Deepening Capital Markets: The Case of South Africa

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Honoured guests;
Finance ministers;
Central bank governors;
Representatives from banks and stock exchanges;
Representatives from the World Bank and IFC; and
Other officials
Ladies and Gentlemen

1. Introduction

The links between finance, economic development and macroeconomic policies have been central themes of some thought-provoking presentations earlier today. Capital markets with adequate depth play an essential role in economic development by mobilising funds to finance longer-term projects. Naturally, the experience of countries in deepening their capital markets differs, and it is my

pleasure and honour today to share with you the case of South Africa, which stands out among emerging markets as having relatively well developed capital markets.

2. The current state of South Africa's capital markets

As is well known, the market for long-term funds typically consists of three main components, namely long-term bank loans and deposits, the bond market and the equity market. These components serve different purposes and are, therefore, complementary to each other. In an environment where all three components of the capital market are adequately efficient, bank loans would generally provide bridging finance or be used for smaller amounts of funding. When larger projects are to be funded and as credit ratings improve, it makes more sense to issue bonds, because of the lower and fixed funding costs. However, maintaining a good credit rating implies that an acceptable debt/equity ratio has to be maintained, which in turn requires funding in the form of equity. In this regard, the equity market plays an essential role. South Africa is in the fortunate position, compared to many other emerging markets, in that all three components of its capital market are well developed.

2.1 The banking sector

I will not spend too much time on the banking sector, but for the sake of completeness, I would like to mention a few things about the South African banking sector. There are currently 18 registered banks, two registered mutual banks and 15 registered branches of international banks in South Africa, with combined assets of just below R2 trillion. The banking sector in South Africa is highly integrated with

the bond and equity markets. South Africa has eight banks that act as primary dealers in the bond market, and the four big banks are also settlement agents of the Bond Exchange of South Africa, with the South African Reserve Bank as fifth agent. Most banks have active trading desks in bonds as well as in equities, contributing largely to the liquidity of these instruments. Seven banks, including the five biggest banks, are listed on the JSE.

All banks registered in South Africa are closely supervised by the Bank Supervision Department of the South African Reserve Bank to ensure that they remain well capitalised commensurate with their risk profiles, that they have proper corporate governance and risk management frameworks in place, and that they make adequate provision for bad debt.

2.2 The bond and equity markets: Measurements of breadth and depth

Both the bond and equity markets are formalised and exchange-driven, in the form of the Bond Exchange of South Africa (Besa) and the JSE Limited (JSE). These exchanges have been very successful in fulfilling their function of raising funds and mobilising capital. In 2005, a total net amount of R23,8 billion was raised through the primary issuance of bonds on Besa (after repayments of redemptions), and R82,2 billion of share capital was raised by companies listed on the JSE. Combined, this equals almost seven per cent of GDP.

Market breadth is usually described by the size of a market and number of participants. The total value of bonds listed on Besa

currently amounts to just over R700 billion – about 46 per cent of gross domestic product (GDP) for 2005. The market capitalisation of the JSE as at the end of October 2006 was close to R4,7 trillion, more than three times the size of GDP for 2005. As at the end of October, bonds of more than 70 different issuers were listed on Besa, representing the central government, local government, parastatals as well as the private corporate sector. On the JSE, 380 companies were listed, representing all sectors of the economy.

Market depth is normally more difficult to measure. Depth refers to liquidity – that is, the ability to execute transactions of a representative size cheaply and rapidly without having too much of an affect on the price. There are a number of proxy measures for liquidity, such as the bid/offer spread, the turnover per year and the turnover as a ratio of market capitalisation.

The bid/offer spread on shares varies from company to company. Recently a quick assessment of the bid/offer spread of a representative selection of companies listed on the JSE was made in the Bank, and it was found that the spread as percentage of the last traded price was very small – in most cases less than half a percentage point. With regard to bonds, primary dealers quote a maximum spread of five basis points on the benchmark bonds in which they have to make a market, with an understanding that this spread would be even narrower in a stable trading environment.

In terms of secondary market turnover, bonds to the nominal value of R8,1 trillion were traded on Besa in 2005 - about 38 times the market capitalisation as at the end of December 2005. Turnover on the

JSE amounted to R1,3 trillion – about 35 per cent of the total market capitalisation of R3,6 billion as at the end of December 2005. Both ratios indicate good liquidity.

Non-residents make a significant contribution to turnover and liquidity on both the JSE and Besa, accounting for around 20 per cent of the daily turnover on both exchanges. There continues to be strong demand from non-residents for South African financial assets: In the year to the end of October, their net purchases of bonds and equities amounted to R20,5 billion and R65 billion, respectively.

3. Capital market development in South Africa

3.1 The bond market

Unlike many African and emerging-market countries, South Africa relies more on its domestic bond market than on international borrowing. This is partly due to historical reasons, but also due to the preferences of the current government.

In the 1970s and 1980s, sanctions were progressively imposed on South Africa, and the country was effectively denied access to international financial markets. At the same time, the government of the day ran large deficits, at times as high as six per cent of GDP. This, of course, was at times imprudent fiscal policy, but it had at least the one benefit of contributing to the development of the domestic bond market. The government had no option but to fund its growing budget deficit in the domestic bond market. Against the backdrop of exchange control regulations and prescribed asset requirements, the large non-bank financial institutions provided a ready demand for these bonds.

Needless to say, government and semi-government debt dominated issuances in the domestic bond market.

At that time, the bond market was still very informal. The government issued bonds periodically, there were no real pricing benchmarks and there was very little transparency. Following investigations into the deficiencies in the bond market, a number of structural improvements were made during the late 1980s and the 1990s. These included the consolidation of government bonds into a few benchmark bonds, the development of a proper yield curve and the introduction of a well-communicated and structured programme by the government in terms of which it issued bonds at regular auctions. These auctions were, and still are, conducted by the South African Reserve Bank on behalf of the government.

Alongside the government's steps to improve the structure of the primary bond market, the South African Reserve Bank played an active role in developing the secondary bond market. In 1990, the Bank started to quote firm two-way prices in a number of benchmark government bonds, thereby acting as an informal market maker. This initiative was specifically aimed at improving the turnover, liquidity and marketability of government bonds in the secondary market. In order to ensure that the SARB fulfilled its function as funding agent for the government by being a net seller of government bonds, even in adverse market conditions, the Bank also became a leading player in the trading of bond derivatives.

A major step forward in formalising the bond market was the establishment of the Bond Market Association (BMA) - a self-regulatory

organisation – in the mid-1980s. The SARB was a founding member of the BMA and an active participant until 1996, when the BMA was granted an exchange license and transformed into Besa. The establishment of Besa introduced a period of rapid development in the South African bond market, both technologically and in terms of market breadth and depth. Some major developments included the introduction of electronic trading, matching and settlement, the immobilisation and subsequent dematerialisation of bonds listed on Besa, the development of a series of total return indices for government and corporate bonds, and the development of a more refined yield curve.

By the late 1990s, the secondary market was judged to be mature enough for the Bank to reduce its involvement in this market. In order to improve the efficiency and transparency of the secondary market, a panel of primary dealers was appointed in 1998, comprising a selection of registered South African banks and branches of international banks. The selection was based on a set of criteria to ensure that such primary dealers would have the capacity to deal with the inherent risks associated with market making.

The National Treasury continued to contribute to the development of the domestic bond market by introducing new types of bonds for which there was demand in the market. These included inflation-linked bonds, floating-rate notes, a Strip programme (standing for Separate Trading of Registered Interest and Principle) and retail bonds, which makes the bond market accessible for smaller investors. This last initiative was enhanced by the introduction of Standard Bank's retail bonds earlier this year.

The government and the South African Reserve Bank played key roles in the development of the South African bond market. However, it is interesting to note that as soon as a certain level of market depth was reached, the private sector started to play a much more active role. In recent years, the growth in corporate bond issuances has by far outstripped those of government bonds. In 1996, government bonds accounted for over 80 per cent of the total debt listed on Besa. That ratio had declined to 66 per cent by mid-2006. Prudent fiscal policy has resulted in smaller and smaller budget deficits, requiring lesser amounts of funding in the domestic bond market. There is a good chance that the South African government will have a budget surplus in the 2007/08 fiscal year, which will most likely imply a reduction in the nominal value of government bonds listed on Besa. This will create even more room for the corporate sector and local government bodies to issue debt in new and innovative ways.

The biggest amount raised in a single debt issuance to date was the R6,5 billion raised on 5 July 2006 by cellphone company MTN, to fund its acquisition of Dubai-based Investcom. This issuance illustrated the healthy demand for corporate bonds, as the book size exceeded R10 billion. The funds were raised at a yield of close to 8,80 per cent for periods of four and eight years. Both Eskom's and MTN's recent bonds are included in the All-bond-index of Besa – a clear sign of corporate bonds becoming more liquid and thinning the representation of government bonds in the index.

A number of recent developments in the corporate bond arena illustrate how the bond market facilitates the development of

infrastructure and economic growth. South Africa's electricity supplier, Eskom, registered a R65 billion multi-term note programme with Besa in March 2006. It launched the first R2,5 billion in March 2006 by issuing a bond with a maturity of 27,5 years, making it the corporate bond with the longest tenor in the history of the South African bond market. The issuance was oversubscribed, allowing Eskom to secure this long-term funding at a yield of 7,48 per cent, which is currently one percentage point below the repo rate of the South African Reserve Bank.

Similarly, the transport parastatal, Transnet, has announced plans to issue bonds and other debt to the value of R18,1 billion to fund an upgrade of its ports and railways. According to Transnet, the money will be raised over three years from both the domestic and international markets.

Finally, a development that is likely to be significant in a regional context is the R350 million that was raised on Besa by the Mauritius Commercial Bank – the first regional or international inward-listed bond in South Africa, which was facilitated by the further relaxation of exchange control in October 2006.

3.2 The equity market

The JSE was founded as far back as 1887 and is currently ranked 17th in the World Federation of Stock Exchanges, based on its market capitalisation in US dollar terms. In the late 1990s, a number of developments were introduced to improve trading on the JSE. The open-outcry floor was replaced by an order-driven, centralised, automated trading system. The JSE also introduced a real-time news

service for the dissemination of company announcements and price sensitive information. Trading on the JSE was fully automated through an electronic clearing and settlement system, STRATE (Share TRAnsactions Totally Electronic). In 2001, the JSE merged with the South African Futures Exchange (Safex) and thereby become the leader in both equities and derivatives trading in the South African market.

An important milestone for the JSE was the strategic alliance that was formed with the London Stock Exchange (LSE) in 2002. In this year, all shares were dematerialised and migrated to the STRATE environment with guaranteed T+5 settlement for all JSE main board trades.

As part of the JSE's alliance with the LSE, its trading system was replaced with the SETS system hosted by the LSE. More than just a change in technology platforms, this change improved the international visibility and acceptability of the JSE. In addition, the JSE modernised its operations with the launch of a new indexing system in conjunction with the FTSE, the FTSE/JSE African Index Series and free-float adjusted series. This system provided international investors with an indexing system with which they are familiar.

The alliance with the LSE required a review of the JSE's Main Board listing requirements to bring it in line with international best practice. This caused a decline in the number of listed companies. In order to continue providing an opportunity for small to medium-sized companies of good quality and with high growth potential to raise capital, the JSE launched an alternative exchange (AltX).

In 2005, the JSE expanded its product base to include not only equities and derivatives, but also interest-rate products with the launch of Yield-X, which is a “one-stop yield shop” for a wide range of spot and derivative interest-rate products traded on one platform. In partnership with Deutsche Bank, the JSE also listed its first Exchange Traded Funds (ETFs).

The latest development in the long history of the JSE was its own demutualisation in 2005. It became a public unlisted company on 1 July 2005, and listed on its own exchange a year later.

4. Conclusion

South Africa’s capital markets have enjoyed an extended rally over the last few years. Bond yields declined to record lows in the first quarter of 2006, while the All-share-index of the JSE still continued to break record high levels in October 2006. Bond yields have, however, risen since May 2006, reflecting the tighter monetary policy stance of the Bank since June 2006 as well as some repricing of emerging-market risk by global investors. However, a number of structural improvements should continue to support the South African bond market. These include the government’s fiscal discipline, South Africa’s recent credit rating upgrades, the entrenchment of inflation expectations within the inflation target range, continued innovation in terms of products and processes, and the growth of the corporate bond sector.

Going forward, capital market development and economic growth

prospects in South Africa are expected to be mutually reinforcing. The South African markets should continue to benefit over the longer term from the improved growth prospects for the South African economy, which are supported by the government's infrastructure development programme and the Accelerated Shared Growth Initiative for South Africa (Asgisa). At the same time, the capital markets will help facilitate the economic growth process by providing an efficient source of finance to both the public and private sectors.

I thank you.