SPEECH 2: AFRICAN REGULATORS' CONFERENCE

Deputy Minister speaks at 9.30am

Building African Financial Markets

Keynote address

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12 September 2013

Good morning Ladies and Gentleman,

Welcome to South Africa!

I am particularly pleased to be invited to address such a distinguished delegation of regulators from all over our continent.

Thank you for the opportunity to address you today.

This morning I have been asked to talk about building African financial markets.

As all of us here know, well-developed and well-functioning financial markets play an important role in contributing to the health and efficiency of an economy.

There is a strong, positive relationship between financial market development and economic growth. Well-functioning capital markets are particularly important to a country's long-term financing needs as they help mobilise resources and 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. The combination of well-developed financial markets and institutions as well as a diverse array of financial products and investments, suits the needs of borrowers and lenders and therefore the overall economy, spurring economic growth.

In various studies it was 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.

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.

In a mixed global picture, our continent of Africa stands out as somewhat of a success story.

In the five years since the 2008 crisis, the sub-Saharan region has grown faster than in the years before the crisis. In other words, even when South Africa was experiencing its pre-crisis growth levels, it did not have the same impact that the region has been experiencing through other countries' growth since. Regional output grew 5.1 per cent last year (2012) and should accelerate to 5.4 per cent by the end of 2013 and 5.7 per cent in 2014. Similar progress and development can be found throughout the African continent, from Nigeria in the west to Kenya in the East.

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.

In light of the recent South Africa – China Markets Forum, held here at the JSE on the 8^{th} August, it is generally accepted that South Africa offers the ideal gateway to Africa in terms of financial market investment and development. As China moves to increase investment in the continent, South Africa and the JSE are perfectly positioned to facilitate increased market trading in Africa. The financial sector has been a key driver of growth in South Africa. South Africa stands out as having the most well-developed and liquid financial markets in the continent. Across emerging market countries, South Africa 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. This holding by non-residents exceeds the 28 per cent held by domestic 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 comprises 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.

As much local success as South Africa has had, assisting with the development of efficient and effective financial markets on a continental scale is a task far too big for us alone. Thus, we need to collaborate with our neighbours, use our strengths to help them and use their strengths to help us. It is important to remember that we all have the same goal, to build the capacity of African financial markets, and this is a goal we need to achieve together.

There are many opportunities and potential benefits of collaboration between markets, as plans for regional integration continue to move forward.

As the National Treasury continues to align its plans with the goals of the National Development Plan, we have moved forward in terms of strengthening regional trade agreements and cooperation in relation to infrastructure development and critical resource management.

As part of our objective to position South Africa as a financial gateway to Africa, we aim to ensure tax and exchange control policies support our expansion into the continent and we are introducing complementary measures to enable international operations to be managed from a South African base. As mentioned in the National Development Plan (NDP), evidence suggests that growth in trade between countries dramatically increases prosperity in the world. There is a strong correlation between overall wealth gains in trade and poverty alleviation, with a generally positive causal effect on the internal distribution of that wealth. Although these relationships may differ from country to country, it is generally accepted that trade, including via financial markets, has a positive effect on wealth creation. In other words, an overall increase in a country's wealth has the potential to reduce income inequality.

Deeper regional integration within Africa is imperative to build markets and create new opportunities for growth, job creation and improved living standards. Regional integration can create more robust, competitive and diversified economies, and attract and reward new sources of investment finance. Regional integration features significantly in the NDP as the integration of the regional financial sector could contribute to enhancing competitiveness across countries. Priorities include strengthening financial infrastructure, harmonizing regulatory policies, and removing market impediments to cross-border activities.

When it comes to lessons learnt from developing financial markets, there are two important ones.

- First, policies to promote financial integration can contribute to regional trade and development. However, they cannot, on their own, overcome significant barriers to intra-regional economic activity.
- And second, the depth of financial integration has to be consistent with the strength of institutions and the political commitment to integration. Otherwise, financial integration can generate instability and impair development.

The Sub Saharan African Experience

Efforts to promote financial integration have been limited in Sub Saharan Africa. In conjunction with the establishment of the FTA, in 2003 the Common Market for Eastern and Southern Africa (COMESA) Council of Ministers adopted a framework and an action plan for harmonizing bank supervision and regulation, emphasizing that all member states should adopt the Basel Core Principles (BCPs), and issued another report on Effective Harmonization of Financial System Development and Stability in 2007. Guided by this report, COMESA countries have made uneven progress in modernizing national financial systems.

These efforts towards regional financial integration in COMESA have been accompanied by a spectacular 17.7 percent annual rise in intra-regional trade over the past eight years. Nevertheless, trade within the region is only 10 percent of total regional trade, due to inadequate regional infrastructure that have kept transport costs high.

However, despite a lack of progress so far, potential and opportunities abound on this continent. One prime example of successful regional integration is the JSE-Zambia grain initiative. This initiative facilitates hedging and limits agricultural price risk, which is vital for food security in the region. This is an example that needs to be followed. As we all know, infrastructure and food security are challenges for the entire African continent, these are also the perfect areas for the South African markets to assist through the facilitation of such hedging and limiting agricultural price risks.

Thus, as covered, it is imperative to step up the African financial integration process.

Some considerations that need to be taken into account as we move forward with this process include:

- The main obstacles to efficient financial markets in many African countries, which generally comprise of the following:

- An inadequate regulatory framework which makes for a highly concentrated banking sector, very low intermediation rates, and inefficient collateral registry systems that further impede businesses and individuals' access to credit.
- A banking sector that fails to exercise its role of intermediation due to very high interest rate spreads which make credit expensive. Moreover, deposits are poorly remunerated.
- Underdeveloped capital markets that remain narrow and illiquid, thereby limiting access to long-term financing and hindering countries capacities for local debt financing.
- A lack of innovative financial instruments, notably those geared towards Small and Medium Enterprises, which constitute a majority of the businesses on the continent but remain too often confined to the informal sector due to inadequate financial services

- In addition, it has been found 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.

- In as much as a large financial sector may contribute to growth, taxes, job creation and the channeling of funds to entrepreneurs and SMEs, a stable, competitive and well-regulated financial system is required to ensure that the sector contributes to equitable growth.

Conclusion

To conclude, it is generally understood that innovation and a wide spread of public and private activities and partnerships can contribute significantly to the development of African financial markets. However, access to finance is still a challenge for most Africans. Overcoming this bottleneck is critical if Africa is to increase its investment rate and its growth potential, as financial intermediation is the key to channelling resources into productive activities.

Making African financial markets work for investment and development will require significant efforts aimed at strengthening their legal and regulatory infrastructure, and lifting the quality and scale of their operations. Major possible reform areas include improving property rights' regimes, diversifying the supply of financial products and services in the banking sector and regionalizing financial markets through legal harmonisation and cross-listing at regional level. This will require intense cooperation among African governments and their partners from other emerging economies as well as innovative solutions that have proven to be successful in Africa, alongside sound macroeconomic policy management.

Conferences such as this play a vital role in stimulating discussion and debate between ourselves. I hope you will have a useful and stimulating two days, and that there will be many opportunities to share experiences and understand challenges.

Thank you.