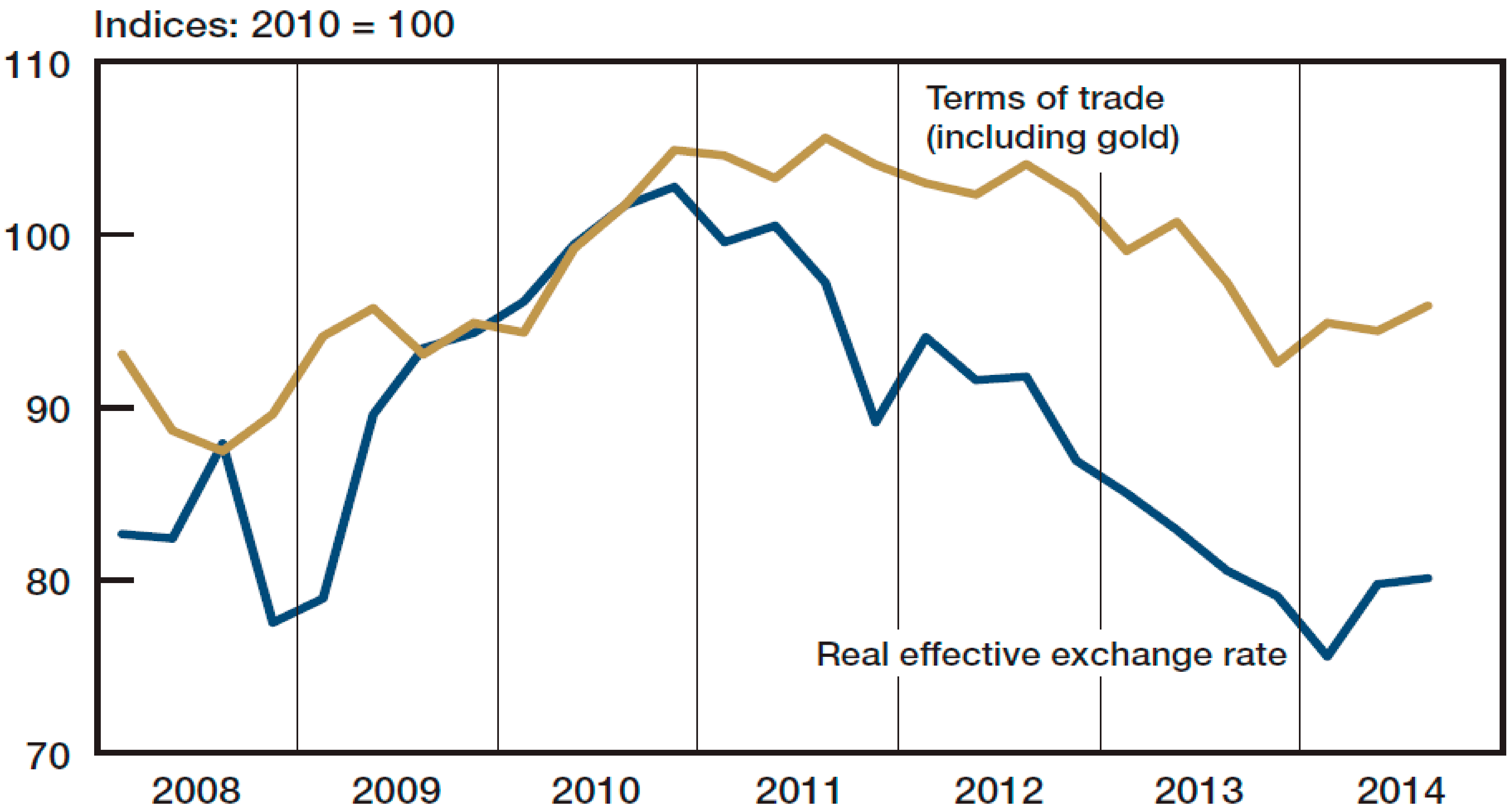
South Africa's terms of trade and real effective exchange rate



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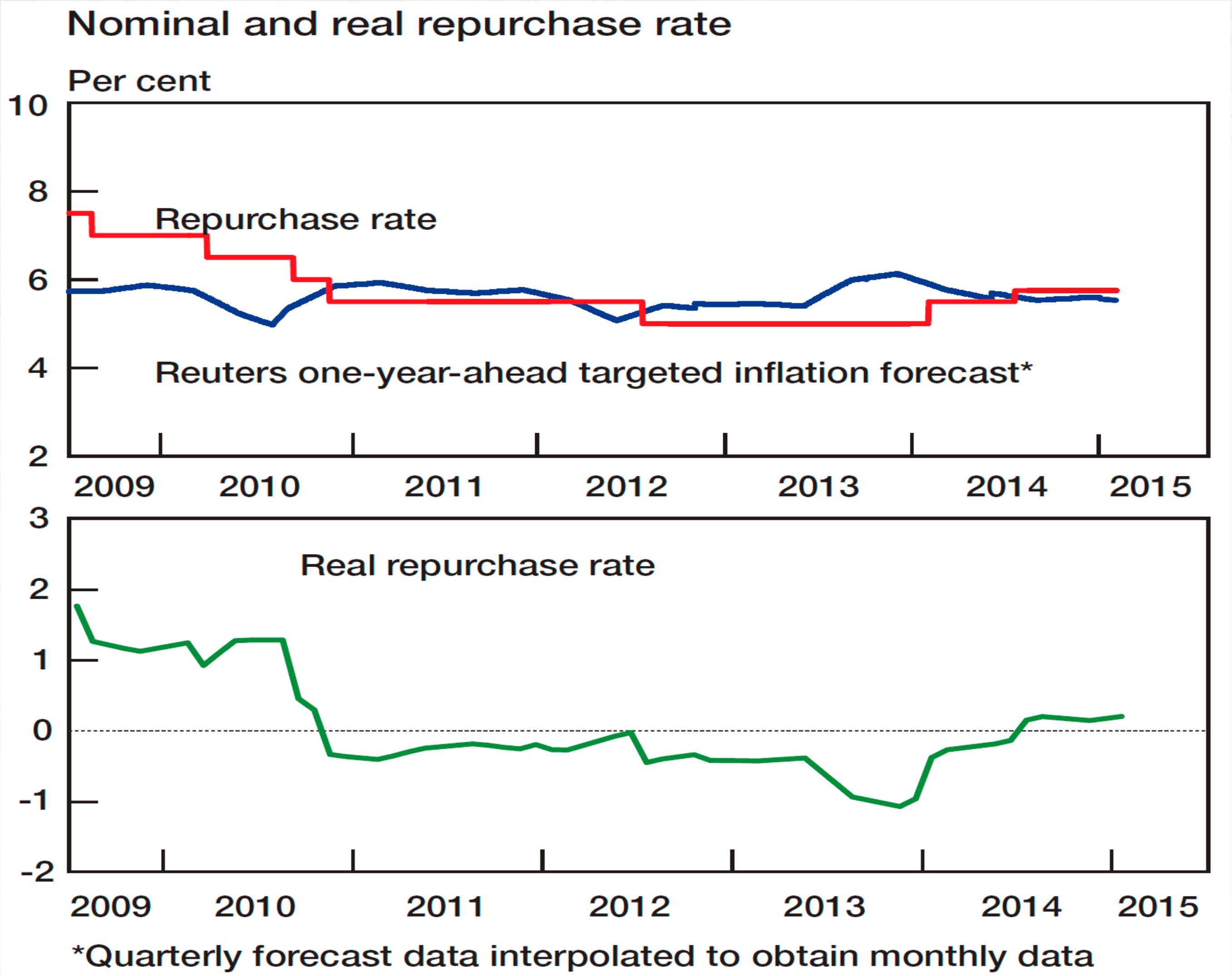
Post-crisis capital flow management

- No direct controls on capital inflows were put in place because of doubts about their efficacy in the SA market:
  - Forex market is relatively deep and liquid, with about 60 per cent of transactions offshore
  - Inability to attract FDI on a consistent basis means reliance on portfolio capital inflows;
- New controls on banks not considered. Prudential requirements effective; not reliant on foreign funding; Basel III compliant; strict limits on open position exposure.
- Monetary policy has not been focused on exchange rate, but on the possible inflationary impacts of exchange rate changes.

Monetary policy remained accommodative despite the depreciation of the rand as pass-through remained subdued



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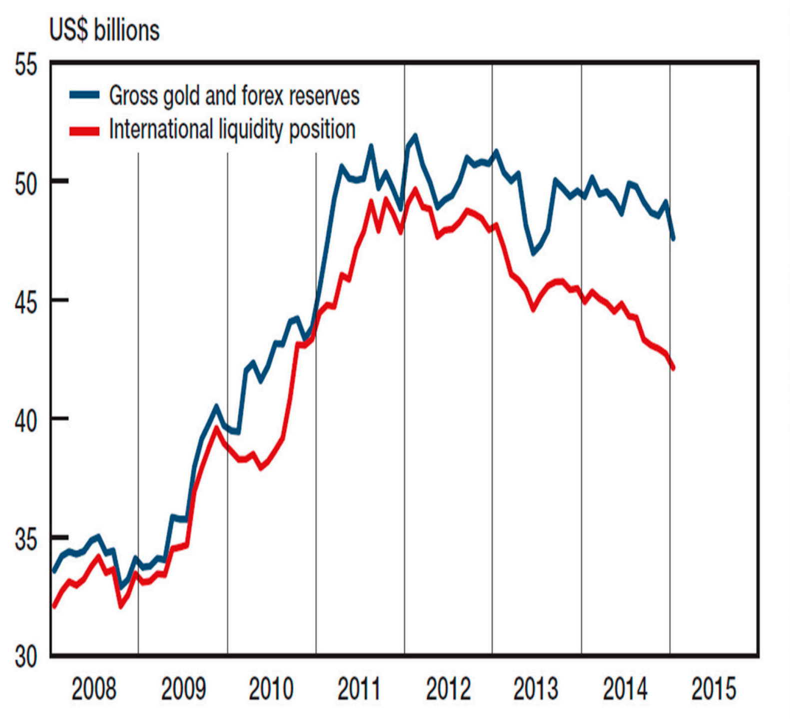
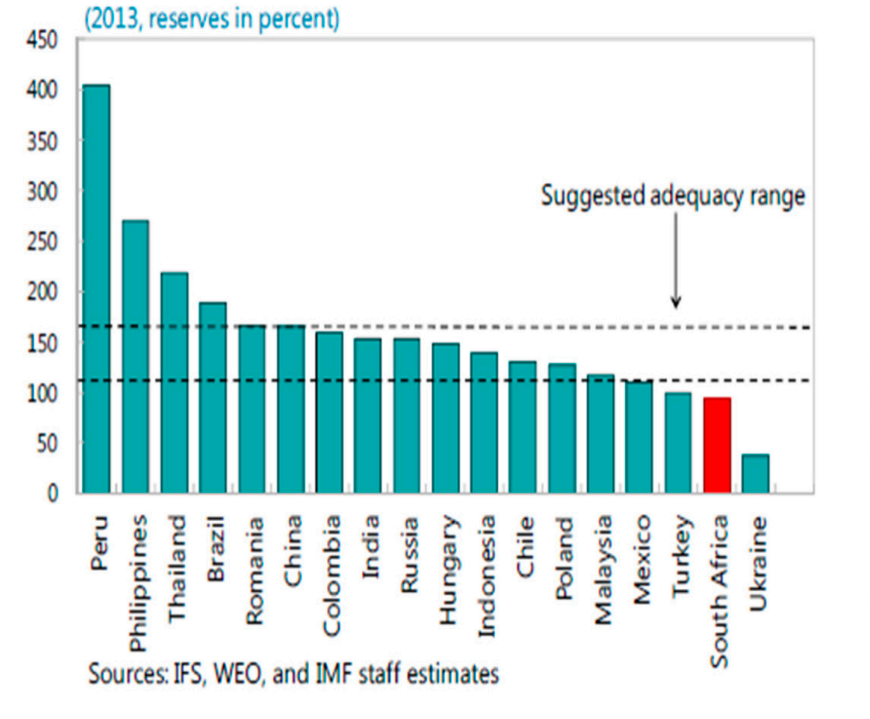
Post-crisis capital flow management

- Stepped up pace of forex reserve accumulation, funded by Bank and Treasury. (Costs of sterilisation high).

- Gross reserves currently around US$50 bn. Still below IMF adequacy metric.





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Post-crisis capital flow management

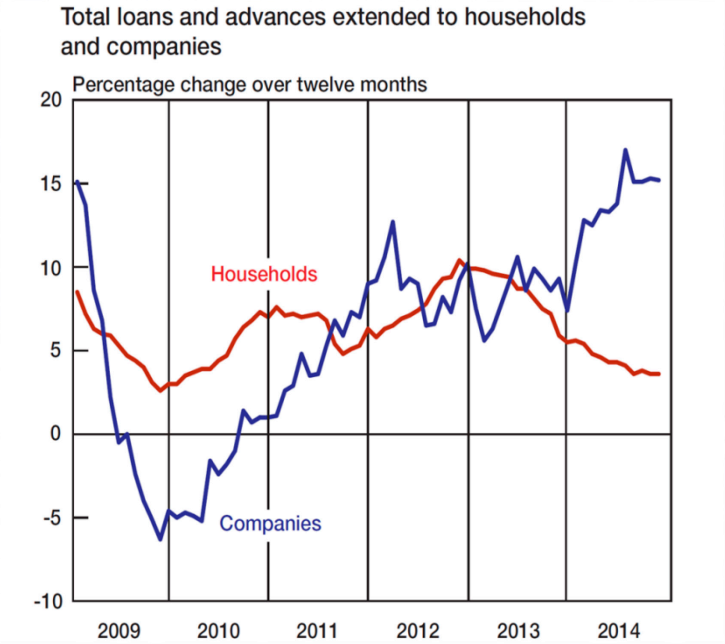
- Inflows associated with FDI transactions bought up and sterilised through forex swaps (overbought forward book).
- Levy on emigrant blocked funds abolished.
- Further relaxation of controls on resident outflows
  - Increased limits for individuals, companies and institutional investors (prudential limits).
- Prudential limits act as an automatic stabiliser as the rand depreciates, as those institutions at their limits will be required to repatriate some funds.

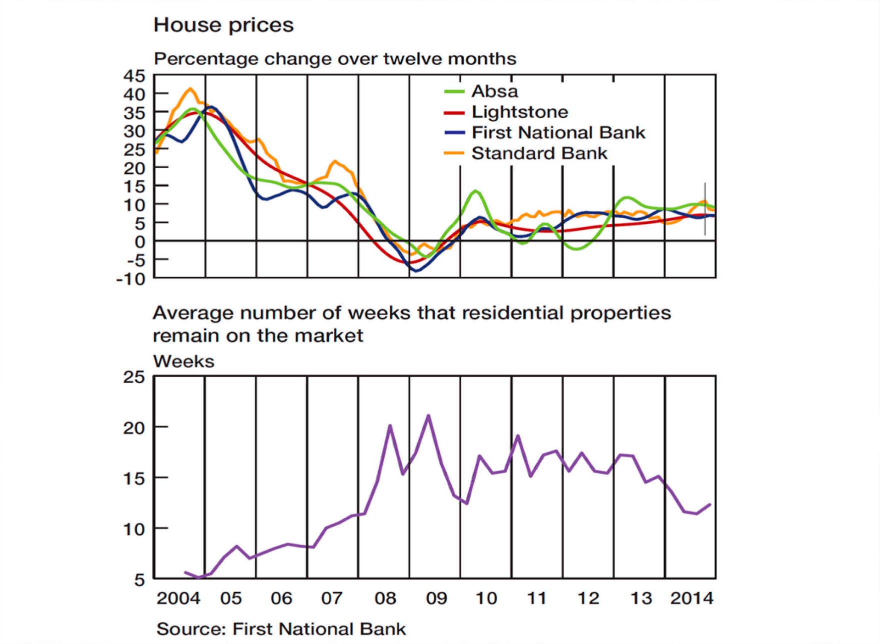
Capital flows: have they been a problem?

- Openness and low level of reserves does make South Africa more exposed to global financial market developments.
- Creates a challenging environment for monetary policy: difficulty in predicting exchange rate movements and impact on inflation.
- Short term volatility can be hedged, longer term volatility more in line with fundamentals.
- Longer term real exchange rate movements a challenge for manufacturing sector, but more difficult to deal with.

Capital flows: have they been a problem?

- During strong inflow period, little sign of credit or asset market bubbles.
- Absence of strong negative balance sheet effects during outflow episodes. “Fear of floating” limited.





Conclusion

- South Africa has adopted a relatively hands-off approach to managing capital inflows.
- Exchange rate flexibility has been a good shock absorber for the economy, but has it been excessive?
- Main concern about the volatility of the real exchange rate for the real economy, but to date there have been doubts about the efficacy of capital flow measures and possible unintended consequences (difficulty of controlling only “bad inflows”).
- Possible future direct interventions are, however, not ruled out.