South African Reserve Bank

Address by Deputy Governor Daniel Mminele, South African Reserve Bank, at the Opening Ceremony of the 1st South Africa-China Capital Market Forum conference, Johannesburg, 7 August 2013

"The importance of well-developed and functioning capital markets for growth and development"

1. Introduction

Good evening ladies and gentlemen. Allow me to extend a special welcome to our visitors from China. Thank you to the Johannesburg Stock Exchange, Shanghai Stock Exchange and Frontier Advisory for inviting me to speak at this inaugural conference of the South Africa-China Capital Market Forum. This initiative bears testimony to the growing relationship between China and South Africa.

In the 15 years since the establishment of official relations between China and South Africa, cooperation between the two countries has improved immensely. A number of Memoranda of Understanding ("MoUs") have been signed, Foreign Direct Investment (FDI) has picked up, and bilateral trade between the two countries has surged. China became South Africa's biggest trading partner in 2009 and is now the largest destination for South Africa's exports. With respect to FDI, China is actively involved in mining, manufacturing and construction with China's FDI presence growing from around R340 million in 2005 to roughly R50 billion in 2012. The most notable FDI transaction was in the banking sector, specifically, the 20 per cent stake that Industrial and Commercial Bank of China acquired in Standard Bank for US$5.5 billion in 2007.

South Africa and China also cooperate in various international groupings, including the G20 and more recently as part of BRICS. South Africa, as you know, was invited to join the BRICS group when China was the chair and successfully hosted the 5th

BRICS Summit earlier this year when it assumed chair of BRICS for 2013. Having been already allotted an investment quota, at this Summit, the South African Reserve Bank (the Bank) and People's Bank of China (PBoC) signed an agency agreement enabling the Bank to invest in China's interbank bond market through the People's Bank of China. South Africa was the first country on the continent to be given access to the Chinese onshore bond market in this way. As part of the growing importance of trade between our countries, this represents an opportunity to diversify the country's foreign exchange reserves accordingly, and to invest in the world's fifth largest bond market which continues to grow rapidly, both in depth and liquidity. Currently, the BRICS are negotiating both a Contingent Reserve Arrangement (CRA) and the establishment of a New Development Bank (NDB). The CRA is a type of financial safety net in the form of a self-managed facility through which BRICS countries can provide mutual support to each other when dealing with short-term liquidity and balance of payment pressures, and will likely take the form of a swap agreement, with an initial size of US$100 billion. The aim of the NDB is to mobilise resources for infrastructure and sustainable development projects in BRICS. Chief Negotiators have been appointed by each country and have commenced negotiations around issues such as membership; governance; capital size; structure and articles of agreement, amongst others.

2. The importance of capital markets

Literature around the relationship between capital market development and economic growth goes as far back as 1873, when Walter Bagehot (followed by Joseph Schumpeter and John Hicks in the 1900s) pointed out that industrialisation in most of the developing countries was due to the availability of the financial system to mobilise productive financial capital. Today this remains a widely debated topic, with some division among economists regarding the importance of finance for growth and the causal relationship between the two. Some would argue that financial development is not important and that it is actually economic development which creates the demand for financial instruments. Others would concur with Bagehot and argue that a well-developed financial system improves the efficiency of financing decisions, supports a better allocation of resources and therefore promotes economic growth and development. Well-developed capital markets not only support growth, but the ability to diversify sources of finance helps to foster more *stable* growth by ensuring that shocks to the supply of bank credit do not impede growth. I would certainly lean towards the camp that argues that the financial system is without a doubt essential for economic growth. To quote the words of Former British Prime Minister Gladstone "…finance is, as it were, the stomach of the country, from which all the other organs take their tone."

Various studies conducted over the years, found that equity market liberalisation led, in some instances, to over one percentage point of additional economic growth in those countries that implemented them in the late 20th century. In addition, as long as domestic government debt remains at moderate levels, the growth of bond markets contributes positively to economic growth and provides a basis for the development of other capital markets. Such studies point out, however, that it is those countries with the highest quality institutions that benefit the most in terms of growth, that is, institutions need to be strengthened along with financial development, for without this, markets can become fragile and pose a threat to financial stability and ultimately growth. Key in this regard is good governance frameworks, transparency and accountability.

Well-functioning capital markets are particularly important to a country's long-term financing needs as they help mobilise resources and efficiently direct the flow of savings and investment inside an economy in a manner that facilitates the accumulation of capital and the production of goods and services. In a similar way, the existence of robust financial markets and institutions also facilitates the *international* flow of funds between countries. Deep and liquid capital markets not only help provide finance for government but also increase the benefits of financial integration and improve the resilience of countries against shocks.

In the absence of well-developed financial markets, it becomes costly to raise capital, information tends to be limited and there is a lack of financial transparency, which means that information is not as readily available to market participants, and risks are likely to be perceived to be higher than in economies with more fully-developed financial systems.

The G20 has recognised the importance of developing local currency bond markets and in this vein adopted an Action Plan to Support the Development of Local

Currency Bond Markets (LCBMs) in 2011. The Action Plan recognized that financial deepening in general, and LCBM development in particular, could enhance the stability of the international monetary system by (i) raising capacity of economies to absorb volatile capital flows and intermediate them efficiently and safely; (ii) reducing reliance on foreign savings; (iii) attenuating external imbalances; (iv) mitigating the need for large precautionary reserve holdings; and (v) improving the capacity of macroeconomic policies to respond to shocks by allowing balance sheets to adjust more smoothly.

A recent guest post by Jingdong Hua of the International Finance Corporation notes that capital markets have been a driver of China's economy, which has displayed remarkable growth of roughly 10 per cent over the past three decades. China has introduced a number of innovative reforms to spur the development of its domestic markets, including amongst others, increasing the ceiling on its Qualified Foreign Institutional Investor (QFII) programme, and doubling the amount of domestic stocks and bonds that foreign institutional investors are allowed to buy.

Some steady progress has been made over the past number of years in developing Africa's capital markets, but these still remain shallow and illiquid and tend to be small and fragmented, owing to a number of factors including low income levels; weak judicial systems; and scarcity of human capital and financial infrastructure. The financial sector is a key driver of growth in South Africa. The South African economy has over the years steadily moved towards being a service oriented economy. As a percentage of economic output, the tertiary sector accounts for almost 70 per cent in real terms, with the finance, insurance, real estate and business services making up 34 per cent of the tertiary sector.

South Africa stands out on the continent as having the most well-developed and liquid financial markets. Across emerging market countries, South Africa also compares favourably with its peers. Turnover in fixed-income securities trading on the JSE has been gradually increasing, from below R10 trillion in 2004 to a record of almost R23 trillion in 2012. Turnover on the equity market over the same period increased from R950 billion and reached R3.4 trillion in 2012. Market capitalisation on the equity market is roughly R9 trillion and R2 trillion for the debt market.

There is no doubt about the many benefits that South Africa has reaped from having well-developed capital markets. The local currency bond and equity markets helped cushion the country during the financial crisis, helping to absorb capital inflows, reduce the dependency on foreign debt and therefore limit the adverse effects of the global crisis.

The liquidity of this market, combined with investors' search for yield in recent years, has seen non-residents become the largest investor base for government funding, holding close to 40 per cent of government bonds (a ratio similar to Poland, Indonesia, Mexico and Malaysia), from 10 per cent at the beginning of the crisis and exceeding the 28 per cent held by pension funds. The South African bond market is well developed in the sense that it is not only dominated by financial institutions and the government, but also comprised of a large number of non-financial corporates, while the maturity extends beyond 30 years. The biggest challenge in South Africa has been that of developing secondary market liquidity in the corporate bond market, while a more developed derivatives market would add to the depth of the market.

Although not a typical central bank function, the South African Reserve Bank initially played an active role as participant in the development of the domestic government bond market through its various phases of development. The Bank played an active role in developing the secondary bond market in the 1990s as the sole market maker, and played a leading role in bond derivatives, inter alia to ensure continued net selling of government bonds in adverse market conditions. In the late 1990s, the Bank reduced its involvement in the secondary market, which at the time was judged to be sufficiently mature.

Capital markets of course also play an important role in policy making, providing instantaneous feedback to policy makers on market expectations and perceptions of policy. Such perceptions and expectations are reflected in bond and equity risk premia.

Having noted the benefits of well-developed financial systems, my remarks would be incomplete without at least briefly referring to the global financial crisis and how this may have changed the views of some on the positive impact of financial development and the role of markets. John Lipsky, former IMF First Managing

Director, put it very well when he said that "…much of this reassessment is natural and sensible. However, it is fair to say that the idea that financial markets are not perfectly self-regulating does not represent a novel insight. To the contrary, there are good reasons why they are regulated universally." In a nutshell, this highlights the importance of regulation and effective supervision in order to try and avoid a repeat of the global financial crises, which led to an economic and sovereign debt crisis, which after 6 years the world economy is still struggling to recover from. However, it is also important that regulation is appropriately calibrated, and that a defensible balance is struck between ensuring maximum benefit from capital markets through innovation on the one hand, and the need to protect markets and financial systems that may be still be in their infancy or not yet sufficiently developed on the other. Particular care needs to be taken when formulating global regulatory standards that do not appropriately take account of country-specific circumstances and may have unintended consequences.

Let me now conclude by congratulating you on this important initiative, which will contribute to the further development of efficient and well-functioning capital markets in both countries, and also promote regular interaction between issuers, investors, brokers and others in the interest of growth and development. I wish you every success in your endeavours, and no doubt you will go from strength to strength in years to come.

I thank you