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The Importance of Financial Stability for Capital Flows to Emerging Economies Referring to the African Continent and South Africa

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Abstract: The majority of African countries has a problem to attract sufficient capital, and especially foreign direct investment. The main reason for this situation is because they don't have sound banking and financial systems. Despite the fact that South Africa has a relatively sound financial and banking system the capital flows are not "correctly" composed.

Keywords: Financial Soundness, Capital Flows, Foreign Direct Investment

Introduction

Although globalisation is not necessarily a new issue in the international monetary environment, the problems that surround globalisation, for example the necessity of financial stability, were emphasised anew by the Asian crisis of 1997 and 1998. Globalisation implies an increase in economic and financial integration among countries that is often measured by various dimensions of international capital flows. Capital flows in themselves can be unstable, but can also lead to instability in the financial systems of countries. The experience in the Latin American countries, for example, showed that capital flows can have a detrimental effect on the stability of a financial system (Calvo, Leiderman & Reinhart, 1994). If the stability of a country's financial system is threatened, it leads to an outflow of capital that brings pressure to bear on the balance of payments and the exchange rate, and ultimately causes economic growth to suffer. As countries become increasingly integrated economically and financially, the risk of contagion increases. In order to reduce the probability of the risk of contagion and apply better management should it occur, there is a general viewpoint that a financial environment that is sufficiently regulated will lead to an improvement of international and national financial stability (Knight 1998). In the international monetary community there are increasing attempts by, among others, the IMF, the Bank for International Settlements and the World Bank to ensure sound financial systems in countries. In the light of globalisation, no country can any longer afford not to have a sound financial environment. In this regard the emerging countries face a very great challenge, namely to ensure that their financial systems meet the international requirements for stability. Should they succeed in this, these countries should be more attractive to international investors. This article is mainly based on a literature study supported by relevant data. The aim of this article is to demonstrate the importance of financial stability for capital flows, referring to the African continent in comparison to South Africa. In order to satisfy this aim, the necessity and significance of financial soundness is discussed in the first instance. Secondly, the situation regarding capital flows to the African continent is described. The lack of foreign direct investment to the African continent is related to foreign direct investment in other emerging economies for the period 1991-1998. Lastly, capital flows to South Africa is discussed and the "wrong" composition of the capital flows is highlighted. The South African capital flows for the period 1991-1999 is illustrated and it is shown that the capital flows are not correctly composed.

The Necessity and Significance of Financial Soundness: The international monetary crises of the last decade of the twentieth century indisputably proved the importance of sound and stable financial systems. Various international attempts have been made to improve and reinforce financial standards, for example the Core Principles for Effective Banking Supervision of the Basle Committee on Bank Supervision and the Objectives and Principles of Securities Regulation that was accepted by the International Organisation for Securities Commission (IOSCO).The consequences of globalisation have shown that there is need for international policy co-ordination and that a new international financial architecture is required to be able to make a positive contribution to international financial stability. Globalisation has resulted in the decisions and events in one country having implications for banks and supervisory authorities in other countries. Fischer (1999) advances the following two reasons for the necessity of better international policy co-ordination:

International capital flows to emerging countries are too volatile. There is too much contagion present in the international monetary system. The need for better international policy co-ordination was underlined by the Asian crisis that reflected the two above-mentioned aspects. History has taught that the solutions for international crises often start with the restructuring of financial systems. For example, one of the elements of the long-term strategy for the solving of the international debt crisis of the early eighties was to strengthen the international banking system. A regulatory safety network was identified that had to ensure the financial soundness of individual banks, for example through safety measures aimed at maintaining the solvability of banks, protecting the liquidity of banks, providing liquidity to banks in cases where diminished confidence on the part of depositors were experienced, and finding solutions for banks that experienced problems (Kapstein, 1992). Even as public confidence had to be restored after the debt crisis, it had to be done again after the Asian crisis. The collapse of banks during this crisis did great damage to public confidence. Banking systems that were poorly equipped and insufficient financial regulation resulted in an inability to manage the pressure caused by the great capital flows properly (Kapur, 1998). Great emphasis was placed on the restructuring of banking and financial systems in the Asian crisis countries with a view to finding a solution to the problems.The Investment Report of the United Nations (2000) revealed that 35 countries introduced regulatory changes pertaining to their investment regimes in 1991. In 1999 63 countries introduced similar changes. In 1991 the number of regulatory changes that benefited foreign direct investments was 80 and in 1999 131.In addition to the important role of a sound banking and financial system in the handling of the demands of large and unstable capital flows, it also plays an important role in the growth and performance of an economy. According to Fischer and Lindgren (1998) a weak banking system is a standing invitation for a macro-economic crisis.The most important characteristics of a sound financial system are the following (IMF, 1998)

1. A banking system in which banks retain adequate capital and are supported by an environment in which market discipline, good quality control and bank governance, a solid management of liquidity and foreign exchange risk, effective internal control measures and an appropriate balance between risk and return are promoted.
2. A well-defined restructuring policy for undercapitalised, weak and insolvent institutions.
3. A financial safety net that promotes confidence in the financial system and can handle problems that may arise around, for example, moral hazard.
4. An autonomous regulatory and supervisory structure with the necessary experience and resources to ensure the stability of financial institutions through the use of precautionary measures such as capital requirements, as well as structures for performing on-site inspections and the ability to intervene in cases where unsound practices occur or where emergency situations arise.
5. A financial infrastructure that functions well, including an effective system of payments, an effective legal structure to ensure the enforcement of contracts and the correct procedures regarding bankruptcies, and rules that ensure transparency and disclosure of information for corporate governance.

These characteristics can, in fact, serve as criteria to determine whether the financial system of a country is sound.If South Africa's financial system is measured against the above-mentioned, it appears that these criteria are met to a large extent. For example, the capital adequacy of South African banks was 11,8% at the end of December 1999 (Bank Supervision Annual Report, 1999). This figure compares good with UK banks for example. In 1999 the capital adequacy ratio for UK banks was 10,7% and banks in Ghana demonstrated a capital adequacy ratio of 11,5% (KPMG, 2000). The official capital adequacy ratio is 8% of risk-weighted assets. Furthermore, South Africa has a well-developed financial infrastructure. In addition the Bank Supervision Department of the SA Reserve Bank conforms to nearly all the principles of the Basle Core Principles for Effective Banking Supervision. In the final instance the SA Reserve Bank also plays its role as lender in last resort in such a manner that institutions with short-term liquidity problems are afforded an opportunity to introduce corrective measures. Where it is a question of insolvency, the Bank intervenes to prevent the risk of contagion (Bank Supervision Annual Report, 1999).

The Role of Capital Flows: Capital flows have positive and negative consequences for a country. On the positive side, foreign capital flows at macroeconomic level lead to higher investment and economic growth, but unstable short-term capital flows that can change course easily have negative consequences for the economy. They can cause great disruptions in exchange rates and other prices in an economy, which can ultimately lead to foreign exchange and financial crises (Griffith-Jones, 1998). Most emerging economies are very dependent on foreign capital flows for, among other things, economic growth. One of the demands made by international investors is that a country must have a sound financial system. In 1996 Indonesia, South Korea, Malaysia, the Philippines and Thailand experienced record capital inflows of $93 milliard. With the collapse of their financial systems these countries experienced a net capital outflow of $12 milliard, with catastrophic consequences for their economies (Makin, 1999).

Capital Flows to Africa: The economic fragility of the African continent can be attributed largely to unstable capital flows and unsound financial systems. The unstable capital flows are mainly due to the share of foreign direct investment in the total capital flows being too small. In addition to the economic advantages obtained through foreign direct investment, it is the stable component of capital flows. Foreign direct investment is less vulnerable to states of panic and is not withdrawn as easily as portfolio investments (Eichengreen *et al.*, 1999).In the case of a crisis such as the Asian crisis, all emerging markets are all lumped together and their vulnerabilities are exposed unmercifully. African countries made no direct contribution to the Asian crisis, but were influenced by it directly. For example, the exposure of banks in Africa was positive during the first half of 1997 with an inflow of $4,7 milliard, while an outflow of $0,8 milliard was experienced during the second half of 1997. In 1998 this situation was aggravated by an outflow of $3,4 milliard in banking funds (IMFb, 1999).The requirements for foreign direct investment differ from the requirements for portfolio investment. In order to facilitate foreign direct investment, it is to the advantage of the receiver country if certain assets and services are already available, for example, an infrastructure, essential services and financial institutions. The availability of these assets and services influence the decisions of international investors.

Notes:

Net capital flows consist of net direct investment, net portfolio investment and other long- and short-term net investment flows, including official and private loans.

As a result of data limitations "Other net investment" can sometimes include official flows. Asia includes Korea, Singapore and Taiwan, but Hong Kong is excluded. The crisis countries are Indonesia, Korea, Malaysia, the Philippines and Thailand. From Table 1 and Fig. 1 it is clear that Africa attracts a very small share of the total net direct investment earmarked for emerging economies. In 1991 Africa attracted 6,39 % of the total, while 19,49 % of the total flowed to the so-called crisis countries in Asia and 26,5 % to the other Asian countries. In 1998 Africa obtained only 5,19 % of the total net direct investment

Table 1: Net capital flows to emerging economies, 1991-1998 ($ milliard)

Total	1991	1992	1993	1994	1995	1996	1997	1998
Private capital flows	123,8	119,3	181,9	152,6	193,3	212,1	149,1	64,3
Net direct investment	31,3	35,5	56,8	82,7	97,0	115,9	142,7	131,0
Net portfolio investment	36,9	51,1	113,6	105,6	41,2	80,8	66,8	36,7
Other	55,6	32,7	11,5	-35,8	55,0	15,4	-60,4	-103,4
Net official flows	36,5	22,3	20,1	1,8	26,1	-0,8	24,4	41,7
Africa								
Net private capital flows	8,9	6,9	8,7	4,8	6,8	7,6	16,3	10,3
Net direct investment	2,0	1,7	1,9	4,4	4,2	5,5	7,6	6,8
Net portfolio investment	-1,5	-0,6	1,0	0,8	1,5	-0,2	2,9	3,5
Other	8,4	5,8	5,8	0,7	1,2	2,3	5,8	0,0
Net official flows	7,8	10,5	7,8	14,0	10,8	3,7	-4,5	1,5
Asian crisis countries								
Net private capital flows	26,8	26,6	31,9	33,2	62,5	62,4	-19,7	-45,3
Net direct investment	6,1	6,3	6,7	6,5	8,7	9,5	12,1	4,1
Net portfolio investment	3,4	5,3	16,5	8,3	17,0	20,0	12,6	-6,5
Other	17,3	15,0	8,7	18,4	36,9	32,9	-44,5	-43,6
Net official flows	4,4	2,0	0,6	0,3	0,7	4,8	25,0	22,7
Other Asian emerging economies								
Net private capital flows	7,2	-8,7	25,5	33,2	32,6	38,1	22,8	-9,6
Net direct investment	8,3	8,5	26,3	38,7	41,1	45,6	50,5	45,1
Net portfolio investment	22,3	13,5	21,8	13,6	9,4	4,1	4,3	8,8
Other	0,9	-19,7	-5,4	-6,6	-2,4	0,1	-15,8	-45,9
Net official flows	6,5	8,3	7,9	5,1	3,8	5,3	3,3	5,9

Source: IMF Annual Report, 1999a, pp. 16-17

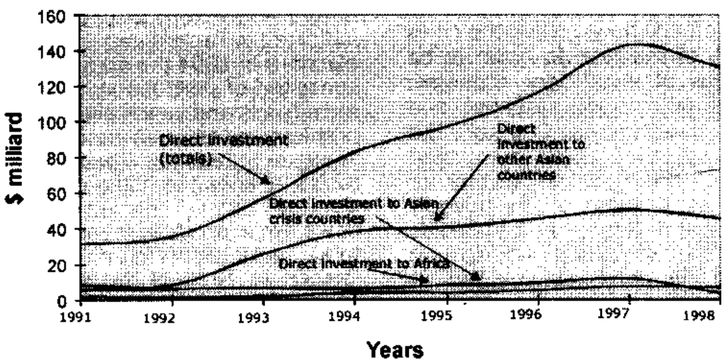

Fig. 1: Foreign Direct Investment in Emerging Economies, 1991-1998

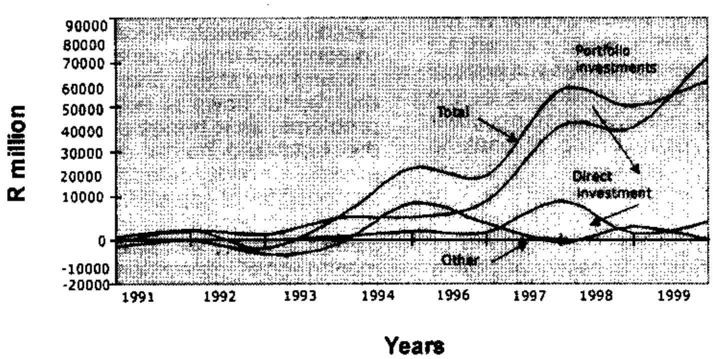

Fig. 2: South African Capital Flows, 1991-1999

Table 2: South African Capital Flows (R million)

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Direct investment	685	10	33	1348	4502	3515	17587	3104	8411
Portfolio investments	1740	5227	2427	10298	10651	17983	51563	50542	82389
Other	-3091	5	-6332	-1554	17217	7492	-1330	6534	-19
Total	-666	5242	-3872	10092	32370	28990	67820	60090	71493

Source: SA Reserve Bank Quarterly Bulletin, June 2000, p. S84 and SA Reserve Bank Quarterly Bulletin, June 1999, p. S84

and the crisis countries (as a result of the Asian crisis) only 3,74 %, but the other Asian countries still obtained 34,43 % of the total. The African countries that received the most foreign direct investment flows in 1998 and 1999 were Angola in the first place, Egypt in the second position, Nigeria in the third place and South Africa fourth. These capital flows were mainly privatisation related and especially directed at the telecommunication industry (Investment Report, 2000, p. 42). In 1997 the largest amount in the period concerned was made available for foreign direct investment, namely $142,7 milliard. Africa obtained only 5,33 % of this amount, In spite of the fact that the Asian crisis started in 1997, the crisis countries still obtained 8,48 % of the total net foreign direct investment, which is a larger share than that of Africa. The situation appears even worse in the case of official flows, where Africa experienced an outflow of funds in 1997. In 1998 Africa received 3,6 % of the total official flows, while the crisis countries received 11,75 % of the total.In order to be able to bridge the problems of insufficient economic growth and poverty, capital inflows are essential, and especially foreign direct investment. One of the preconditions for achieving the above-mentioned objectives is the reform of the financial sectors of countries. To illustrate the seriousness of the poverty problems and the need for capital, Ghana can be used as an example.In spite of the structural adjustment programme of the IMF that has been implemented in Ghana since the early nineties, great poverty still prevails. One of the characteristics of Ghana's poverty is a lack of access to credit and capital. Although the rural banks attempt to make micro-loans available, these banks are characterised by poor management, inadequate supervision by boards of directors, low-quality personnel and a poor location of the banks (IMF Staff Country Report, No. 2, 2000: 112). Because the local financial system does not meet the required standards, problems are experienced in acquiring international capital. On occasion Pierre Ugolini of the IMF indicated in Paris that if Africa wishes to attract capital, sound banking systems and practices will have to be established (IMFc, 1999). A study conducted by the World Bank (1997), however, indicated that no great success is achieved with the restructuring of banking systems in Africa. Experience in Kenya, Tanzania, Uganda and Mozambique for example revealed a lack of commitment on the part of the various governments to the successful carrying through of the restructuring of the banking systems. In addition it is essential that a legal and regulatory framework be established that will ensure that effectiveness and competitiveness can be achieved (Camdessus, 2000). In addition to the importance of financial stability, the political environment also plays a critically important role in Africa. Africa is characterised by political instability, which discourages foreign investors (Guillaume & Stasavage, 1999).

Capital Flows to South Africa: Although South Africa does not have a problem in respect of the soundness of its financial system, its emerging market status on the one hand results in a financial fragility and, on the other hand, leads to a "wrong" composition of the capital flows to the country. Despite these problems, South Africa and Egypt were identified as the most attractive destinations for foreign direct investment for 2000-2003 (Investment Report, 2000). The emerging market status of the South African economy resulted in the instability of the Asian crisis also engulfing this country. In addition to the influence of international crises outside the African continent on South Africa, it is also at the mercy of crisis situations in its neighbouring countries, as the recent crisis in Zimbabwe clearly showed. This aspect is supported by studies that showed that investment in African countries depend on the stability of neighbouring countries, as well as on the acceptability of their policies (Easterly & Levine in Guillaume & Stasavage, 1999). The nature and extent of capital flows to South Africa are indicated in Table 2 and Fig. 2. Since the first democratic elections in 1994 the greater part of the capital flows has consisted of portfolio investments, which are not long-term funds and which are withdrawn when the slightest problem arises or in case of bad news. Foreign direct investment reached a peak in 1997, but slipped back by 82,35 % after the Asian crisis in 1998. In 1998 foreign direct investment formed only 5,17% of the total capital flows, while portfolio investments formed 83,96% of the total. In 1999 foreign direct investment increased and formed 11,76 % of the total capital flows. This can be ascribed mainly to the improvement in the economic prospects of South Africa, as well as to more stable conditions in the emerging countries in general. It is expected that foreign direct investment will start to improve should it prove possible to make significant progress in respect of privatisation (Institute of International Finance, 2000). If foreign direct investment is expressed as a percentage of GDP, it is seen that it was 0,01% in 1993 before the first democratic elections in comparison to 1,06% in 1999 (SA Reserve Bank Quarterly Bulletin, several issues). Although the financial system of South Africa, as distinct from that of the majority of African countries, meets the requirements for a sound and stable financial system, the composition of the capital flows is not correct. This situation causes problems, as it brings pressure to bear on the value of the rand and has a detrimental effect on economic growth. In order to address the problem regarding the composition of capital flows, the following solutions can be considered: On the international front surveillance in general must be strengthened in order that the monitoring of international capital flows can be improved (Fischer, 1999). In this regard the IMF should play a more efficient role. It would, however, not be easy, as the IMF does not enjoy equal support in all circles. South Africa, however, does not have control over the implementation of this solution. An important challenge for the South African authorities is to ensure that capital flows are less volatile than is currently the case. This task is made more difficult by the fact that the majority of capital inflows consist of portfolio investments that are by nature very volatile. A possibility that can be considered in this regard is to apply capital control measures to capital inflows and, for example, keep the funds concerned in South Africa for at least one year. In 1991 Chile introduced capital control measures on the inflow of short-term capital (Singh, 1999). In spite of these control measures, Chile still experienced capital inflows because foreign investors were encouraged to invest in Chile on a long-term basis by means of various incentives. The question is whether this solution would be acceptable in the spirit of liberalisation and freer movement of capital in the international monetary community; especially if the sensitivity of the South African financial markets is taken into account. If control measures do not offer an acceptable solution, attractive incentives for long-term investments will have to be found, for example, a favourable tax dispensation for international investors. Lower labour cost and a more flexible labour policy will also make South Africa a more attractive destination for foreign direct investment.

Conclusion

The financial and banking systems of emerging economies will have to meet international standards in order to be attractive enough to foreign direct investment. Africa still falls far short in this regard. In general the various financial and banking systems do not inspire sufficient confidence in international investors. The financial structures of most African countries do not meet the requirements of the international investors and the criteria for financial soundness. In spite of the fact that South Africa, as distinguished from most of the countries in Africa, has a well-developed financial and banking system that meets international standards, a price is paid for the mistakes of, among others, neighbouring countries such as Zimbabwe and for the emerging market status of the country. This results in the composition and structure of capital flows to South Africa not being correct, with detrimental consequences for economic performance. Ultimately such a situation has detrimental consequences for economic growth and is causing instability in the financial markets. The problem is that the causes of this situation are largely uncontrollable. The viewpoint that a sufficiently regulated financial system will lead to an improvement of national financial stability does not always hold for South Africa. The suggested solutions that can be considered in South Africa, such as control measures on capital inflows, will not necessarily be acceptable to the international investment community. The sensitive nature of the South African markets can diminish the possibility of using this solution even further, unless it is combined with, for example, attractive incentives for long-term investments.

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