FINANCIAL GLOBALISATION: LESSONS FOR SOUTH AFRICA

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ABSTRACT

Globalisation has become one of the contentious issues of our time. Some have praised it while others have strongly criticised it. The debate on the merits of financial globalisation intensified in the aftermath of the emerging market crises. The realisation that even countries with high growth rates and sound macroeconomic policies could be severely affected by a rapid reversal of capital flows spurred this debate. This happened just when South Africa was increasingly becoming part of this global village, where national borders have been made 'meaningless'. The resulting havoc that followed the emerging market crises, has affected even the most vulnerable groups of our society. This study aims to examine financial globalisation, its impact on the South African economy and the lessons, if any, that can be drawn from the experiences of other countries.

South Africa's experiences are typical of the broader experience of financial globalisation in other emerging market economies. However, there are distinct differences in the nature of financial globalisation in these countries and the policy responses of the respective countries. Thus there are different lessons that follow from the Asian and Latin American experiences. This limits the whole transfer of best practice from these regions to South Africa.
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ACRONYMS

BIS: Bank for International Settlements
CREFSA: Centre for Research into Economics and Finance in Southern Africa
EU: European Union
FDI: Foreign Direct Investment
GATT: General Agreement on Tariffs and Trade
GEIS: General Export Incentive Scheme
GDP: Gross Domestic Product
GNP: Gross National Product
IBRD: International Bank for Reconstruction and Development
ILO: International Labour Organization
IMF: International Monetary Fund
ISI: Import-substitution industrialisation
JSE: JSE Securities Exchange South Africa
NICs: Newly Industrialising Countries
NOFP: Net Open Forward Position
OECD: Organization for Economic Co-operation and Development
RSA: Republic of South Africa
SADC: Southern African Development Community
SARB: South African Reserve Bank
UNCTAD: United Nations Conference on Trade and Development
US: United States
WTO: World Trade Organization
CHAPTER ONE
THE PROBLEM AND ITS SETTING

1.1. Introduction

The growing integration of national economies has changed the way the world financial systems work. The present times are characterised by rapid changes, in particular, the increased internationalisation or globalisation of economic activity over the last couple of decades. The significant political and social consequences that flow from this exert a powerful confluence of forces that drive globalisation. While some of these influences reflect government policies, fundamentally these forces have a life of their own. These forces are driven by technological change, especially in the fields of transport and communications.

The benefits of globalisation are yet to be enjoyed globally in all countries. However, the living standards are steadily rising in many developing countries. Global economic integration is helping to increase prosperity in many developing countries, but the challenge remains to prevent the marginalisation of those lagging behind. For good or bad, globalisation has become the economic buzzword and reality of the 1990s. National economies are undoubtedly becoming steadily more integrated as cross border flows of trade, investment and financial capital increase. Consumers are buying more foreign goods and a growing number of firms now operate across national borders. Savers are investing more than ever before in far-flung places. Whether all of this is good or bad is a topic of heated debate and examined in this research.

One positive view is that globalisation is an unmixed blessing, with the potential to increase productivity and living standards everywhere. This is because a globally integrated economy can lead to a better division of labour between countries. Firms are therefore able to exploit bigger economies of scale. With globalisation, capital can be shifted to whatever country offers the most productive investment
opportunities. Capital need not be trapped at home financing projects with poor returns.

Critics of globalisation take a gloomier view. They predict that increased competition will destroy jobs, and that pressure to compete will erode the ability of governments to set their own economic policies. The critics also worry about the increased power of financial markets to cause economic havoc, as happened during the currency crises of the 1990s. While the supporters of globalisation have stressed its opportunities and benefits, there has been increasing criticism among others. Among factors put forward by the critics of this concept is the lack of tangible benefits for most developing countries from opening their economies. The large economic losses and social dislocations that are being inflicted on many developing countries by rapid financial and trade liberalisation, the growing inequalities of wealth and opportunities arising from globalisation, and the perception that social and cultural problems have been made worse by the workings of the global free market economy are examples of this.

The aim of this paper is to examine the nature of financial globalisation and the key aspects including trade and investment liberalisation, recent developments and the implications thereof for South Africa. This dissertation examines the impact of globalisation on the South African economy, with specific reference to benefits and risks of embracing this phenomenon. It analyses various macro-economic and financial market indicators as well as the economic reforms that have taken place during the periods before and after 1994. These aspects are explained in the light of the social disparities that exist in South Africa.

1.2. Relevance of the study

After years of international economic isolation, South Africa's democratisation in 1994 heralded its re-entry into the international arena and the globalisation of the South African economy. The last few years have marked a historical turning point in South African political and economic systems. In 1994, the new government initiated a much-needed process of economic reform, with the aim of creating an
outward-oriented economy. This went hand-in-hand with efforts to improve social equity and income distribution.

The challenges facing South Africa's first democratically elected government at the start of the transformation process were significant. Several decades of economic isolation meant that firms were not well prepared to take advantage of the opportunities arising from trade liberalisation, while the potential adjustment costs were correspondingly high. A major recession during the early 1990s had led to falling living standards for the majority of the population. In addition to this, past economic policies have favoured capital-intensive sectors, to the detriment of labour-intensive ones and employment creation. This was a rather peculiar policy feature in a country characterised by an abundant and under-utilised, unskilled labour force. By 1994, the unemployment rate had reached alarming levels. Moreover, following several decades of segregation and exclusion from the political and economic mainstream, the African population aspired to both a rapid improvement in political rights and better social and economic conditions. In a way, the main policy issue tried to satisfy these legitimate aspirations while at the same time creating a stable macroeconomic framework. This led to enhancing the integration of South Africa in the international economy. Objectively however, the prevailing economic situation at the time made the task problematic, because the country was simply not well prepared to take advantage of economic and trade reforms.

With hindsight, the economic performance has done better than feared by many. Trade liberalisation has proceeded, including a scheduled gradual decrease in import tariffs from 1994 onwards. This has permitted a significant increase in trade flows. Not only have most non-tariff barriers been lifted, but tariff rates themselves have also been brought down. These are expected to be reduced further over the next few years. Export subsidies have been suppressed and South Africa has become an active member of the WTO. South Africa is the most important participant of the SADC and has finalised its trade discussions with the European Union. Likewise, progress has been made in the area of foreign direct investment (FDI) liberalisation. At least until the recent Asian crisis, FDI inflows were on the rise. South Africa has been liberalising its economic policy in order to reap the potential
fruits of the globalisation process. This has induced a process of outward oriented growth in the economy, created jobs and increased the welfare of many of its citizens.

Unfortunately, the situation on the employment front has been deteriorating, since the early 1990s. Unemployment, which is above 30 percent, remains very high and on the increase, endangering social stability.

This study argues that the forces driving globalisation cannot be halted and have a life of their own, such as the level of technological change. At the same time, it argues that this process is also driven by the policy choices taken at national level by governments or individual countries. These choices have led to the rapid liberalisation of finance, trade and investment. However, the recent financial crises, which include outflows of capital and exchange rate volatility as well as their effects on the domestic economy, have catalysed a serious rethinking of some of these policies. This includes the suitability or unsuitability of these policies on development objectives and whether the country is pursuing the right or fair approach to globalisation and liberalisation. The main objective is to obtain a better understanding of financial globalisation and how this may benefit South Africa.

1.3. Method of research

This study is mainly a literature research based on the existing literature and it makes use of primary and secondary economic data to analyse and interpret certain findings. Each chapter starts with a brief introduction, followed by the content and a short conclusion.

Chapter two explains the definitions of the globalisation concept. Chapter three discusses the historical development of financial globalisation as well as the forces that are driving globalisation. Chapter four focuses on international experience of financial globalisation with specific reference to developing countries. This chapter examines the main aspects of financial globalisation including the integration of financial markets, the benefits, costs and risks including the recent financial crises,
the role of capital flows as well as the lessons that can be drawn from these countries. Chapter five provides a general overview of the South African economy, including its integration into the global world. This chapter also examines the various policies that have been followed, their implications and impact as well as the role of globalisation in these policy options. Finally, chapter six draws some general conclusions on financial globalisation and lessons to be learnt from the experiences of globalisation. Some policy implications and recommendations for improving the situation are suggested for South Africa.
CHAPTER TWO
THE CONCEPT OF GLOBALISATION

2.1 Introduction

This chapter presents some detailed definitions of globalisation. Globalisation has become one of the most debated concepts of the 1990s and onwards. As Kiely (1998:2) points out "much of the debate surrounding globalisation has been extremely abstract". He further notes that there is often a lack of clarity in definitions of the term, its novelty and how people throughout the world are experiencing it. By setting out clearly what the concept - globalisation - means and what is being globalised, a better understanding of the phenomenon that has been blamed for the many ills that have affected humankind, be they political, economic and or social can be gained. The reasons why some have praised it for the role it has played in raising the standard of living and helping to increase prosperity in many developing countries are also analysed.

2.2 The definitions of the concept of globalisation

The world has become smaller and more interconnected. This is attributed to the rapid pace of global economic integration in the past decade, which is underpinned by economic liberalisation and technological discoveries that facilitate transport and communication networks. According to Alonso-Gamo, Fedelino and Horvitz (1997:6) production and trade have become intertwined, production processes are spread across the globe and most products entering the market are either traded or heavily reliant on traded components. Trade flows have increased fifteen-fold in the last four decades. This trend has been accompanied by a shift away from official financing (aid flows) to more amounts in the nature of capital flows to developing countries. Portfolio investments and foreign direct investment (FDI) have become the important component of private flows, with FDI joining international trade as the primary driver of globalisation. FDI facilitates the international division of labour and is the most effective mechanism for the diffusion of productive know-how on capital flows and
the creation of wealth. It can also release much of the untapped production potential of today's developing and transition economies, while opening up new markets for high value-added products and services that generate high-income jobs (Alonso-Gamo et al., 1997:6).

But the question arises, what is globalisation? While globalisation has become the buzzword of the 1990s and onwards, this phenomenon means different things to different people. According to the International Monetary Fund (IMF, 2000:2) globalisation refers to the increasing integration of economies around the world, particularly through trade and financial flows. This concept also refers to the movement of people and knowledge across national borders as well as the extension beyond national borders of the same market forces that have operated for centuries. This takes place at all levels of human economic activity, including village markets, urban industries and financial centres (IMF, 2000:2). International transactions in trade and financial flows have been made easier and quicker to complete by advanced technological processes.

Friedman (2000:9) defines globalisation as "a dynamic ongoing process, which involves the inexorable integration of markets, nation states and technologies to a degree never witnessed before. It happens in a way that is enabling individuals, corporations and nation states to reach around the world farther, faster, deeper and cheaper than ever before. It also produces a powerful backlash from those brutalised or left behind by this new system". Friedman further mentions that globalisation is driven by free-market capitalism. The more market forces are allowed to rule and the more the economy is opened to free trade and competition, the more efficient and flourishing the economy will be.

Guillén (2000:4) describes globalisation as an ideology with multiple meanings and lineages that is sometimes loosely associated with neo-liberalism and technocratic solutions to economic development and reform. Lubbers and Koorevaar (1999:1) regard globalisation as an "abstract concept" that does not refer to a "concrete object" but to an interpretation of a societal process. As mentioned earlier globalisation means different things to different people, and for most authors and
scholars globalisation is a complex process that involves political, economic and socio-cultural changes and sometimes refers to the consequences it carries. Lubbers and Koorevaar (1999:2) refer to globalisation as "a process in which geographic distance becomes a factor of diminishing importance in the establishment and maintenance of cross-border economic, political and socio-cultural relations. This process reaches such intensity that relations change fundamentally, and people become aware of that change. The potential internationalisation of relations and dependencies creates opportunities, but also causes fear, resistance, actions and reactions."

However, in Guillén (2000:3), the sociologist Anthony Giddens regards globalisation "as a decoupling between space and time (that is an intensification of worldwide social relations which link distant localities in such a way that local happenings are shaped by events occurring many miles away and vice versa)". Geographer David Harvey and political scientist James Mittelman observe that globalisation entails a compression of the world and the intensification of consciousness of the world as a whole, while political scientist Robert Gilpin defines globalisation as the increasing interdependence of national economies in trade, finance and macroeconomic policy (Quoted in Guillén, 2000:3).

Kiely (1998:10) refers to the globalisation of the world economy as the ability of capital to move freely across national borders. This movement is particularly strong for finance capital, which does not face the constraints of fixed locational costs associated with industrial capital. Because this form of capital can move rapidly around the world, it is the most globalised form of economic activity.

Crockett (1999:178) refers to globalisation as a term that is widely used, but defies precise definition. He defines it as a process in which geographic and market barriers are being rapidly eroded. This allows economic agents to make financial transactions with limited hindrance in all major markets of the world. These agents can also switch with increasing ease between different types of intermediation (Crockett, 1999:178).
The development of new communications technologies makes the 'time-space compression' even more evident as people get to know what is happening elsewhere more quickly. These new technologies have promoted a global culture of instant communication, in which time and space horizons have collapsed (Kiely, 1998:3). Globalisation is characterised, amongst others, by the rapid trade expansion, geographical explorations, with the money economy increasingly superseding the national or self-sufficient economy and the integration of national economies. These global changes including economic and financial have, amongst others, been brought about by the theories that suggest that global markets promote efficiency through competition and division of labour. This includes the specialisation that allows people and economies to focus on what they do best. This could be traced to the foundation laid by Adam Smith in his book "Inquiry into the Natures and Causes of the Wealth of Nations". Smith (The Economist, 1996:23) reckoned that the engine of growth was to be found in the division of labour, in the accumulation of capital and in technological progress. He emphasised the importance of a stable legal framework, within which the invisible hand of the market could function. He explained how an open trading system would allow poorer countries to catch up with richer ones.

According to the IMF (2000:2), global markets offer greater opportunity for people to tap into more and larger markets around the world. This means having access to more capital flows, technology, cheaper imports and larger export markets. However, the IMF also emphasises that these global markets do not necessarily ensure that the benefits of increased efficiency are shared by all. In order to reap the benefits of global markets, countries must be prepared to embrace the policies needed to become part on an integrated world economy. Integration into the world economy is regarded as a means towards achieving sustainable improvements in the welfare of the most vulnerable groups in a society, while opening the economy is generally considered as the key to taking advantage of globalisation and becoming better integrated into the world economy.
2.3 The definition of financial globalisation

Yang (2000:153) defines it as a process that "encompasses integration of international money markets, international capital markets and capital mobility across countries". For international investors this means the ever-increasing speed and freedom of moving funds across national markets. For emerging markets, due to the fact that their financial markets are relatively primitive, financial globalisation entails liberalisation of domestic financial markets and relaxation of capital controls to allow for financial capital inflows and outflows.

According to Crockett (1999:178) the most obvious manifestation of globalisation is the large upsurge in cross-border financial transactions. In 1975, cross-border purchases of bonds and equities in the G-7 major industrial countries were estimated at about 4 percent of the annual GNP of these countries. By 1985, the comparable figure was around 30 percent and close to 200 percent by 1995. There are several large countries where cross-border securities are now several times larger than their national GNP.

With many countries jumping onto the wagon of free market orientated policies, these countries have lifted capital controls on financial flows and markets. The fall of the Bretton Woods system between 1972 and 1973 opened up international trade in foreign exchange that has expanded at phenomenal rates (Khor, 2000:3). The daily turnover in the world foreign exchange markets has grown from around $15 billion in 1973 to over a trillion at present (Bank for International Settlements (BIS), 2002). The early 1990s saw a resumption of economic growth and declining rates of inflation in many emerging market economies. But overall, the 1990s also experienced intense financial instability both of domestic origin and also linked to the global economy. The Mexican crisis of 1994, the Asian crisis of 1997, the Russian crisis of 1998 as well as the Brazilian crisis of 1999 wreaked havoc, "causing the worst financial turmoil and economic recession in the post World War II period" (Khor, 2000:3). Global economic integration has been boosted by the adoption of market-orientated economic policies in many developing countries and transition economies. This has been accompanied by substantial financial volatility.
characterised by currency crises, affecting large developing countries and transition economies including South Africa.

2.4 Conclusions

The definitions discussed above show that globalisation expresses different assessments of global change in which more parts of the world are drawn into a global system and as a result are affected by what happens elsewhere. However, in this dissertation globalisation means the widening of the scope of economic activities across national boundaries. This can take the form of direct and portfolio investments. Financial globalisation allows the integration of international financial markets and capital mobility. For private investors, financial globalisation means the freedom of moving funds across national markets. For the recipient countries of these funds, financial globalisation means liberalisation of financial markets. This also entails creating an environment conducive for capital to flow in and out without limits or constraints.
CHAPTER THREE
HISTORICAL DEVELOPMENT OF FINANCIAL GLOBALISATION

3.1 Introduction

According to Khor (2000:3), globalisation is not a new process, because over many centuries companies in the economically advanced countries have extended their outreach through trade and production activities. This was more the case during the colonial period when expansion took place to territories all over the world. The policies of liberalisation that have swept across the world, as well as technological developments have accelerated the phenomenon of globalisation during the past two to three decades. This has led to the international spread of trade, financial and production activities, the breaking down of national economic barriers and growing power of transnational corporations. Khor (2000:3) gives an example of the uneven process of globalisation, which affects almost every country. "For example, a low-income country may account for only a minuscule part of world trade, but changes in demand or prices of its export commodities or a policy of rapidly reducing its import duties can have a major economic and social effect on the country". Khor (2000:3) further asserts that the external liberalisation of national economies involves breaking down the national barriers to economic activities. This can result in greater openness and integration of countries in the world markets, with barriers being removed in the areas of finance and financial markets, trade and direct investment.

This chapter analyses the historical development of globalisation or the integrated world economy with specific emphasis on financial globalisation. The chapter is divided into three sections. The first section gives a historical background of globalisation. In the second section some of the factors driving globalisation are discussed and these include the advances in telecommunications and transport and the last section summarises the chapter.
3.2 Historical development of globalisation until 1945

Despite much free talk about the "new global economy", today's economic integration is not unprecedented. The fifty years before the First World War saw large cross border flows of goods, capital and people. That period of globalisation, like the present one, was driven by reductions in trade barriers and by sharp falls in transport costs. This happened mainly as a result of the development of railways and steamships (The Economist, 1997:103). In a way, the present surge of globalisation is a resumption of that previous trend. According to Solimano (1999:2) the last decades of the nineteenth century from the 1870s to the early twentieth century up to 1914 were a period of rapid growth of the global economy based on an expansion of international trade and free capital mobility under the gold standard.

Baldwin and Martin (1999:1) also agree that globalisation "is not quite as new as some would have it". In fact, they disagree with the notion that today's globalisation is unprecedented. These authors distinguish between two waves of globalisation, the first one roughly between 1870 and 1914, while the second one covers the period between 1960 and the present. They believe that the two waves of globalisation share many superficial similarities but are fundamentally different. According to Baldwin and Martin (1999:1), both globalisation waves were driven by radical reductions in technical and policy barriers to international transactions. However, the one fundamental difference lies in the impact that these reductions have had on trade in goods versus trade in ideas.

The significant reduction in communication costs has greatly shaped the uniqueness of recent globalisation, despite both waves of globalisation having seen reductions in costs. A second fundamental difference lies in the different conditions between the two waves of globalisation. The first one was characterised by a world that was fairly homogeneous, that is homogeneously poor and agrarian. At the beginning of the second wave the world was sharply divided between rich industrial nations and poor primary producers (Baldwin and Martin, 1999:2). According to the World Bank (2002:24) the first wave of globalisation, which is set between 1870 and 1914, was triggered by a combination of falling transport costs such as the switch from sail to
steamships and reductions in tariff barriers. Cheaper transport and the lifting of man-made barriers opened up the possibility of using abundant land while new technologies such as railways created large opportunities for land-intensive commodity exports.

While the beginning of globalisation is also a contested issue Held et al. (1999, as quoted by Guillén, 2000:4) states that globalisation began with the dawn of history. World-system theorists maintain that expansion of European capitalism in the 16th century marks the beginning of globalisation. The processes that are usually quoted when people speak of globalisation have therefore existed for some 500 years (Wallerstein, 1999:1).

Some historians take globalisation as far back as the first circumnavigation of the earth in 1519-1521 (Guillén, 2000:4). However, Baldwin and Martin (1999:2) trace the beginning of globalisation as far back as the beginning of the industrial revolution, which started in Great Britain. This resulted in the great transformation of the British economy. This period saw major breakthroughs in key transport technology, with the most important being the rapid expansion of railroad networks and the widespread use of steam-driven ships for inland and oceanic routes. Railroads revolutionised land transport while steamships revolutionised ocean travel.

The whole process was fostered by the rapid development of financial intermediation, centred in London, during the last half of the 18th century. This also shifted the nation from a rural society to having almost two thirds of its population in urban areas (Baldwin and Martin, 1999:2). According to the World Bank (2002:25) these shifts and the production of primary commodities required people or labour. This resulted in migration from Europe to other countries including North America and Australia. Migration flows took place from densely populated China and India to less densely populated Sri Lanka, Thailand, the Philippines and Vietnam. But, the production of primary commodities for export also required large amounts of capital, resulting in institutions needed for capital flows being established. These institutions, combined with the improvements in information transmitted by telegraph enabled governments in developing countries to tap into the major capital markets.
Around half of all British savings were channelled abroad during this period. By 1914 the foreign capital stock of developing countries had risen to 32 percent of their income (World Bank, 2002:25).

New industries and production methods emerged during the second half of the 19th century. Thus began the so-called second industrial revolution (Baldwin and Martin, 1999:3). Further advances in shipbuilding and railroads pushed the prices of sea and land transportation further down. The first transatlantic telegraph cable in 1866 and the subsequent cabling of all oceans revolutionised communications, lowering intercontinental communication times from weeks to minutes. Faster and more reliable communications encouraged more trade and investment.

This earlier attempt at globalisation ended abruptly with the First World War, after which the world moved into a period of fierce trade protectionism and tight restrictions on capital movement (The Economist, 1997:103). This period was followed by macroeconomic turbulence during the 1920s and high inflation rates in several developed economies and thereafter the Great Depression of the 1930s. Countries sharply increased their tariffs during the early 1930s, and this made the effects of the Great Depression even greater, as the volume of world trade fell sharply. International capital flows dried up during the inter-war period as governments imposed capital controls to try to insulate their economies from the impact of a global slump (The Economist, 1997:103).

The role of international trade and capital movements as engines of growth and prosperity changed, with global capitalism seen as an unstable system prone to periods of volatility and inflation. According to Obstfeld and Taylor (2002:4) the global economy that was coming together was destroyed during the period of 1914 to 1945. The world economy went from globalised to almost autarkic in the space of a few decades. This inter-war period was characterised by minimal capital flows, raised suspicions on international investment, while international prices and interest rates fell completely out of synchronisation (Obstfeld and Taylor, 2002:5). Global capital, along with finance in general, was demonised and seen as a principal cause of the world depression of the 1930s.
3.3 Historical development of globalisation after World War II

After the Second World War, the big economic powers agreed to reduce trade barriers, as this was seen as vital to recovery. This led to the setting up of the General Agreement on Tariffs and Trade (GATT), which organised a series of negotiations that gradually reduced import tariffs (The Economist, 1997:103). A new set of global financial institutions emerged in the 1940s, known as the Bretton Woods Institutions. The IMF was given the mandate of assuming a normal payments system under a system of fixed exchange rates and providing external financing to countries running balance of payments deficits. The World Bank provided long term financing for economic reconstruction and development (Kiely, 1998:25-26). This was called the golden age of capitalism, as it was a period of considerable stability, and rapid growth and prosperity, lasting to the early 1970s. This period was based on a globally regulated market economy. But it soon ran out of steam in the industrial economies, like many that came before it. This was mainly due to the oil shocks during the 1970s and the stagflation that followed. Developing countries borrowed heavily following the oil shocks, culminating in the debt crisis of the 1980s (World Bank, 2002:31).

At the end of the Second World War, the United States had emerged as the most powerful economy in the world, controlling around 70 percent of world gold and foreign exchange reserves and around 40 percent of industrial output (Kiely, 1998:25-26). This meant that it had strong influence on the structure of the global economy, especially in terms of shaping it. However, the demand for independence in the Colonial world from Europe and Japan, as well as what was termed the 'alternative to the West's social and political systems', that is communism in the Soviet Union, meant that the US had to compromise with other countries over the shape and future direction of the international economy. At that time, the United States had converted to the principle of free trade and committed itself to an anti-communist foreign policy. All these factors helped to shape and influence the way in which development as an idea was perceived (Kiely, 1998:27).
The nature of the post-war international economy led to the establishment of various institutions, including the IMF, the World Bank, GATT and the conclusion of the Bretton Woods agreement (Kiely, 1998:26). While the post-war settlements favoured the US, US actively encouraged the advanced capitalist countries to rebuild their economies, and became sympathetic to the voices of the Third World as US was gripped by the fear of communism spreading throughout the Third World countries. This laid the foundation for the idea of development in order to help these countries (Kiely, 1998:27).

Economic growth was seen as the key to the development of underdeveloped areas. In this scenario, the state would play a leading role in planning output and investing in dynamic industries such as new industries. According to Kiely (1998:28) industrialisation was seen as a key strategy, because new rounds of technological investments increased productivity and thereby expanded output. However, the leaders of new states in the Third World became critical in the way the new international order tended to marginalise their interests. This led to the formation of the Non-Aligned Movement in 1961 and the United Nations Conference on Trade and Development (UNCTAD) in 1964. The former was to "promote an independent path between the interests of the communist and capitalist world", while the latter was to attempt "to win some reforms in the international economy" (Kiely, 1998:28). These institutions had a different emphasis from Western-based theories of modernisation, but both approaches shared the same assumption that the most effective strategy for development was rapid economic growth. Import-substitution in industrialisation became the major development strategy that was used in the Third World during the 1950s to 1970s. This policy involved the development of a domestic industrial sector, initially producing for the domestic market, but with the long-term aim of breaking into export markets. The new industries were protected from competition and cheaper foreign imports through high tariffs or import controls.

Development was seen as a process whereby the Third World could catch up with the modern industrialised countries, thus enabling the Third World to reduce poverty levels in their respective countries. However, when the International Labour Organisation (ILO) released figures in 1972 (as quoted by Kiely, 1998:29) estimating
that 39 percent of the population in the Third World was destitute and around 67 percent was seriously poor, the hopes of development improving the lives of many became difficult to sustain. This led to the revision of the development strategy in the 1970s. The new strategy was based on the ideas of redistribution with growth and basic needs. The pursuit for high investment returns instead of securing full employment for the peoples of the Third World turned the tide against such strategies by the early 1980s.

Between 1971 and 1973, the Bretton Woods system of fixed exchange rates was briefly abandoned, when the United States devalued the dollar against the price of gold, allowing the introduction of a system of floating exchange rates. Unfortunately this partial collapse of the Bretton Woods system coincided with the significant rise in the price of oil, between 1973-1974. Oil producing countries cashed in during this period, making significant profits that were deposited in Western banks. This money was lent to Third World countries, mainly in Latin America at low rates. By 1982 the nine largest banks in the US had lent over twice their combined capital base to non-oil producing Third World countries (Kiely, 1998:30-31). In 1982 Mexico defaulted on its debt obligations and was followed by other countries. A debt crisis emerged, resulting in the rise of the 'neo-liberal counter revolution'. The IMF and World Bank advocated policies that more or less reflected the neo-liberal paradigm.

The main contention of neo-liberal theory is that 'orthodox' state led development and in particular import-substitution in industrialisation (ISI) is inefficient. State intervention in the economy was deemed to be inefficient (Kiely, 1998:31). Neo-liberals argued that ISI was not a sustainable strategy for Third World developers, because it encouraged the growth of inefficient and expensive activities through state protection of domestic producers. This also discouraged export-earning activity and discouraged traditional wealth-creating activity such as farming, because of state discrimination in favour of other industries. The neo-liberal remedy for these problems was the encouragement of the private sector and the liberalisation of Third World economies. This included recommendations of currency devaluation, liberalisation of international trade and reduction of state economic activity. The theory of neo-liberalism had a strong influence on the structural adjustment and
stabilisation programmes introduced by many Third World governments. This happened mainly on the advice of IMF and World Bank (Kiely, 1998:28-32).

However, of the three aspects of liberalisation namely finance, trade and investment, the process of financial liberalisation has been the most pronounced.

3.4 Evolution of financial capital markets

According to Ayling (1986:44) the origins of modern international markets are entrenched in ancient history and the people's desire to explore and trade with neighbouring countries. This desire has remained the same over the centuries, but the ways of achieving this has changed considerably over the years. Ayling (1986:44) refers to the period when Babylonian merchants used the temples to deposit funds, as early as 2000BC. In 400BC Greeks also had their equivalent of the modern joint-stock company and markets for handling currencies and interest-bearing securities. The need to trade set the stage for the provision of capital to meet the needs of the developments taking place at the time. The first half of the nineteenth century was characterised by free movement of capital. The reason for this was the fact that Great Britain was the main industrial power and thus the main financial center at the time. Most of the capital or funds from Britain were moved to other countries including the United States. The relatively stable political environment during this period provided security and encouraged international flows of private capital. The nineteenth century also witnessed the establishment of many stock exchanges including those at Geneva, Tokyo and Hong Kong (Ayling, 1986:44-45). New York became the leading financial centre as the British pound weakened considerably during the period 1900 to 1930. Around 90 percent of international capital movements were in the form of portfolio investment. This followed the need for the separation of ownership from control, the need to finance innovative new industries and the growing interest in stock companies. Equity capital gained prominence as stock market facilities increased.

The interest in equity capital increased, reaching new highs. This was followed by the disastrous Wall Street crash, leading to a loss of confidence in equity markets.
This had dire consequences that lasted well into the 1930s (Ayling, 1986:45-46). The period of the 1930s was characterised by restrictions on capital movements as mentioned earlier. However, the 1940s and 1950s saw the resurgence of private capital flows and large volumes of government loans. The need to finance new industries after the Second World War was the result of this resurgence. This period also saw moves towards agreements at government level on financial matters, which were of common international interest. The introduction of a fixed exchange rate system, the setting up of the IMF, and the International Bank for Reconstruction and Development (IBRD) came during this period. The periods after this, from the sixties to the eighties saw the extension of international financial markets and infrastructure to other regions including less industrialised countries such as Latin America, Asia and Africa (Ayling, 1986:46:48). Calls for the abolition of exchange controls to allow wider scope for international investors in foreign markets, and co-ordination of markets' organisational and legislative frameworks took centre stage once more, especially in Europe. International capital movements continued to grow amongst the countries and across borders. Different types of capital emerged, moving from just aid flows to portfolio flows.

### 3.5 Forces driving globalisation

Alonso-Gamo et al. (1997:7) refer to the upsurge of trade and changing trade links as one of the factors behind globalisation. This has been supported by the increase of multilateral and regional trade initiatives as well as the deepening and diversification of trade linkages in the developing countries. The second reason behind this is the integration of world capital markets, as the developing countries are liberalising their financial markets, including their capital accounts. The third factor put forward is the increased importance of private flows and foreign direct investment, with equity and portfolio flows surpassing other forms of investment or financial flows. Advances in telecommunications and transport, which have brought about the end of geography through the advent of faxes and global computer networks have been one of the main drivers behind globalisation. Finally, changes in the movements of labour have been mentioned as another factor, contributing to the transfer of managerial know-how or skills.
3.5.1 The role of information technology in globalisation

Technology has fundamentally changed the landscape of the global financial marketplace by lowering transaction costs and reducing asymmetric information thus levelling the playing field for investors and issuers. The rise of the internet and the explosive pace of consolidation of exchanges have created "an increasingly round-the-clock, borderless global trading network (Cheung, 1999:1). According to Cheung (1999:1), this has increased the market efficiency and reduced transaction costs.

There are different facets of technology that have contributed to the emergence of an increasingly interrelated global market place. Firstly, advances in telecommunications and information processing offer financial institutions the capability in handling large amounts of data at very high speed and at relatively low costs (Cheung, 1999:1). Technology has shrunk the world and reduced the importance of geographical location of markets. This serves as a catalyst for exchanges to abandon the open outcry method of trading and adopt screen-based trading technology. Exchanges are fostering alliances with overseas counterparts in an effort to reduce high development costs in technology and to increase market share.

Secondly, the emergence of the internet is reducing information asymmetry, giving individual investors unprecedented access to the global marketplace (Cheung, 1999:2). Smaller investors are gaining access to real-time market information and low-cost trading and risk management systems, which have until recent years only been largely accessible by financial institutions.

Thirdly, methodological breakthroughs in the pricing of sophisticated derivative products have led to the invention and marketing of new financial instruments and trading strategies in repackaging risk and return profile (Cheung, 1999:2-3).
3.6 Conclusions

The arguments put forward in this chapter show that the level of integration, interdependence and openness of national economies commonly referred to, as globalisation in the present era is not unprecedented. The integration of the global economy began centuries ago. This started as soon as countries engaged in trade with other countries. While the level of integration has not changed significantly, the advances in technology and techniques used, has altered the intensity of the present integration. Over the years, the pursuit of neo-liberal policies has promoted the free movement of capital and the dismantling of capital controls in many countries around the world. This has allowed for transformation in the types or forms of investment flows that the countries receive. The era before the First World War experienced its own level of integration and transformation. The mechanisms or factors driving globalisation have been in place for almost the entire twentieth century and even earlier than that. These have been in one form or another including the sharp falls in transport costs as a result of the development of railways and steamships.

However, this new era from the 1980s onwards has its own set of factors driving interdependence among countries. These include technological advances, making this era more pronounced than the previous ones. Other factors include the upsurge of trade and changing trade links, the integration of world capital markets, as the developing countries are liberalising their financial markets, including their capital accounts, the increased importance of private flows and foreign direct investment, with equity and portfolio flows surpassing other forms of investment or financial flows as well as advances in telecommunications and transport, which have brought about the end of geography through the advent of faxes and global computer networks. Finally, changes in the movements of labour have been mentioned as another factor, contributing to the transfer of managerial know-how or skills.
CHAPTER FOUR
FINANCIAL GLOBALISATION AND INTERNATIONAL EXPERIENCE OF DEVELOPING COUNTRIES

4.1 Introduction

This chapter examines the role of developing countries in the global financial integration process. The first section analyses the key issues of financial globalisation and what it entails. The following section examines the deregulation of financial markets and capital account liberalisation. This is followed by a discussion of the benefits and challenges of financial liberalisation and the role of capital flows in developing countries. The damaging effects of financial crises in these countries are illustrated by a brief analysis of the Asian and Mexican crises. The final section summarises the main findings of the chapter.

4.2 The key issues surrounding financial globalisation

The past few decades have seen a steady increase in cross-border financial flows around the world, with various institutions expanding their activities all over the world. Financial institutions acted as intermediaries to channel funds from lenders to borrowers across national borders. Giddens (1999:8) argues that in the late nineteenth century there was already an open global economy, with a great deal of trade, including trade in currencies. But the difference is that the level of world trade today is much bigger than it was before and involves a much wider range of goods and services. The level of finance and capital flows and what is referred to as electronic money or money that exists only as digits in computers is even more different today. This makes the current world economy unparallel to any previous markets (Giddens, 1999:8-9).

Fund managers, banks as well as millions of individual investors can transfer large amounts of capital from one side of the world to another at the click of a mouse during this era of new global electronic economy. As they do so, they can
destabilise what might have been rock-solid economies. This has happened during the events of Asia and some other emerging economies (Giddens, 1999:9). The global currency trading has gained a life of its own and is increasingly getting delinked from the flows of real resources and long-term productive investment. More than a trillion dollars is turned over each day on global currency markets. This is over one-tenth of the annual output of the US economy in 2001 (BIS database, 2002; IMF database, 2002). The fluctuations in these markets, which occur in split seconds, often determine the value of the money held in bank accounts. But what are the factors behind this? The next section analyses the factors behind the fast trans-border capital mobility.

4.3 Financial liberalisation in developing countries

The deregulation and globalisation of financial markets as well as capital account liberalisation in many developing countries, coupled with lower interest rates and institutionalisation of savings have been cited as one of the main factors behind the fast trans-border capital mobility. The global investors are usually attracted by short-term speculative gains, as these financial flows are highly liquid and 'footloose' and can leave the country as quickly as they come.

Khor (2000:22) points to various factors that have been driving globalisation in the financial sector. These include:

- The policy choice of financial deregulation and liberalisation, which includes opening up to international capital flows by both developed and developing countries,
- The development of technology particularly electronic communication, which facilitated the large cross-border movement of funds,
- The emergence of new financial instruments such as derivatives and financial institutions. The latter includes highly leveraged hedge funds, and
- The collapse of the international fixed exchange rate system. This made it possible for profits to be made from speculation on changes in the rates of currencies.
While financial globalisation is considered a relatively recent phenomenon, it has been associated with the most severe financial turmoil and economic losses for many developing countries. Those countries that have integrated into the global financial markets have suffered the most. The view that there were benefits to be derived from opening up to international capital inflows partly led to the rapid process of financial liberalisation by many developing countries, without considering the risks inherent in short-term capital inflows (Khor, 2000:22).

As a result, many of these countries, especially the developing ones, did not take the necessary measures to minimise or insulate themselves against the risks. They hastily removed existing capital controls, allowing domestic institutions to take foreign-currency loans and the trading of their local currencies abroad (Khor, 2000:22). This problem was further compounded by the domestic structural weaknesses in the financial sectors of the recipient countries, which found it difficult to manage the volatile capital flows.

The recent financial crises that hit many emerging markets have raised concerns about the structure of the present international financial and economic architecture, as they are seen as the outcome of international financial liberalisation. These crises have also exposed the negative effects caused by short-term capital flows and the risks and dangers that accompany financial liberalisation in developing countries (Khor, 2000:22). He refers to this as "the fallacy of the orthodox view", whereby developing countries are advised to open up to global finance, as this will bring mainly benefits and lower costs. Many developing countries have discovered in the most painful way, that such investments and short-term capital flows have their costs. Rapid changes in investor sentiment can cause significant instability, particularly in developing economies. The Asian crisis followed a period of financial liberalisation, which contributed to a build-up of vulnerability of the countries to external financial forces. This included large inflows of short-term capital, which led to an asset price bubble. The asset price bubble burst when speculative currency attacks and reversal of the capital flows caused severe depreciations that rapidly spread to other countries. This presented further problems when these countries could not service their foreign debt, which they accumulated in a relatively short
period (Khor, 2000:23). Foreign reserves were exhausted and were later followed by IMF-led multibillion-dollar bailout programmes. These realisations raised further questions such as whether developing countries can find ways to capture the gains from financial globalisation without running such large risks, which often jeopardise the poorest individuals. Are the benefits of liberalising capital accounts worth the costs? The following section examines the benefits and risks or costs of such a move to financial liberalisation.

4.4 Benefits and costs/risks of globalisation in developing countries

According to Summers (1999:12) the world does not stand still. Continuing improvements in technology, increasing skill levels in developing countries and the spread of cross-border organisations are all operating to increase global integration. This brings significant benefits but inevitably it also circumscribes government's ability to correct market failures. Perhaps most significantly just at the time that integration may be increasing the desire for policies that insure citizens, it may also be making important income generators more mobile, thus reducing the capacity for insurance and redistribution. The upshot of all this is that those who believe that increasing international integration of economies is a good thing have to accept the concomitant obligation to press for more effective international efforts to insure that public interest in correcting market failures is defended. Or put differently, economists expect their fellow citizens to understand what they know about the benefits of free trade. This is further stressed by Ouattara (1999:1) who also agrees that a globalised world offers many benefits including the chance to quicken the pace of investment, job creation and growth. Many East Asian developing countries have benefited greatly from their openness over the past few decades. This has led to very high economic growth rates and an enviable record of poverty reduction. Ouattara argues that while the recent rounds of crisis presented a setback, with very high social costs, these do not undo the achievements realised.

The dreams of modernisation are coming true in many parts of the world, even in remote areas of underdeveloped countries, but not as social scientists had envisaged. Globalising structures and international agencies interacting with
individuals and communities are delivering modernity to some people formerly far removed from meaningful participation in cross-border flows of capital, knowledge, information and consumer goods. However, not all people share in these benefits. A measure of transformation is being compressed into a short time and often despite officially managed processes (Mittelman, 1996:1).

Many developing countries, especially the poorest ones, have yet to benefit from globalisation. Khor (2000:7) refers to globalisation as "a very uneven process, with unequal distribution of benefits and losses". A few countries and groups gain while many others lose out or get marginalised. This process excludes many of the developing countries and those that participate in very marginal ways. Their participation is often to their detriment, for example, it causes instability that may accrue from financial liberalisation and import liberalisation. This may harm local producers.

Globalisation affects different categories of countries differently and is categorised as follows (Khor, 2000:7):
- growth and expansion in a few leading or fully participating countries;
- moderate and fluctuating growth in some countries attempting to fit into the globalisation or liberalisation framework; and
- marginalisation or deterioration experienced by many countries unable to address the acute problems such as debt and also unable to cope with problems of liberalisation.

The fast growing gap between the world's rich and poor people, between developed and developing countries, and by the large differences among nations in the distribution of gains and losses is a manifestation of the unevenness and unequal nature of globalisation (Khor, 2000:7). The pace of international economic integration is likely to increase further over the next years. This is the result of increased world trade in the wake of global and regional multilateral trade liberalisation initiatives, the economic reforms that are liberalising capital flows and the encouragement of privatisation. But what does this mean for a developing country that has to choose between globalising or risking being marginalised?
4.5 Integration of global markets

Obstfeld (1998:10) argues that economic theory leaves little doubt about the potential advantages of global financial trading. International financial markets allow residents of different countries to pool various risks, thereby achieving more effective insurance than purely domestic arrangements would allow. Obstfeld (1998:10) states that developing countries with little capital can borrow to finance investment, thereby promoting economic growth without sharp increases in saving rates. At the global level, the international capital market channels world savings to its most productive uses, irrespective of location. He agrees that the resulting economic gains are difficult to quantify and may work through subtle mechanisms. While it is difficult to quantify the gains countries have realised from international capital mobility, historical evidence suggests substantial benefits for smaller countries.

4.6 The challenge of financial integration facing developing countries

The rising demand for better public management of global integration has taken on greater prominence and urgency in the wake of events in global financial markets. Financial disturbances have propagated nationally and internationally with virulence perhaps greater than at any time in the past fifty years. Even nations thought to be managing their economies well, such as those in East Asia, have seen financial disturbances wipe out years of economic progress and create significant economic insecurity among their citizens (Summers, 1999:8). Reversals of international capital flows have played an important role in the crises in a number of countries. The international community has been called on to provide financial support to a number of countries on an unprecedented scale.

Bhagwati (1998:7-12) suggests that developing countries resist the integration of national capital markets. Summers (1999:12-13) stresses that in retrospect it is clear that capital flows to a number of emerging markets in the mid-1990s were excessive and dangerous to both borrowers and lenders. With hindsight it is also clear that vigorous government efforts to promote and attract short-term capital
flows, including Mexico's issuance of dollar-indexed domestic government debt or
Thailand's active encouragement of offshore foreign borrowing, represented a
partially risky or imbalanced form of integration. This was often backed by explicit or
implicit government guarantees, which led to moral hazard.

However, the correct assessment of these experiences is that they underline even
more firmly the importance of pacing the liberalisation of domestic capital markets to
the development of adequate regulatory and supervisory capacities and a strong
domestic financial infrastructure. It would be a tragedy if the lesson learnt from
recent rounds of crises was that the flow of capital from rich to poor countries be
discouraged rather than encouraged (Summers, 1999:12-13).

The challenge for policy-making in the financial area is to find solutions that can
navigate between these impractical extremes to build a strong global financial
market. Strong national policies are by far the most important element in resolving
any crisis (Summers, 1999:14). Most countries now accept that external,
conditioned finance can make an important difference, by giving them financial
breathing space to implement reforms. The trick will be to have mechanisms in
place to provide for finance in sufficient quantities in a world of significantly
increased volumes of global capital. This has to be achieved without weakening the
incentive of governments or investors to change their ways (Summers, 1999:15).

In view of the growing impact of global economic integration Alonso-Gamo, et al.
(1997:6), highlight some of the important features of globalisation. Firstly,
globalisation cannot be halted and cannot be ignored. The forces that drive
globalisation are linked to technological advances in transport and communications.
They have a life of their own and are largely independent of government. Therefore,
participating in globalisation may not be optional. In this new age of information
technology, it might prove very difficult for a country to isolate itself from the world

Secondly, globalisation implies that some of the old distinctions between
international and domestic policies are becoming increasingly irrelevant. With
greater reliance on private capital, countries strive to retain the confidence of international financial markets and attract FDI. Sound domestic policies are therefore all the more important (Alonso-Gamo, et al., 1997:6).

Thirdly, globalisation is not always painless. Continuing international economic integration and trade liberalisation can have social and economic costs in the short run. This is mainly due to the displacement of workers as protected sectors open up to competition. There is a transition period before other sectors expand, even if in the long run efficiency gains stimulate activity and create jobs, which more than compensate for the losses. However, there may be winners and losers in most cases over the short term. Globalisation exposes the social fissures between those with the education, skills and mobility to flourish in an unfettered world market. In this case the government faces the task of managing the transition and dealing with the distributional consequences of change (Alonso-Gamo, et al., 1997:6).

Finally, the benefits of globalisation have yet to reach all participants. The current external environment offers greater opportunities for integration. Increased participation in the world economy yields important benefits. It improves resource allocation. It also enhances efficiency by increasing competition among firms and induces learning and technology. As a result, a nation's wealth is increased. With open trade and liberal financial markets, poorer countries should be able to benefit from technology spillovers via imported capital goods. In view of the very wide technology gaps that exist, the potential for technological catch-up is significant (Alonso-Gamo, et al., 1997:6).

4.7 The role of emerging markets in the global financial integration process

For many years international investors thought the East Asian newly industrialising countries (NICS), including Hong Kong, South Korea, Singapore and Taiwan, could do nothing wrong until early 1997. The experience of sustained economic growth in these countries, which later was followed by rapid growth in South East Asia, became the model of growth which other developing countries were expected to learn from. The success of these countries became what was termed the “Asian
miracle" and they were referred to as the Asian Tigers. As Lucas (1993:251) argues, the process of economic growth needs models that are able to replicate the East Asian miracle. This miracle consists of the fact that a few export-oriented small economies in East Asia have been growing at rates that were extremely high by historical standards, for more than three decades. These countries' outstanding growth performance has been accompanied by a spectacular increase in their volume of manufacturing exports (Lucas, 1993:251-272). Young (1995:641) also shows that these miracles can be explained, in the traditional growth-accounting sense, as the sole result of factor accumulation and not of factor productivity growth. Even if their savings rates were high, standard growth predicts that the growth rates of these countries should have returned to average. The question is how these countries have been able to defy the law of diminishing returns for such a long period. In a world of trading economies, this type of growth miracle is possible. The secret is to open the economy and be patient. The reward is a continuous process of capital accumulation and structural transformation and until the bubble bursts (Young, 1995:641-80).

By the end of 1997, beginning of 1998, everyone was writing about the end of the "Asian miracle". Its swiftness confounded the experts and the end of the Asian economic miracle was ranked second only to the unravelling of Soviet socialism. It is seen as the greatest surprise of the last half century (Bello, 1998:1), while Metzger (2001:191) refers to it as the economic event of the closing 20th century. The Asian tigers were queuing up for multibillion-dollar bailouts from the IMF, the same financial institutions that had celebrated them as the engines of world growth, and perceived them as having stable governments, market friendly policies and offered them as models of growth (Hirst and Thompson, 1999:135). By then (1998), these countries were seen as a source of financial contagion and the trigger of global deflation. Asian countries soon lost flavour with international investors and questions started arising as to how this could happen? Solimano (1999:6) argues that one of the problems with globalisation is the fact that in a more interdependent and interlinked world economy any adverse global or regional shock is rapidly propagated to other economies.
Highly integrated financial markets tend to transmit global, regional or local shocks much more rapidly than in the past decades when financial markets were less integrated (Solimano, 1999:6). The shifts in portfolio flows often affect exchange rates, interest rates and economic activity. For example, these shocks can have destabilising effects on many economies because of the large volumes of these transactions in currencies.

Higgot and Phillips (1999:10) provide answers to some of the questions above. They stress that these answers "are as psychological and political as they are economic". They point out that individual investor rationality resulted in collective irrationality. The contagion was not new, but the difference compared with shocks during the era of the gold standard between 1870 and 1914, is that modern technology accelerates transmission speed for capital transfers. As a consequence, increases in the potential for panic and herd-like destabilisation in the market place is much greater nowadays (Higgot and Phillips, 1999:11). For years, the lessons of Asian growth were widely perceived to be stable government, market-friendly policies as well as external and internal financial market liberalisation that attracted foreign investment. It is therefore still useful to understand the crisis in relation to the different patterns of economic development in these Asian economies. The remarkable economic progress and experience of the East Asian economies was instrumental in changing established views regarding trade policy and economic development. This was particularly the case in altering the consensus view from favouring "import-substitution" to favouring "outward looking" trade policies.

A key ingredient of the East Asian economies' successful development strategy was their export orientation. Although these economies went through an initial import-substitution phase, they subsequently promoted exports. Their exports and imports grew even faster than their output and the newly industrialised Asian economies' shares of world trade exceeded their shares of world output (IMF, 1998:96).

Exports have been regarded as vital to the East Asian growth strategy for several reasons. Firstly, exports provided the demand needed to sustain the growth process. Secondly, producing for export markets encouraged efficiency, because
domestic firms had to compete internationally. Furthermore, as part of their export-promotion strategies, East Asian governments encouraged the import of technology by fostering licensing for knowledge-intensive or technology-intensive products. This was achieved by promoting inward foreign direct investment geared mainly towards the export industry. Thirdly, export promotion reinforced both the need for, and the ability to maintain macroeconomic stability (IMF, 1998:97).

Maintaining fiscal and monetary stability was important to prevent real currency appreciation and exchange rate instability (IMF, 1998:97). These countries also provided incentives for foreign investment directed towards exports. The export drive was also abetted by the availability of external markets, particularly in Japan and the United States, but also increasingly within the Asian region.

Expanding intra-regional trade also played a critical role. A large part of this trade consisted of trade in intermediate goods allowing these to generate economies of scale. The increased regional trade integration has undoubtedly been a positive element in the region's economic development, but it has also tended to exacerbate the regional spillovers of the recent financial crises (IMF, 1998:98-99).

Even more central to the success of these countries was an emphasis on stability-orientated macroeconomic policies and high rates of physical and human capital accumulation. Empirical studies regarding the growth effect emanating from international trade have been ambiguous (Strydom, 1995:552). It appears that the benefits from trade were not evident across the board and in certain countries the growth aspects were absent. The successes of outward orientated policies appear to be dependent on certain conditions of supportive actions.

The relationship between economic growth and international trade is therefore not a clear-cut one. Certain conditions need to be met first as this was later realised. Over the last two decades, the financial markets of leading industrial countries have melded into a global financial system, permitting ever-larger amounts of capital to be allocated not only to their economies, but also to developing and transition economies (World Bank, 2000:70). The world in the 1990s was literally awash with
large amounts of money speculatively seeking high, short-term returns in the markets of small to medium sized countries. The domestic financial markets have proved incapable of coping with the shocks that can be delivered by the volatility in international financial markets (Higgit and Phillips, 1999:11).

The amount of net foreign direct investment in developing countries has increased more than twelvefold since 1980 (World Bank, 2000:70). In contrast, net portfolio investment flows have been far more volatile throughout the 1990s exceeding $100 billion in 1993 and 1994 and falling considerably since then especially at the height of the Asian crisis (World Bank, 2000:70). Between 1990 and 1996, the developing countries' share of total world FDI increased from 14.9 percent to 37.8 percent and now stands at 27.6 percent for 2001. Of the total FDI directed to developing countries, 49.8 percent was directed to Asia, 41.7 percent to Latin America and the Caribbean and Africa only received about 8.4 percent (UNCTAD database, 2002). Between 1994 and 1996 net private inflows into Indonesia, Korea, Malaysia, Thailand and the Philippines grew from US$48 billion to US$93 billion. The figure for 1997 was minus US$12 billion. Financial instruments with very similar risks pay similar returns no matter where they are issued, providing further evidence of the integration of capital markets.

Mutual funds, hedge funds, pension funds, insurance companies and other investment managers now compete with banks for national savings. Although this phenomenon has been confined primarily to industrial economies thus far, the consequences for developing countries could be far-reaching. Institutional investors have taken advantage of the easing of restrictions in many industrial countries to diversify their portfolios internationally. This enlarges the pool of financial capital potentially available to developing and transition economies. In 1995 these investors controlled $20 trillion of these funds, 20 percent of which were invested abroad. This figure represents a tenfold increase in the funds and a fortyfold increase in such investments since 1980 when the figure was $2 trillion (World Bank, 2000:71).
4.8 Liberalisation of capital flows in developing countries

The liberalisation of capital account transactions and the trend toward more flexible exchange rate regimes have taken centre stage during the 1990s. This entails changes in policies toward different types of private capital flows such as FDI, foreign bond and equity investment, and short-term borrowing from abroad. The speed and depth of capital account liberalisation have varied across countries, with some opting for the big-bang approach, while others have chosen a gradual approach (World Bank, 2000:71-72). Other policies that have made many developing countries a more attractive destination for foreign investment include macroeconomic stabilisation and structural reforms, privatisation policies, relaxed rules on FDI, and lower interest rates in industrial countries (World Bank, 2000:72).

Some lessons could have been drawn from the experiences of Australia and New Zealand when they deregulated their financial sectors including the dismantling of capital controls in the 1980s. Dieter (1998:6) points out that in a nutshell, both the Australian and New Zealand governments sought to improve the efficiency of their sectors by deregulating them and by allowing foreign competition. Capital could flow freely in and out of the countries. The consequences were disastrous. Initially money flowing into the Australian economy put upward pressure on the Australian dollar. In that situation, many private investors permitted to do so in the deregulated environment borrowed money abroad. Some Australian farmers, ill advised by their local bank managers, borrowed in foreign currency without knowing the risks. When the Australian dollar plunged, the crisis spread into the real economy. Both Australia's and New Zealand's foreign debt rose considerably after deregulation. In Australia, gross debt rose from A$35,7 billion in 1983 to A$191,3 billion in 1992, while in New Zealand the foreign debt rose from NZ$17,4 billion in 1984 to NZ$62,1 billion in 1992 (Dieter, 1998:6).
4.9 The rationale for foreign capital in developing countries

Domestic savings are the only source of capital in a closed economy. However, as globalisation of investment develops, domestic investment can be financed by foreign capital. Foreign capital becomes even more important, when a country's savings rate is low. Many developing countries liberalise their capital flows with the objective that foreign capital will contribute to the long-term drive for economic growth (Yang, 2000:153). Foreign capital flows are considered beneficial to the extent that they help lower the cost of capital and boost capital formation and growth in the recipient economy. The recipient country receives either foreign direct investment or financial flows such as short-term and long-term debt securities and equities or both forms of investment.

Unfortunately, the supply of financial capital to developing countries is anything but steady (Yang, 2000:153-155). This is substantiated by Armijo (1999:302) who states that portfolio capital flows are "extremely volatile and unforgiving". Internal and/or external adverse events can cause financial capital flows to suddenly stop or even reverse, thus derailing investment projects. The financial innovation of floating rate debt makes debt servicing even more difficult. Yang (2000:155) asserts that the inherent disruptive nature of financial capital inflows is not coherent with the developing countries' desire for long-term growth. According to Yang (2000:157-158), financial capital inflows are characterised by the following:

> Excess liquidity in the international markets, with international investors setting the timing, the amount, and the price at which the developing countries can extract financing externally. Therefore, there is no guarantee that there will be a constant flow of capital to finance long-term economic growth.

> Secondly, financial capital flows are subject to sudden reversal. Due to the fact that they are liquid in nature, they can easily be withdrawn once there are changes in expectations, whether economic, political or social. This can
accelerate the problems of the recipient country, with major adverse consequences (Yang, 2000:157).

➢ Thirdly, financial capital inflows can become the source of speculative attacks on the domestic currency. In case of managed or fixed exchange rates this entails a sudden and significant restructuring of portfolios in which market participants attempt to reap gains or avoid losses from an expected change in the exchange rate regime. A speculative attack is considered as a market’s rational response to a perceived inconsistency in economic policies.

➢ Finally, financial capital flows are influenced by interest rates in industrial countries. Interest rates in industrial countries, particularly in the US have significantly affected the capital inflows and outflows in the emerging markets. When interest rates are low in industrial economies, investors are more than willing to move their funds to developing countries in the hope of earning higher returns (Yang, 2000:158).

The capital flow related financial crises have so far been more severe in developing countries than in industrial countries. This has been due to the relatively undeveloped domestic financial markets and relatively small sizes of their economies. These crises have had long-lasting damages on developing countries, such as the painful economic adjustments. These adjustments sometimes take a painful toll on the income and standard of living of the affected countries. Other damages include, high borrowing costs, as international financial markets demand high premiums for new lending in these countries as well as slow economic growth (Yang, 2000:158-160).

4.10 Lessons from the East Asian and Mexican experiences

The East Asian crisis started when the Thailand authorities suspended the Thai currency peg (‘baht’) to the US dollar in July 1997. According to Metzger (2001:191) the events that followed hold similar relevance for developing theory and policy to that of the Latin America debt crisis, which kept economists busy during the 1980s.
Even though there were apparent differences in the appearance and the way these two crises occurred, their development strategies have been characterised by a build-up of foreign debt. This created depreciation expectations and culminated in a balance of payments crisis. The following sections highlight the problems that these countries encountered and the actions taken to resolve some of the problems. The discussion below also reflects on lessons for the developing countries as a whole, of which South Africa is part.

4.10.1 The experiences gained from the Asian crisis

Many arguments have been put forward, which offered to explain the Asian crisis. One was that the crisis was not primarily the product of the behaviour of foreign investors, but the result of fundamental flaws in the policies and the institutions of the recipient countries. Some argued that Asia experienced a crisis because most of its countries did not liberalise their financial sectors enough and in essence this argument does not blame liberalisation of financial markets, but the failure to go far enough (Hirst and Thompson, 1999:137-138).

The second explanation to the Asian crisis was that it was due to the sudden withdrawal of short-term funds by Western investors and large-scale short selling on foreign exchange and equity markets by speculators. This shows the inherent destructiveness of the new globalised economy (Hirst and Thompson, 1999:138). In Southeast Asia, where most countries' GNP grew by between 6 and 10 percent from 1985 to 1995, the crisis stemmed from a development process sustained not principally by domestic savings and investment, but by large infusions of foreign capital. In the late 1980s the region's growth was heavily dependent on Japanese direct investment. When this began to taper off in the early nineties, alternative sources of capital had to be tapped, particularly international banks looking for higher yields on their loans and mutual funds, and other speculative institutions searching for more profitable investments than were available elsewhere.

Dornbusch (2001:5) summarises the crisis as follows, "the background of the Asian crisis includes the large build-up of capital inflows in the first half of the 1990s, not
FDI but bank loans and portfolio capital. The crisis involved the sudden drying up and reversal of these flows in 1997 and the resulting macroeconomic pressures of currency depreciation, high interest rates, output decline and financial stress“.

In Thailand, which was seen as the precipitating country in the crisis, the growth of foreign borrowing and the failure of effective control followed rapidly on the twin liberalisations of the domestic financial system and the external controls on the capital and the current account. These liberalisations began in 1990, when Thailand’s technocrats pioneered a three-pronged strategy for attracting foreign capital (Bello, 1998:1). This included liberalisation of the financial sector and maintenance of high domestic interest rates to attract portfolio investment and bank capital. It also included the pegging of the currency to the dollar to reassure foreign investors against currency risk.

Financial intermediaries took full advantage of the relaxation in policy. They borrowed in foreign currencies at lower foreign rates of interest (Hirst and Thompson, 1999:143). The financial liberalisation of financial markets by Thailand was soon copied by other countries in the region, with the blessing of the IMF and the World Bank. This was hailed as the step in the right direction as Thailand had earlier moved to eliminate barriers between the domestic and global financial markets.

Foreign capital flowed in, reaching peak levels, but much of it was short-term and made up of portfolio investment and equity flows. These flows were not boosting the real domestic output or upgrading the manufacturing industry. Thailand’s ratio of short-term debt to foreign exchange reserves was 121 percent, with $45.6 billion of short-term debt outstanding and reserves of $37.7 billion in June 1997 (Hirst and Thompson, 1999:144). These reserves were too small to cope with the potential demand. It became clear that the Thailand economy was headed for trouble, as manufacturers and exports needed a cut in the value of the baht as export performance was deteriorating (Hirst and Thompson, 1999:144, Bello, 1998:1)
The devaluation of the currency was to become a too expensive exercise, as this would mean a significant increase in the debt burden. Consequently the authorities held on to the pegged rate. The foreign capital that has been pumped into Thailand found its way into the high-yield sectors such as the stock market, consumer financing and in particular, real estate (Bello, 1998:1). This spelt trouble as commercial banks and finance houses became overexposed in respect of real estate. Foreign portfolio investors and banks that had made loans to Thailand entities soon discovered that their customers were carrying a load of non-performing loans. The rest of the pieces started to fall quickly with the current account deficit reaching 8.2 percent of GDP in 1996 (Bello, 1998:1).

This struck fear in the hearts of investors as they recognised that the figure was about equal to that of Mexico when it suffered its financial meltdown in 1994. By early 1997 many investors concluded that it was time to get out and to do so fast. With over US$20 billion in baht parked in Thai stocks, paper or non-resident bank accounts the stampede was potentially disastrous, for it meant unloading trillions of baht for dollars. With too many baht chasing too few dollars, there was significant pressure for devaluation. The ensuing panic attracted currency speculators. The Bank of Thailand initially sought to defend the baht by dumping its dollar reserves on the market, but by July 2, after losing at least US$9 billion of its US$39 billion in reserves, it decided to give up (Bello, 1998:2).

Speculators spotted similar skittish behaviour among foreign investors in Manila, Kuala Lumpur and Jakarta where the same conjunction of commercial bank overexposure in real estate, weak export growth and a widening current account deficit was stoking fears of a currency devaluation that could devastate their investment. As in Thailand, speculators made profits from the exit of foreign investors (Bello, 1998:2).

By late October 1997, the Philippine peso, the Malaysian ringgit and the Indonesian rupiah were still on a downspin as capital continued to exit. This resulted in a combination of highly rising import bills and spiralling costs of servicing the foreign debt of the private sector. Higher interest rates caused a decline in economic
activity and a chain reaction of bankruptcies. The Southeast Asian miracle had come to a screeching stop (Bello, 1998:2).

The economic situation deteriorated in South Korea during 1998. The heavily indebted South Korean conglomerates, referred to as 'chaebols', found it hard to get trade credit (Hirst and Thompson, 1999:145). Unlike Southeast Asia, Korea built its strength principally on domestic savings, generated partly through equity-enhancing policies such as land reform in the 1950s. Government intervention meant that local financial resources were extracted through a rigorous system of taxation plus profits derived from the sale of goods to a protected domestic market and to foreign markets. This form of strategy constituted the main source of capital accumulation, with the private sector flourishing under a regime in which the state had the commanding role (Bello, 1998:2).

By picking winners, providing subsidised credit and protecting them from transnational competition in the domestic market, the state nurtured companies that it later pushed out into the international market. In the early 1980s, the state-controlled conglomerates appeared unstoppable, as the commercial banks, extremely responsive to government wishes, provided the funds for Hyundai, Samsung and other conglomerates to carve out international markets. By the early nineties, however, the tide had turned. Failure to invest significantly in research and development translated into continued dependence on Japan for basic machinery, manufacturing inputs and technology, worsening Korea's trade deficit with that country. The balance of trade with the United States also reversed from a US$6 billion surplus in 1988 to a US$11 billion deficit by 1996 (Bello, 1998:2). To maintain the shrinking profits, businesses lobbied for legislation in late 1996 to expand its rights to lay off excess labour and make the surviving work force more productive, based on the American model. This was essentially a return to the formula of the early years of the miracle, when the primitive accumulation of capital was derived from harsh exploitation of unskilled labour. When fierce street opposition arose in response to this move, many conglomerates had no choice but to rely on the government and the banks to keep money-losing operations alive. That lifeline could not be maintained without the banks themselves facing liquidity problems. By
October 1997 non-performing loans were estimated at more than US$50 billion. Foreign banks, which already had about US$200 billion worth of investments and loans in Korea, became reluctant to release new funds. By late November 1997, Seoul, saddled with having to repay some US$72 billion out of a total foreign debt of US$110 billion in one year, joined the IMF queue for financial aid (Bello, 1998:2).

Hirst and Thompson (1999:148) point out that corruption was the product of ill-conceived liberalisation, a deviation from the model of a developmental state and not a direct consequence of it.

4.10.2 The Mexican crisis

Both domestic and external factors contributed to the crisis in 1994, with the first major factor being the country's low savings rate. The relatively large gap between the savings and investment rate forced the Mexican economy to be heavily dependent on external savings. The Mexican government allowed credit to expand sharply through the state-owned development banks on the eve of the 1994 presidential elections (Molano, 1999:301-302). As a result, the current account deficit rose quickly, reaching 8 percent of GDP. This was followed by other political factors such as the assassination of the presidential candidate and the attorney general. However, another important factor was the government's decision to cede monetary policy by pegging the exchange rate (Molano, 1999:301-302).

External factors were also very important, and these included the sudden rise in interest rates in the US as well as the economic woes in Japan, which led to the repatriation of capital, and a decline in global liquidity (Molano, 1999:302). Instead of trying to adjust to the situation, the Mexican central bank dollarised the debt through the issuance of tesobonos or short-term dollar-indexed debt. This was a high-risk bet since the public sector assumed all devaluation risk. A series of subsequent policy mistakes and the intolerance of increased risk led to the final depletion of international reserves. The Mexican central bank was finally forced to devalue the peso, pushing the economy into a recession (Molano, 1999:301-302). The events of late December 1994, revealed a lack of cohesion and policy
coordination. The central bank decided to devalue the peso by 15 percent in December 1994. The devaluation process undermined investor confidence and there was a further run on the currency. The central bank was then forced to float the peso less than a week after devaluing it, as it was unable to sustain the exchange rate. Eventually, the peso depreciated by 122 percent, the Mexican economy was devastated and GDP fell by 11 percent. Monthly inflation increased to 8 percent and the unemployment rate almost tripled (Molano, 1999:301-305).

The Mexican and Thailand crises show the hazards of rapid financial regulation and the perils of fixed exchange rates. They also show the contagion effects of currency crises. In 1995, the Mexican crisis spread to Argentina and Brazil. The Argentinean GDP growth declined sharply from 3.13 percent in the first quarter of 1995 to minus 7.7 percent in the third quarter, while the Brazilian GDP growth decreased from 10 percent to 1 percent during the same time period (Molano, 1999:306).

However, foreign real investment in productive capacities contributes directly to economic growth and should be encouraged (Yang, 1999:168-169). The following lessons could be learnt from these crises. Rapid integration into global financial markets carries risks of financial crisis and disruption. Capital mobility reduces the policy autonomy of countries. Domestic economies become more exposed to market's sentiment. Reliance on short-term capital flows can be very detrimental to the well being of a country, as investors can easily sell their assets in securities markets. Sudden withdrawals of foreign investment can cause major disruptions to domestic financial systems leading into significant changes in liquidity. Financial crisis can easily and rapidly be transmitted from one emerging market to another.

4.11 Conclusions

In a world of highly integrated capital markets, international transmission can as easily be good for a country as bad. This happens when adverse domestic developments are in part passed off to the rest of the world. Still, the majority view remains that countries are overall better off with modern globalised financial markets than without them. The Asian crisis exposed the view that opening up the economy
to global finance brings not only benefits but also large costs, especially to developing countries. But as Ouattaro (1999) pointed out this does not undo the achievements that these countries have experienced. Developing countries can still choose between all the models of development that have been implemented in the rest of the world, including those in Asia, with all their strengths and weaknesses.

Financial globalisation as a world trend may bring new opportunities for developing countries, but also challenges. Financial capital inflows as part of financial globalisation may not necessarily serve the purpose of long-term economic growth in developing countries. They can be very disrupting due to the relatively undeveloped nature of financial markets in the developing countries and the erratic movements in the international financial market.

The experiences of various countries suggest that financial globalisation can be a mixed blessing. Tapping into world capital markets can help individual countries smooth their consumption and finance productive investment. Foreign investment, particularly foreign direct investment can facilitate the transfer of technological and managerial know-how. Portfolio investment, on the other hand, can also contribute to the deepening of the domestic financial markets. It has been touted in many circles, that reversal of capital flows, is usually a reflection of mismanagement of economic policies. It is for this reason that some believe that capital flows can promote more disciplined macroeconomic policies, as they will increase rewards for good policies and also increase penalties for bad policies. The experiences of Asian countries also show that the ability to borrow from abroad helped many emerging countries to accelerate the speed at which their productivity and living standards converge to that of the industrialised countries. This has been the case in many developing economies, especially in Asia, as they enjoyed high economic growth rates over the years.

At the same time, financial globalisation entails various risks. The crises in Mexico and Thailand underscore the dangers facing developing countries. These countries were once paradigms of development and economic reforms, yet they both showed the weakness of their economic and political systems. The two crises had many
similarities but also key differences. Both countries shared a lack of independent institutions, fragile political systems, high levels of corruption and a lack of transparency amongst others. The major difference though, was the fact that the Mexican crisis was mainly driven by the public sector, while the private sector drove the Thai crisis. South Africa has at least followed a proper process or sequence of liberalising its economy. While it may avoid some of the mistakes that these countries made, open capital markets will continue to punish any perceived macroeconomic mistakes. The important lesson is that governments should have and exercise more prudent macroeconomic policies, to avoid having many years of progress being wiped out.

The debate on the merits of financial globalisation intensified in the aftermath of the emerging market crises. The realisation that even countries with high growth rates and sound macroeconomic policies could be severely affected by a rapid reversal of capital flows spurred this debate.

Countries, therefore, need to tread carefully when allowing foreign investment in their countries, especially short-term capital flows. They need to encourage more long-term foreign investment.
CHAPTER FIVE
FINANCIAL GLOBALISATION IN SOUTH AFRICA

5.1 Introduction

The aim of this chapter is to provide a broad overview of the South African economy by analysing the structural economic reforms that have taken place over the years as the necessary steps to become part of an integrated world economy. The first section gives a background of the South African economy prior to 1994 followed by a section on the developments that occurred after 1994. There are two main reasons for this. Firstly, it emphasises the role that globalisation has played in changing the landscape of the South African economy. The second reason is to highlight the impact, in terms of benefits and risks, of financial globalisation on the country. These are examined in the third section.

5.2 Background on financial globalisation in South Africa before 1994

The pre-1994 period was characterised by economic slowdown, lack of fiscal discipline, debt standstill arrangements and problematic monetary policy. According to Calitz (2002:248) this period was also characterised by socio-political problems for many decades. These were in the form of apartheid legislation and government regulations, which limited or prohibited the active and unrestrained participation of the entire population in the market economy. These policies also constrained the development of human skills to participate competitively. For many years South Africa favoured import-substitution and inward looking development policies. This was in line with the policies followed by many developing countries or Third World countries during the 1960s and 1970s. However, the application of trade sanctions against the country in the mid 1980s lent considerable impetus to those tendencies. Import surcharges ranged between 10 percent and 60 percent, and were directed especially at the importation of luxury goods (IMF, 1992:33). During the 1980s, a variety of incentives were introduced to promote exports including the General Export Incentive Scheme (GEIS), which provided direct subsidies on the domestic
component of exports according to the degree of manufacture of the exports (Strydom, 1995:557). The government's high investment during the 1970s resulted in an unusually well developed infrastructure, but this infrastructure served only a certain portion of the population. South Africa also had extremely modern financial markets. Its business sector, consisting of mining, agriculture, forestry, citrus, wines, refining, manufacturing of metals, and electrical engineering, was high cost, labour intensive, and highly concentrated after years of protectionism.

This period was characterised by periods of both capital inflows and outflows. Before 1984, the country experienced periods of inflows, although these were disrupted by key political shocks during this time, notably the 1960 Sharpeville massacre and the 1976 Soweto riots (CREFSA, 1998:4). At the beginning of the 1980s, access to international debt capital recovered, accelerating significantly between 1982 and 1984. During this period, short-term debt accumulated as a result of the demand for external borrowing to finance current account deficits and the weak foreign reserves position. Potential liquidity problems combined with the underlying structural problems and a set of unfavourable socio-political circumstances resulted in the debt crisis of 1985 (CREFSA, 1998:4,6).

South Africa's access to long-term foreign borrowing was effectively cut off when it imposed the debt standstill and re-introduced the two-tier exchange rate mechanism in September 1985. The debt standstill resulted in a prolonged period of capital outflows (CREFSA, 1998:6). Total net flows remained mostly negative until early 1992. However, the disinvestment in the equity market was partly offset by net purchases of bonds, by foreign investors. The onset of a recession, political uncertainty, a falling gold price and high yields on debt securities offered to foreign investors through the combined effect of high interest rates and the yield premium created by financial rand, were the factors underlying the switch from equity to bonds (CREFSA, 1996:12).

The major political reforms that took place in the early 1990s, including the lifting of the ban on 'political liberalisation movements' and the release of the 'political prisoners' contributed to some recovery in capital inflows during this period,
especially in the equity market. The bottoming of a recession and improved progress in political negotiations also contributed. However, the associated uncertainty led to significant capital outflows in 1993 and early 1994 (CREFSA, 1998:6).

5.3 Economic developments related to financial globalisation after 1994

South Africa's re-entry into the international arena, after years of international economic isolation, has accelerated the integration of its economy into the global economy. The need for structural economic reform across the world had become evident from the early 1970s. This was a result of "the growing realisation that Keynesian-style macroeconomic stabilisation policies were inadequate to ensure sustainable economic and employment growth (Van Bergerijk et al. 1999 quoted by Calitz, 2000:218). An early lifting of international trade sanctions resulted in a review of the protectionist policy with a view to moving toward a more open regime. As a result South Africa shifted away from inward looking policies and became committed to an outward-looking approach. This led to the opening of its borders and becoming an active member of various international organisations and institutions including the World Trade Organisation (WTO). South Africa embarked on a substantial revision of its tariffs, in line with the conditions of the WTO, protectionist measures and phasing out of its export subsidisation scheme (GEIS), which was implemented in the early 1980s in order to protect the domestic producers. Calitz (2002:569) emphasises that trade liberalisation implies greater exposure to foreign competition through trade and financial liberalisation, rather than shielding the economy against international competition through import substitution policies. This also entails a restructuring of the role of government in order to enhance and speed up the development of efficient markets, and to enable the orderly integration of domestic markets in the international arena. This also included the improvement of the quality and quantity of production factors.

In response to this outward-orientated approach and the establishment of a democratic process in South Africa, it received Trading Preferences from several countries. In 1995, South Africa started free trade talks with the European Union
(EU) via the Lome Convention. After five years of negotiations, South Africa secured a deal with the EU (FBC Fidelity Investment Bank, 2000:15-16). Europe is South Africa's most important trading partner, accounting for about 45 percent of all trade. More certainty of an open market would give South Africa an added advantage in attracting investments and once implemented, the free trade agreement should liberalise more than 90 percent of the annual US$20 billion bilateral business between the EU and South Africa (FBC Fidelity Investment Bank, 2000:15-16).

The post-1994 period has also been characterised by monetary and fiscal policy discipline, which generated macroeconomic stability, debt repayment and the termination of the dual exchange rate system (Strydom, 1995: 558). This effectively abolished many foreign exchange controls and led to an increase in the level of economic growth albeit at a lower rate.

The international sanctions imposed on South Africa prior to 1994 meant that South Africa became the latecomer in the globalisation process (Calitz, 2000:573). South Africa had to choose between fully integrating itself into the great global village that the world has become or risk being left marginalised. Calitz (2000:573) explains this as follows "as with the arrival of spring, it is hard to date the start of South Africa's economic globalisation. What we do know for sure is that it followed the South African winter of discontent with the country's deteriorating economic and political performance after the early 1980s".

Calitz (2000:573) further mentions a number of prominent features in the globalisation process, such as the signing of an agreement with the WTO and what the agreement entails. One of the features mentioned was the announcement made by the government in March 1994, of gradual phasing out of foreign exchange controls. This process of external financial liberalisation is still under way, but has already removed most exchange controls on foreigners Calitz (2000:573). This was preceded and subsequently complemented by domestic financial liberalisation, which involved enhanced market entry. This gave permission to foreign banks to open branches in South Africa and allowed the development of new markets, such as the market for financial derivatives. The introduction and development of other
financial markets, such as commercial paper, equity options and futures contracts and the replacement in March 1998 of the Bank rate with a more market-related repo rate followed. The monetary policy discipline that has characterised the post-1994 period has been further enhanced by the official adoption of inflation targeting in 2000, with inflation targets set at between 3 and 6 percent for 2002 (RSA National Treasury, 2000:6).


The normalisation of international capital markets and the availability of foreign trade financing at relatively reasonable financing costs contributed to the large net inflow of capital during 1995 (Wesso, 2001: 60).

The Ministry of Finance has also committed government to a steady reduction in the budget deficit as a percentage of GDP from 9,1 percent in the 1993/94 fiscal year to a budgeted 1,6 percent in 2002/03. This figure has been revised downwards and was previously 2,1 percent in the 2002 Budget (RSA National Treasury, 2002:32 and 2000:20). These measures have generated some degree of macroeconomic stability, with inflation rates at the consumer level falling from the high of 15,3 percent in 1991 to only 5,3 percent in 2000 and 5,7 percent in 2001. Economic growth has rebounded with the economy growing by 3,4 percent in 2000 and slowing to 2,2 percent in 2001, after falling to 0,8 percent in 1998 due partly to the effects of the emerging markets' crises that affected the economies around the world (Statistics South Africa database, 2002).
South Africa, like other countries decided to follow a gradualist approach to its restructuring of the economy, which differed from the big bang approach adopted by some countries in the 1980s and early 1990s. South Africa has followed a sequential approach to financial reform that ensures stability, while capturing the benefits of integration into global financial markets. This policy sequence is outlined in chronological order by Calitz (2000:575) and includes:

- Macroeconomic measures of stabilisation, particularly in terms of expenditure restriction and exchange rate adjustment;
- reform of domestic commodity and labour markets, removing price and wage controls and phasing out subsidies;
- tax reforms including broadening the tax base and rationalising many taxes; Trade reforms such as the removal of quotas and reduction of tariffs plus further exchange rate adjustment were also introduced.
- domestic financial liberalisation such as the removal or raising of interest rate ceilings and loosening restrictions on commercial bank activity;
- external financial liberalisation and removing controls on capital inflows and outflows.

South Africa has managed to follow this sequence and is still working on some thorny issues related to labour and tax rationalisation.

5.3.1 The reasons for the financial reforms

More than ever before, people over the world are sharing the tangible gains from liberalisation. Yet there are growing doubts and anxieties among citizens about the consequences of the liberalisation process (OECD, 1998:1). The case for open markets rests on solid foundations. One of these is the fact that when individuals and companies engage in specialisation and exchange, a country will exploit its comparative advantage. It will devote its natural, human, industrial and financial resources to their highest and best uses. This will provide gains to firms and consumers alike. Free trade broadens the range and quality of products that consumers find in the shops (OECD, 1998:1).
Another factor is the strong preference of people all over the world for more, rather than less, freedom of choice. Open markets bring greater freedom of choice, specialisation and exchange. A more open domestic market is not a handicap, but a source of competitive strength. Exposure to international trade is a powerful stimulus to efficiency. Efficiency, in turn, contributes to economic growth and rising incomes (OECD, 1998:2). However, liberalisation is not the only important reason for transformation in many economies. Many other factors play a role, most notably technology-driven structural change. Nor is liberalisation an end in itself. It is a part, albeit an important one, of a whole set of policies aimed at bringing well-being to societies and citizens.

Protection is not the answer to globalisation as it inevitably translates into more protracted and more costly adjustment. What is needed are policies targeted at the root of the problem. However, more open economies enjoy higher rates of private investment, which is a major determinant of economic growth (OECD, 1998:1).

Trade liberalisation in South Africa has been blamed for the decline in employment, with many debates on the impact of trade liberalisation and labour inflexibility. A report by the International Labour Organisation (ILO, 1999) sheds some light on this debate. The report found that whilst there have been important job losses in import-competing sectors, these are less significant than those that can be attributed to a process of rationalisation and the 'rightsizing' of export orientated firms (ILO, 1999:3).

The report also confirms that a lack of investment may also lie at the heart of the employment problem, while increased investment was found to be closely associated with higher employment levels (ILO, 1999:3). At present investment represents only about 14.8 percent of GDP for 2001 in South Africa, a comparatively low level considering the levels in other middle income countries (SARB, 2002:S150). Countries that have been successful in creating employment typically invest more than one quarter of GDP.
Whilst globalisation may hold some opportunities for economic growth, it can also have very destabilising effects and requires adequate policy interventions (ILO, 1999:24). The ILO study refutes the idea that globalisation is eroding government's ability to set policy at a national level. Drawing on international experience, the study suggests that the extent to which South Africa is able to reap the potential benefits from integration into the global economy and alleviate the negative consequences depends on particular policy interventions such as disciplined domestic financial policies.

According to Jenkins and Thomas (1999:3-4) there is some consensus that initial socio-economic conditions are important if a country's economic performance is to be explained. Socio-economic conditions are generally reflected in indicators of initial per capita income, life expectancy and primary education. Poorer countries tend to grow faster if they are able to take advantage of the technological advances of richer countries. This process is often being referred to as convergence. However, health and education also appear to be critical to the process of growth, representing a long-term investment in human capital as well as contributing to the overall social well-being of a country (Jenkins and Thomas, 1999:4).

In addition to these factors, studies of worldwide growth have identified a variety of other explanatory factors, which are just as important (Jenkins and Thomas, 1999:4). These include openness to international trade, the type of investment undertaken and not just the volume, political stability, diversification away from primary exports, the presence or absence of market distortions, and global location. Institutions, especially the quality of administrative capacity of government and of the judiciary, are also important (Aron, 1998 quoted by Jenkins and Thomas, 1999:4). Furthermore, econometric studies exclusively focused on explaining growth performance in African economies found that the magnitude and persistence of external shocks and economic instability correlate negatively with growth (Jenkins and Thomas, 1999:4-5).

Almost all studies of growth in Africa have found that impediments to trade, whether these are natural barriers such as being land-locked, or deliberate policies, have
significantly reduced growth rates in an historical context (Jenkins and Thomas, 1999:4). These findings have, in many cases, led to great emphasis being placed on the need for trade liberalisation in order to improve African economic performance. However, trade liberalisation cannot be viewed in isolation. Given the range of influences on economic growth highlighted above, trade liberalisation has to be accompanied by wide-ranging complementary policies to encourage private sector investment, both domestic and foreign (Jenkins and Thomas, 1999:4).

Free trade is almost always better than protection. The argument for free trade is based on the theory of comparative advantage. According to Ricardo's theory (The Economist, 1998:4), both countries will be better off if each specialises in the industry where it has a comparative advantage, and if the two trade with one another. Specialisation increases world output. In essence, the theory of comparative advantage says that it pays countries to trade because they are different. Another argument for free trade is that opening up markets to foreign suppliers increases competition. Without free trade, domestic companies may have enjoyed monopolies or oligopolies that enabled them to keep prices well above marginal costs. Trade liberalisation will undermine that market power. Competition also has to spur domestic companies to greater efficiency, because they will not be able to pass on the costs of slackness in higher prices (The Economist, 1998:5).

In addition, free trade means that firms are no longer limited by the size of their home country. They become part and can sell into bigger markets. In industries where average production costs fall as output increases, producing economies of scale, means lower costs and prices. In such industries, trade also increases the variety of products on offer. Freer trade can mean faster economic growth (The Economist, 1998: 5-6).

Making markets bigger creates more scope for learning by doing, that is firms become more efficient with repetition. Larger markets also offer bigger incentives for firms to invest in research and development. Moreover, trade disseminates knowledge and technology. Simply by participating in international markets,
countries are exposed to other countries' techniques, and have an incentive to copy and improve on them (The Economist, 1998:6).

Pinning down the link between freer trade and growth is not easy. One problem is how to measure the openness of a country's trade policy. Trade barriers can take many different forms, but even so, there is good reason to believe that freer trade and faster growth generally go together (The Economist, 1998:6).

5.4 South Africa's integration into the global financial markets since 1994

After many years of international economic isolation, structural and economic reforms in South Africa gained prominence and momentum after the constitutional change in 1994. The political and social reforms were accompanied by equally important changes in international financial relations. The election of a new government in April 1994 was preceded by the termination of the Debt Standstill arrangement of 1985. This was done at the beginning of 1994. In terms of that decision, exchange rate controls on non-residents were partly lifted when restrictions on the repayment of certain blocked loan funds of foreign lenders were removed in terms of a final rescheduling agreement entered into with South Africa's foreign creditors (Stals, 1996b: 1). Following the political transition, international economic sanctions, trade boycotts, disinvestment campaigns and pressures for the withdrawal of foreign loans from South Africa were repealed. As a result South African banking institutions, importers and exporters gained access again to international financial markets. The South African authorities agreed on a gradual relaxation of exchange controls (Stals, 1997:1-2).

The monetary authorities also started replenishing the country's depleted official gold and foreign exchange reserves. South Africa negotiated for international sovereign credit ratings from Moody's, Standard and Poors and later Nippon Investor Service of Japan (Stals, 1996b: 1. The country's credit ratings were good enough to allow South Africa to enter the international capital markets for public issues. Following this, the government made three successful issues in the global dollar market, the Japanese Samurai market and the British sterling market. This also gave access to
a number of South African parastatals and private sector companies to raise funds from the international capital markets through either loan or equity issues. Foreigners became active investors on the Johannesburg Stock Exchange (Stals, 1996a:1). The JSE is now called the JSE Securities Exchange South Africa as from 2002.

The country's re-integration in the international financial markets also allowed for the emergence of a Eurorand market, where non-resident institutions raise funds through the issue of rand-denominated bonds sold to non-resident investors. These non-resident borrowers normally hedge their rand exposures by reinvesting the funds in South African bonds (Stals, 1996a:1).

South Africa also opened its doors to foreign banks, which operated through branch offices and/or subsidiaries while other foreign banks have representative offices. These foreign banks provide increased competition for South African banks, particularly in arranging and providing foreign finance for South African importers and exporters, and in raising foreign funds for South African borrowers (Stals, 1996a:1-2). The domestic banks also established branches and subsidiaries in the main financial centres of the world.

Another major event that took place was the abolition of the financial rand system in March 1995, thus removing the remaining exchange controls applicable to non-residents. The level of openness of the South African financial markets to foreign competition and participation is provided by the turnover in the South African foreign exchange market. This figure now amounts to around US$9.6 billion a day (SARB, 2002:S103). In response to some of the reforms designed to make the investment environment more attractive, there has been an increase in foreign direct investment as well. However, this remains considerably low. The government authorities, in line with the objectives of GEAR are also committed to privatisation of some state-owned entities. The proceeds from this are likely to boost FDI over time. Despite some of the painful adjustments, as Fedderke (2002:611) points out, "growth continues to elude the South African economy". South Africa's efforts at integration have not been worthless, as South Africa made some gains as discussed in the
following section that examines the benefits of integrating into international financial markets.

5.4.1 Direct consequences and benefits of capital flows

The process of financial globalisation has had important implications for the South African economy. The major advantage has been the increasing amounts of capital inflows, which have been used to supplement the scarce resources of finance needed for economic development. The savings of more developed countries are therefore channelled to South Africa to supplement domestic saving. Stals (1996b:1-2) lists the important benefits of capital inflows for the South African economy as follows:

5.4.1.1 Capital flows to South Africa since 1994

The fact that, after years of persistent net outflows of capital, South Africa could afford to let the domestic economy, in particular domestic expenditure, expand at a more rapid rate. This stands out for the period between 1994 and 1995, when imports from the rest of the world increased sharply as a result of the sharp rise in the demand for goods and services. Consequently, the current account of the balance of payments moved into a substantial deficit of R12,7 billion in 1995. This, however, created no problem as the inflows of capital provided the required foreign exchange to cover the deficit.

Figure 5.1 shows that after recording large outflows of capital for most of the early 1990s up to the middle of 1994, South African capital flows switched from a net outflow of R13,7 billion during 1993 to a net inflow of R2,6 billion in 1994. The peaceful transition to democracy marked a turning point for capital flows in mid-1994. Net inflow of capital during 1995 totalled R16,6 billion (Wesso, 2001:60). The normalisation of international capital markets and the availability of foreign trade financing at relatively reasonable financing costs contributed to the large net inflow of capital during 1995 (Wesso, 2001: 60). The improvement in non-resident investor confidence, following the inclusion of the now JSE Securities Exchange South Africa
in the International Finance Corporation’s emerging market index also contributed to the rise in net capital inflows, while the return of a significant number of foreign companies also helped as they made new investments in South Africa.

Figure 5.1 Total net capital flows¹

![Graph of total net capital flows from 1990 to 2002.]


¹ Total net capital flows as per the South African Reserve Bank represent the change in capital transfer and financial accounts, including unrecorded transactions.

Inflows of portfolio capital represented a sizeable portion of foreign financing during the period since 1994. As a result South Africa has had painful first-hand experience of the dangers related to over-reliance on foreign capital inflows (Weso, 2001:61). Foreign concerns about South Africa’s political prospects led to a large decline in the level of net capital flows from the second half of 1995 into 1996. The trend worsened during the last quarter of 1997 well into 1998 mainly as a result of the emerging market crisis. International capital flows to and from South Africa during 2000 were dominated by flows of portfolio capital, which are by their nature very volatile. During 2000 South Africa experienced bouts of capital inflows and outflows, but on the whole total net capital flows totalled R8.5 billion (SARB, 2001: 27).
An improvement in international investor's sentiment towards emerging markets and the relatively low prices of domestic financial assets following the depreciation in the external value of the rand during the fourth quarter of 2001 contributed to the renewed capital flows into South Africa during the first half of 2002. The second quarter recorded R21,5 billion of net capital flows, the largest surplus ever in a single quarter (SARB, 2002a:27). The major portion of this capital is attributable to portfolio investments, which are subject to sudden reversals. Portfolio investment was R14,1 billion during the second quarter of 2002 (SARB, 2002a:27).

According to study estimates done by Walters and Prinsloo (2002:69) the offshore primary listing by some resident subsidiaries (companies) has had a positive spin-off, contributing about 7½ percent to South Africans gross domestic product in 2000. These capital inflows were used to reduce the NOFP, which is perceived as the major source of vulnerability to external shocks in the South African economy.

5.4.1.2 Accumulation of foreign reserves

South Africa could again accumulate foreign reserves as the capital inflows exceeded the current account deficit.

Figure 5.2 Gross reserves and the forward position

Source: SARB, 2002a:S102, SARB, 2002b:2
Figure 5.2 shows that foreign reserves increased during 1997 to 2002 from US$2,7 billion to US$7,5 billion at the end of 2001. However, the rand crisis of 1998, discussed in section 5.4.1.3, stopped this rise during the period 1998-1999 where after foreign reserves increased again and remained over US$7 billion for the period 2000-2002. The South African Reserve Bank decided to intervene in the foreign currency markets following the sharp depreciation of the rand. Foreign exchange reserves were used to defend the rand, as a result the net open forward position (NOFP) defined as the extent of the Reserve Bank’s uncovered position in foreign exchange markets, rose sharply to US$23,2 billion at the height of the 1998 crisis (SARB, 2001:S102). However, the SARB has managed to reduce this exposure or NOFP. The Reserve Bank plans to eliminate this exposure by the end of this 2002/03 fiscal year. The net open forward position stood at only US$1,7 billion at the end of September 2002. Foreign exchange reserves have remained relatively stable at around US$7,5 billion (SARB, 2002b:2).

5.4.1.3 Fluctuations in the value of the rand from 1990 to 2002

Thirdly, because of the capital inflows, the exchange rate of the rand remained relatively strong in 1995, following the 1994 elections. Figure 5.3 shows that the nominal trade-weighted rand has suffered serious bouts of decline as a result of the weakness of the rand against the major currencies in 1996, 1998 and 2001. The trend over the period 1990-2002 is downward with three crises where the rand depreciated at a faster rate. The average weighted value of the rand against the basket of the more important foreign currencies declined by only 3,6 percent in 1995 in nominal terms. This was less than the difference between inflation in South Africa and the average rate of inflation in the other countries (Stals, 1996b:2). However, owing largely to unfounded rumours about the health of former President Nelson Mandela during the beginning of 1996, the exchange rates of the rand decreased sharply against all the major currencies. The external value of the rand, however stabilised in May of that year regaining some of its losses of February and April 1996 (SARB, 1996:13). The rand came under severe downward pressure during 1998 amid general nervousness about financial stability in emerging markets and concerns about the future stability of the rand. The average weighted value of the
rand against the four major currencies declined by 24.6 percent from the end of 1997 to the end of August 1998 (SARB: 1998:18-19).

**Figure 5.3** Nominal trade weighted rand value for the period 1990 to 2002

![Graph showing nominal trade weighted rand value from 1990 to 2002 with indices for 1995 = 100, showing significant declines including the 1996 and 1998 rand crises and the 2001 rand crisis.]


**5.4.1.4 Access to foreign finance**

Fourthly, banking institutions in South Africa have had easier access to foreign sources of finance and could supplement their domestic liquidity by borrowing short-term funds from their foreign correspondents and from foreign financial markets (Stals, 1996b:2). This enabled the banks to increase their total lending to the South African private sector by R47 billion in 1995 compared with 1994. This amount stood at R662 billion for 2001 (SARB, 2002a:S22).
Figure 5.4 Money supply and private sector credit for the period 1990-2002

Figure 5.4 shows that the increase in total lending to the South African private sector contributed to an excessive increase in money supply. This made it difficult for the Reserve Bank to maintain overall financial stability as the rate of increase in bank credit fluctuated above the level of inflation (SARB, 1996:16). The strong demand for consumer durables and a switch from foreign to domestic financing of trade transactions in view of the unstable external value of the rand during 1996 pushed up private sector credit growth (SARB, 1996:17). These levels of growth were maintained during 1997 and 1998.

However, a sharp decline in the value of the rand, which led to interest rates rising sharply, subdued demand for credit during 1999 and beginning of 2000. The higher level of private sector economic activity and the faster pace of overall economic expansion were the main drivers of the acceleration in credit extension in the latter part of 2000. However, the decline in interest rates also contributed. Rising inflation and pre-emptive buying by consumers and businesses ahead of anticipated price increases, following the depreciation of the rand in late 2001, led to a sharp rise in
private credit growth during the early part of 2002 (SARB, 2002a:35-36). However, this has declined somewhat.

5.4.1.5 Relaxation of exchange controls due to capital flows

Lastly, capital inflows enabled South Africa to further relax exchange controls applicable to residents. In addition to abolishing most exchange controls on non-residents, applications from the South African corporate sector to acquire foreign direct investments were treated more leniently by the exchange control department of the Reserve Bank. Institutional investors were given permission to diversify their investment portfolios through asset swap transactions with foreign investors and the Reserve Bank substantially reduced its role in the forward foreign exchange (Stals, 1996b:2).

The asset swap mechanism was introduced in July 1995. It created another avenue for portfolio equity investment. The asset swap mechanism provides a means by which South African institutional investors can diversify their portfolios abroad through swaps with foreign investors without impacting on the level of foreign reserves (CREFSA, 1996:14). According to CREFSA (1996:14) the asset swap mechanism has advantages but also important difficulties. The most significant problem arises as a result of large trades not passing through the JSE thereby undermining the official asset price. As a result, a significant volume of portfolio investment has been diverted off the securities exchange including long-term foreign portfolio (CREFSA, 1996:14).

The gradual integration into the world financial markets has made it possible for South Africa to tap into global capital markets to supplement its low savings to finance economic development in the country (Stals, 1996b:2). However, there is a flip side to this, namely the indirect consequences of capital inflows. As mentioned earlier, portfolio flows can be extremely volatile and unforgiving.
5.4.2 Indirect consequences and costs of capital flows

The integration of the South African financial markets in the global village has had important implications for the monetary policy of the Reserve Bank and the economy at large (Stals, 1996a:2). The major disadvantage is that the South African financial situation can easily be influenced by changes in other countries that are of no direct relevance for South Africa. This was experienced at the end of 1994 when an international financial crisis struck Mexico and almost all the emerging economies were adversely affected by subsequent changes in capital market conditions (Stals, 1996b:2). The effects of the Asian crisis in 1997/98, the mini crisis in Brazil during 1999 and the continued association with other countries in the region, such as Zimbabwe have not left South Africa unscathed.

However, South Africa has also had its share of crises and experienced the effects of adverse changes in the attitude of foreign investors to a specific country in an environment of globally integrated financial markets. A change in perceptions of foreign investors on the creditworthiness of a country can easily lead to a major disruption of financial stability (Stals, 1996b:2). These include the 1996 rand crisis and the most recent, which occurred at the end of 2001. While some of these changes may be inspired by events that are completely external to the affected country, more often they are linked to internal political, social and/or economic developments within the country itself. This leads to the conclusion that a country that has become part of the global village, that adheres to the world-wide system of floating exchange rates, and that is open to large in- and outflows of foreign capital, has become subject to the disciplines, the whims and the preferences of the international financial markets (Stals, 1996b:3).

At the monetary policy level, the exchange rate of the rand has suffered the most, as it has become more "exposed to the whims of international investors and can easily be influenced by changed international perceptions of the South African political, social and economic situation" (Stals, 1996a:2). The substantial depreciation in the exchange rate of the rand during 1996, 1998 and 2001 was due to a number of adverse domestic and international factors. These included during 1996,
rumours about the health of Nelson Mandela who was the president of South Africa at the time. The rumour of the impending resignation of Chris Stals, the former governor of the Reserve Bank also rattled the financial markets, resulting in undue pressure on the domestic currency. The emerging market crisis of 1998 and the change of leadership at the Reserve Bank also reflected the magnitude that a change in foreign investor perceptions can have on a country. Many commentators have given reasons behind the depreciation of the rand during 2001. These reasons include the Zimbabwean land reform crisis as well as the rumours of the abolition of exchange controls, coupled with the indecisiveness on the part of the Reserve Bank and the Ministry of Finance to quell the rumours in time, which saw the rand losing about 40 percent of its value against the US dollar over a short period of time at the end of 2001.

5.4.2.1 The rand crises and its impact on the economy

This section analyses the reasons behind the rand's depreciation and the effect this has had on the economy. According to Nedcor (2002:1) in its "Guide to the Economy", the rand has had three periods of strong depreciation since the elections in 1994. The first occurred in 1996, the second in 1998, and the most recent crisis started in 2000 and intensified significantly late in 2001. The latter period rivals 1985 for being the worst currency crisis in South Africa's history. However in 1985, South Africa was politically isolated, capital flows had ceased and the country was forced into a debt standstill. The 2001 rand crisis occurred despite the fact that South Africa has followed liberal economic policies such as exemplary fiscal policies, responsible monetary policies, low foreign debt and a transparent, respected, stable political dispensation (Nedcor, 2002: 1-2).

Various reasons have been put forward for these disturbances, however most point to the vulnerabilities of being part of a bigger world. The reasons could be structural, sentimental and technical (Nedcor, 2002:2-3). However these disturbances have had serious implications for the South African economy, as interest rates and inflation increased sharply. During the height of the 1998 crisis interest rates increased sharply to 25.5 percent over a short period, crippling the economy with
dire consequences for both the consumers and business sector (SARB, 2001:S28). The recent depreciation of the rand has led to inflation doubling within months, reaching levels last seen in the late 1980s and early 1990s (Statistics South Africa database, 2002).

The question is whether becoming part of the integrated world is worth all the pain when it affects even the most vulnerable groups in a society. There is always trade-offs in an economic development. The benefits have to be weighed against the costs and decisions taken based on the outcome.

In an environment where capital flows enter and exit without much restrictions, South Africa will be tested from time to time, and political, social, and economic developments in South Africa will have significant effects on the exchange rate of the rand (Stals, 1996a:4). The processes of financial integration are not without any setbacks, but some of the adjustments were necessary for South Africa to tap into these capital markets.

According to Stals (1998:9) the integration of South Africa in the world financial markets was stimulated by, the major political reforms in the country since 1994, the need of the country for foreign capital inflows to supplement its scarce own resources, and the worldwide trend towards financial globalisation.

This process required of South Africa to apply sound and acceptable macroeconomic fiscal and monetary policies, phase out exchange controls, albeit on a gradual basis and open up the domestic banking sector for international competition. South Africa also had to restructure the financial markets, upgrade the national payment, clearing and settlement system, and get more involved in the development of the financial structure of the Southern African region (Stals, 1998:9).
5.5 Conclusions

After decades of economic isolation, many distortions were created within the South African economy. The political transition that took place during 1994 meant that South Africa had to face the challenge of re-joining the world economy. This happened at a time when the global financial markets were in a process of major changes. South Africa, therefore, had to embark on a number of structural economic reforms as part of the process of re-integration into the global markets.

In this chapter the economic policies that existed prior to 1994 and their consequences on the macroeconomic environment are discussed. This period was characterized by problematic monetary policy, lack of fiscal discipline and socio-political problems. The economic policies that existed during that time constrained the levels of capital flows into South Africa and deprived the country of the much-needed foreign capital for economic development. However, after 1994 South Africa undertook to move toward a more open regime. South Africa followed a gradual approach to the dismantling of exchange controls, which were initially introduced in 1961. This paved the way for foreign capital to flow in and out of the country with relative ease. Amongst other reasons the peaceful transition into democracy, lifting of exchange controls and trade sanctions allowed foreign investors to invest in South Africa, ending the long period of persistent capital outflows. The macroeconomic impact of these inflows and their reversal has highlighted the challenge that South Africa faces in attempting to manage cross-border capital flows.

South Africa’s experiences are typical of the broader experience of capital inflows in other emerging market economies. Capital inflows can have beneficial effects by easing the external constraints and providing access to funds, which, if invested rather than consumed, help foster higher rates of growth. However, surges in capital inflows, especially if temporary, are at best a mixed blessing as they can potentially cause significant macroeconomic imbalances and leave the recipients vulnerable to the consequences of sudden reversals. The re-integration of South Africa in the global economy has brought some advantages, such as foreign capital, but at the
same time exposed the country to the risks of becoming part of the global village. The liberalisation of financial markets has widened the scope and field in terms of financial instruments offered by banks. The process of financial globalisation has spurred competition, but most importantly re-integration into the global economy has forced more discipline on the management of the economy and on business enterprises. However, South Africa has also experienced the risks of global integration and the painful adjustments forced on economies through the actions of participants in the markets. On balance, South Africa is still on the right track and has been doing relatively well compared with other developing countries.
CHAPTER SIX
CONCLUSIONS AND RECOMMENDATIONS

6.1 Summary of the main findings

Internationally, trans-border capital is here to stay. Growing trade links, new communication technologies and increasingly sophisticated financial markets are making national borders more permeable to financial flows. The challenge facing policy makers in developing countries is how to navigate through this financially integrating world. Since 1997, when the East Asian crisis began, the world has learned that poorly managed financial liberalisation can lead to a protracted economic downturn and a renewed cycle of poverty. However, the potential benefits of international capital flows can be significant for a developing country, which is dependent on foreign capital to meet its development needs. For example, foreign direct investment can have a positive spin-off by boosting productivity in recipient countries.

In the context of worldwide liberalisation of capital flows and abundant liquidity on international capital markets, finance has become more easily available, but at the same time more volatile. This mobility of capital has reduced the domestic policy autonomy of many countries, but most particularly of developing countries and countries in transition. While more progress has been made in the internationalisation of financial markets, this progress has not been without setbacks as evidenced by numerous occurrences of financial crises. Some of the financial crises exerted disruptive and protracted effects on the domestic and international economies. This has resulted in economic policy makers together with market participants devoting considerable attention to the issue of how best to avoid these crises.

Chapter two provided some detailed definitions of globalisation. The definitions that were reviewed show that globalisation expresses different assessments of global change in which more parts of the world are drawn into a global system. As a result
the changes in one part of the world can easily affect other countries. The premise of this dissertation is on financial globalisation, which allows the integration of international financial markets and the freedom of moving funds across national markets. For international investors, this means the ever-increasing speed and freedom of moving funds across national markets. For emerging markets, due to the fact that their financial markets are relatively primitive, financial globalisation entails liberalisation of domestic financial markets and relaxation of capital controls to allow for financial capital inflows and outflows. The most obvious manifestation of financial globalisation is the large upsurge in cross-border financial transactions, with cross-border securities now several times larger than several countries' national GNPs.

In chapter three, the historical development of financial globalisation was discussed. A distinction between the two waves of globalisation is reviewed. The first wave of globalisation covers the period between 1870 and 1914, and the second wave mainly covers the period after the Second World, that is after 1945. The argument put forward in this chapter is that the present-day economic integration is not unprecedented as the period before the First World War saw large cross-border flows of goods, capital and people. While the two waves of globalisation share many similarities, they are fundamentally different. Reductions in trade barriers and sharp falls in transport costs drove the first period of globalisation. The present period of globalisation is a resumption of that previous trend as it has also been driven by sharp fall in communication costs. However, technological advances have significantly shaped the uniqueness of the recent financial globalisation. The rise of the internet and consolidation of global financial markets have created an increasingly around the clock, borderless global trading network.

Chapter four examined the role of developing countries in the global financial integration process. The experiences of various countries suggest that financial globalisation can be a mixed blessing. Tapping into world capital markets can help individual countries smooth their consumption and finance productive investment. Foreign investment, particularly foreign direct investment, can facilitate the transfer of technological and managerial know-how. Portfolio investment, on the other hand, can also contribute to the deepening of the domestic financial markets. It has been
touted in many circles, that reversal of capital flows, is usually a reflection of mismanagement of economic policies. It is for this reason that some believe that capital flows can promote more disciplined macroeconomic policies, as they will increase rewards for good policies and also increase penalties for bad policies. The experiences of Asian countries also show that the ability to borrow from abroad helped many emerging countries to accelerate the speed at which their productivity and living standards converge to that of the industrialised countries. This has been the case in many developing economies, especially in Asia, as they enjoyed high economic growth rates over the years.

At the same time, financial globalisation entails various risks. The crises in Mexico and Thailand underscore the dangers facing developing countries. These countries were once paradigms of development and economic reforms, yet they both showed the weakness of their economic and political systems. The two crises had many similarities but also key differences. Both countries shared a lack of independent institutions, fragile political systems, high levels of corruption and a lack of transparency amongst others. The major difference though, was the fact that the Mexican crisis was mainly driven by the public sector, while the private sector drove the Thai crisis.

The Mexican and East Asian crises highlighted the drawbacks of excess capital inflows in an environment characterised by a weak regulatory framework of domestic financial systems and weak corporate governance. With many capital markets in developing countries now embarking on more liberalisation of capital flows including wider opening of domestic capital markets to foreign investment, the challenge of managing capital flows has become more complex. The question has been how to reduce the volatility of capital flows (and its impact on the volatility of domestic asset price) and how to avoid boom-bust cycles by reducing excess capital inflows.

While these are considered complex issues, they need to be tackled by a variety of measures, both at the national and international level. The combination of thorough-going international and external liberalisation and sometimes combined with rigidly pegged exchange rate has proved to be a disaster for developing countries. Given
the relative shallowness of the developing countries' financial markets and the difficulty of constructing appropriate regimes of supervision by domestic authorities and practices of transparency by local firms, the tendencies towards exuberant over-borrowing and the excessive growth of credit are difficult to prevent. When capital flight begins, attempts to contain it by defending the exchange rate using foreign currency reserves are generally futile. Utilising reserves simply allows investors to exit without altering the eventual necessity of devaluation.

Chapter five provided an overview of the South African economy by analysing the structural economic reforms that have taken place over the years as the necessary steps to become part of an integrated world economy. The economic policies that existed prior to 1994 and their consequences on the macroeconomic environment are discussed. This period was characterized by problematic monetary policy, lack of fiscal discipline and socio-political problems. The economic policies that existed during that time constrained the levels of capital flows into South Africa and deprived the country of the much-needed foreign capital for economic development. However, after 1994 South Africa undertook to move toward a more open regime. This paved the way for foreign capital to flow in and out of the country with relative ease. The re-integration of South Africa in the global economy has brought some advantages, such as foreign capital, but at the same time exposed the country to the risks of becoming part of the global village.

South Africa has at least followed a proper process or sequence of liberalising its economy. While it may avoid some of the mistakes that some of the developing countries made, open capital markets will continue to punish any perceived macroeconomic mistakes.

The process of financial globalisation has forced more discipline on the management of the economy and on business enterprises. However, South Africa has also experienced the risks of global integration and the painful adjustments forced on economies through the actions of participants in the markets. On balance, South Africa is still on the right track and has been doing relatively well compared with other developing countries.
6.2 Recommendations for improved integration of developing countries

The discussion in this dissertation has highlighted the vulnerability of developing countries to short-term capital flows. The following related measures for developing economies wishing to integrate into global financial markets are put forward. Firstly, even if an economy is isolated from foreign financial flows, the benefits of domestic financial liberalisation cannot be assured without a strong regulatory framework. Secondly, governments must continue to develop policies that reduce the volatility of short-term foreign inflows and need the help of the IMF to achieve this. Thirdly, developing countries will need to increase their attractiveness to long-term foreign investment in order to augment their low saving rates. Finally, efforts to co-ordinate aspects of financial and regulatory policies can be advantageous to developing economies. Financial crises in developing countries are not always home-grown. Fluctuating interest rate differentials between industrial countries have increased the volatility of global capital flows, which can be ameliorated by policy co-ordination among industrial countries.

The experiences with capital inflows and policy reactions in Latin America and Asia have been useful in analysing the impact of capital flows to South Africa. While these regions' experiences shared common features such as high growth rates, the accumulation of reserves as well as inflationary and exchange rate appreciation, there are important differences in the nature and the uses of the inflows and the policy responses. Thus there are different lessons that follow from the Asian and Latin American crises.

South Africa is also different from both Latin America and Asia. This limits the whole transfer of best practice from these regions to South Africa. At present South represents the only major destination for international capital flows to Sub-Saharan Africa, in terms of value. This is unlike countries in Asia and Latin America that need to compete for the regional flows. Unfortunately, as a result, South Africa does not have the advantage of being part of the regional allocation of an investment fund. At the same time, South Africa does not have the disadvantage of losing funds
allocation because of a crisis contagion. Still, it has to compete with other emerging economies as a whole. South Africa also differs from these regions in terms of its neighbours. Unlike the Latin American and Asian countries, South Africa does not have a rich neighbour and therefore it is less likely to be bailed out should a crisis occur.

South Africa has, in many ways, a more sophisticated domestic financial system than most emerging markets, a stock exchange that has one of the highest capitalisations in the world, and a long established and fairly comprehensive economic data, which makes it fairly transparent. South Africa also enjoys good ratings by the leading risk rating agencies.

In conclusion, South Africa will continue to have to make hard choices, as there is no 'best practice' applicable to all countries. While continuing to understand the painful experiences of other countries with regard to the constraints and problems imposed by financial globalisation, South Africa's success will depend to a great degree on the policies the country pursues. As mentioned earlier, the benefits of globalisation have not yet reached all the people of the world, and the critics of globalisation will continue to point to its ills. But the most important lesson is that countries are more likely to be better off when they embrace globalisation than being left out.
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