

THE EFFECTS OF
FINANCIAL LIBERALISATION
IN
EMERGING MARKET ECONOMIES

by

SHOBHA CHAUHAN

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SUPERVISOR: PROF. PIET HEIN VAN EEGHEN
JOINT SUPERVISOR: MS CECILIA VAN ZYL

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Declaration

Student number: 3374 056 9

I, Shobha Chauhan, declare that *the Effects of financial liberalisation in emerging market economies* is my own work, and that all the sources that I have used or quoted have been indicated and acknowledged by means of complete references.

(Ms) SHOBHA CHAUHAN

DATE

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Summary

The aim of this research is to show the effects of financial liberalisation on emerging market economies, how these economies removed restrictions on financial institutions so that they can be globally integrated, and to show the flow of international finance in and out of a country. This research also illustrates how the financial system in these economies moved from being government-led to being market-led. The main finding of this research is that many countries failed to reap the benefits of liberalisation because of weaknesses in the regulatory structure, undercapitalised banks, volatile markets and contagion effects. The research concludes that the long-term gains of liberalisation certainly supersede short-term instability of liberalisation. Thus, for financial liberalisation to have predominantly positive effects, attention should be drawn to the importance of a more prudent regulatory and supervisory environment. Furthermore, financial liberalisation must be accompanied by a sound institutional infrastructure, proper conduct of monetary and fiscal policies, a reduction in corruption, and an increase in transparency. In addition, liberalisation should be a gradual process whereby the right measures are taken in the right sequence.

Key terms:

Asian financial crisis; Basel Committee on Banking Supervision; Basel I; Basel II; Basel III; capital account liberalisation; central bank; deregulation; monetary policy; emerging market South Africa; exchange rate volatility; financial crisis; financial fragility; financial liberalisation; financial regulation; inflation targeting; *International Convergence of Capital Measurement and Capital Standards*; *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*; prudential supervision; sequencing; subprime mortgage crisis; Washington Consensus.

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Overview

The term 'financial liberalisation' is defined by various economists in different ways, yet they all arrive at the same meaning. For example, Patnaik (2011:1) states that

financial liberalisation is used to cover a whole set of measures, such as the autonomy of the Central Bank from the government; the complete freedom of finance to move into and out of the economy, which implies the full convertibility of the currency; the abandonment of all "priority sector" lending targets; an end to government-imposed differential interest rate schemes; a freeing of interest rates; the complete freedom of banks to pursue profits unhindered by government directives; the removal of restrictions on the ownership of banks, which means de-nationalisation and full freedom for foreign ownership.

While Baswir (2007:1) defines financial liberalisation as "an integrated part of overall economic liberalisation. Specifically, the objective of financial liberalisation is to promote the role of the market and to minimize the role of the state in determining who gets and gives credit and at what price". Similarly, Baden (1996:2) advocates that "financial liberalisation means the removal of government ceilings on interest rates and of other controls on financial intermediaries. It is concerned with macroeconomic aggregates (interest rates, savings and investment) and conditions in formal financial markets".

Based on the above definitions, in the context of this thesis, financial liberalisation can be defined as the removal of various constraints in the financial sector such as the withdrawal of interest rate restrictions and deregulation of banks, combined with better monetary policy frameworks, to enhance development and growth in the financial sector. Financial liberalisation

brings both costs and benefits to emerging market economies. The potential benefits could be better mobilisation of savings, both local and foreign; higher economic growth; reduced poverty; and enhanced stability. McKinnon (1973) and Shaw (1973) concur that liberalisation enhances growth in an economy by allowing domestic and international firms to access their financial markets, and by improving the efficiency and corporate governance in domestic financial systems. However, the potential cost must be considered too. Following liberalisation, many developing countries found that their financial markets had become more unstable, and their financial institutions more fragile because of unfamiliar practices, excessive risk-taking and weaknesses in the regulatory structure.

The aim of this research is to show the effects of financial liberalisation on emerging market economies, how these economies removed restrictions on financial institutions so that they can be globally integrated, and to show the flow of international finance in and out of a country. This research also illustrates how the financial system in these economies moved from being government-led to being market-led. By 'government-led' is meant the extensive regulation, legislation and intervention by government on the domestic financial sector, for example, by restricting the allocation of credit through controls on prices and imposing several constraints on cross-country capital movements. A 'market-led' financial system is when agents of the markets (such as borrowers, investors and financial institutions) are seen as a driving force of the markets. The current research interprets data relating to the positive and adverse effects of financial liberalisation in emerging markets, with information being sourced from the International Monetary Fund (IMF), World Bank, Bank for International Settlements (BIS), South African Reserve Bank (SARB) and academic articles. Particular attention is paid to specific countries and banks where the positive or negative spin-offs of financial liberalisation were most pronounced.

The main finding of this research is that liberalisation brings benefits to countries but in order to reap these benefits, countries must implement proper regulatory framework and legal structures. For financial liberalisation to have predominantly positive effects, it must be accompanied by a sound institutional infrastructure; the proper conduct of monetary and fiscal policies; a reduction in corruption; an increase in transparency; and vigilant prudential supervision. In addition, liberalisation should be a gradual process whereby the right measures are taken in the right sequence.

Chapter 1 reviews the need for regulation by central banks in order to counteract market failures and the common types of regulation that are at stake, and the advantages and disadvantages of these types of regulation. Furthermore, it explains the history of financial regulation before liberalisation. Chapter 1 also explains how developed economies were deregulated, touching on the forces that led to the move towards liberalisation.

In Chapter 2 the general characteristics of developing economies, and the rationale for liberalisation and the way in which it was typically implemented by these economies are discussed. The financial crises that ensued during the 1990s are described and the underlying reasons for the crises are analysed.

Chapter 3 is a review of the lessons learnt, and an analysis of the interrelationship between the conduct of policy and financial liberalisation. Attention is drawn to the importance of a more prudent regulatory and supervisory environment to prevent bank failures and systemic risks. In addition, international best practices and the manner in which they regulate market behaviour are explained.

Chapter 4 concentrates on South Africa and contains a historical overview of its economic instability, explaining the impact of sanctions on the domestic economic environment. Furthermore, South Africa's reintegration into the global economy, and its experience during the first ten years of liberalisation and thereafter is explained. The chapter sets out how South Africa modified its domestic financial sector by restructuring its policies in a sequential manner during liberalisation in order to maintain a stable economic and financial sector.

Finally, Chapter 5 presents the findings of the research and provides recommendations for an economy before it decides to liberalise and also makes suggestions for further research.

Chapter 1

Financial regulation and financial liberalisation

1.1 Why do banks and financial markets need to be regulated?

The general consensus (BCBS (2010a); Aizenman (2009); Hoban (2010)) is that neither too much regulation nor too little is good for an economy. This is evidenced by a variety of financial crises and periods of instability that have occurred during the past decade or two. The uniqueness of banks lies in the financial services that they provide, their deposit-taking capabilities, and their ability to create deposit money in the process of making credit available to individuals and institutions. However, in answer to the question as to why regulation is needed, the conventional response is usually linked to bank instability. For example, regulation maintains public confidence and decreases the risk of a run on banks; it prevents banks from taking the type of risks that can cause economic instability. Since banks and financial markets have become more complex in their services, the need for regulation has become more important.

Furthermore, because the central bank oversees the deposit insurance activities that protect depositors (some countries, such as South Africa, do not have deposit insurance), it creates a moral hazard on the banking side where banks pay too little attention to the risks they take. In addition, the central bank is a lender of last resort but it would generally accommodate banks, first, by utilising various facilities and instruments before lender-of-last resort facilities would be offered. It accommodates the regular cash needs of solvent banks and provides lender-of-last-resort facilities to illiquid but solvent banks, or to insolvent banks that are “too big to fail” (in some cases banks that are “too big to fail” are allowed to fail if it would not pose a systemic risk to the financial system). Banks have to be regulated so that they do not take advantage of this facility by recklessly lending or borrowing, and thus exposing themselves and the economy to

risks. The payment system that central banks provide is a system that settles all payments made through banks. If a bank fails to meet its payment obligations, this can have a ripple effect throughout, and threaten the financial system (i.e., settlement risk). Therefore, the need for regulation is essential: it is necessary to counteract market failures to ensure stability and order in the financial markets.

1.1.1 The role of the central bank, and ways in which it regulates banks and financial markets

It is generally accepted that the main aim of a central bank's policy interventions is to provide "stability in the purchasing power of the currency of the country, as well as in the workings of the financial system including the payments system" (White, 2009:4); to act as a lender of last resort; and to set the interest rate on cash reserves as a way of influencing the level of spending and, ultimately, of prices. No central bank can distance itself from the functioning of the financial markets if it is to execute its monetary policies in a satisfactory manner. Its first responsibility is to foster and maintain monetary stability (i.e., price stability) and financial system stability, which can be defined as the absence of systemic risks (i.e., a risk that affects an entire financial market or system, and not just specific participants (Investorwords (1999a)) in the financial system that can contribute to market failure.

Bernanke (2011:12) states that "the objective of monetary policy should remain focused on macroeconomic objectives, while more-targeted micro-prudential and macro-prudential tools should be used to address developing risks to financial stability, such as excessive credit growth". By contrast, Svensson (2011) maintains that the objective of monetary policy and that of financial stability are distinct. He explains that "monetary policy, in the form of flexible inflation targeting, has the objective of stabilising both inflation around the inflation target and resource utilisation around a sustainable level, while financial stability has the objective of maintaining

and promoting financial stability . . . through supervision, regulation and financial stability reports that may provide early warnings of stability threats”. However, he continues to explain that these policies need to work in harmony with one another as monetary policy affects the real economy and financial stability policy affects the transmission mechanism of monetary policy. Kamin et al. (1998:8) state that the “objective of monetary policy is to achieve sustainable economic growth with a reasonable level of internal and external stability”. Monetary policy enhances price stability by ensuring that markets are functioning in an efficient manner. Thus price stability, in turn, contributes to financial stability by anchoring inflation expectations, thus limiting uncertainties in the market arising from inflation. Tools that central banks use to conduct monetary policy include the following:

- *The accommodation rate:* This is the official interest rate determined by the central bank. In South Africa the accommodation rate is called the ‘repurchase (repo) rate’. The official interest rate usually has an impact on economic activity and inflation through several means, which are known as the ‘transmission mechanism’ of monetary policy. Once the official interest rate is changed, banks react by also changing their prime lending rates. The change in the banks’ prime lending rate affects households, assets and shares, among other things. All these changes in the market will affect aggregate demand in the economy as spending patterns of consumers and firms may either increase or decrease. For example, if interest rates increase, then aggregate demand will decrease. Furthermore, the exchange rate may change in reaction to the new level of interest rates set by the central bank. The level of imports and exports will also be affected due to the changes in the exchange rate. Finally, the impact on aggregate demand may also affect gross domestic product (GDP) and inflation since too much demand can be inflationary.

Cash reserve requirements and open-market operations are subservient to the aim of influencing the interest rate level through the accommodation rate.

- *Cash reserve requirement:* This is where banks are obligated to hold cash reserves with the central bank. These reserves can be used if there is a change in domestic liquidity, for example, in the event of a financial crisis, or if a troubled bank is in need of funds. However, in a classical cash reserve system this tool is there to create a money-market deficit. It is seldom used as an “operational tool” to influence the size of the money-market deficit, because that will imply changing the percentage regularly.
- *Open-market operation:* This is another tool used by a central bank to influence the liquidity in the market by buying or selling securities. For example, if the central bank sells treasury bills or government bonds, business buys the paper “causing money market liquidity to tighten and money supply to decline” (Mboweni, 2002).

Another function of a central bank (although not in all countries) is to act as a supervisor to banks. Since banks have the potential to generate instability, the central bank as bank supervisor ensures that they are adequately capitalised so that they are more solvent; it also ensures that banks comply with risk management procedures to determine and manage various risks. The methods of supervision that are used include off-site and on-site supervision. The off-site approach is characterised by a set of statutory returns that a bank submits to the supervisor. This data is analysed by the supervisor who then provides the individual banks with feedback based on the data. The on-site supervisory approach is based on visits to the banks. A discussion with the bank's service management is held, and an examination of the bank is completed and an opinion is formed based on the information gathered. The main reason for bank supervision lies in the various risks that banks take and the consequences for the whole

economy should things go wrong as a result. Therefore, supervision is aimed at enhancing proper risk management for credit risk, liquidity risk, interest rate risk, price risk and currency risk.

The central bank may also conduct exchange rate policy which is “the policy of government towards the level of the exchange rate of its currency” (Farlex, 2008). There are different types of exchange rate regimes that can be adopted such as a fixed exchange rate and a floating exchange rate.

A fixed exchange rate or pegged rate is a rate set by the central bank and maintained as the official exchange rate against a major world currency, while a floating exchange rate is determined by the private market through supply and demand. A floating rate is often termed “self-correcting”, as any differences in supply and demand will automatically be corrected in the market assuming the relevant price elasticities are sufficient (Investopedia, 2007).

The reason why central banks adopt these exchange rate policies is that the exchange rate can have a profound impact on economic performance.

The central bank is also a custodian of gold and foreign-exchange reserves, and manages them by maintaining foreign currency liquidity, assisting government with regard to external debt obligations and providing confidence to the markets in times of crisis when borrowing is limited.

Along with ensuring stability in the economy, in some countries (e.g., South Africa) the central bank may also act as a banker, agent and adviser to the government. The central bank has the obligation to issue treasury securities on behalf of government, hold government’s deposit

accounts, which are used for receiving funds and making payments by government departments, and settling foreign currency transactions, among other things.¹

The central bank also plays a key role in adopting the macroprudential and micro-prudential policies. Macroprudential policy is concerned with the stability of the financial system and mitigating risks to the financial system, while a micro-prudential policy is aimed at the responses of an individual bank to exogenous risks and the prevention of failure of individual financial institutions. The central banks role is therefore to communicate information about financial stability and to provide information, analysis and recommendations about systemic risks.

Another function of the central bank is that it is responsible for the safety and efficiency of the payment and settlement systems. Through this system the central bank ensures that there is reliable transfer of funds between participants in the financial system. Furthermore, the central bank is responsible for the regulation and supervision of the payment and settlement system, and monitors the operations of the payment and settlements system.

All central banks collect and interpret economic data pertaining to various sectors of the economy. This function is important for monetary policy decisions, monitoring of exchange rates, economic analysis or outlook and the promotion of financial stability. Recently, central banks have begun using surveys as a method of collecting data to get more timely statistics.

Other important functions of a central bank may include the issuing of banknotes and coin, research, and acting as the custodian of the cash reserves of commercial banks. Most of the functions and duties of the central bank are met through the regulation and supervision of the

¹ This is, however, not applicable to all central banks, for example, the Reserve Bank of Australia (RBA) has deregulated its financial system and is independent of government but acts in consultation with it.

financial markets and banks, to ensure a more sound and efficient economic environment.

These functions follow from the central bank as

- (i) provider of cash reserves; and
- (ii) supervisor and regulator of the banking system (prudential supervision).

1.2 Types of central bank regulation, and the advantages and disadvantages of these regulatory stances

The most common types of regulation include the direct and indirect method, prudential supervision, and so-called twin peak regulation. The direct method of regulation (which has been used mostly in the past) is composed of a mixture of “monitoring individual transactions, setting minimum capital requirements [still used today] and imposing entry restrictions” (Hellmann et al., 2000:147). Das (2004:52) emphasises that these policies include “controls over interest rates on both deposits and loans, as well as over exchange rates, capital markets and capital flows”.

Some of the advantages (for authorities and central banks) of this direct method of regulation in a pre-liberalised banking financial sector are that they maintain only a small number of domestic banks for easier control and prohibit foreign banks from entering the domestic financial system. Interest rate ceilings imposed by government ensure that bank competition is very limited, that excessive risk-taking is minimised, that banks operate as oligopolies and that government owns all or many of the banks. The disadvantage of this method can be expressed by inefficient financial markets, low economic growth rates and high inflation.

The indirect method of regulation is based on safeguarding depositors, monitoring and managing banks' risks, and ensuring that banks have sufficient capital in relation to the risks to

which they are exposed. Hellmann et al. (2000:148) explain this change in three steps. First, emphasis is placed on monitoring a bank's risk management system, rather than individual transactions. Second, with the removal of a ceiling on deposit rates, banks have a wider choice of assets and, third, more emphasis is placed on capital requirements. The disadvantage of this indirect method of regulation or deregulation is that bank managers are faced with unfamiliar practices and modes of regulation, which results in increased risk-taking.

Prudential supervision is related to systematic risk and is concerned with preventing a problem in one institution from spreading to another. Polizatto (1990:1) maintains that "prudential regulation is designed to remove or lessen the threat of systemic instability". Its primary objective is broadly to promote the stability of financial institutions and/or the financial system. It therefore focuses on institutions with a view to protecting their solvency. The aim of prudential regulation is to protect the banking system from crises. The direct way of regulation is not an alternative to prudential supervision. This is because prudential supervision encourages an open-market system and competition, whereas direct regulation does not. In addition, prudential supervision ensures proper disclosure and transparency of banking activity.

Twin peak regulation is when prudential regulation and market conduct regulation are separated, with the central bank responsible for prudential and systemic risk regulation, and operates alongside a conduct of business regulator. In other words, the central bank is responsible for potentially systemic institutions, and oversight of the payment and settlement systems, while the business regulator is responsible for the conduct of business across the financial system such as banks, insurance and securities services. Twin peak regulation is common in Australia, the Netherlands and Canada. The advantages of twin peak regulation are that it strengthens the operational independence, integrity and accountability of all regulators; clarifies roles and responsibilities; increases the scope of regulation and improves enforcement

capacity (National Treasury, 2011:27–36). The disadvantage is that in this type of regulation there could be duplication of work and jurisdictional overlap if roles and responsibilities are not clearly defined; and conflict can exist between the two regulators (National Treasury, 2011:29).

1.3 A broad outline of the history of financial regulation before liberalisation in developed economies

According to Ribakova (2005:03), “prior to liberalisation there was little need for prudential supervision because of government control, limited competition, and small banks”, which escalated into financial repression. Denizer et al. (1998:3) define ‘financial repression’ as “a set of policies, laws, formal regulations and informal controls, imposed by governments on the financial sector that distorts financial prices, interest rates and foreign-exchange rates, and inhibits financial intermediaries from performing at their full potential.” Since the early 1970s, financial repression has usually been associated with less-developed countries, but before the 1970s, economists in developed economies also favoured financially repressive policies. It is generally argued that the main reasons for the implementation of the repressive policies were for government officials to control fiscal resources and to extract rent from the banking system. Financial repression also took the form of restrictions on the in- and outflow of capital.

McKinnon (1973) and Shaw (1973) identified financial repression as regulatory restrictions on competition in the financial sector and government interventions. They were among the first to point out concerns regarding financial repression. They argued that an economy that was constrained in this way discouraged savings and investment because of lower rates of return compared to a competitive market; in other words, institutions are unable to direct most savings into investment effectively, which affects the growth of the economy. In addition, Roubini and Sala-i-Martin (1992; 1995) also argue that financial repression has negative repercussions for

economic growth when (i) the output of investment is negatively affected; (ii) the general level of investment and savings has declined in the economy; and (iii) intermediation costs increase.

The impact of financial repression is that it induces great economic distortions. It leads to bank insolvencies, high and persistent inflation, and an underdeveloped financial system. Financial repression is said to hamper economic growth. Excessive regulation and financial repression result in large-scale rigidities in the financial system. This is evidenced by the

direct controls used in many [Organisation for Economic Co-operation and Development] OECD countries during the 1960s and 1970s to allocate finance to preferred industries during the post-war reconstruction period; restrictions on market access were partly motivated by a concern for financial stability; and controls on banks and financial institutions were frequently used as instruments of macroeconomic management. (Edey and Hviding, 1995:8.)

Historically, financial repression resulted in heightened economic costs, corruption and inefficiencies. The desire for more financial resources, pressure from international trade, and demand for better finances led to the relaxation of controls on the financial sector and a shift towards liberalisation.

1.4 A brief history of deregulation and liberalisation in developed economies

Edey and Hviding (1995:8) assert that the shift towards liberalisation was due to “interrelated factors which made direct controls increasingly ineffective in achieving their intended purposes”. McKinnon (1973) and Shaw (1973) postulated that financial repression was not the answer to economic growth. They argued that an increase in interest rates to market-related levels would lead to savings which, in turn, would spur economic growth. They convinced regulators and authorities that that strategy would improve investments and growth. Developed economies

then started implementing this macroeconomic policy by lifting the restrictions on interest rates and implementing more positive interest rates.

Eventually, the direct methods of regulating were relaxed because they were hampering institutions from adapting to changes in the financial market environment. For example, during the 1980s the United States' (US), Australia's and the United Kingdom's (UK) efforts to remove direct interest rate controls were eventually accomplished. Thus, for many banking regulators, the change from direct to indirect regulation of banks was seen as an effort to liberalise. Furthermore, deregulation and financial liberalisation were important components in shaping the financial system and in making it more effective.

Another force that also led to the move towards liberalisation was globalisation: central banks were attempting to adjust their policies to comply with international standards. Some economists began considering that an independent central bank would ensure a more favourable monetary policy. In addition, the introduction of new technology in the areas of information and communication, financial innovation and in improved risk management systems encouraged a faster shift towards liberalisation.

A further factor that pushed these economies towards liberalisation was the need for a more efficient financial system, which was better equipped to achieve growth and development. Therefore, further reform policies were implemented in the 1990s. These policies included a change in bank supervision from a micro-level, for example, monitoring banks' individual transactions, to a broader macro-level, for example, banks' compliance with corporate governance, international best practices, more risk-based supervision, transparency in disclosure and an appropriate legal infrastructure. Thus regulations that were retained include

prudential regulation at a macro-level, which has evolved over time to ensure stability within the economy and to reduce the effect of shocks.

1.5 Conclusion

In conclusion, banks have to be regulated because of the threat financial instability poses to the economy. History proves a need for regulation. However, the manner in which it is conducted will determine the state of how the financial system is run. For example, if the policies that are implemented by government are repressive, then the outcome will produce inefficient markets; increased economic costs and hampered economic growth. If the policies implemented by government are more market-friendly, then this will result in greater competition and more efficient markets. However, the change from repressive to more open liberal markets is not an easy one, as will be discussed in Chapter 2. The impact of liberalisation on economic growth, stability and crisis prevention should be considered.

Chapter 2

Developing economies, financial liberalisation and the crises of the 1990s

2.1 Characteristics of a developing economy before liberalisation

A developing economy is generally characterised by medium economic growth rates, generally low export capability and poor infrastructure. In some developing economies the banking system generally has poor liquidity, is subject to reserve requirements (all though all countries have reserve requirements) and provides an inefficient payment system. While not completely unindustrialised, a developing country has relatively low levels of industrialisation compared to more developed countries. It does, however, have a higher standard of living compared to some less-developed peers. Before liberalisation, developing countries were inundated with financial repressive policies. As mentioned earlier, financial repression was said to hamper economic growth and bring about large-scale rigidities in the financial system. Roubini and Sala-i-Martin (1995:276) mention that in a pre-liberalised financial system, a typical developing country had the following characteristics:

- Anti-usury laws were needed for social reasons
- Tight control and regulation of the banking system were considered necessary to ensure banking soundness and a properly functioning monetary policy transmission mechanism
- Financial resources were allocated to certain sectors or projects deemed “strategic” by government.
- Interest rates were kept below market rates in order to reduce the cost of servicing government debts.

2.2 The rationale for liberalisation in developing countries during the 1990s

In response to the adverse effects of financial restrictions, many countries became engaged in liberalisation strategies. The aim of liberalisation was to ensure the free flow of international finance in and out of a country, to remove restrictions on financial institutions in order for countries to become participants in world financial markets, and to provide for central bank independence from government (Patnaik, 1999:1). The idea was to make the domestic financial sector part of the international sector, with the intention of it operating according to market forces and thus more effectively.

Different strategies were followed in the process of liberalisation, among which were the Washington Consensus, intervention in the banking sector and actions taken in capital accounts.

2.2.1 The Washington Consensus

The history of financial liberalisation in developing countries became more pronounced with the Washington Consensus, a reform policy developed by Williamson in 1989. The aim of this policy was to restructure developing countries in Latin America after the macroeconomic crisis they had experienced during the 1980s when economic growth was slow and foreign credit could not be accessed. The Washington Consensus was one of the first reform programmes and proposed ten broad economic policies as recommendations to bring stability within an economy. According to Williamson (2004:3), the recommendations were as follows:

- i. Exercising fiscal discipline
- ii. Reordering public expenditure priorities, such as switching expenditure in a pro-growth and pro-poor way, from matters such as non-merit subsidies to basic health and education and infrastructure

- iii. Reforming the tax system: A tax system that would combine a broad tax base with moderate marginal tax rates
- iv. Liberalising interest rates
- v. Introducing competitive exchange rates
- vi. Establishing international trade liberalisation: This entailed the liberalisation of imports
- vii. Liberalising inward foreign direct investments (FDIs): This did not include comprehensive capital account liberalisation
- viii. Privatising state enterprises
- ix. Deregularising, that is, easing barriers to entry and exit
- x. Extending property rights to a broader base, in order to provide the informal sector with these rights.

This reform package served as a benchmark and was promoted by the IMF, the World Bank and the US Federal Treasury Department. The policy emphasised freeing up the private sector by removing government controls, opening up local markets to international competition and maintaining macroeconomic discipline. Developing countries increasingly modelled their policies on the Washington Consensus which, broadly speaking, created a paradigm shift away from a government-led financial system towards a market-orientated system.

Gore (2000:791–94) describes this paradigm shift as consisting of two main elements. The first refers to the partial globalisation of development policy analysis, which means a shift from a national to a more global frame of reference. He adds that, before the Washington Consensus, development processes were typically explained in terms of local factors and development policies were geared towards local objectives. The second element refers to a shift away from historical towards non-historical performance assessment. He regards “development as a societal and economy-wide transition from a traditional, rural, agricultural society to a modern,

urban, advanced society” (p. 794). Furthermore, he notes that “this process was expected to consist of a sequence of growth stages through which all countries had to go. The shift to a non-historical performance assessment focused mainly on a country’s economic performance, among others, ‘performance’ being the key term to evaluating the success of a policy measure” (p. 794).

The Washington Consensus was implemented on a one-size-fits-all basis, as a stepping stone for other countries to follow. It was seen as an ideal reformation policy to ensure high economic growth. It was thus quickly regarded as a model for the wider developing world. Countries that participated in implementing it, other than the Latin Americans, included India, Indonesia, South Korea, Thailand, Zambia and Russia. The degree and timing of the implementation varied in different countries, for example, African countries implemented it during the 1990s, while East Asian countries did so in the 1980s and South Asian countries in the 1970s. However, the Washington Consensus proved fatal to some countries, as will be seen later in this chapter.

2.2.2 The banking sector

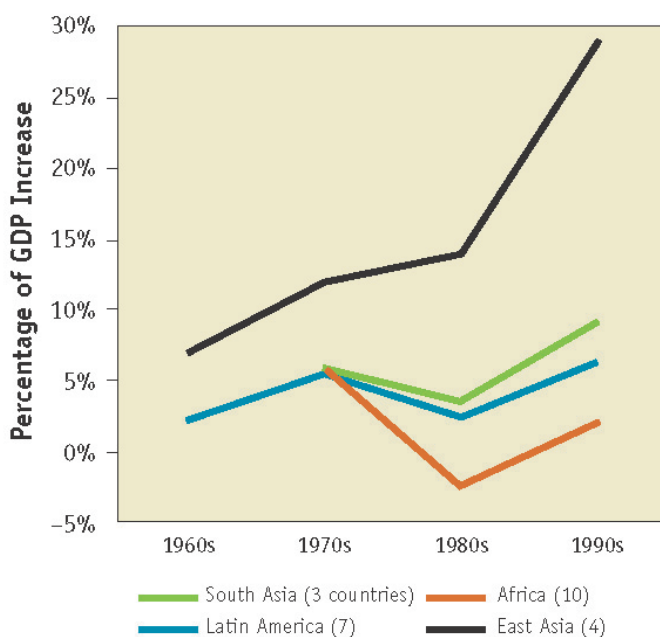
Further reasons for the liberalisation of developing economies included the belief that financial liberalisation would positively affect the banking sector. Liberalisation was said to bring about foreign currency deposits in the financial system of countries, which would positively influence the foreign deposit-to-GDP ratio. Government authorities, together with institutional supervisors, believed that an increase in this ratio would have positive effects on economic growth in that it would help finance large fiscal and current-account deficits, and also have a spillover effect on productivity, investment and savings. For example, in 1992 in South Africa prior to liberalisation (which will be discussed in Chapter 4), banks’ foreign currency deposits were in the vicinity of R6,8 million. After liberalisation, foreign currency deposits grew to R1,2 billion in 1994. Ten years after liberalisation, foreign currency deposits increased to R27,7 billion in 2004 and in

2008 it stood at R78,2 billion. As a result, the foreign deposit-to-GDP ratio increased from 1,85 per cent in 2004 to 4,31 per cent in 2008. The increase in deposits had a positive effect on the country's growth, which is evidenced by the increase in GDP. In 1994 to 2004 GDP increased gradually from 3,2 to 4,6 per cent. In 2007 GDP increased further to 5,5 per cent. However, in 2008 GDP declined to 3,7 per cent due to the global financial downturn.

Furthermore, liberalisation was said to contribute to an increase in general bank deposits. This is evidenced by the IMF study on the progress of Asia, Latin America and Africa in bank deposits. Figure 2.1 reveals that the growth of bank deposits as a share of GDP increased in the 1990s compared to the 1980s. In India, East Asia and some Latin American countries non-bank deposits from, for example, non-bank financial intermediaries, pension funds, credit unions, *stokvels*² and so forth, also supplemented the growth of bank deposits. Other factors that contributed to the growth in deposits were the slowdown of inflation in the 1990s, new deposit instruments and positive real deposit rates.

² A group of people who contribute a certain amount of money every month, and each person has the opportunity to use the total amount on a rotational basis.

Figure 2.1: Increase in average deposits-to-GDP ratio in major countries by region 1960s–1990s (Difference between three-year average of bank deposits-to-GDP ratio at the end of each decade)



Source: IMF (2007:208)

Note: Countries and regions covered:

East Asia: Indonesia; Republic of Korea, Malaysia, the Philippines, Thailand

Latin America: Argentina, Brazil, Chile, Colombia, Mexico, Peru, República Bolivariana de Venezuela

Africa: Ghana, Kenya, Nigeria, Tanzania, Uganda, Burkina Faso, Cameroon, Côte d'Ivoire, Mali, Senegal

South Asia: Bangladesh, India, Pakistan

Moreover, there was the belief that the presence of foreign banks in developing countries would increase the capacity of local banking sectors to lend and support development, and introduce international best practices and know-how to domestic banks, and so to increase their efficiency. Financial liberalisation was said to enhance foreign competition in the domestic markets, thereby decreasing the cost of doing business. Foreign presence was believed to allow financial institutions to implement the latest financial knowledge and technologies. As a result, financial liberalisation would stimulate institutional reform.

These beliefs and expectations were, to some extent, realised as shown in a study by Laeven (2000), who analysed 20-year data of emerging market economies, and concluded that the liberalisation did ease financial restrictions that domestic institutions faced, such as high interest rates, credit ceilings and excessive regulation. The integration with international firms also accelerated transformation and contributed towards the achievement of a more robust financial system, that is, a financial system that was sounder, and more efficient and effective. Thus, emerging market economies did, to some extent, benefit from financial liberalisation by being able to tap into global capital, which contributed towards increasing the degree of investment and output, and improved the efficiency of capital allocation.

2.2.3 Capital account liberalisation

The capital accounts of developing economies were also liberalised, which was said to benefit these economies. Kose and Prasad (2004:50) define 'capital account liberalisation' in broad terms, as "the easing of restrictions on capital flows across a country's borders, which presumably results in a higher degree of financial integration with the global economy through higher volumes of capital inflows and outflows". Since the capital account covers a variety of financial inflows, such as portfolio flows, FDI and bank borrowing, controls on these accounts can be restricted for the purpose of a country shielding itself from danger related to volatility in international capital flows. As a result, capital inflows that are of short duration can be suspended when a country experiences macroeconomic shocks, thereby magnifying their macroeconomic effect. However, Kose and Prasad (2004:50) advocate that "in some developing countries capital controls are also used to manoeuvre the composition of inflows towards more stable forms such as FDI and that countries favour FDIs because the benefits of the flows are usually long term and not subject to rapid reversals associated with changes in investor sentiment".

Generally, the benefits of capital account liberalisation include a higher return on savings for people in developed countries, and improvement in economic growth and strengthening of employment opportunities in developing countries. This is because, according to Kose and Prasad (2004:50), “capital account liberalisation allows for a more efficient global allocation of capital from industrial to developing economies. Capital account liberalisation may also be interpreted as signalling (to First World investors – mostly pension funds and other investment companies) a country’s commitment to good economic policies.”

There are, however, also dangers associated with capital account liberalisation. The argument in favour of capital account liberalisation assumes that investments in financial markets (mainly the stock exchange) amount to real investments in capital stock, which is clearly not the case. Moreover, Gourinchas and Jeanne (2002:27) assert that “capital account liberalisation will not induce a significant catch-up in the development of less developed economies if its only effect is to reallocate capital internationally, since the international allocation of capital is not the main factor behind the inequality across nations.” Furthermore, “a country’s policy environment could be ruined by domestic and foreign investors, who could suddenly pocket capital out of the country if that country has an open capital account” (Kose and Prasad, 2004:50). Despite these dangers, Gourinchas and Jeanne (2002:27) advocate that “capital account liberalisation could, in combination with other policies, play a significant role in the economic take-off of less developed countries, and to the extent that it does, it would have large benefits”.

Theory suggests that under certain assumptions the benefits of capital account liberalisation for developing countries include globalisation of finance, which could result in a higher economic growth rate and lower macroeconomic volatility. Globalisation of finance promotes potential for growth in developing countries and reallocation of capital around the world, in that capital movement without barriers should move from capital-rich places to capital-poor places.

According to Licchetta (2006:5), this is because “the return on new investment is higher where capital is limited. As a result, the amount of saving and the level of physical capital in poor countries can be positively influenced. This, in turn, can help the recipient economy to raise its rate of growth and improve its living standards.” Thus the lack of investment in less-developed countries is not mainly due to the lack of savings.

Fischer (1998), Stulz (1999), Rodrik (1998) and Stiglitz et al. (2000a, b) have a similar view of the effects of capital account liberalisation on the financial sector. The allocative efficiency view shows that when restrictions on the capital account are eliminated, then capital movement across borders commences. Hence, capital from rich economies moves to poorer economies, where the marginal rate of return is higher.

In addition, with the many risks that liberalisation creates, the globalisation of finance can reduce both production and consumption volatility in developing countries as more capital flows to these countries. Accordingly, production volatility will reduce which, in turn, will result in production growth being diversified. Henry and Sasson (2008:2) argue that “when liberalisation occurs the cost of capital reduces, which stimulates firms to increase their rate of investment”. They explain that

for a given growth rate of the labour force and total factor productivity, a higher rate of investment increases the ratio of capital per effective worker, driving up the marginal product of labour, and in turn, the market-clearing wage. Thus, the growth rate of labour productivity rises sharply in the aftermath of liberalisation. (P. 2.)

Furthermore, borrowing abroad during periods of recession and lending during periods of expansion sometimes allow developing countries to smooth their consumption over time and increase their domestic welfare (Licchetta, 2006).

2.3 General characteristics of an efficient financial system

Before getting to the core of the financial crises that ensued in the 1990s, it is important first to capture the essence of an efficient financial system. This can be identified by the stability of that system. Financial stability requires the financial system, which comprises financial intermediaries, markets and market infrastructures, to be able to tolerate shocks for the foreseeable future. This is important for all economies, especially those experiencing financial turmoil. A financial system or economy that is resilient to shocks can be identified by its well-operating institutional framework. Institutions that contribute to (or damage, as the case may be) the financial system operating well include banks, insurers, securities exchange, central banks and national regulators. These institutions conduct economic transactions and promote investments. Therefore, it is crucial that the financial system is sound since it plays a role in the country's economic growth.

In contrast, financial instability frequently leads to a financial crisis. A financial crisis generally occurs when creditors, especially when they are banks, are unable to fulfil their obligations. Usually, a fragile financial system will lead to instability in an economy. This is evident from a weak banking system, insufficient liquidity buffers, low-quality capital, uneven supervision, lack of effective regulation, fiscal imbalances and macroeconomic vulnerabilities. The SARB (2004a:25) states that “financial instability can be triggered by a whole range of developments such as inherent weaknesses in the fabric of the financial system itself”, for instance,

- inadequate banking laws and supervision;

- quality of the financial system infrastructure, such as lack of transparency and inadequate payment system; and
- the probability of a shock.

A crisis may have a ripple effect. In this case it is usually known as 'contagion', where a crisis spreads from one sector to another or from one country to another. Some of the reasons why a particular sector or country is vulnerable to contagion are generally as follows:

- It has exposure to other sectors or countries (usually through liberalisation):* An example of this can be observed in the relationship between an insurance company and a bank, where failure of an insurance company can disrupt the banking system because of the exposure the bank has to risks. If the risks are not mitigated, it could lead to financial system instability.
- So-called amplifiers that cause a small crisis to turn into a big one:* An example of this can be seen in a fragile financial market where a small shock in the financial market can promote large changes in asset prices. Hence, this volatility can cause a crisis and if contagion occurs, then amplification is possible. Thus, the ripple effect of the crisis can have a much larger effect compared to the original.

2.3.1 Description of financial crises during the 1990s

Typical crises that ensued during the 1990s were observed in many countries such as Mexico, Russia, East Asia and Brazil. These crises were all preceded by liberalisation of the financial sector and capital accounts characterised by a reduction of reserve requirements, removal of credit allocation, entry deregulation and relaxation of interest rates. Furthermore, in response to domestic pressures and pressure originating from international financial institutions, some of

these countries had opened up their financial systems before reforming their existing policies. Following liberalisation, many developing countries found themselves involved in a condition of high instability and increasing fragility of their financial systems. This was because of weaknesses in the regulatory structure and excessive risk-taking. As a result, financial liberalisation led to a difficult transition in order to achieve an efficient financial system. It “coincided with heightened financial instability, culminating in dramatic financial crises” (Kirkpatrick, 2002:2). According to Walter (2002:1), this was because “weak prudential regulation and institutions created substantial vulnerabilities in the financial systems of various developing countries”. In addition, “the increase in moral hazard problems eroded bank profitability” (p. 1). This was because previously government had protected banks’ profits by restricting banking competition, but after liberalisation competition increased and banks did not have that privilege of government protection. This resulted in greater risks being taken by these banks to maintain the previous levels of profitability which, in some cases, led to an erosion of profitability.

2.3.1.1 Crises arising from the Washington Consensus fallout

Jomo (2005:12) states that the Washington Consensus failed to deliver on its promise of high economic growth. According to him, countries that resisted the consensus experienced much higher growth compared to those that had implemented it.

The Washington Consensus was an important reason for the crises in many countries, because it focused less on sustainable development and more on increasing GDP. This was problematic because observing GDP alone was not a sufficient tool to measure the contribution of economic developments to improving or growing an economy. Implementation of the Washington Consensus in Russia led to a financial crisis that was “rooted in the fiscal imbalances and the

structural weaknesses in its enterprise and banking sectors” (IMF 1999a:31). Owing to the pressure to deregulate, little gains from FDI were brought into the economy as a result of the volatility of international markets. Russia experienced increased imports in spite of GDP declines affecting the country’s trade balance, which caused it to be negative. In addition, fiscal imbalances resulted from excessive government expenditure commitments and a swell in debt-servicing costs. Furthermore, the Russian central bank fell short in adequately monitoring risk management procedures at banks, which led to a reduction in the aggregate capital in the banking sector, and tax revenues fell, which could not cover domestic expenditure. These weaknesses drove Russia to high inflation rates in 1998, depreciation of the exchange rate and a fall in GDP, which led to a strong control of money supply. Instead of averting a crisis, the Washington stabilisation programme exacerbated the Russian crisis. According to the IMF (1999a:28–31), Brazil was also affected by the contagion from the Russian crisis due to the credit risk shock. Although Brazil’s financial crisis originated in the collapse of the exchange rate peg, which ultimately put Brazil under the watchful eye of investors, when Russia announced a devaluation of the rouble and a moratorium on foreign debt payment, Brazil’s stock and bond market fell on fears of default. This eventually resulted in restrictions on the outflow of capital.

Argentina, in turn, experienced numerous occurrences of recessions, hyperinflation and debt default. In an attempt to create a sound economic background that would contribute to economic growth and development, Argentina implemented the Washington Consensus which required liberalising its markets. However, the implementation of the consensus was negatively received as Argentina experienced a flight of capital, its currency depreciated and its financial markets collapsed. This crisis had occurred because of the exorbitant debt incurred by government, following reduced tax revenues, which led to an increase in interest rates. Moreover, a wave of privatisation, which previously contributed to FDI, eventually withered and the peso-to-dollar exchange rate was devalued.

The Mexican crisis of 1994–5, was evidenced by an overvalued exchange rate and a current-account deficit. At the core of the country's macroeconomic instability was its growing current-account deficit financed by short-term capital. In accordance with the consensus, Mexico also deregulated its financial sector where lending and borrowing rates were allowed to float and extensive privatisation of banks was carried out. However, with the new adjustments to the banking sector, the supervision of banks was poor. As a result, the combination of limited capitalisation of banks, excessive lending and non-performing loans were some of the factors that contributed to the crisis.

In implementing the consensus, other countries such as Poland and Bolivia liberalised their economy with a “big bang” approach, that is, a wholesale immediate change. The aim of this approach was to do away with the country's budget deficit, get rid of its inflation, close its trade deficit, privatise its state-held companies and improve its fiscal policies. However, these countries did not take into consideration the legal or institutional framework or the state of their financial markets before liberalising. This resulted in a rise in unemployment and a loss of income because of the shock and rapid change to the economy.

Many critics, such as Quiggin (2005), Stiglitz (1998) and Arestis (2004), argued that the Washington Consensus proved inadequate and was a failure, even though it brought about lower inflation, economic growth and lower debt ratios to some countries. They argued that the side-effect of the consensus increased poverty and unemployment, and that it gave business from developed economies opportunities to take business advantage of poor economies. This is evidenced by the consensus prescription of trade barrier reduction and free movement of goods across borders. In this case companies from developed economies use cheap labour from less-developed countries to manufacture their goods and sell them at a high price, while the wage earned by labourers in less-developed countries remained the same and was offset by high

inflation. Quiggin (2005) argues that “the Washington Consensus was weak in its approach to financial stabilization”. Furthermore, he argues that during the crisis of the 1990s “financial markets appeared to have contributed to the crisis, first by financing unsound investments and then by facilitating capital flight when the crises began”. He argued that “the Washington consensus discouraged the use of capital controls as a way of managing debt problems, and encouraged countries to deregulate their financial systems”.

2.3.1.2 Crises arising from East Asia

During the 1990s, East Asian countries experienced considerable economic growth, accompanied by favourable fiscal conditions and large investments. This favourable condition was due to the countries’ financial liberalisation which obviously attracted foreign investors. The substantial inflows of foreign capital led to an increase in credit in these countries, resulting in a rise in bank credit being extended to the private sector. Foreign investors (mostly foreign banks) gave short-term loans, in dollar terms, to local banks rather than through local financial markets; these foreign loans were attractive to local banks, because they carried relatively low interest. Local banks, in turn, lent the money on a long-term basis to locals at much higher interest rates, which was obviously very profitable for these banks. Consequently, local bank borrowers used the money to finance projects of questionable quality and those that carried little promise of earning additional foreign currency. As a result, the factor that triggered the eventual crisis was the strengthening of the dollar. This caused an overvaluation of the local currency as it was pegged to the dollar and worsened the trade account. Country risk increased, which eventually led to uncertainty and insecurity on the part of foreign banks. This caused them to stop rolling over loans, thereby precipitating a general disinvestment from local markets. A massive dollar shortage in the local markets ensued, followed by a huge fall in the value of the local currency.

At that time, local banks could not obtain dollars and failed, which caused the local economic crisis.

The Asian crises, as explained by Stevens (2007:3), were due to

underdeveloped capital markets, where capital inflow tended to be intermediated through the banking sector. Exchange rates were heavily managed and the counterparts of the inflow were a large build-up in money and credit in the domestic financial sector . . . Neither borrowers nor bankers were managing their risks due to weak risk management capacities and ineffective supervision.

Miller and Luangaram (1998:3) describe the East Asian crises as “a creditor panic, which was in large part due to economic excesses in the domestic private sector and inadequate regulatory responses by the government, particularly in respect of banking” and note that “the main features of the Asian crises were inefficient and inadequate regulation and (implicit or explicit) government guarantees” (p. 3). Other critics (Guitian (1998); Radelet and Sachs (1998)) generally agree that the East Asian crisis was caused by large-scale movement of funds out of domestic financial markets, beginning in Thailand and quickly spreading to neighbouring countries, as investor sentiment deteriorated. Table 2.1 shows the banking crises in the Asian economies and their liberalisation dates.

Table 2.1: Banking crises and liberalisation dates in East Asia

Banking crisis	Indonesia	Korea	Malaysia	Philippines	Thailand
Year	1997–2002	1997–2002	1997–2001	1998	1997–2002
Decontrol of interest rates	1983	1991	1991	1983	1992
Abolition of direct credit	1983	1981	1985	1993	1992
Allowance of capital flows	*	1996	*	1995	1992
Privatisation	1996	1983	*	1995	1993
Deregulation	1992	1988	1989	*	1993

Source: Noy (2005:6)

* Blank space denotes sector liberalised either before 1980 or not yet liberalised.

Table 2.2: Exposure of individual international banks to the four most-affected countries (1997–8)

Country	Bank	South Korea			Indonesia			Malaysia			Thailand			Total		
		End 1997	End 1998	% Change	End 1997	End 1998	% Change	End 1997	End 1998	% Change	End 1997	End 1998	% Change	End 1997	End 1998	% Change
France	BNP Credit Agricole	1,7	1,6	-0,06	1,0	0,8	-0,20	0,6	0,5	-0,17	1,0	0,7	-0,30	4,3	3,6	-0,16
	Credit Lyonnais	1,9	1,0	-0,47	0,7	0,5	-0,29	0,2	0,1	-0,50	1,1	0,6	-0,45	3,9	2,2	-0,44
	Paribas	3,7	2,4	-0,35	1,3	1,0	-0,23	0,3	0,2	-0,33	0,6	0,5	-0,17	5,9	4,1	-0,31
	Société Générale	1,5	1,0	-0,33	0,4	0,4	0,00	0,3	0,3	0,00	0,4	0,3	-0,25	2,6	2,0	-0,23
	Générale	4,5	2,7	-0,40	0,8	0,6	-0,25	0,9	0,6	-0,33	2,4	1,8	-0,25	8,6	5,7	-0,34
	Total	13,3	8,7	-0,35	4,2	3,3	-0,21	2,3	1,7	-0,26	5,5	3,9	-0,29	25,3	17,6	-0,30
UK	Barclays	1,0	0,8	-0,20	0,5	0,2	-0,60	n/a	n/a		0,5	0,2	-0,60	2,0	1,2	-0,40
	Natwest	1,8	1,3	-0,28	0,4	0,3	-0,25	n/a	n/a		0,4	0,2	-0,50	2,6	1,8	-0,31
	HSBC	4,1	3,6	-0,12	1,8	1,4	-0,22	n/a	n/a		2,8	2,3	-0,18	8,7	7,3	-0,16
	Llyods TSB Abbey National		0,5												0,8	
	Total	6,9	6,2	-0,10	2,7	1,9	-0,30				3,7	2,7	-0,27	14,1	11,1	-0,21
Japan	Bank of Tokyo	3,4	2,7	-0,21	2,6	1,2	-0,54	1,3	1,1	-0,15	4,5	2,7	-0,40	11,8	7,7	-0,35
	Mitsubishi Dai Ichi Kangyo	1,6	1,7	0,06	1,4	1,0	-0,29	0,4	0,4	0,00	1,8	1,6	-0,11	5,2	4,7	-0,10
	Sanwa	0,9	2,0	1,22	2,3	0,9	-0,61	0,8	0,7	-0,13	2,2	1,7	-0,23	6,2	5,3	-0,15
	Fuji	0,9	1,2	0,33	1,4	0,8	-0,43	0,6	0,5	-0,17	1,8	1,1	-0,39	4,7	3,6	-0,23
	Sumitomo	1,6	1,2	-0,25	1,2	0,9	-0,25	0,6	0,6	0,00	2,0	1,4	-0,30	5,4	4,1	-0,24
	Tokai	0,4	0,3	-0,25	0,6	0,5	-0,17	0,6	0,5	-0,17	1,4	0,8	-0,43	3,0	2,1	-0,30
	Sakura	0,7	1,0	-0,43	1,4	1,4	0,00	0,3	0,3	0,00	2,4	1,5	-0,38	4,8	4,2	-0,13
	Total	9,5	10,1	0,06	10,9	6,7	-0,39	4,6	4,1	-0,11	16,1	10,8	-0,33	41,1	31,7	-0,23
US ¹	Chase Manhattan	5,3	2,4	-0,55	2,2	1,2	-0,45	0,9	0,6	-0,33	1,4	0,9	-0,36	9,8	5,1	-0,48
	Citicorp	2,6	<0,8	n/a	0,6	n/a	n/a	0,7	n/a	n/a	0,3	n/a	n/a	3,5	n/a	n/a
	JP Morgan	3,4	1,7	-0,50	0,8	0,2	-0,75	0,4	n/a	n/a	1,2	0,2	-0,83	5,8	2,1	-0,64
	Total (1)	11,3	4,1	-0,64	3,6	1,4	-0,61	2,0	0,6	-0,70	2,9	1,1	-0,62	19,1	7,2	-0,62
Grand total	41,0	29,1	-0,29	21,4	13,3	-0,38	8,9	6,4	-0,28	28,2	18,5	-0,34	99,6	67,6	-0,32	

Source: Cailloux and Griffith-Jones (2000:21)

Notes: Some banks include their on- and off-balance sheet exposure, while others do not. Data exclude for most banks sovereign risks, trade credit risk and export credit agency guarantees

1 The total for the US needs to be interpreted with care due to lack of data

In analysing total exposure by country it can be seen that the outflow from the four Asian countries totalled US\$32 billion in 1998. In 1997, at country level, France's exposure was US\$25,3 billion, that of the UK US\$14,1 billion, Japan's total exposure was US\$41 billion and US exposure amounted to US\$19,1 billion. In 1998 international banks' exposure to the Asian economies totalled US\$67,6 billion.

All in all, the institutional factors that increased the crisis-proneness of these countries include their liberalised markets, weak supervision and risk management, and their exchange rate pegged to the dollar. The factors that set the scene for the crisis were attributed to foreign investors and local banks. The crisis-prone countries ended up having weaker banking systems, reduced credit availability and slower, or even negative, economic growth.

2.3.1.3 Exchange rate volatility

The East Asian crisis drew attention to the importance of a sustainable exchange rate regime. This is because during the Asian liberalisation process, authorities used a blend of fixed exchange rate policies with open capital account policies, even though the markets and regulatory institutions were weak, and this also contributed to the drastic financial crisis.

Most of the Asian economies had their exchange rate pegged against the US dollar to ensure price stability, and to make foreign capital obtainable at a reduced rate for business ventures by means of bank finance and FDIs. Pegging against the dollar encouraged domestic companies in general to take loans from foreign banks, while foreign banks lent recklessly in US dollars on a short-term basis. However, when the dollar appreciated against other major currencies, this resulted in competitive losses for the East Asian economies as their currencies became overvalued and made exports less competitive. Since the Asian economies were export-driven,

overvaluation of the currency aggravated the current-account balances when export growth fell. Chow et al. (2007:3) advocate that “unless domestic financial sectors are sufficiently developed and an exchange rate sufficiently flexible, capital account liberalisation is premature and effectively neutralises the stability benefits of fixed exchange rates”.

Since fixed exchange rate strategies increased systemic risks during the Asian crisis, some countries abandoned the fixed exchange rate and switched to a floating regime (although the float is seldom completely free due to central bank intervention, to some extent, in foreign-exchange markets), and others tried to eradicate the excessive capital movements while still remaining pegged to the US dollar. However, abandoning the fixed exchange rate led to the Asian currencies depreciating substantially and governments were unable to protect the Asian currencies due to their small foreign reserves. This consequently left businesses with enormous foreign debts that had to be paid with more local currency. Banks refused to extend further credit, which brought about many corporate bankruptcies.

2.4 Underlying reasons for the crises

According to Bird and Rajan (2001:889), “banking crises seem to be more likely following financial liberalisation with sharp increases in domestic lending”. Some of the underlying reasons for the crises are identified as (i) banking mismanagement and weak supervisory capacity; (ii) weak credit review and speculative activities by banks; (iii) lack of regulatory measures in the financial system; and (iv) a fixed exchange rate regime, all of which are described below.

2.4.1 Banking mismanagement and weak supervisory capacity

In the Asian crisis bank managers borrowed short term and lent long term, and their risk management stance was not strengthened, nor was it reviewed. In addition, Asian banks did not hold sufficient capital to buffer the risks that they took, as the extra capital could have acted as a safeguard or cushion for unforeseen circumstances. Instruments of prudential control were eliminated and bank managers' regulatory oversight was weakened. In addition, the shift in financial market sentiment exposed structural weaknesses in these economies. Developing economies had not taken into account the efficient running of their economy and the importance of the stability of the financial system. Therefore, these economies were unable to withstand the shocks that they experienced.

2.4.2 Weak credit review and speculative activities by banks

Information asymmetry can be regarded as one of the reasons for weak credit review on the part of supervisors. In the case of the Mexican and Asian crises, banks' ability to exercise credit judgement was impaired. Overexposure to credit and speculative activities contributed to the crises. Ribakova (2005:3) states that "when liberalisation occurs, bank competition increases, risky investments increase and bank managers often lack the experience in traditional banking, thus supervisors need to enhance supervision by concentrating on a more risk-based method".

2.4.3 Lack of regulatory measures in the financial system

In some countries weaknesses in the regulatory structure had led to a financial crisis, which the government was unable to control. This happened for the obvious reasons that macroeconomic policies and market discipline were not reviewed to cater for the deregulation. However, Noy (2004:1) argues that "liberalisation can lead to financial instability either because of insufficient regulation of the financial sector or because of erosions of previously granted monopolies of

existing banks". His theory on lax supervision and the monopoly power hypothesis "explains the relationship between financial liberalisation and banking crises in developing countries" (Noy 2005:3). In the lax supervision hypothesis, a fully liberalised domestic financial banking sector has no government restrictions, which leads to bank managers being unfamiliar with the new challenges or risks facing them and which results in their taking more risks. Noy (2004:3) asserts that "financial liberalisation will enable undue risk taking behaviour and a consequent crisis, if this behaviour is accompanied by inefficient supervision". The monopoly power hypothesis, in turn, can be viewed as pre-liberalised banks having monopoly power to their advantage, because government has protected these banks from competition. However, during liberalisation, domestic bank profit margins are decreased because of an increase in deposit rates and a decrease in lending rates. In addition, the entry of foreign banks increases competition and those banks that are inefficient will go bankrupt. Noy (2004:4) adds that "under this scenario systemic problems in the banking sector are an almost inevitable result of financial liberalisation". However, inefficient banks going out of business is not a negative development in itself. It may also create space for efficient, more prudent banks to thrive – as long as no contagion occurs. As mentioned, bank failures can generate financial instability due to weak banking systems and when risks are mismanaged. Walter (2002:2) asserts that "greater competition may lead banks to take greater risks to sustain levels of profitability previously ensured by government restrictions on competition in the banking sector." Stiglitz et al. (2000a:2) similarly mention that

liberalisation causes an increase in competition, which in turn, reduces franchise value (i.e. the capitalised value of expected future profits) and if franchise value falls, then incentives for good loans also fall. This is as a result of competition eroding profits. Thus, increased competition tends to promote gambling in the banking sector.

2.4.4 Fixed exchange rate regime

The collapse of the exchange rate in countries such as Argentina and Asia was due to the exchange rate peg. These countries pegged their currencies in order to maintain the stability of the currency and hence decrease inflation. As a result of market volatility in Argentina, the Brazilian real depreciated in terms of the dollar and in Asia the dollar appreciated against the yen, which contributed to the crises in those areas. According to Mishkin (1998:23), “an exchange rate peg is a very dangerous strategy for controlling inflation in emerging market countries as it increases financial fragility and makes the potential for financial crises more likely. Instead central bank independence and the adoption of inflation targeting is a better strategy to controlling inflation.”

2.5 Conclusion

Financial liberalisation was implemented so that the negative effects of the financial restrictions were eliminated and the domestic financial sector operated more effectively as part of the international sector. The Washington Consensus, which was the father of liberalisation, emphasised that a country should open its markets to the world, as a result, moving from a government-led to a market-orientated financial system. Liberalisation of the financial sector was said to bring foreign currency deposits into the country’s financial system and increase financial efficiency. Furthermore, liberalising a country’s capital account and fixing the exchange rate was said to improve economic growth through globalisation of finance, lower macroeconomic volatility and also to ensure price stability. However, in response to deregulation, many countries were shattered by a crisis. The underlying reasons for these crises were undercapitalised banks, contagion effects, volatile markets and weaknesses in the regulatory structure.

Chapter 3

Lessons learnt: Measures to ensure effective financial liberalisation in developing economies

3.1 Practical experience of improvements during the 1990s and 2000s

Financial liberalisation intensified the fragile state in some developing countries, thus exposing these countries to recurring financial and currency crises. As explained in Chapter 2, the impact of financial liberalisation was more negative than theory postulated, as it led to many crises due to the lack of regulation and policy implementation in some emerging market economies. The sudden liberalisation of capital accounts, domestic banks, exchange rates and so forth brought about huge financial instability, and was mostly responsible for the negative impact of financial liberalisation.

However, in recent years and after many financial crises, other countries started liberalising their economies through a more gradual process so that they could better adjust to the changes. Consequently, if any irregularities in the financial system were detected, they could be rectified and a crisis diverted. As a result, developing countries started adopting a slower and more cautious move into liberalisation, which served their future stability better. This gradual process, known as 'sequencing', is defined by Nsouli et al. (2002:4) as "the order in which either macroeconomic policy actions or specific reforms are introduced. It involves the order in which reforms are undertaken across sectors and the order in which reforms are undertaken within sectors." In this light, liberalisation needs to be sequenced carefully so that economic stability and fiscal sustainability are secured.

The advantage of sequencing is that it enhances the outcome of macroeconomic policies, stimulates the development of markets and strengthens the structure of the markets. In addition, in the event of a policy readjustment, sequencing can allow for a flexible portion of the readjustment process, thus reducing the chances of a crisis. Nsouli et al. (2005:759) outline four key factors as guidelines for policymakers when sequencing:

- i Preparatory time is important, since implementing different reforms can vary;
- li Prerequisites are necessary, for example, financial stabilisation may be a prerequisite for another reform;
- lii Complementarities are seen as vital in shaping sequencing, for example, fiscal policy, trade liberalisation and public enterprise reforms can complement one another; and
- iv Conflict between different policy instruments should be considered, for example, trade liberalisation and a depreciation of the exchange rate versus capital account liberalisation and an appreciation of the exchange rate.

The issue of sequencing shows that if reform policies are implemented in a structured fashion, then liberalisation is less crisis-prone, less complicated and better accepted. Mishkin (2006:28) also agrees that “to avoid financial instability, policymakers need to put in place elements of a proper institutional structure before liberalising their financial systems”. A good example of this is the case of Bulgaria, which experienced deep economic and financial crises during 1996. However, after reforming its policies, such as adopting a disciplined fiscal stance and implementing it in a more structured fashion, it has managed to continue on a path of economic growth.

Likewise the Washington Consensus, exchange rate regime, capital account liberalisation and monetary policy have either been reformed or been done away with to ensure more effective financial liberalisation.

3.1.1 Washington Consensus follow-up

Following the crisis that resulted from the Washington Consensus, Joseph Stiglitz (1998) developed a Post-Washington Consensus in an attempt to improve liberalisation strategies. The difference between the Post-Washington Consensus and the Washington Consensus is that while the Washington Consensus focused on trade liberalisation, macroeconomic stability and stable prices, the Post-Washington Consensus concentrated on making the market economy more effective and efficient by including in its policy, financial reform that was transparent, contained a strong legal framework and readily available information; and by enhancing the government's role in the private sector and the market as a whole. The Post-Washington Consensus places emphasis on sustainable, equitable and democratic development. Stiglitz (1998) points out that the aim of this consensus is to address market imperfections, and to ensure limited regulation, better living standards and sustainable development.

However, according to Onis and Senses (2003:20, 26), the Post-Washington Consensus displayed certain limitations. First, it was seen as extremely narrow and weak, because it failed to take into account skewed income distribution, extreme poverty and lack of self-sustained growth in many developing economies. Second, it focused on the transparency and accountability of domestic institutions, yet ignored the lack of such accountability and transparency in the international sphere. Third, it displayed a

technocratic approach towards state-market interactions at local and global levels as existing power structure are seen as predetermined. As a result, failure to address fundamental power

relations and asymmetries of power that exist between classes at the level of the nation state and powerful versus less powerful states in the global economy. (P. 28.)

For this reason, some economists say that the power relations should not be taken as an analytical starting point. Arestis (2004:251) argues that

both the Washington Consensus and the Post-Washington Consensus have proved to be a disaster for developing countries, because prerequisites were not mentioned when implementing the consensus. These include sequencing in financial liberalisation policies, where capital flows should follow the establishment of liberalised and robust domestic financial systems; and institutional preconditions, where sound financial institutions should be in place before financial liberalisation is introduced.

As a result, economists started questioning the pace and sequencing of deregulation and liberalisation. However, Nsouli et al. (2005) propose that because each country is unique in its own way, the sequencing of reforms and the pace at which a country wants to make adjustments should be country-specific.

3.1.2 Shifts away from capital account liberalisation

The risks and economic fluctuations that resulted from the sudden liberalisation of the capital account brought little benefits to the previously crisis-prone economies. Nowadays, economists (e.g., Das (2004); Stiglitz et al. (2000a)) believe that capital account liberalisation does not distribute financial resources effectively because the difference between global capital movements and real economic activities are not related. The reason for this is that such capital tends to be invested in second-hand financial assets, which do not induce more real investment.

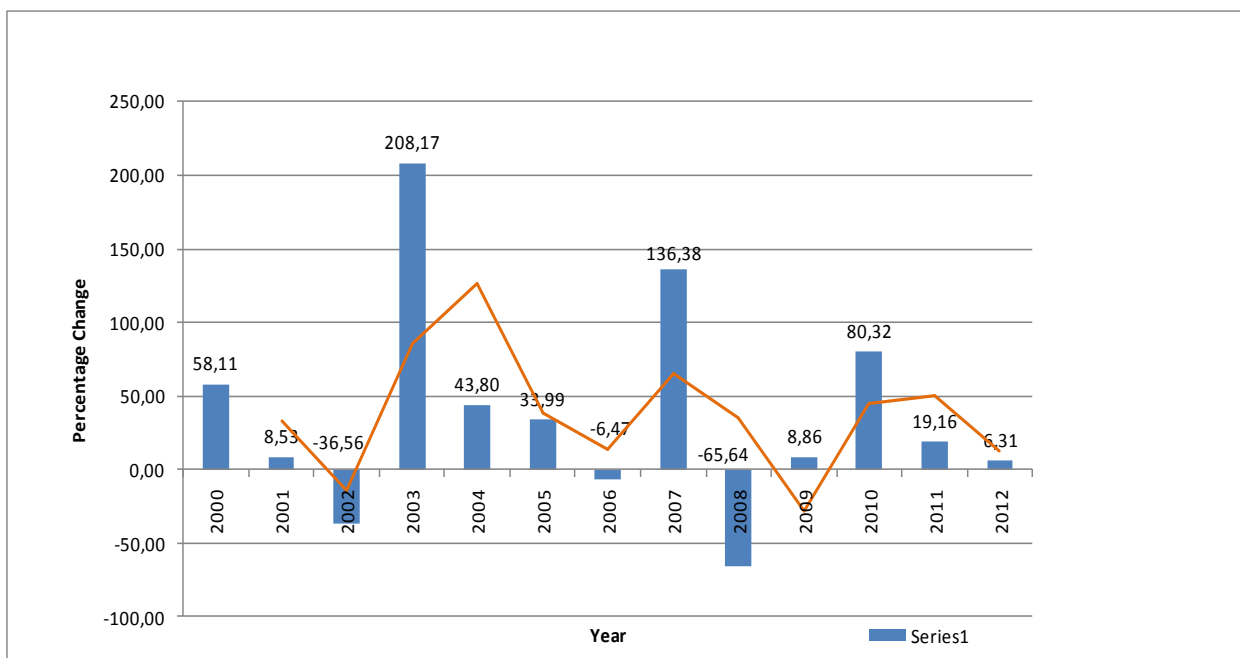
Rodrik and Subramanian (2008) also support the shift away from capital account liberalisation. In their study they argue that different economies (e.g., a savings-constrained economy or an investment-constrained economy) will respond differently from capital account liberalisation. They found that in an investment-constrained economy investments are unaffected by liberalisation because they are determined by forward-looking returns. In this case the effect of liberalisation simply enhances consumption. In a savings-constrained economy the rise in the availability of finance through capital account liberalisation encourages domestic investment by firms, and consumers who experience a change in prices tend to engage in more spending and less savings. Rodrik and Subramanian (p. 2–14) further argue that financial globalisation has not contributed to higher growth in emerging markets. This is because some emerging economies may have insufficient access to finance, while others are limited by too-little investment demand as a result of low social returns or too low private appropriability. Countries that rely less on capital inflows have grown rapidly, with the result that “financial globalisation has not led to better smoothing of consumption or reduced volatility” (p. 18). Examples of countries that rely less on capital inflows and yet have grown rapidly include Singapore, Korea, China and Indonesia.

Another important argument against capital account liberalisation is that it tends to overvalue the exchange rate, which damages developing countries’ chances to be competitive in export markets. Moreover, it adds to exchange rate volatility when short-term capital is withdrawn from a country, often for unsystematic reasons.

Wyplosz (2001:14) also asserts that capital account liberalisation opens the doors to potential risk-taking. He adds that “in the absence of adequate supervision and regulation, risk-taking may easily become excessive” (p. 14). In his analysis of the effects of liberalisation on developing and developed countries, using a sample of 27 countries, he finds that financial

liberalisation is more destabilising in developing countries than in developed ones. This is because when developing countries liberalise their capital accounts, they experience an immediate boom followed by a sudden decline. He explains that the sudden large inflow of capital causes vulnerability in the developing countries, as a considerable “inflow of capital tends to be followed by sudden outflows, which impact on the exchange rate” (p. 4). For example, in 1980 the net private capital flows in Asian crisis countries before liberalisation was US\$7,52 billion. After liberalisation, net private capital flows increased to US\$62,52 billion in 1995. However, net private capital flows fell considerably in 1997 to -US\$17,73 billion due to the Asian crisis (IMF, 1999b). Further data on emerging and developing market economies as a whole show that there have been sudden declines in net private capital flows (Figure 3.1). As evidenced by the IMF (2011c), in 2003 these flows had peaked by 208 per cent year on year to US\$167 billion from US\$54 billion in 2002, but fell at a continuous rate between 2004 and 2006. The small volumes of net private capital flows was due to the financial market volatility experienced in developed economies, which led to interest rates increasing, hence impacting developing economies asset prices where investors had taken large exposures that had appreciated. Again, in 2007 net private capital flows peaked by 136 per cent year on year to US\$715 billion from US\$302 billion in 2006. However, owing to the financial crisis, in 2008 net private capital flows fell by 65,6 per cent year on year. Recovery was evident in 2009 where net private capital flows increased 8,6 per cent year on year. In 2010 and 2011 net private capital flows totalled US\$482 billion (2009: US\$ 267 billion) and US\$574 billion respectively.

Figure 3.1: Net private capital flows: Emerging and developing market economies



Source: IMF (2011c)

According to the Institute of International Finance (IIF) (2009; 2011; 2012), the private capital flow to emerging market economies for 2007 was US\$928,6 billion; in 2008 it was US\$622 billion and in 2009 it was US\$602 billion due to the slowdown of global economic growth. Capital flows for 2010 was at US\$1 040 billion but in 2011 capital flows was down to US\$910 billion. The IIF also forecasts net private capital flows for 2012 to be US\$746 billion and for 2013 to be US\$893 billion due to the financial turbulence in the Euro area.

The shifts away from capital account liberalisation in emerging markets are due to higher growth rates and lower macroeconomic volatility failing to materialise sufficiently. Licchetta (2006:5,21) suggests that “it is only for the special case of FDI . . . that an open capital account leads to higher growth rates . . . and that . . . financial integration is not a necessary condition for achieving high growth rate”. This can be seen in Table 3.1, which lists the fastest-growing

developing economies and the slowest-growing economies during 1980–2000 with their status of financial openness.

Table 3.1: Fastest- and slowest-growing economies during 1980–2000 and their status of financial openness

Fastest-growing economies 1980-2011	Total % change in per capita GDP*	More financially integrated	Slowest-growing economies 1980-2011	Total % change in per capita GDP*	More financially integrated
China	278.24	Yes/No**	Haiti	-43.3	No
Korea	182.26	Yes	Niger	-27.34	No
Singapore	135.01	Yes	Nicaragua	9.73	No
Thailand	138.49	Yes	Togo	-48.21	No
Mauritius	123.3	No	Cote d' Ivcoire	-51.21	No
Botswana	138.64	No	Burundi	-8.2	No
Hong Kong SAR	118.14	Yes	Venezuela	0.21	Yes/No**
Malaysia	107.43	Yes	South Africa	16.56	Yes
India	134.06	Yes/No**	Jordan	30.39	Yes
Chile	93.54	Yes	Paraguay	20.61	No
Indonesia	104.38	Yes	Ecuador	33.13	No
Sri Lanka	117.91	No	Peru	41.6	Yes

Source: Prasad et al. (2003), IMF (2011d)

* Note: Growth rate of real GDP per capita is expressed in current constant local currency units.

** Yes/No means limited capital account liberalisation

China and India have limited capital account liberalisation, yet have achieved very high growth rates. In addition, Botswana and Mauritius also have a high growth rate, even though they are not financially integrated into the world financial system. In contrast, Jordan's and Peru's growth rates in per capita GDP show that financial integration with the world is not a panacea for growth. From the table it can be seen that there is some positive correlation between growth in GDP and financial integrated economies, but capital account liberalisation alone is not an adequate requirement for fast economic growth. This is because economic growth is a function of more than one factor.

However, capital account liberalisation does bring about indirect benefits to an economy in the sense that domestic financial markets get better developed in the long run, there are improvements to local institutions and there is an inflow of knowledgeable foreign investors, which increases competition and stimulates efficiency among local investors (CGFS, 2009). Indeed, the implicit argument of those who favour capital account liberalisation is that insufficient capital is the main bottleneck in investment and growth which, for most developing countries it is not, Rodrik and Subramanian (2008) also tend to agree with this argument. Moreover, money inflows tend to be invested in secondary assets in financial markets. There are therefore no contributions to the real capital stock of a country at all because real production capacity remains the same; only share values increase.

In the case of Brazil, the leap to capital account liberalisation brought about some rewards. Previously, the country adopted a system according to which capital flows were taxed. According to Brazil's FDI and loans regulation in the 1960s (Laws 4,131 [9.3.62] and 4,390 [8.29.64] and decree 55,762 [2.17.65]), foreign capital inflows had to be registered and income tax paid in order to obtain permission for associated outflows such as profits, interests, royalties, and repatriation. Cardoso and Goldfajn (1997:16) explain that "proceeds of foreign borrowing were subject to a financial transaction tax with rates that range from 5 percent for loans with maturities under 3 years to zero percent for loans with maturities over 6 year . . . Purchasers of foreign exchange for some current invisibles were subject to financial transaction tax of 25 percent". With regulations like these in place, Brazil's macroeconomic performance was volatile.

In their study, Goldfajn and Minella (2007) found that during the pre-liberalised period from 1970 to 1982 the majority of Brazil's capital inflows were composed of loans (74,3%) while portfolio investments were small (5,4%). Gross external debt as a percentage of GDP was 31,5 per cent

in 1982 and peaked at 53,8 per cent in 1984. Brazil also experienced a shortage of capital flows (in 1983–1991) during the external debt crisis, which resulted in the loan flow balance being negative.

However, after Brazil had liberalised its capital account in the early 1990s, Goldfajn and Minella (2007:351) maintain that the liberalisation process had the following benefits in the country:

1. The debt accumulation pattern changed substantially after the liberalization of the capital account and, especially, after the floating of the currency. The private sector decreased significantly its issuance of external debt.
2. The profile of external financing has also changed since liberalization and the floating regime. After a period based on portfolio investment, FDI replaced it as the main financing source. Since 1998, net direct investment has comprised more than 100 percent of net private capital flows.
3. Net financial flows have, in general, financed current account deficits. Some differences emerge over time. Net financial flows financed
 - (a) a strong accumulation of international reserves between 1992 and 1996;
 - (b) a large expansion of the current account deficit from 1995 to 1997, representing a growth of both investment and consumption; and
 - (c) an increase in the current account deficit from 1998 to 2001, resulting from a higher deficit in net income from abroad.
4. Following capital account liberalization, consumption—its growth rate and share in GDP—has been more stable than in the 1980s. In comparison to the 1990s growth episodes, economic growth in 2000–2001 took place in a different context. First, net capital flows have been of a lower magnitude and have been dominated by FDI. There has been no significant surge of short-term flows or portfolio investment. Second, the expansions have been accompanied by a more favourable situation in the trade balance.

Goldfajn and Minella (2007) support the fact that capital account liberalisation has led to a more resilient economy, even though the country made a transition when it experienced macroeconomic volatility.

Griffith-Jones (2003:1) asserts that for capital account liberalisation to be gainful to developing countries, three prerequisites should apply. First, there should be adequate private capital flows feeding into developing countries. She asserts that this condition was met during the 1990s. However, the situation had changed drastically in the wake of the Asian crisis with capital flows to emerging markets reducing. This was due to “structural changes where domestic banks have crossed the border and will replace domestic lending with foreign lending as there are not many ‘sufficiently large’ companies left for equity investors to buy in developing countries” (p. 2).

Second, capital flows should be long term and not too relaxed where they can easily be switched so as to avoid a costly crisis. In her research, Griffith-Jones emphasises that FDI is the key supply of net capital flows, which is more long term and less easily reversible. However, non-FDI capital flows to emerging markets (e.g., debt and portfolio equity) seem to have become increasingly volatile due to the increased use of derivatives and other institutional factors.

Third, there should be global assistance in both crisis prevention and better crisis management in order to make crises shorter and less costly, for example, the IMF lending to Brazil in mid-2002 contributed to a more stable market sentiment.

3.1.3 A more sustainable exchange rate regime

Since the Asian crisis, many countries have attempted to overhaul their exchange rate regime to make it more sustainable in order to optimise growth. Chow et al. (2007:2) advocate that “when we combine a fixed exchange rate and premature opening of the capital account with a weakly structured domestic financial sector, currency crises quickly turn into financial crises and perhaps to full-blown economic and political crises”. Capital account liberalisation should thus not be isolated. In fact, it should be sequenced with appropriate macroeconomic reforms and exchange rate policies. In addition, the exchange rate regime must also be consistent with other policies to achieve macroeconomic stability so that large volatility in, and disruptions to, the economy are prevented.

In choosing an exchange rate regime, the execution of policies is significant for a country's economic and financial stability. The advantage of having a floating exchange rate is that it is better able to absorb shocks. Experience has proven that economies are more robust and resilient with flexible exchange rates. This can be seen in the case of Brazil in 2002, when the markets put substantial downward pressure on the real before the presidential elections. Although the Brazilian real had depreciated against the US dollar for a little while, it gained momentum and later appreciated. “The floating Brazilian real averaged US\$2,34 against the USD, within a range of US\$1,32 on the outset to US\$3,96 on 22 October 2002” (Campos Meirelles, 2009:1). Another example can be seen in the effects of the 2007 global economic crisis (explained later in the chapter). According to Kaltenbrunner and Paineira (2009:1)

late in 2008, Brazil experienced one of the largest exchange-rate depreciations in the world as short-term speculative capital flooded out of the economy. However it had little to do with Brazil's ‘economic fundamentals’, such as its current-account balance, its fiscal balance or its public-sector debt. Instead, it was linked directly to deteriorating conditions in international financial markets.

However, sizeable short-term capital inflows are causing the exchange-rate to appreciate again. The downside to flexible exchange rates is that of greater volatility with important destabilising effects on the inflation rate. It is worth noting that economies that are robust and resilient to shocks with strong domestic and well-functioning markets can generally tolerate this volatility.

Dodge (2005) explains that a flexible exchange rate alone is insufficient. He maintains that a combination of a flexible exchange rate with a domestic anchor, such as inflation targeting and sound fiscal policy, can work more effectively and provide a more complete monetary policy framework. He adds that a floating exchange rate, together with anchors, helps the economy to adjust to transforming environments and that changes in the exchange rate are seen as a warning signal by businesses, thus helping the economy adjust to changing circumstances.

To avoid irregular capital flows and unstable exchange rates, a gradual approach to liberalisation should be followed. Nsouli et al. (2005) agree with McKinnon (1973) and suggest that countries should follow a gradual approach to liberalisation and liberalise their domestic financial sector first, followed by the exchange rate and then the capital account. Chow et al. (2007:5), in contrast, propose the cascading of financial liberalisation where all aspects of a liberalisation programme are executed concurrently. They advocate that

under optimal cascading, selected lifting of capital controls and a limited degree of exchange rate flexibility can take place while the domestic financial sector is developing. As the domestic financial sector deepens, increased exchange rate flexibility and an increasing liberalised capital account will not only be possible, but optimal. (P. 5).

Nowadays, exchange rate and external financial strategies are established concurrently to maximise potential growth and development while reducing risks. It is important for central

banks to settle on exchange rate policies in conjunction with financial account liberalisation. In addition, an appropriate exchange rate regime should reflect the individual properties and characteristics of an economy.

3.1.4 Better monetary policy in general

The process of liberalisation has impacted on the conduct of monetary policy in a significant manner. Some of the key issues that emanated from financial liberalisation include the role of monetary policy authorities and their co-operation in avoiding future crisis, the risks of contagion and threats it poses to macroeconomic and financial stability, and increased competition and globalisation.

Ferguson (2002:2) explains that “in preventing financial instability, central banks should foster a macroeconomic environment of low and stable inflation and sustainable economic growth”. However, Crockett (2001:4) argues that “the combination of a liberalised financial system and a fiat standard with monetary rules defined exclusively in terms of inflation is not a sufficient condition for financial stability”.

These developments have led to the refinement of the objectives and strategies of monetary policy in that central banks are concentrating on financial stability in formulating their monetary policy. Svensson (2011) defines ‘financial stability’ as

a situation in which the financial system can fulfill its main functions of submitting payments, transforming saving into financing and providing risk management with sufficient resilience to disruptions that threaten these functions Financial-stability policy directly affects spreads, lending and other aspects of financial conditions as well as the transmission mechanism of monetary policy.

The objective of central banks globally is generally to maintain monetary and financial stability. While monetary stability relates to price stability, financial stability can be seen as the smooth functioning of the financial system. The smooth functioning of financial institutions and markets can be identified by the absence of disruptions, such as crisis or volatility, to the various sectors. “The transmission of monetary policy to the real economy depends crucially on the smooth functioning of key financial institutions and markets” (Ferguson, 2002:3), because monetary policy affects the overall liquidity conditions of these institutions; in other words, if monetary policy is loose or tight, the balance sheet of financial institutions is affected but not necessarily the balance-sheet totals. The institutions either expand their balance sheet via collateralised loans or contract their balance sheet by reducing stock of repos (i.e., by selling repos) in exchange for more cash. This effect ensures that the supply of liquidity either increases or decreases in these institutions but leaves the balance-sheet totals unaffected (but recently balance sheet adjustment has become more complex after the introduction of quantitative easing which is explained in section 3.2.3.3 Lender of last resort). Accordingly, consumption expenditure and investments also increase or decrease, which eventually affects output. This influences the effectiveness of the transmission mechanism.

Monetary stability and financial stability are intertwined in that price stability encourages positive investment and longstanding growth which, in turn, is favourable to financial stability. Borio (2011:12) is in agreement and asserts that central banks cannot abandon financial stability and therefore its “operational autonomy in pursuing price stability should be safeguarded”. ‘Price stability’ can be defined as “a state in which the general price level is literally stable or the inflation rate is sufficiently low and stable” (Papademos, 2006).

In promoting financial stability, Mishkin (2006:2) says that “financial deepening must be promoted . . . by developing an institutional infrastructure that enables the financial system to

allocate capital efficiently”; for example, the reform in Thailand was gradual, which allowed institutions to adjust. This reform included strengthening the monitoring and examination of the financial system; developing the payment system, and the countries’ debt market and instruments; and allowing foreign firms to access the domestic financial market.

Opening up the financial system to global institutions enhances competition and allows for better practices, which should strengthen the functioning of financial markets. Mishkin (2006:17) asserts that

because many emerging market and transition economies are more volatile than industrialised countries, having a large foreign component to the banking sector is especially valuable because it can help insulate the banking system from domestic shock. Encouraging entry of foreign banks is thus likely to lead to a banking and financial system that is substantially less fragile and far less prone to crisis

since better competition, governance and more efficient and knowledgeable market participants will help sustain a competent financial system.

In the new environment of globalisation and financial integration up to the beginning of 2007 the monetary policy stances of central banks (e.g., South Africa and Brazil) have proven adequate in influencing and safeguarding financial stability in the domestic sector. Threats to the financial system (e.g., excessive competition, overcrowding in the banking sector, misguided regulation, and currency and banking crises) cannot be completely discarded. However, a well-regulated financial system can limit these threats.

The liberalisation process has brought about many changes in the economic and financial environment in many developing countries. The central banks of most developing countries have implemented various monetary policy strategies and best practices after liberalisation with a better regulatory framework (which will be discussed later in this chapter), in order to ensure a less-volatile and more stable economic environment. It is evident that monetary policy is an important function in limiting the effect of future possible crises.

Monetary policy should be adopted in such a way that it should try to prevent a volatile market and high rates of inflation by all means. This is because volatile inflation rates can affect consumers as well as firms, for example, high inflation may cause central banks to increase interest rates. Banks react by also increasing their lending rates, which can trigger bankruptcy, thus affecting the performance of bank loans due to the risk that some borrowers cannot repay their loan in time. However, if inflation is low in a loose monetary policy stance, then investment and consumer spending increase, which contributes to an increase in growth and can again accelerate inflation. However, too-low or negative inflation can be risky, because borrowers will prefer holding cash rather than bank deposits as the interest on the bank deposit may be non-existent or insignificant. As a result, this can affect the bank's profits. Sinclair (2000:388) states that "monetary policy should therefore aim at stabilising inflation with positive and stable short-run nominal interest rates, as quick temporary changes in short nominal rates may add to uncertainties in financial markets".

3.2 Various best practice standards

In response to the Asian financial crisis, attention was drawn to the importance of a more prudent regulatory and supervisory environment to prevent bank failures and systemic risks. International financial institutions, such as the Basel Committee on Banking Supervision

(BCBS), the OECD, the Financial Stability Forum (FSF),³ the IMF and the World Bank, have created a number of international standards to control market behaviour. These standards, now known as 'best practices', are being assessed through various methods (which are explained later in this chapter). Some of the changes that these standards have brought about include supervisors focusing on better risk management practices, and government strengthening regulation and prudential supervision of financial institutions. Furthermore, these best practices, which are benchmarks for countries to follow, now include a reform of the *International Convergence of Capital Measurement and Capital Standards* (Basel I) (followed by the *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II) which will be explained in the next section and the subsequent Basel III), safety net practices and the Financial Sector Assessment Program (FSAP). Stevens (2007:10) asserts that "these and other efforts represent an attempt to use what was learnt from the Asian and other crises to reduce susceptibility, or at least to get an early warning of regional level problems in the future."

3.2.1 Raised capital requirements

3.2.1.1 Basel I

In Noys's (2004:343) description of the lax supervision hypothesis (also explained in section 2.4.3) he says that "if an efficient supervisory structure is in place, excessive risk-taking will not occur, and financial liberalisation is unlikely to have an adverse effect on the stability of the banking system". If the same line of thought is followed, it is evident that one of the ways to maintain stability in the banking sector is for banks to have an adequate amount of capital in order to do business, as a bank's net worth (i.e., value of assets minus the value of debts) can

³ In April 1999 the FSF was summoned, at the initiative of the Group of Seven (G-7) Finance Ministers and Central Bank Governors, in order to promote financial stability globally and improve the manner in which financial markets operated by co-ordinating the efforts of various authorities responsible for financial stability.

become negative, if asset values depreciate at a fast pace. Thus, this can result in the bank experiencing technical bankruptcy. Therefore, in international banking there needs to be a set standard across the globe of maintaining capital to mitigate risks and to ensure that financial systems are more robust.

The BCBS therefore developed a framework to set standards for maintaining capital levels for international banks so that systemic stability could be maintained. This framework was the first Accord, known as Basel I, which was released in 1988. “The framework was mainly directed towards assessing capital in relation to credit risk” (BCBS, 1998:2). As a result, a risk-weighted ratio method was used to classify banks’ assets into various risk categories, five risk categories to be precise (see Table 3.2). Banks were required to retain at least 8 per cent capital of their risk-weighted assets, especially if their businesses were based abroad. Table 3.2 shows the banks risk categories and weights under Basel I.

Table 3.2: Banks’ risk categories and weights under Basel I

Risk weights (%)	Risk asset category
0	Cash, central bank and government debt and any OECD government debt
0, 10, 20 or 50	Public sector debt
20	Development bank debt, OECD bank debt, OECD securities firm debt, non-OECD bank debt (under one-year maturity) and non-OECD public sector debt, cash in collection
50	Residential mortgages
100	Private sector debt, non-OECD bank debt (maturity over a year), real estate, plant and equipment, capital instruments issued at other banks

Source: BCBS (July 1988)

The main weakness of Basel I was confirmed in the few credit risk categories and the vague weightings of some loans for capital-adequacy purposes. First, critics such as Griffith-Jones and Spratt (2001) argue that the distinction between OECD countries and non-OECD countries in risk weights is biased, as developing countries will long to become a member of the OECD.

Second, the 20 per cent risk weight to non-OECD countries for short-term loans seemed more profitable for creditor banks. Furthermore, Table 3.2 shows that loans to non-OECD countries with maturity over a year required a 100 per cent risk weighting. The reason for this was that non-OECD countries were regarded as being risky countries in terms of debt repayment. International banks were therefore discouraged from lending long-term loans. While the risk weight of loans with a maturity of under one year made to non-OECD members was 20 per cent, whether it was for long- or short-term loans, this rule pushed international banks to lend excessively in the short term to developing countries, which was obviously cheaper considering the risk weight capital. Some developing countries used their short-term loans to fund long-term projects, which eventually became problematic due to the instability in the financial system.

3.2.1.2 Basel II

Basel II is a revised framework of the 1988 Capital Accord, which did not take into account the advances in risk management practices, technology and financial markets. Basel I encouraged banks to boost their capital positions and reduce competitive inequalities by adopting a standard approach to internationally active banks. Whereas Basel II focuses on the improvement of safety and soundness in the financial system, an increase in competitive equality and a more comprehensive approach to addressing risks, the goal of Basel II is to ensure a sound financial market and to enhance financial stability by making sure certain banks have sufficient capital to guard against the risks that they face. Previously, under Basel I, banks were required to maintain 8 per cent of their capital requirements to counter risks, but Basel II states that banks would have to calculate how much of their capital to reserve for each risk area.

The reason why banks are subject to capital requirements is because capital acts as a cushion against banks' unexpected loss and a foundation for a bank's future growth. If capital levels are

in short supply, then banks may be vulnerable to huge losses, thus this may increase the risk of a bank failure or technical bankruptcy. However, if capital levels are excessively high, then banks may limit the use of their resources which, in turn, may hamper the available credit that they offer to the public.

So, as part of strengthening the financial environment, capital reserves are viewed as an appropriate instrument to mitigate risks to which a bank may be exposed. This will lead to bank managers enhancing their risk management and prudential supervision. However, with the recent global economic crises (which will be touched on later in this chapter) it is debatable whether increased capital acts as a cushion against unexpected losses as it did little to prevent or ameliorate the recent subprime problems. What it does, is ensure that more of the risk is carried by shareholders instead of deposit holders and other lenders to banks, without reducing the overall risk very much.

The goal of Basel II is to be accomplished by three pillars. According to the BCBS (2003), they are as follows:

i Pillar 1: Minimum capital requirements

These requirements are more risk-sensitive and closely aligned to the bank's actual risk of economic loss. The primary risk categories include credit risk, market risk and operational risk.

Credit risk is defined as the risk of a counterparty (borrower) failing to perform according to contractual agreements. As a result, Basel II allows for the measurement of this risk in three different ways, namely (i) the standardised approach, for less complex forms of lending; (ii) foundation internal ratings-based (IRB) approach, where banks can determine the probability of

default by using their own risk model; and (iii) advanced internal ratings-based (AIRB) approach, where institutions will be allowed to use their own internal measures of credit risk as primary input to capital calculation.

Market risk is defined as the risk that the market price of an asset changing, may lead to a loss. Market risk is measured using the value-at-risk (VaR) method.

Operational risk is defined as the risk of loss caused by staff, failures in systems, processes and so forth. This risk is measured in three ways, namely (i) the basic indicator approach; (ii) the standardised approach, which is used for minimum operational risk exposure, and (iii) the advanced measurement approach (AMA), which is more risk-sensitive, and caters for internationally active banks and banks that are largely exposed to operational risks.

ii Pillar 2: Supervisory review

This pillar is a review of the banks' overall risks to ensure that management has set aside adequate capital for all the business risks beyond minimum requirements.

iii Pillar 3: Market discipline

This pillar complements Pillars 1 and 2, and encourages cautious management by improving the transparency and disclosure in the bank's public reporting. Market discipline is enhanced through policies such as corporate governance, accounting policies and auditing policies, thus increasing information about the banks and companies.

Internationally active banks implemented Basel II in January 2008, while other emerging countries are making an effort to work towards Basel II at their own pace. Basel II is expected to

bring many advantages, such as improved risk management systems to address the complexity and innovation in the markets; enhance firms' and financial systems' resilience in the changing financial landscape; and a more flexible framework to accommodate risk strategies. However, there has been a general dispute because it is believed that Basel II has a negative consequence for developing countries as it affects the cost of capital and thus can limit the developing countries' access to external financing. In addition, because emerging market economies' financial institutions are not properly structured, problems with implementation will exist. Furthermore, a high proportion of information asymmetry exists in these economies, making credit risk difficult. Accordingly, Powell (2004:2) asserts that "Basel II was not written with developing countries in mind, but that does not necessarily mean that there is nothing in it for developing countries or that it can be ignored".

Recently, there has been a call for further improvements in Basel II by the Group of Seven (G-7) Finance Ministers and Central Bank Governors (FSF, 2008:1) due to the global financial crisis in 2007, which was caused by the US subprime mortgage crisis (see section 3.2.3.1 Financial regulation). The FSF was tasked by the G-7 Finance Ministers and Central Bank Governors to "set out recommendations for increasing the resilience of markets and institutions going forward" (FSF, 2008:1). According to the FSF (2008:3), these recommendations include the following:

- *Strengthening prudential oversight of capital, liquidity and risk management:* Raising capital requirements for certain structured credit products such as collateralised debt obligations (CDOs).
- *Changes in the role and uses of credit ratings:* [credit rating agencies] CRAs have undertaken a series of actions to improve their rating process, such as utilising

differentiated ratings, and expanded information on structured products and CRA assessment of underlying data quality.

- *Strengthening the authorities' responsiveness to risks:* Other risk management and supervisory initiatives, where the BCBS has worked with the International Accounting Standards Board (IASB) and the International Accounting and Auditors Standards Board (IAASB) to ensure that fair-value estimates in financial statements were reliable, relevant and auditable.
- *Enhancing transparency and valuation:* Better valuation and disclosure practices relating to structured products and off-balance-sheet exposures.
- *Robust arrangements for dealing with stress in the financial system:* Central bank operational frameworks should be sufficiently flexible in terms of potential frequency and maturity of operations, available instruments, and the range of counterparties and collateral to deal with extraordinary situations.

3.2.1.3 Basel III

In December 2010 the BCBS released new regulations for capital and liquidity, known as Basel III (which was endorsed by the Group of Twenty (G-20) Summit in Seoul in September 2010) due to the weaknesses in the banking sector which was an accessory to the global financial crisis in 2007. Basel III is not a substitute for Basel I and Basel II but is seen as a supplement to the previous frameworks. The intention of Basel III is to ensure that banks are faced with higher capital requirements, especially the bigger banks due to their systemic influence on the economy in cases of bank failures. In this case the aim of Basel III is to ensure that the banking system is appropriately armoured to handle extreme financial and economic volatility. The reform has a micro- and a new macroprudential approach to it. In the microprudential approach, the importance of a clearer definition of capital is stressed where good-quality capital now means “more loss-absorbing capacity”, while more emphasis is placed on common equity.

The micro-prudential approach further elaborates on

- i. bank liquidity risk profiles where global minimum liquidity standards will “make banks more resilient to potential short-term disruptions in access to funding and to address long-term structural liquidity mismatches in their balance sheets” (BCBS, 2010b:6);
- ii. a stronger Pillar 2 guidance which enhances risk management and supervision; and
- iii. a revised Pillar 3 requirement for better disclosure of risk exposure and the regulatory capital base.

In the macroprudential approach, ways to reduce procyclicality are also addressed through a capital conservation buffer and a countercyclical buffer. The reason for this is to protect the banking sector and absorb losses during periods of volatility and excess credit growth. Further to the macroprudential approach is the issue of systemic risk of banks and how they are connected to other banks on a global basis. The BCBS (2010b:10) is looking at “measures to mitigate the risk or externalities associated with systemic banks, including liquidity surcharges, tighter large exposure restrictions, and enhanced supervision”. Basel III will be gradually implemented over from the period 2011 to 2019 (Table 3.6).

3.2.2 Financial Sector Assessment Program

The FSAP was jointly introduced by the World Bank and the IMF in 1999 after various financial crises. Its objective is to increase the soundness of financial systems in member countries. The aims of the FSAP include determining risk management, and identifying the strengths and weaknesses of a country's financial system. The key component of the FSAP lies in its observance of various standards and codes, which gives rise to the *Report of Observance of Standards and Codes* (ROSC). The ROSC reviews countries' compliance with internationally recognised standards and codes. These standards and codes are set by established

international bodies for a sound financial system. The standards and codes are composed of 12 globally accepted key standards ranging from core principles for financial supervision to market infrastructure issues, such as corporate governance, which are promoted by the FSF. According to the FSF (2000) the key standards help to

- strengthen domestic financial systems by encouraging sound regulation and supervision, greater transparency, and more efficient and robust institutions, markets, and infrastructure; and
- promote international financial stability by facilitating better-informed lending and investment decisions, improving market integrity, and reducing the risks of financial distress and contagion.

Table 3.3: Twelve key standards for sound financial systems

Area	Standard	Issuing body	Date
Macroeconomic policy and data transparency			
1. Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF	July 1999
2. Fiscal policy transparency	Code of Good Practices on Fiscal transparency	IMF	April 1998
3. Data dissemination	Special or General Data Dissemination Standard	IMF	March 1996
Institutional and market infrastructure			
4. Crisis resolution and deposit insurance	Core Principles for Effective Deposit Insurance Systems	BCBS/IADI	December 2010
5. Insolvency	Insolvency and Creditor Rights	World Bank	April 2000
6. Corporate governance	Principles of Corporate Governance	OECD	May 1999
7. Accounting and Auditing	International Financial Reporting Standards	IASB	Various
	International Standards on Auditing	IAASB	Various
8. Payment, clearing and settlement	Core Principles for Systemically Important Payment Systems	CPSS/IOSCO	January 2001
	Recommendations for Securities Settlement Systems		November 2001
	Recommendations for Central Counterparties		November 2004
9. Market integrity	The Forty Recommendations and Nine Special recommendations Against Terrorist Financing	FATF	1990
Financial regulation and supervision			
10. Banking supervision	Core Principles for Banking Supervision	BCBS	September 1997
11. Securities regulation	Objectives and Principles of Securities Regulation	IOSCO	September 1998
12. Insurance supervision	Insurance Core Principles	IAIS	October 2000

Source: FSF (2000)

BCBS: Basel Committee on Banking Supervision
 FATF: Financial Action Task Force
 IASB: International Accounting Standards Board
 IMF: International Monetary Fund
 OECD: Organisation for Economic Cooperation and Development

CPSS: Committee on Payment and Settlement Systems
 IAIS: International Association of Insurance Supervisors.
 IFAC: International Federation of Accountants
 IOSCO: International Organisation of Securities Commissions
 IADI: International Association of Deposit Insurance

3.2.3 A financial safety net for banks

Demirgüç-Kunt and Huizinga (2003:10) define a 'financial safety net' for banks as "the whole of financial regulations and institutions that seek to prevent or limit depositor losses in case of an (impending) bank failure". Such a safety net plays an important role in helping to preserve financial stability and would be implemented because of the unique contribution that banks make towards the financial system such as contributing to economic growth. The safety net also improves information asymmetry. Disruptions to banking activities can have negative externalities that can extend into other sectors of the economy. Most countries have decided to establish a safety net for banks because it can assist in preventing a crisis, especially if the banking system is weak or it can help government deal efficiently with a crisis. The most common components of a safety net include financial regulation, deposit insurance and a lender of last resort. These components will be discussed in more detail in sections 3.2.3.1, 3.2.3.2, and 3.2.3.3.

3.2.3.1 Financial regulation

Financial regulation is a form of regulation or supervision that is managed by government or non-governmental organisations and that ensures that financial institutions adhere to certain conditions or guidelines, with the aim of maintaining systemic stability and consumer protection.

Bamber et al. (2001:11) assert that the rationale for regulation is identified by the following:

- Potential systemic problems associated with externalities.
- The correction of market imperfections and failures.
- The need for monitoring of financial firms and the economies of scale.
- The need for consumer confidence and consumer demand for regulation.

Although the regulators' main concern deals with liquidity, solvency and riskiness of institutions, other important concerns include the protection of consumers from potential exploitation and protection of the systemic stability of the economy against crisis. Mishkin (2006:7) asserts that "since financial institutions like banks are at the core of what can go wrong and trigger financial instability, promoting financial stability to prevent financial crises must start with governments providing effective prudential supervision and regulation of the financial system". Ensuring a safe and sound institutional environment is one of the key objectives of regulation. Therefore, regulators need to ensure that their regulatory stance does not create barriers to, for example, the entry or exit of institutions, or unwarranted costs on the economy and consumers. Instead, regulation should impose restrictions on institutions in such a way that it does not cause a moral hazard problem and ensure a system of direction or conduct is provided. According to the SARB (2004a:25), "too much regulation can give rise to inefficiencies; inconsistencies; overlaps; duplication; and higher administrative costs, which can be as damaging as financial instability".

New developments, technology and structural changes make it possible for countries to harmonise their financial regulations. Therefore, it is important for regulatory policies to be flexible so that innovation is not stifled and competition is promoted. Likewise, Thompson (1996:34) asserts that changes in the financial system, such as increased competition, require adaptation in supervision and regulation. His concern is that the securitisation⁴ of mortgages (which is a fairly new development in the market) by non-bank originators should be regulated and subjected to prudential capital requirements similar to those for a bank. In addition, the creditworthiness of borrowers should be observed by the mortgage originators. According to Thompson (1996:34), "these new channels of finance draw attention to the competitive impact

⁴ Securitisation is the bundling of loans into packages financed by the sale of marketable securities; an example is housing loans.

of prudential requirements". The SARB (2004a:25) cautions that "regulation can never provide absolute assurance that financial failures will not occur", but providing sound regulation and supervision, and increasing the level of institutional transparency are preventative measures against a crisis occurring. According to Bamber et al. (2001:86), proper regulation could have prevented financial crises when, among other factors,

- (i) there are increasing bank liabilities with large maturity and currency mismatches. In this case, an unhedged debtor position in foreign exchange not only makes banks and their customers more vulnerable, but also makes it harder to deal with a banking crisis once it occurs; and
- (ii) there are weaknesses in the accounting, disclosure and legal framework where there are banks that make bad loans look good by lending more money to troubled borrowers (in other words, lending to borrowers who are in default so that they appear not to be in default). In this case, borrowers are over indebted; as a result, banks are faced with the problem of excessive risk exposure.

A recent example of regulation failing to prevent a crisis was that of the US subprime mortgage crisis⁵ where subprime borrowers⁶ defaulted on their loans, which caused a ripple effect of the crisis to other sectors. The Committee on Capital Markets Regulation (2009a) explains that a lack of *effective* regulation was key to the crisis. The committee explains that the US economy

⁵ During the past years (i.e., between 2002 and 2007), the borrowing and lending rates in the US were extremely low, which increased the demand for houses. Home loans were offered to borrowers with inferior credit histories thus creating "subprime mortgages". These subprime mortgages were packaged and securitised. Securities backed by the packaged mortgages, combined with credit default swaps to decrease the risk, received high ratings from rating agencies and were then sold at attractive rates. This attracted investment banks and hedge fund owners to bet big on this emerging aspect of the US economy. However, when the United States Federal Reserve System (US Fed) began a cycle of interest rate hikes, the cost of borrowing became expensive, which led to several subprime mortgage holders defaulting on their loans. In addition, "teaser rates" (which are lower interest rates offered to the borrower initially with higher market-related interest rates kicking in later, usually after a number of years) also lapsed at the same time.

⁶ A 'subprime borrower' is defined as one who cannot qualify for prime financing terms but can qualify for subprime financing terms. Most subprime borrowers are declined by traditional lenders because of the huge risks of them defaulting on their debt payments.

failed to protect investors and support market discipline because of the lack of transparency; regulation was not consistent across products and services; supervision was uneven; and global rules lacked co-ordination. The impact of the subprime mortgage crisis has seen record levels of loan defaults and home repossessions.

In addition, the securitisation of the mortgages resulted in contagion affecting major global investment banks such as Bear Stearns, which came under strain in May 2008 because of its dealings with the US subprime market; General Electric, which decided to sell its WMC Mortgage subprime lending business; and Lehmann Brothers, which eventually went bankrupt. The securitisation of mortgages created a contagion effect, because it was crammed with subprime loans and then sold in the global market at attractive rates. Furthermore, the subprime mortgage crisis has affected credit in the economy in that consumers are not willing to buy homes for fear of losing value in their purchase and investors are no longer willing to take the risk of purchasing securities that are exposed to mortgages.

NematNejad (2007) explains that “subprime loans⁷ are generally considered risky for both the borrower and the lender. It is risky for the lender because borrowers usually have lower incomes and a poor record for paying debt, which increases their default probability. It is also risky for borrowers” in terms of loss such as foreclosure on homes when the interest rate increases.

However, similar to Noys’s (2004) theory of lax supervision (as explained in Chapter 2, section 2.4.3), in this case subprime borrowers (and not bank managers) lack the knowledge of the types of loans or the contracts they sign. This places borrowers in a situation where they are unable to assess their mortgage risks, thus enabling undue risk-taking behaviour, which results

⁷ Subprime loans tend to have a higher interest rate compared to the prime rate offered on traditional loans.

in a crisis. Furthermore, a lack of supervision on the part of the lenders and a lack of government regulation also contributed to the crisis, thus fulfilling Noys's theory. Schafer (2007:1) asserts that

a prudential checking and assessment of creditworthiness and credit standing, as well as appropriate real-estate valuation, should be an essential pre-requisite for granting a loan. If these conditions are fulfilled and proper debtor-creditor relationships meet the requirements of prudential risk management there is no reason for the objection to the provision of innovative housing loans.

Even though the subprime mortgage crisis was essentially a First World economy illness, it had serious consequences for emerging market economies too, but not directly. The transmission effects of the crisis from the US to Europe to the rest of the world occurred through many channels affecting financial systems and economic activities. Although some emerging market economies did not engage in certain banking activities (such as credit default swaps or collateralised debt obligations), they were still unfortunately hit by the crisis. Some of the ways in which the crisis was transferred to these economies were through:

- *Withdrawal of funds:* During the crisis, business holdings of major financial institution located in emerging economies withdrew their funds. This action limited funding to emerging economies that relied on foreign currencies such as the dollar or euro.
- *Credit limitations:* The international credit markets were constrained, in that international banks and the global bond markets were closed to lending facilities which was a consequence of a decline of inward flows to the emerging market economies. As a result this action caused significant financial stress especially for those countries that operated with large current account deficits.

- *Economic activity:* The impact of the crisis on economic activity affected exports in those emerging markets that supplied developed economies. Exports contracted rapidly, thus this lack of trade also destabilised the domestic economies of emerging market countries.
- *Decline in remittances:* The transmission effects of the crisis also influenced the flow of remittances. Remittances to emerging markets declined and domestic remittances (i.e., transfer of money from individuals – who are moving from rural to urban areas usually in search of employment – to their families) also declined because of the high unemployment rate.

The ripple effect of the subprime mortgage crisis resulted in a global recession and a significant fall in the growth rate of the world economy, which affected emerging countries. In Asia, for example, export- and manufacturing-orientated countries were negatively affected by the recession. Exports in Asia were hard hit by the drastic decline in external demand and in 2008 manufacturing had recorded huge downfalls of about 25 per cent in industrial production compared with levels a year earlier (IMF, 2009:72). Moreover, in emerging European countries imports slumped due to the tightening of external financing by developed economies, as markets in the developed economies were illiquid. As a result, some of these emerging countries were traumatised by severe recession.

In contrast, Latin America's experience of the first part of the crisis was different. It enjoyed high economic growth, which led to an increase in portfolio inflows, strengthening of the currency and an accumulation of reserves. This high growth rate was a consequence of the boom in commodity prices. However, Latin America was hard hit when the commodity prices began falling in mid-2008. Stock markets plunged, currencies depreciated (by 40 per cent in Brazil and almost 30 per cent in Chile) and remittance flows contracted significantly (Cox, 2009).

Countries in Africa managed to escape the subprime mortgage crisis because of their low levels of financial integration. Generally, African banks have not been involved in complicated financial products, because their financial markets are still underdeveloped. However, the contagious effects of the subprime crises affected some African countries, especially those that are dependent on natural resources. As in Latin America, the fall in commodity prices resulted in a depreciation in currencies, a decline in foreign-exchange reserves and non-profitability in some of the oil-producing countries, for instance, the price of crude oil dropped by 65 per cent, from US\$125,73 per barrel at the start of the financial crisis to US\$43,48 in January 2009 (African Development Bank, 2009:1–7).

Despite the contagious effects of the subprime crises, some of the emerging markets managed to rebound and stabilise, for example, according to the IMF (2009:72), the rebound in Asia can be linked to the following three factors:

- (1) Expansionary fiscal and monetary policy.
- (2) A rebound in financial markets and capital inflows, which eased financing constraints for smaller export enterprises and improved consumer and business confidence.
- (3) The growth impulse for industry following large inventory adjustments due to the increase in domestic demand which was accompanied by policy adjustments.

Whilst few emerging economies had limited exposure to the subprime market, for example, the Czech Republic and Poland showed signs of stabilisation during the crisis due to their strong macroeconomic fundamentals.

In containing financial market turbulence, government should strengthen the regulation and prudential supervision of financial institutions and implement ample reform efforts, such as

better financial and economic policies. Therefore, regulatory authorities should ensure an effective and efficient system of regulation, where consumers are protected, institutions are sound and the stability within an economy is secured. The SARB (2004a:25) suggests that “regulation should permit healthy competition between the regulated institutions as far as development of new products, services and competitive strategies are concerned, while ensuring that regulatory objectives are met”. South Africa, for example, is in the process of improving its financial regulatory system by moving towards a twin peaks approach of the regulatory architecture where prudential conduct of regulation and market conduct of regulation will each have separate key roles. In addition “South Africa will adopt a system-wide approach to financial stability and regulation, bolster the supervision of individual institutions, and ensure better coordination and information sharing. The scope of regulation will also be extended to cover presently unregulated financial activities that have the potential to create systemic risks to financial stability” (National Treasury, 2011:23). The Committee on Capital Markets Regulation (2009b:1) states that for an effective regulatory system the following four objectives must be achieved:

- i. Reduced systemic risk through more sensible and effective regulation;
- ii. Increased disclosure to protect investors and stabilise the market;
- iii. A unified regulatory system where lines of accountability are clear and transparency is improved; and
- iv. International regulatory harmonisation and cooperation.

However, with that being said, one would question why Basel II did not prevent the crisis when it was designed to reduce systemic risks and places emphasis on disclosure. Blundell-Wignall and Atkinson (2008), Petersen et al. (2009) and Alles (2010) argue that Basel II exacerbated the financial crisis. They are of the opinion that Basel II prescribes inadequate levels of required

capital and that the framework strengthens business cycle fluctuations, resulting in limited bank lending during times of recession: for example, minimum capital requirements tend to be procyclical; in other words, when measured risks are low and the market is expanding, minimum capital requirements are low, but when there is a contraction in the market and measured risks are high, minimum capital requirements increase. Thus, this amplifies cyclical instability which, in turn, raises financial instability. Furthermore, the procyclical behaviour of banks is due to weak risk management. Therefore, supervisors with weak risk management will make hasty decisions such as cutting lending when there is a slowdown in the market.

Other reasons why economists such as Eichengreen (2008), Kirk (2007) and Alles (2010) believe that Basel II exacerbated the financial crisis include the issue of rating agencies assessing the creditworthiness of borrowers. These economists question the reliability and quality of the rating agencies' assessment. They are of the opinion that the rating models for mortgage-related structured products were inconsistent. This is because the subprime products that were previously rated high were suddenly downgraded during the crisis, which was unprecedented. This resulted in write-downs by financial institutions and intensified a downward trend. Furthermore, the interaction of accounting rules (e.g., fair-value accounting) with the new Capital Accord lacked specific guidelines. It is argued that International Accounting Standard (IAS) 39 is not in line with banks' credit risk measurement. This is because fair-value accounting is extremely procyclical if liquidity disappears: for example, during the financial crisis, many institutions were compelled to liquidate their assets and prices developed by these institutions were not met by the requirements for fair-value measurement. Owing to limited guidelines, financial institutions had to carry out fair-value measurement on the basis of unreasonable market prices. This inflated book losses and intensified the vicious cycle.

In contrast, other economists (Caruana and Narain (2008); Cannata and Quagliariello (2009)) argue that the crisis occurred while countries were still in the process of implementing Basel II; in other words, they were still in the Basel I phase. Griffin (2008) argues that “although Basel I provided a regulatory capital incentive, it resulted in reduced incentives for banks to monitor the credit quality of the loans that banks pumped into collateralised loan obligations and other structured vehicles”. He further states that “Basel I rules failed to highlight contingent credit risk, which put strain on banks’ capital once the credit risk from conduits and structured investment vehicles (SIVs) started to come back on to bank balance sheets”. Caruana and Narain also agree that one of the shortcomings of Basel I is that “it did not capture well the risks associated with banks’ securitisation exposures, which have grown significantly since the implementation of the accord” (p. 25). In spite of this, they further explain that during the transition phase of Basel II risks had to be managed and that advanced approaches had to be factored in over a number of years, bearing in mind that Basel I still applied (pp. 25,26). An example of this can be seen in Table 3.4 where Japan had implemented the standardised approach in 2007 and the advanced approach only in 2008. Hence, many countries did not fully implement the framework in 2007 when the financial crisis began to unfold due to operational delays and legislative bottlenecks. Similarly, Cannata and Quagliariello (2009:14) also agree that Basel II had not played a major role in the financial crisis. They argue that the epicentre of the financial crisis was in the US and that the US’s implementation of the accord had been deferred to 2010. Moreover, in 2007 in the European Union (EU) the use of Basel II was minimal when the crisis erupted because banks took advantage of the Capital Requirements Directive which allowed them to defer Basel II to 2008. As a result, the financial crisis occurred under the Basel I Framework.

Table 3.4: Basel II implementation schedules

Country	Credit risk standardised	Credit risk advanced
Australia	1 January 2008	1 January 2008
Canada	1 November 2007	1 November 2007
European Union	1 January 2007	1 January 2008
Hong Kong SAR	1 January 2007	1 January 2007
Japan	1 March 2007	1 March 2008
Korea	1 January 2008	1 January 2008
Singapore	1 January 2008	1 January 2008
South Africa	1 January 2008	1 January 2008
United States	Not announced	Mid 2009

Source: Caruana and Narain (2008)

The BCBS (2010b:1) states that the crises was intensified by weaknesses in the banking sector such as “excessive leverage, inadequate and low quality capital, and insufficient liquidity buffers”. In order to address these issues, the BCBS introduced a revised set of rules called ‘Basel III’. As mentioned earlier, the aim of Basel III is to ensure that the banking system is appropriately armoured to handle extreme financial and economic volatility. Thus banks are currently in the process of implementing Basel III. The implementation process will have some effects with regards to capital composition, leverage ratio and liquidity standards. For example:

Capital composition: The importance of a clearer definition of capital is stressed where good-quality capital now means “more loss-absorbing capacity”, while more emphasis is placed on common equity. Because of the emphasis on common equity in future Tiers 1 and 2 capital will no longer cater for regulatory capital deduction but common equity will cater for this instead. Thus the minimum requirement for common equity will be raised from 2 per cent to 4,5 per cent (see Table 3.5). If the capital conservative buffer is taken into account, then the total common equity requirement will be 7 per cent. The Tier 1 capital requirement will now increase from 4 per cent to 6 per cent, while Tier 1 leverage ratio will be 3 per cent during testing of on- and off-balance-sheet exposures. Furthermore ways to reduce procyclicality is also addressed through

a capital conservation buffer of 2,5 per cent and a countercyclical buffer of 0 to 2,5 per cent, both composed of common equity.

Leverage ratio: The implementation of the new leverage ratio began in January 2011 which can be seen as the initial period of supervisory monitoring. However, from January 2013 to January 2017 a parallel-run period will commence to determine if the proposed level of the leverage ratio is appropriate for a full credit cycle. From 1 January 2015 banks will be required to disclose their leverage ratio.

Liquidity standards: The observation period for the liquidity coverage ratio (LCR) began in January 2011 and observation for the net stable funding ratio (NSFR) will begin in January 2012 after which LCR will be introduced in January 2015 and NSFR will move to minimum standard in January 2018.

The implementation of Basel III is summarised in Table 3.6.

Table 3.5: Calibration of the capital framework: Capital requirements and buffers (all numbers in percentage)

Capital requirement and buffer	Common equity (after deductions)	Tier 1 capital	Total capital
Minimum	4,5	6,0	8,0
Conservation buffer	2,5		
Minimum plus conservation buffer	7,0	8,5	10,5
Countercyclical buffer range*	0–2,5		

Source: BCBS (2010 (c))

* Common equity or other fully loss-absorbing capital

Table 3.6: Phase-in arrangements (all dates are as of 1 January, in percentage)

	2011	2012	2013	2014	2015	2016	2017	2018	2019
Leverage ratio	Supervisory monitoring		Parallel run 1 January 2013 – 1 January 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum common equity capital ratio			3,5	4,0	4,5	4,5	4,5	4,5	4,5
Capital conservation buffer						0,625	1,25	1,875	2,50
Minimum common equity plus capital conservation buffer			3,5	4,0	4,5	5,125	5,75	6,375	7,0
Phasing in of deductions from CET1 (including amounts exceeding the limit for DTAs, MSR and financials)				20	40	60	80	100	100
Minimum Tier 1 capital			4,5	5,5	6,0	6,0	6,0	6,0	6,0
Minimum total capital			8,0	8,0	8,0	8,0	8,0	8,0	8,0
Minimum total capital plus conservation buffer			8,0	8,0	8,0	8,625	9,25	9,875	10,5
Capital instruments that no longer qualify as non-core Tiers 1 or 2 capital			Phased out over ten-year horizon beginning 2013						
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio		Observation period begins						Introduce minimum standard	

Source: BCBS (2010c)

The implementation of Basel III also creates a unique set of challenges for every organisation. Thus there are many complexities to the implementation of Basel III. These include the following:

- *Design complexity:* Banks must now build an integrated view of credit, migration, and default risks for the trading book, whereas under Basel II regulatory capital for credit risk was addressed only in the banking book. Banks must also develop methodologies for calculating stressed VAR, and incremental risk charge, none of which were required under Basel II (Harle et al, 2010: 21).
- *Data quality:* The challenge for data management in Basel III is more strenuous than before since managers must ensure that high-quality data is available for the calculation

of enhanced capital, new liquidity ratios and new leverage ratios for regular reporting purposes. Furthermore, the banks' risk and finance teams must have easy access to accurate data that reflect various risks the bank may incur such as credit, market, operational, liquidity and concentration risks. Complexities arise where organisations have fragmented data.

- *Operational complexities:* Under Basel II many banks exceeded their budgets which, of course, led to significant cost increases. With the implementation of the new Basel III there is a possibility that these risks can be even greater.

3.2.3.2 Deposit insurance

Deposit insurance is a guarantee that depositors placing their funds in banks will not suffer a loss when the bank goes bankrupt. It has recently become an important player in the financial safety net, especially in the aftermath of severe banking crises such as the East Asian crisis and the current global economic crisis. Similar to prudential supervision, the aim of deposit insurance is to provide stability in the financial economy by preventing runs on banks or bank failures, thus deposit insurance provides a sense of security and confidence in the market. Mishkin (2006:10) emphasises that “by decreasing the incentive for depositors to withdraw their money if the bank gets into trouble, deposit insurance can prevent bank panics because depositors will no longer run on banks”. In addition, deposit insurance ensures a stable financial system by giving depositors confidence that their insured money will be available to them in the event of a bank failure and that there would be no need for a run on banks. Thus, deposit insurance reduces the notion of panic from spreading in the financial system.

Conversely, deposit insurance does display some disadvantages in that it creates moral hazard problems where banks tend to adopt excessive risk-taking strategies and abuse government

protection, and households or businesses have little incentive to monitor banks' risk-taking; in other words, banks will reap the benefits of risky investments while being protected from losses. Demirgüç-Kunt and Detragiache (2002) found in their research that moral hazard was problematic in liberalised financial systems where huge risk-taking possibilities were at hand. They point out that in countries with weaker institutions, moral hazard problems were also greater because in these countries it was more difficult to supervise and control risk-taking by banks.

Calomiris (1997:19) asserts that

any meaningful reform of deposit insurance must either credibly restrict risk-taking or make the cost of protection against losses to bank deposits sensitive to the riskiness of insured deposits. Doing either would remove any incentive for banks to increase risk in response to a capital loss, since they would receive no subsidy from raising their risk.

However, a deposit insurance system allows government to support the country's banking system against the potential threat of disruptions or bank failures. In Chile banks have time deposits: these deposits are deposit insurances that do not have 100 per cent coverage. This strategy is to encourage debt holders to monitor banks as they will suffer the consequences. Unlike Chile, Argentina's deposit insurance was abolished in 1992. The banking crises in Argentina during 1980, 1985 and 1989 led to the regulation that Argentinean banks now have to finance 2 per cent of their total deposits in the form of subordinated debt, which must comply with the principles of the private market.

During the 2007 financial crisis, the role of deposit insurance proved to be inadequate as the deposit insurance was insufficient to cover bank runs. For example, in the US during the crisis

the reserves of the Deposit Insurance Fund were hard hit. The reserves fell to 1,01 per cent of insured deposits in June 2008, and decreased by US\$15,7 billion (45%) to US\$18,9 billion in the fourth quarter of 2008, plunging the reserve ratio to 0,4 per cent of insured deposits, its lowest level since June 1993 (Acharya et al., 2009:5). The crisis revealed that the major part of the deposit insurance was designed for individual bank failure and not for systemic risks. Furthermore, the insignificant coverage or partial insurance proved that the deposit insurance premiums were insensitive to risk.

Countries affected by the global crisis, such as the US and the UK, have now taken more precautionary steps to safeguard their financial markets against future turmoil seeing that a weak deposit insurance scheme does little for financial stability. These countries have extended deposit insurance coverage to new areas in addition to increasing their level of coverage. Furthermore, Australia and New Zealand have also initiated guarantees for the first time.

In having a deposit insurance system in place, it is vital to conform to recognised best practices. As a result of the current global economic crisis, in 2009 the BCBS and International Association of Deposit Insurers (IADI) developed a new set of Core Principles for the Effective Deposit Insurance System. These principles were developed so that countries could use them as a standard when launching a new deposit insurance system or modifying their deposit insurance systems to suit the needs of the country, and to deal more severely with financial stress. There are 18 core principles that are divided into 10 groups. According to the BCBS and IADI (2009:9–18), they are as follows:

- i. *Setting objectives*: Such as public policy objectives and mitigating moral hazard.
- ii. *Mandates and powers*: Mandates should be formally specified and consistent with the public policy objectives whilst the deposit insurer should have the power to fulfil its mandate.
- iii. *Governance*: The deposit insurer should be independent and not influenced by industry or politics.
- iv. *Relationships with other safety net participants and cross-border issues*: A framework should be in place for close coordination and information-sharing, which should be formalised. Also relevant information should be exchanged between deposit insurers in different jurisdictions confidentially.
- v. *Membership and coverage*: Membership in the deposit insurance system should be compulsory for all financial institutions accepting deposits from those deemed most in need of protection and policymakers should define clearly in law, what an insurable deposit is.
- vi. *Funding*: A deposit insurance system should have available all funding mechanisms necessary to ensure the prompt reimbursement of depositors' claims.
- vii. *Public awareness*: The public must be informed on an ongoing basis about the benefits and limitations of the deposit insurance system.
- viii. *Selected legal issues*: The deposit insurer and individuals working for the deposit insurer should be protected against lawsuits.
- ix. *Failure resolution*: There should be a framework that provides for the early detection and timely intervention and resolution of troubled banks.
- x. *Reimbursing depositors and recoveries*: The deposit insurance system should give depositors prompt access to their insured funds and the deposit insurer should share in the proceeds of recoveries from the estate of the failed bank.

Furthermore, the deposit insurance system must be based on the following preconditions, which will have a direct impact on deposit insurance:

- An ongoing assessment of the economy and banking system.
- Sound governance of agencies comprising the financial system safety net.
- Strong prudential regulation and supervision.
- A well-developed legal framework and accounting and disclosure regime. (BCBS and IADI, 2009:2.)

The new principles stress that an effective safety net system must be in place for deposit insurance to be credible. In order for deposit insurance to be effective, safety net authorities need to work hand in hand. Mishkin (2006:10) believes that “without adequate prudential regulation and supervision to reduce banks’ incentives to take on too much risk, deposit insurance can increase, rather than decrease, the likelihood of a banking crisis”. Deposit insurance alone cannot increase financial stability: strong capital standards and sound banking supervision should also be included in maintaining a sound financial system.

3.2.3.3 Lender of last resort

The lender of last resort is usually a country’s central bank that provides support by offering loans to banks that are facing liquidity problems. Mishkin (1996:35) defines the ‘lender of last resort’ role as “a role in which the central bank stands ready to lend during a financial crisis”. The aim of these official financial operations is to limit the risk of problems in banks spreading to other parts of the financial system. Similar to deposit insurance, the lender of last resort serves to protect depositors and prevent large panic withdrawals from banks. Goodhart and LLLing (2002:293) state that “the lender of last resort has undertaken two roles: crisis lender and crisis manager. The crisis lender provides financing to deal with a crisis, while the crisis manager takes responsibility for dealing with a crisis or potential crisis, whether or not the institution itself lends for that purpose.”

It should be noted that banks do not access the lender-of-last-resort facility on a regular basis: this only happens during times of financial crisis, for example, Finland experienced a severe banking crisis during 1991–4, which was mainly due to bad banking and bad policies. The country did not have the specific legal or institutional framework for managing banking crises. Therefore, the central bank took the initial lead in crisis management since it had both the legal competence and financial resources. The central bank, together with government, took over the savings banks, injected capital into the savings banking sector and implemented special crisis support to the whole banking sector. Mishkin (1996:36) suggests that “recovery from a financial crisis in many developing countries is a much more complicated exercise than it is for developed countries . . . and that the lender of last resort role of a central bank must be used far more cautiously in a developing country”. This is because most developing countries’ debt is in foreign currencies and is of short duration, with the result that inflation in these countries can rise further and their domestic currency can depreciate substantially.

Bagehot (1873) suggests that in a crisis the lender of last resort should offer assistance, at a penalty rate, on the basis of a guarantee or security that is marketable in a usual business day that is free from market panic. Conversely, Freixas (1999:11) argues that “in a liquid market Bagehot’s principle would contradict itself, since the private sector would be willing to lend against collateral with a lower penalty. Only in an illiquid market, can the lender of last resort intervene and only through open market operations”. Fitz-Gibbon and Gizycki (2001:10) add that the “provision of last-resort support should be confined to those financial institutions that are of systemic importance and that a special case can be mounted for the provision of support to banks”. However, those banks that play a crucial role in the economy or that are of systemic importance are usually huge. Policymakers therefore regard these banks (mainly the commercial banks) as being “too big to fail”; in other words, policymakers ensure that these banks are not allowed to fail due to the contagion effect it will have on the rest of the economy.

In the recent financial crisis significant banks that had to be bailed out in the US cost the treasury billions of dollars: for example, Bank of America, which was severely affected by the crisis, received a bailout from government that amounted to US\$20 billion in government aid and US\$118 billion worth of guarantees against bad assets.

Rodrik (1999:20) is of the view that “the costs of domestic regulatory failure should be substantially lower when domestic regulation is backed by a central bank that performs a lender of last resort function”. The recent general preconditions for a lender of last resort to be enforced entails that the troubled banks should have ample room for solvency; that the lender-of-last-resort assistance should have adequate collateral; that all other existing sources of funding have been looked into before seeking lender-of-last-resort support; and that shareholders have taken the initiative to provide liquidity as a demonstration of their own commitment. In addition, the troubled bank must take appropriate steps to deal with its liquidity setbacks. At present, some of the common instruments used by central banks to provide lender-of-last-resort assistance include the purchase of the institution’s placements with other banks that are acceptable to the central bank; repurchase of securities that are in the domestic currency, such as exchange fund bills and notes and investment grade securities; and a credit facility against the banks’ residential mortgage portfolio. However during the 2007 financial crisis central banks also used the quantitative easing facility to expand the supply of money and credit into the markets to protect local and small banks (whose main business is lending) from bankruptcy. ‘Quantitative easing’ is defined as a composition of open-market operations on long-term maturities to lower long-term interest rates, namely an increase in quantities through open-market operations after the interest rate has reached the zero bound (Tropeano 2011). The US was one of the countries that implemented quantitative easing after a very lax monetary policy. When the Fed’s interest rate reached its lower zero limit, the interest rates was not effective enough as a monetary policy instrument, thus the implementation of quantitative

easing. During the crisis, quantitative easing has allowed for the purchase of various types of assets from financial institutions with different maturities and more supply of money and credit into the market.

As with deposit insurance, some critics argue that the lender-of-last-resort facility encourages banks to acquire more risks since the central bank serves as a backup strategy. An example of this function would be the recent crisis that shook the financial markets in the UK when the mortgage lender Northern Rock could no longer refinance its maturing obligations. The main reason for this was its engagements with reckless borrowing, huge risks and a dependence on wholesale markets instead of depositors for its funding. In addition, depositors withdrew about £2 billion, exposing the economy to a financial crisis. The Bank of England took a stand against bail-outs, because of the message it would send out to other banks on taking excessive risk, thus the moral hazard issue. Despite this, it eventually had to offer support in the bailing out of Northern Rock at a penalty rate on fears of a threat to the stability of the financial system. Goodhart and LLLing (2002:499) explain that a moral hazard problem has “no specific solution”. The authors assert that “the lender of last resort should seek to limit moral hazard by imposing costs on those who have made mistakes. Lending at a penalty rate is one way to impose such costs.” However, Fitz-Gibbon and Gizycki (2001) believe that “while a lender of last resort may reduce the frequency of bank runs, it may create an environment where the runs that do occur are more severe”. In contrast, Stiglitz (1999:45) suggests that strong supervision is an essential part of any system of lender of last resort.

It is clear that financial liberalisation, combined with a lack of financial infrastructure, has brought about a more careful consideration of regulation and standards. Financial crises have transformed from “country crises” to “systemic crises”, as can be seen from the occurrence of the Asian crises and the more recent subprime mortgage crisis. International standards are now

regarded as benchmarks that can be used by authorities to identify weaknesses and pinpoint areas that require improvements in their financial system; they also ensure a more stable international financial system. Interestingly, the new regulatory practices, combined with the efforts made to liberalise, have ensured that developed and emerging market economies have integrated more closely. However, the question now arises whether these practices will provide more protection from crises than in the past?

Furthermore, it has become clear that supervisors and managers should act in a more prudent manner in order to prevent problems such as that of the East Asian and the US subprime mortgage crisis. As regards the East Asian crisis, liberalisation was one of the factors that contributed to the impact and spread of the crisis. In the US subprime mortgage crisis bad monitoring, and a lack of risk management and regulation exacerbated the crisis. Had prudential supervision been implemented more efficiently and effectively, it would have contributed to minimising or preventing both crises. Mishkin (2006:19–24) explains that to make prudential supervision work, the following reforms should be considered:

- Implementation of prompt corrective action – which requires supervisors to prevent financial instability by intervening early and closing down institutions if they are close to insolvency.
- Adequate resources and statutory authority for prudential regulators/supervisors – without sufficient resources and incentives, supervisors will not adequately monitor the activities of the banks and their managers. Therefore, it is crucial to provide supervisors with the latter to promote a safe and sound financial system that is resistant to financial crisis.
- Independence of regulatory/supervisory agencies – where agencies are independent from the political processes and will not be encouraged to engage in forbearance.
- Make supervisors accountable – if they engage in regulatory forbearance, they should be subject to criminal prosecution, censure and penalties.

Countries should not delay upgrading financial prudential supervision, as it can be seen as an addition to a sounder macroeconomic environment; in other words, it adds the ability of the financial sector to weather a storm. Prudential supervision complements financial liberalisation if an adequate risk management system is in place, sufficient disclosure is practised by institutions, there is discipline in the regulatory stance and supervisors are able to intervene if a problem arises. Prudential supervision can be viewed as a prerequisite for a strong and efficient financial system, since it can secure better economic performance and provide the economy with resilience in the face of adverse events.

3.2.3.4 Recent developments on the financial safety nets

In addition to the above standards, after the recent financial crisis more updates to the financial safety net were implemented by authorities and the creation of new policies. For example, the update on deposit insurance design features now includes higher coverage levels, a better payout process, more transparency for depositor awareness and deposit insurers to be involved in failure resolution. Other policy measures that are in the process of being fully implemented by institutions include policy measures for systemically important financial institutions (SIFI), over-the-counter (OTC) derivatives market reforms, compensation practices and shadow banking.

a) Systemically important financial institutions

The FSB recommends that authorities put measures in place for those institutions that have a high systemic risk factor, and externalities affecting domestic and global systemically important financial institutions. It is recommended that supervisors intensify their supervision of SIFIs and improve their supervisory tools and methods. For those systemic institutions that have a global link, a higher loss-absorbency capacity is recommended above the minimum levels agreed in Basel III as the size, complexity and interconnectedness of these global institutions would cause significant disruption to the wider financial system and economic activity. Thus the FSB further

recommends that a recovery and resolution planning be implemented to reduce the impact of failure of institutions.

b) Over-the-counter derivatives market reforms

The FSB recommends that reforms for OTC derivatives should include improved transparency and regulatory oversight, and that authorities should aim for international consistency. Thus by the end of 2012, “all standardised OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties; that OTC derivative contracts be reported to trade repositories; and that non-centrally cleared contracts be subject to higher capital requirements” (FSB, 2010:3).

c) Compensation practices

In the light of employees being paid large sums of bonuses during short-term profits without consideration for long-term risks imposed on companies, when risks became visible during the global economic crisis, firms were left with little resources to absorb losses. This also contributed to the intensity of the financial crisis. As a result, the FSF introduced the principles for sound compensation practices. These principles aim to “ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation” (FSB: 2011a).

d) Shadow banking

The shadow banking system can broadly be described as “credit intermediation involving entities and activities outside the regular banking system” (FSB, 2011b). Shadow banking can lead to systemic risks because of its interconnectedness with the normal banking system. In addition, this type of banking has the potential to threaten stricter bank regulation through arbitrage. Thus the FSB recommends that more effective monitoring should be implemented in

these institutions and that authorities should concentrate on those shadow banks that can cause systemic risks. In doing so authorities should take into consideration four key risk factors which include

1. maturity;
2. liquidity transformation;
3. imperfect credit risk transfer; and
4. leverage.

3.2.4 Improved measures in central banking

3.2.4.1 Inflation targeting in developing countries

Inflation targeting has become more formal and commonly used by monetary authorities since the 1990s. Under an inflation-targeting regime, the central bank sets a target rate of inflation and is obligated to meet this target because this is a very transparent method of enforcing monetary policy. Masson et al. (1997:7, 8) state that the main prerequisites for an effective inflation-targeting framework are (i) the central banks' scope for conducting independent monetary policy and (ii) the undisputed primacy of the inflation objective. Roger and Stone (2005:6) explain that "the key elements of the inflation targeting framework are the governance structure, the specification of the inflation target, and the arrangements for policy transparency and accountability". They say that "these elements of the framework provide the central bank with the authority and incentives to pursue the inflation target". Since inflation targeting is determined by the consumer price index (CPI), the framework on which it is based gives the public an opportunity to observe how committed the central bank is to its target.

However, central banks commonly miss their target range. When deviating from the target range, they could either be above or below the set range. The reason for this varies from

country to country. However, some of the common reasons for missing the inflation target include sharp exchange rate depreciation or appreciation, lower- or higher-than-expected food prices, an interruption to capital inflows, a fall or rise in fuel prices, geopolitical issues, too-tight or too-loose fiscal and monetary policies, and large current-account deficits.

Table 3.7: Inflation target misses and shocks and reason(s) for deviation

Country	Miss	Period	External shocks			Domestic shocks			
			Capital flows	World fuel prices	Other external	Domestic food supply	Other Domestic	Fiscal policy	Monetary policy
Brazil	over	2001–3	x				Controlled prices, political risk		
Czech Republic	under	1998–9				x	Retail competition		
Iceland	over	2002	x				Real wages	x	
Israel	under	1998			Immigration			x	x
	under	2001–2	x				Productivity		
	over	2002–3	x		Intifada			x	x
Poland	over	2000		x		x	Taxes		x
	under	2002					Taxes		
South Africa	over	2002–3	x	x	Regional political risk				

Source: Roger and Stone (2005:30)

Research shows that emerging market countries are susceptible to large inflation target misses because of domestic vulnerabilities. Masson et al. (1997) believe that some developing countries with high inflation rates do not meet the requirements (e.g., freedom from commitment to nominal anchors such as wages or exchange rates, and an independent monetary policy, i.e., freedom from fiscal interventions) for adopting inflation targeting. However, Kasa (2001:4) explains that “inflation targeting can work in developing countries but it is not a ‘one-size-fits-all’ policy”.

Roger and Stone (2005) illustrate through their research the largest inflation target misses during the period 1998–2003 (Table 3.7). According to them, it is not an uncommon feature that central banks miss their inflation target. The authors established that all of the above countries had some common features, namely that the countries were “vulnerable to external shocks; the largest deviations of inflation from target occurred during disinflation and misses were triggered by a mix of domestic and external shocks” (p. 29). Some of their conclusions are that “in countries with stable inflation targets, target ranges are missed about 30 percent of the time, while disinflation countries miss their targets nearly 60 percent of the time” (p. 31).

However, in many developing countries, inflation targeting has been fairly new. It is therefore important for inflation targeting to be harmonised with *financial market reforms*, for example, sound supervisory practices, the presence of competition in the banking sector and the absence of government dominance over this financial activity; *economic reforms* such as adequate fiscal policies and controlled government debt; and *institutional reforms*, such as proper governance and accountability (Roger and Stone 2005). The reason is that financial market reform contributes to a more efficient and stable financial system; economic reform ensures sound policies; and institutional reform ensures proper disclosure and transparency. All these reforms together will make it easier for inflation targeting to be implemented. In 1999 in Chile, for example, the country adopted an inflation-targeting regime to strengthen its monetary policy. However, before fully implementing inflation targeting, it gradually got rid of its fixed exchange rate policy and adopted a floating exchange rate; developed a modelling and forecasting strategy; and increased its communication with the public. On the fiscal side, Chile reformed its fiscal policy by implementing a structural budget surplus rule, which ensures that there is a ceiling on government expenditure of 1 per cent of its GDP. This exercise reduced the government’s public debt, and strengthened its credibility and accountability. Furthermore, institutional reforms such as the legal framework also ensured transparent reporting of statistics,

fiscal accounts and so forth. In 2001 the Central Bank of Chile started to target inflation at a range of 2–4 per cent. At present, Chile's inflation is at 3,40 per cent year on year and GDP is at 5,80 per cent.

During the 2007 economic crisis, economists such as Marinković and Radojičić (2009) and Leijonhufvud (2008) were of the view that inflation targeting did little to stabilise the economy and thus failed. However research on the performance of inflation targeting countries during the recent global economic crisis showed that inflation targeting countries performed better during the global economic crisis compared to non-inflation targeting countries. Research done by Roger (2010) reveals that in the period 1991–2000 and 2001–2009 inflation targeting in low-income and high-income economies experienced considerable declines in inflation volatility while non-inflation targeting low-income and high-income economies encountered more volatility in inflation. Furthermore, the global economic crisis stimulated a price shock in many economies with growth declines and inflation surges. During this period, high-income inflation targeting economy's growth rate fell partially and their increase in inflation was slightly less compared to the high income non-inflation targeting economies.

De Carvalho Filho (2010) also conducted research on the performance of inflation-targeting countries during the global economic crisis and found that inflation targeting brought about key benefits to inflation-targeting countries compared to non-inflation-targeting countries. Her research found that inflation-targeting countries were safe from a deflationary stance, and avoided the liquidity trap and dangers of zero interest rate zone compared to non-inflation-targeting countries. Furthermore, since inflation targeting allows for tight monetary policy during booms and excess liquidity, when the financial crisis began inflation-targeting countries were in a better position to cut interest rates from a higher nominal rate, and thus had more opportunities for further rate cuts, compared to non-inflation-targeting countries. During the

crisis, both inflation-targeting and non-inflation-targeting countries experienced an increase in unemployment. But later on, inflation-targeting countries unemployment rates stabilised and the unemployment rate of non-inflation-targeting countries continued to increase. As regards economic growth, de Carvalho Filho's (2010) finding was similar to that of Roger (2010) where high-income inflation-targeting countries' growth rates were higher than the high-income non-inflation-targeting countries. Roger (2010:48) confirms that "these results are consistent with the notion that inflation expectations are better anchored in countries that adopt inflation targeting". Thus inflation targeting did, to some extent, provide proper tools for dealing with the financial crisis.

3.2.4.2 Monetary policy transparency

Monetary policy transparency is also a product of liberalisation. It is a contributing factor to changes brought about by liberalisation. It has emanated as an important trait of monetary policymaking during the last decade. 'Transparency' can be defined as a situation of symmetric information. In line with this, the IMF developed a Code of Good Practices on the Transparency of Monetary and Financial Policies.⁸ The IMF argues that this best practice can be more successful if monetary authorities' goals, underlying principles and means of execution are communicated to the public in a timely manner. Likewise, Siklos (2000:15) confirms that the "benefits of openness, transparency, and accountability increase the awareness of financial markets and the public about the aims and limitations of monetary policy. As a result, one would expect these developments to increase the credibility of central bank actions". Geraats (2005:112) stipulates that "a reduction in information asymmetries between monetary policymakers and the private sector improves the transparency of monetary policy".

⁸ The code was developed to strengthen the international monetary and financial system with a view to increasing transparency. The code contains a list of broad principles that central banks and financial agencies should seek to achieve.

The IMF (2011a:1–2) code has as its aim to improve the transparency of monetary policy, and in view of this it rests on the following four broad principles:

- i Clarity of roles, responsibilities, and objectives: Where central bank goals should be communicated to the public in a clear manner and written into law.
- ii Open process for formulating and reporting policy decisions: Central banks should explain to the public how they are going to achieve their objectives by using framework and instruments.
- iii Public availability of information on policies: The central bank should ensure that its monetary policy is in line with the IMF's data dissemination standards and that its balance sheet is always available to the public.
- iv Accountability and assurances of integrity: Central bank officials should meet with the public on a regular basis to account for the effects of their policy

According to the IMF's (2003a) report on the outcome of the implementation of the code, several benefits accrued. The December 2003 report showed that in countries that had adopted the code the transparency policy enhanced the usefulness of monetary policy by ensuring that it was less vague; it was advantageous to financial market operations, which depended on information; and it improved the harmonisation of monetary and fiscal policy. Tables 3.8 and 3.9 show a follow-up of a review of the code completed in the December 2000 Board Paper using the experience of 23 countries.

Table 3.8: Monetary and Financial Policy Transparency Code assessments of monetary policy¹

Compliance	All monetary policy transparency practices of the code	Clarity of roles responsibilities and objectives of agencies for monetary policy	Open process for formulating and reporting monetary/ financial policy decisions	Public availability of information on monetary policy	Accountability and assurances of integrity by the central banks
December 2000 Board Paper²					
Observed	73	78	71	70	69
Broadly observed ³	19	17	19	27	16
Not observed	8	5	10	3	15
Current review⁴					
Fully observed	69	69	68	75	63
Broadly observed	12	12	14	12	9
Partly observed	13	16	13	11	13
Not observed	6	3	4	3	14

Source: IMF (2003a) Country assessment of the Monetary and Financial Policies (MFP) Transparency Code

- Notes:**
- 1 Numbers in the table represent the average percentage share (across the detailed practice-by-practice assessments) of the applicable and assessed practices from the respective sections of the MFP Transparency Code categorised as being observed, broadly observed and not observed.
 - 2 A total of 21 countries were assessed in Board Paper 1.
 - 3 Some assessment at the time of the first Board Paper did not have a "partly observed" rating, therefore, the rating "broadly observed" combines ratings of both "broadly" and "partly observed".
 - 4 A total of 35 countries' transparency practices in monetary policy were assessed in the current review.

Table 3.9: Monetary and Financial Policy Transparency Code assessments of financial policies (in per cent)

Financial supervisory agencies assessed					
Compliance	Payment systems	Banking supervision	Insurance regulation	Securities regulation	Deposit insurance
December 2000 Board Paper²					
Observed	75	77	75	78	84
Broadly observed ³	19	16	19	15	5
Not observed	6	7	6	7	11
Current review⁴					
Fully observed	69	71	61	69	73
Broadly observed	10	10	10	11	7
Partly observed	15	13	16	13	14
Not observed	6	6	10	7	6

Source: IMF (2003a) Country Assessment of the MFP Transparency Code

- Notes:**
- 1 Numbers in the table represent the average percentage share (across the detailed practice-by-practice assessments) of the applicable and assessed practices from the respective sections of the MFP Transparency Code categorised as being observed, broadly observed and not observed.
 - 2 A total of 21 countries were assessed in Board Paper 1.
 - 3 Some assessment at the time of the first board paper did not have a "partly observed" rating, therefore, the rating "broadly observed" combines ratings of both "broadly" and "partly observed".
 - 4 The transparency practices in financial policies of a total of 37 countries were assessed in the current review.

According to the tables, central banks and financial agencies have broadly observed the transparency practices. Furthermore, most of the financial agencies implemented a high standard of transparency in their policies. The implementation of the code has made financial agencies more conscious of the importance of transparency in both monetary and financial policy. Many countries have therefore adopted these codes, as of March 2011, 346 countries have undergone a transparency assessment in both monetary and financial policy (IMF, 2011a:2). Geraats (2005:116) says that the main effects of monetary policy transparency are “that it improves the predictability of monetary policy actions and outcomes; it induces reputation building and it enhances credibility and makes long-run private sector inflation expectations more stable”.

In analysing policy transparency, Walsh (2001:1,2) asserts that “a policy is transparent about objectives if the public can accurately gauge the central bank’s intentions”. But even with the central banks’ intention to be transparent, monetary policy will still be unclear to the public due to the public’s vague comprehension of the economic model used by the central bank to assess different policies. However, if the public is familiar with the central banks’ economic model, it may not be in possession of some of the economic information the central bank obtains, thus, according to Walsh (2001:1;2), “monetary policy is opaque as there are no quantitative estimates of either gains or costs of transparency”.

The combination of inflation targeting and monetary policy transparency has become a norm in many countries. The inflation target is made public, which ensures that the intentions of the central bank are transparent enough. Inflation targeting has become more widespread since the 1990s as emerging market countries abandoned their fixed exchange rate regimes. Some of the countries that implemented an inflation-targeting regime include South Africa, Brazil, Mexico, Poland, Colombia, Thailand, South Korea and Switzerland. However, although some central

banks make use of exchange rate targeting, they are not as transparent as inflation targeters, because inflation targeters are more visible in terms of publishing data and other information to the public. Geraats (2005:113) maintains that “although the adoption of inflation targeting has contributed to the rise in monetary policy transparency; inflation targeting is not a sufficient condition for transparency”.

3.3 Conclusion

When countries liberalise their financial systems, it is commendable. Thus it is important to keep up with international norms. But experience shows that (i) it is disastrous to liberalise an economy in one concerted effort; (ii) premature liberalisation of the capital account with a weak domestic financial sector does not result in efficient allocation of financial resources; (iii) having a pegged exchange rate does not guarantee price stability and growth; (iv) a very tight monetary stance can push inflation to negative levels; and (v) harmonising international best practices without proper domestic supervision and regulation can disrupt the financial system.

With this in mind, the following are some of the measures that should be adopted to ensure effective financial liberalisation:

- Sequencing, which will strengthen the market structure and ensure a less complicated liberalisation process.
- Appropriate macroeconomic reforms and exchange rate policies should be in place before liberalising capital accounts, and capital flows should be long-term and not easily changed to avoid crises.
- A flexible exchange rate can be more effective and better able to absorb shocks if it is accompanied by good fiscal policies and inflation targeting.

- Monetary policies should be aimed at stabilising inflation and preventing volatile markets; and central banks should be transparent and accountable so that the public is aware of the goals of monetary policy.
- It is important for policies to be flexible so that new developments, technology and structural changes are not stifled and competition is promoted.

Although the above steps are important for more effective financial liberalisation, it is clear that financial liberalisation, combined with a lack of financial infrastructure, has resulted in a more careful consideration of regulation and standards. Financial crises have transformed from “country crises” to “systemic crises”, as can be seen from the Asian crises and the more recent subprime crisis. Regulatory practices and efforts to liberalise have ensured that developed and emerging market economies have integrated more closely. The question arises whether these practices will provide more protection from crises than in the past. New policies and updates to the financial safety net call for supervisors and managers to be more prudent in order to prevent problems such as that of the East Asian and the US subprime crisis. As regards the East Asian crisis, liberalisation was one of the factors that contributed to the impact and spread of the crisis. In the US subprime crisis bad monitoring, and a lack of risk management and regulation exacerbated the crisis. Had prudential supervision been implemented more efficiently and effectively, it would have helped to minimise or prevent the crises.

It is of no use if countries cannot update their regulatory regimes after liberalisation. In the case of the US and EU, although they are considered to have liberalised economies they were in the epitome of a crisis because they delayed in implementing current international practices such as Basel II, and the resultant ramifications were severe. Therefore, liberalisation and a continuous updating of regulation due to changing times are important to maintain systemic stability within any economy.

Chapter 4

South Africa and financial liberalisation

4.1 Historical overview of South Africa's economic instability

4.1.1 Liberalisation in South Africa after the De Kock Inquiry

South Africa, like other emerging countries was also burdened with repressive policies in the period 1960–1980. The link to these repressive policies falls within the ambit of the post-war period where the central bank played a role as the bank of rediscount which accommodated the banking system with liquidity requirements. At the peak of the post-war period the South African economy experienced huge upswings which resulted in the expansion of the liquidity base of the banking system, an increase in inflationary pressures, continued excessive credit creation and overspending. At that time the authorities decided that conventional monetary policy was inadequate to curb the economic pressures mentioned before and more direct controls were necessary to curb, among other things, the problem of inflation and credit. As a result, government implemented direct monetary controls which included ceilings on bank credit to the private sector, deposit rate control, exchange control and direct consumer credit controls. The monetary controls were put into effect through the market mechanism, the coordinated application of fiscal policy, public debt management and interest rate policy to obtain the ultimate goal of stability in the value of money and economic growth.

Although there were many negative consequences to these policies, the following are just a few outcomes of the policy stance of the country at that time:

In implementing these repressive policies, direct deposits and lending rate controls were used as measures to keep interest rates low to avoid large increases in politically sensitive interest

rates and to minimise the cost of certain forms of socially desirable credit, such as building society mortgage loans and Land Bank cash credit advances.

During this period, the central bank used credit ceilings and extensive rises in minimum liquid asset requirements to restrain bank credit to the private sector. This resulted in banks investing more funds in government stock. At the time the 'grey market', together with its steep interest rates plus credit controls, brought about a fall in the industrial sector's business confidence. This caused a reduction in private fixed investment expenditure. As a result, funds were channelled to the services sector as an alternative investment means with higher returns on capital. This shift in investment led to supply constraints which provoked greater inflationary pressures.

Deposit rate controls were set to ensure that home mortgage rates were not increased as interest rates increased. Furthermore, control over the deposit rates was essential in keeping competition between banks and building societies in abeyance, and from possibly pushing mortgage and deposit rates upwards, especially when bank liquidity was abundant and interest rates falling. It was believed that competition between banks could lead to unstable practices that would be at the inconvenience of borrowers.

After the breakdown of the Bretton Woods System in 1973, the exchange rate was delinked from the sterling and re-valued in terms of the dollar. The central bank aspired to increase the foreign-exchange reserves of the country. This ultimately led to an increase in money supply (which were induced by advances in the gold and foreign-exchange reserves). Thus, as cash reserves increased (due to an increase in money supply), the banking sector also became more liquid. As a result, interest rates were depressed which ultimately influenced capital outflows. The latter, together with an increase in business cycle upswing, led to an increase in inflation.

All these considerations brought about a new awareness for the need for a monetary reform. A Commission of Inquiry into the Monetary System and Monetary Policy in South Africa was employed in 1977. This commission was chaired by Dr Gerhard de Kock. The De Kock Commission's final report, which was released in 1985, stated that the only effective way to restore and maintain reasonable stability of the price level in South Africa was to exert better control over money creation and total spending with full acceptance of the implications this would have for interest rates and exchange rates (Kantor, 1986:94). This conclusion was solely based on the growing sophistication of the financial markets, which are important contributors to economic growth; and a need for a market approach to monetary policy which should ultimately contribute to (i) the moderation and stabilisation of the growth of the monetary aggregates; (ii) more effective control over disintermediation and other velocity-related developments; (iii) the maintenance of realistic and market-related interest rates; and (iv) the attainment of realistic and market-related spot and forward exchange rates (Kantor, 1985:98). The outcome of the report prompted a shift in policies that directed South Africa away from the financial repressive policies of direct control, towards a stance of financial liberalisation. Thus the report emphasised that amendments should be placed on the following three areas:

- a) Exchange rates
- b) The foreign-exchange market
- c) The money market and interest rates

a) Exchange rates

Since exchange rates were given precedence in the inquiry, a provisional report was issued in 1979. The outcome of the De Kock Commission report suggested that the country's exchange rate policy should be revolutionised in a slow, but continuous manner. As a result, this recommendation led to a reform of the exchange rate policies. This included that the rand no

longer be pegged to the dollar, the exchange rate system should be managed and that free floating be abolished, the exchange rate system be determined by the country's balance of payments and domestic economy, and that the rand become an independent currency.

b) The foreign-exchange market

As regards the foreign-exchange market, previously the central bank used to quote predetermined buying and selling rates for US dollars at which it was prepared to transact with. After the De Kock Commission report (1985), the bank introduced reforms to develop a more sophisticated foreign-exchange market. The reforms were as follows:

- The compulsory fixed buying and selling rates of US dollar was brought to a stop so that South Africa's foreign-exchange market could be more dynamic and competitive.
- Dealers of foreign exchange were requested to retain open positions in the foreign-exchange market and to transact in foreign exchange within limits as prescribed by the central bank. These dealers were monitored on a continuous basis.
- When it was established that the exchange rate of the rand would be determined by market forces, the central bank began participating as a buyer and seller of dollars in the market with the aim of still influencing the progress of the rand/dollar rate.
- To contribute to a more dynamic foreign-exchange market, proceeds from Kruger rand and diamond sales were no longer in the care of the central bank but rather in the hands of authorised foreign-exchange dealers, thus making the market more conducive to a floating rand.

Furthermore, most of the foreign transactions were denominated in foreign currencies and the need for forward cover facilities was based on the fact that:

- traders needed to be safeguarded against the risks stemming from exchange rate fluctuations;
- exporters were at a competitive disadvantage to exporters in other countries who had forward cover to deal with exchange rate risks;
- local commercial banks would be able to cover their own forward positions in the external foreign-exchange markets; and
- the central bank would be better able to evaluate its future foreign currency requirements and improve the management of its gold and foreign-exchange reserves, its currency working balances and investment portfolio, and future gold sales on the private market.

Provision was therefore made for forward cover which took the form of cover in dollars against the rand at a fixed cost of 1 per cent per annum for either purchase or sales contracts. Forward cover was provided to local traders, authorised dealers and public corporations. Eventually, excessive foreign borrowing by the central bank and government caused an imbalance in the forward book where forward sales of dollars exceeded forward purchases. In 1975, the rand devalued and the central bank incurred substantial losses. The De Kock Commission pointed out the deficiencies in the forward exchange policies and recommended a more active and competitive forward exchange market.

Steps were taken to develop a more sophisticated forward exchange market. These included the following:

- The central bank no longer quoted a fixed charge or commission to be paid by both importers and exporters for forward cover but rather one middle price for forward dollar of any maturity and later on

- A dollar discount (or rand premium) of 2 per cent a year was set by the central bank for forward margins on US dollars.
- Dealers were encouraged by authorities to merge forward sales and purchases of dollars, and to cover their net forward liabilities by holding spot foreign assets.
- Forward cover facilities were extended to the private sector (who had exchange control approval) on a year-on-year basis for foreign loans negotiated in respect of rand/dollar exchange risk.
- The central bank decided to continue with forward cover on public loans.

With all the above taken into account, the central bank fell in line with the De Kock proposals from the beginning of the 1980s and henceforth only furnished forward cover in US dollar for loans raised by the public corporations.

c) Money market and interest rates

Monetary policy in South Africa took a turn after the recommendations of the De Kock Commission. Changes in the growth rate of the domestic broad money supply (M3) became an important element in the monetary policy decisions and in the central bank's objective of protecting the value of the currency. "The monetary policy model was based on monetary targeting which anchors monetary policy decisions to changes in the money supply" (Stals, 1997:3). In 1985 the central bank began announcing broad money targets and in the subsequent years a target for M3 growth was announced. Stals (1997) acknowledged that the monetary model worked extremely well, especially during South Africa's segregation from the global world. In 1992 M3 growth met the target range. However, afterwards the association between M3 and the demand for goods and services did not fully represent the transmission mechanism of monetary policy. This was due to the fact that financial markets began extending their services and becoming integrated with global counterparts. As a result of this, the degree

of global capital flows increased substantially and domestic interest rates changed frequently. This in effect affected the exchange rate of the rand, and also affected time lags in policy change and its influence on the economy and inflation. Thus the link between interest rate, money supply and inflation became vague. Money supply was no longer a credible indicator for inflation and became unworthy as a guideline for monetary policy. The central bank then shifted from money supply targets towards the eclectic monetary policy approach.

4.1.2 Socio-political effects on the South African economy

As shown in the preceding chapters, liberalisation ensures better integration of the domestic economy into the world economy. The pace of liberalisation differs between countries: in some countries liberalisation efforts were gradual, while in others it was speedy. South Africa adopted a more cautious liberalisation strategy, which had positive effects in terms of reducing vulnerabilities to various international financial crises. Owing to socio-political circumstances, South Africa's response to liberalisation was a delayed one, compared with other emerging economies of the world, which removed restrictions on bank entry and exchange controls swiftly, and introduced international rules for financial regulation and supervision promptly. However, the need for major financial reforms was long overdue in South Africa; economic restructuring in South Africa improved only after the constitutional change in 1994 (Calitz, 2002).

South Africa's financial isolation from the world was evidenced by many restrictions that were related to its political regimes. Sanctions on international trade and finance that one country imposes on another for political reasons (Investorwords, 1999b) intensified from the 1980s until 1993 and this affected the country's average growth rates, capital inflows, foreign investment, trade and so forth. Owing to sanctions, there were also large withdrawals of foreign capital. As a result, South Africa's economic performance was deteriorating rapidly, leaving large government

deficits to be financed through borrowing and putting pressure on private capital markets. For example, in the late 1980s the public sector borrowing requirements amounted to R8,5 billion; its fixed investment relative to GDP declined from 27,8 per cent in 1981 to 15,5 per cent in 1993; government taxes (which was a dominant factor in generating revenues), increased considerably from 19,5 per cent of GDP during 1975 to 26 per cent during 1987/8; and the ratio of domestic savings to GDP contracted from 24,5 per cent in 1985 to 17 per cent in 1994 (SARB, 1991, 1996). While other developing countries such as Chile, Mexico and Brazil were in the process of liberalising their markets, South Africa was still fighting the impact of sanctions.

Cross (2003:104) argues that the most visible impact of sanctions in South Africa was the imposition of a debt standstill in September 1985. While prime overdraft rates were at a historical high of 25 per cent, international banks such as Chase Manhattan and Barclays fled, as they were under extreme pressure to restrict their dealings with the local economy. They detached themselves from the South African economy by withdrawing their direct operations and placing a moratorium on lending. This placed South Africa in a more vulnerable position because of its dependence on loan capital and foreign investments. Cross (2003:104) explains that despite this debt standstill, “foreign capital still flowed out of the country; averaging 2,5 per cent of GDP in 1985 and 13 per cent of gross domestic fixed investment in 1994”.

Rustomjee (2006) believes that the debt crisis was due to a variance in the maturity structure of the country's private sector debt (i.e., the income on the repayment of the debt was not matched, because the debt matured earlier than the income generated; as a result, there was less income available to service the debt). He further explains that after the announcement of the debt standstill, the SARB and government intervened in response to the crisis through exchange controls and by swapping rand for dollars, which was to be repaid at the forward rate at maturity. Hence, a dollar overdraft materialised, which contributed to the net open forward

position, which is a measure of the country's short-term foreign currency exposure or, uncovered foreign-exchange liabilities, amounting to US\$25,8 billion in 1995 (SARB, 2004c). As a result, government and corporations were equally exposed to the foreign-exchange problem, which resulted in the value of the rand depreciating. "The commercial and financial rand⁹ plummeted, with the rand losing over 30 per cent of its real trade weighted value in a matter of months" (Commission of Inquiry, 2001).

Table 4.1: National accounts: Percentage changes in selected data at constant 1990 prices

Period	GDP	Exports of goods and non-factor services	Imports of goods and non-factor services
1983	-1,8	-2,6	-16,1
1984	5,1	4,1	19,8
1985	-1,2	8,9	-14
1986	0,0	-3,8	-2,5
1987	2,1	-1,8	3,5
1988	4,2	9,8	21,9
1989	2,4	5,4	0,3
1990	-0,3	1,7	-5,8
1991	-1,0	-0,1	2,1
1992	-2,2	2,5	5,3
1993	1,3	4,8	7,0
1994	2,7	1,0	16,1
1995	3,4	10,5	17,1
1996	3,2	11	9,2
1997	1,7	5,3	4,6

Source: SARB (1998)

⁹ South Africa had a dual-exchange rate system composed of the commercial and financial rand (the commercial rand was used for ordinary current transactions, while the financial rand was used to control the outflow of foreign investments from the country which related to non-residents investing in South Africa). Its aim was to provide some protection to the domestic economy from the adverse effects of large capital outflows. It originated in the exchange control measures that were introduced in 1985.

Analysis of economic aggregates of the apartheid era provides evidence of the macroeconomic instability that occurred during this period. For example, during the period 1984–1993, net capital outflows amounted to more than R50 billion, which affected the balance of payments. This, on average, amounted to R5 billion per annum. To fund this outflow, a surplus on the current account was needed, therefore imports were decreased and exports were encouraged. However, the official foreign reserves were also added to the current-account balance in order to meet the outflow challenge. Despite this, the accumulated net capital outflow still exceeded the sum of the current-account surplus plus the official foreign reserves. This left the country with a zero balance of net official foreign reserves in 1994. This is evidenced by the percentage change in export growth from 8,9 per cent in 1985 to 9,8 per cent in 1988, and further positive and negative balances throughout the years until 1993 (Table 4.1). In comparison, percentage change in imports decreased by 14,0 per cent in 1985 and by 2,5 per cent in 1986, and increased by 3,5 per cent in 1987, mainly due to the low demand for imports. This may have added to the shortfall in the accumulated net capital flows. In 1988 the 21,9 per cent increase in imports was due to the ramification of the Asian financial crisis, which caused the value of the rand to decrease, and domestic expenditure and merchandise imports to increase. Furthermore, Table 4.1 shows that the percentage change in GDP in 1985 was -1,2 per cent at the beginning of sanctions but improved slightly in 1993 to 1,3 per cent. South Africa's average CPI also fell from 16,2 per cent in 1985 to 8,8 per cent in 1994.

4.2 South Africa's reintegration into the global economy

4.2.1 The South African experience

Loots (2003:219) argues that "South Africa re-entered the international economy at a time when the process of globalisation was beginning to gain momentum". Since 1994, South Africa's integration into the global economy has led to important modifications in the domestic financial

sector. The abolition of apartheid sparked new challenges that led South Africa to embark on a path of reform. This included further liberalising the domestic economic sectors. Liberalisation in South Africa was aimed at attracting foreign investments, contributing to economic growth, supporting a more sound market, and enhancing South Africa's involvement and acceptance in the world economy. To accomplish this, it had to reform its policies in order to develop and maintain a robust and stable financial sector. The restructuring of the policies included amending the legal and regulatory framework; improving its economic policies and rehabilitating the financial infrastructure. An example of how the policy framework as a whole was adjusted and improved can be viewed in Table 4.2.

Table 4.2: Development of the South African financial sector

Date	Description
Prior to the 1980s	<ul style="list-style-type: none"> • Import control (permit control) in respect of numerous product categories; generally high import duties, including a surcharge on imported goods; some export subsidies. • Credit ceilings, deposit interest rates controlled.
1980	<ul style="list-style-type: none"> • Deposit interest rate controls and credit ceilings abolished. • 7,5 per cent surcharge on imports abolished.
1985	<ul style="list-style-type: none"> • Surcharge on imports reintroduced at a rate of 10 per cent.
1986	<ul style="list-style-type: none"> • Introduction of money supply targeting, flexibly applied.
1990	<ul style="list-style-type: none"> • Money supply targets renamed 'money supply guidelines', to emphasise flexibility.
1995	<ul style="list-style-type: none"> • Comprehensive reduction in import duties introduced in September; the first step in the implementation of the announced tariff reduction programme. • Remaining surcharge on imports abolished in October.
1997	<ul style="list-style-type: none"> • South African gold producers are no longer required to market their gold through the South African Reserve Bank. • Foreign banks are allowed to open branches in South Africa.
1998	<ul style="list-style-type: none"> • Informal, central bank announced inflation target introduced, alongside money supply guidelines.
2000	<ul style="list-style-type: none"> • Formal inflation targeting introduced.
2003	<ul style="list-style-type: none"> • South Africa became a member of the Financial Action Task Force (FATF) to combat money laundering.
2005	<ul style="list-style-type: none"> • Implementation of the National Credit Act (NCA) to regulate institutions that provide credit and to curb reckless behaviour by credit providers.

Date	Description
2008	<ul style="list-style-type: none"> • Upgrade from Basel I to Basel II.
2011	<ul style="list-style-type: none"> • South Africa to begin implementing Basel III. • Draft Credit Ratings Services Bill to provide for the conditions for the issuance of credit ratings.

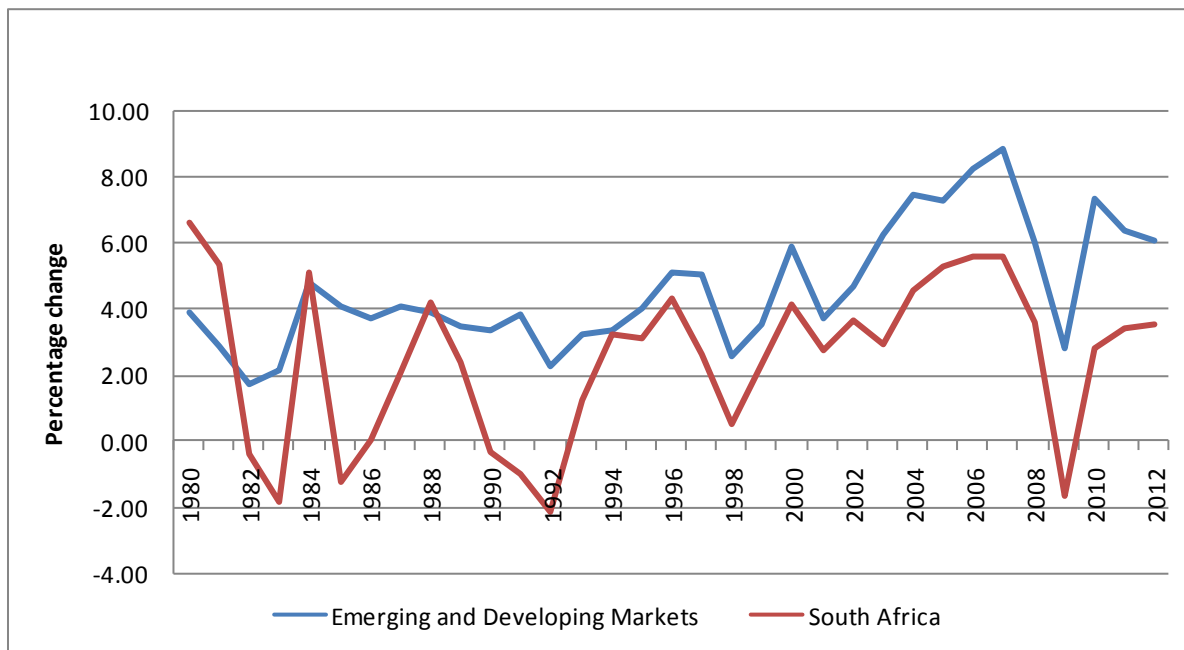
Source: Cross (2003)

These adjustments were necessary and were made in a sequential manner to ensure a healthy and upgraded financial sector. The SARB had made further efforts to reform the economic sector by adopting the 12 key standards of the FSF (which were discussed in Chapter 3) to enhance transparency, and to ensure that policies were conducted in an understandable and timely manner. Furthermore, in 2000 the SARB moved from an eclectic monetary policy stance to an inflation-targeting framework (which is forward-looking and more transparent), with a view to maintaining inflation between a 3 and 6 per cent band. With South Africa's reintegration into the global economy, countries began reinvesting in South Africa. This led to positive contributions to the domestic sector, such as improved macroeconomic performances, FDI inflows and relaxation of exchange controls.

4.2.1.1 Economic improvements

South Africa's macroeconomic performance in comparison with other emerging and developing market economies can be viewed in Figures 4.1, 4.2 and 4.3.

Figure 4.1: GDP growth rate

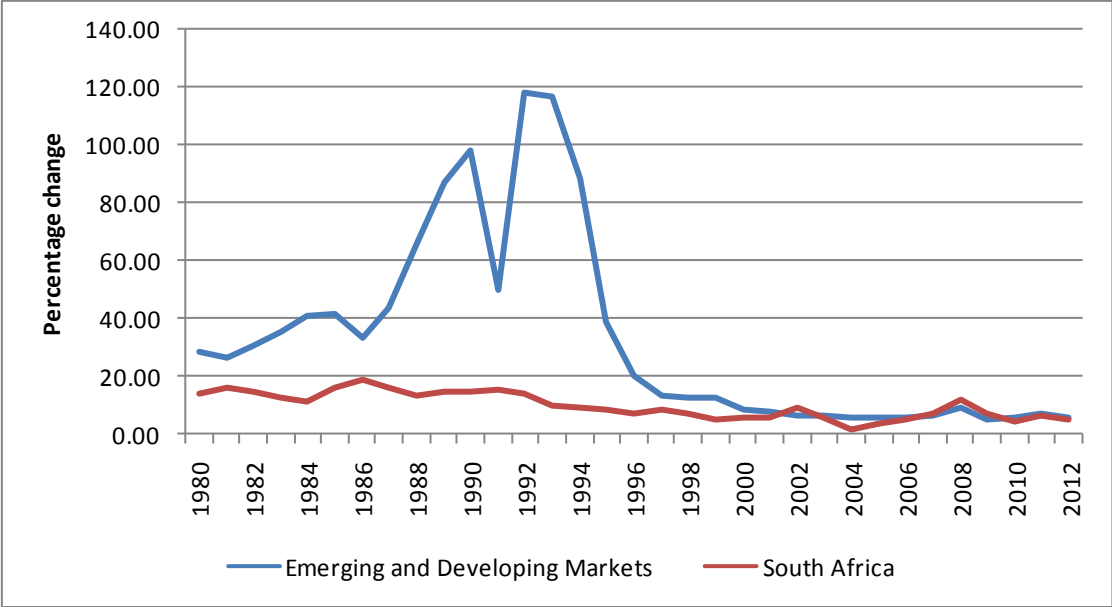


Source: IMF (2010a; 2011b)

During the period 1980–1992, South Africa experienced its worst decline in GDP growth. For example, in 1980 South Africa's GDP growth was 6,62 per cent, in 1983 it plunged to negative 1,85 per cent, in 1985 GDP growth reduced again to negative 1,21 per cent and in 1992 the country experienced a further decline in GDP growth to negative 2,14 per cent, mainly due to political and economic instability. In comparison, although emerging and developing markets' GDP growth in 1980 was 3,90 per cent – much lower than that of South Africa – emerging and developing economies also experienced a short drop in GDP growth but it has gained momentum. In 1983, for example, its GDP growth rate was 2,12 per cent, in 1985 4,07 per cent and in 1992 2,25 per cent, all of which were higher than that of South Africa. Since 1993, South Africa's GDP growth trend has gained momentum and has been in line with that of other emerging markets. GDP growth for both emerging and developing markets, and for South Africa in particular, has shown signs of recovery in general economic activity. This is confirmed by the upward trend of GDP growth during the period 1993–7, after which both markets experienced

fluctuating movements in GDP growth. The latest GDP growth figures show that South Africa experienced a growth rate of 3,40 per cent in 2011, while other emerging and developing market economies' growth rate in 2011 was at 6,40 per cent.

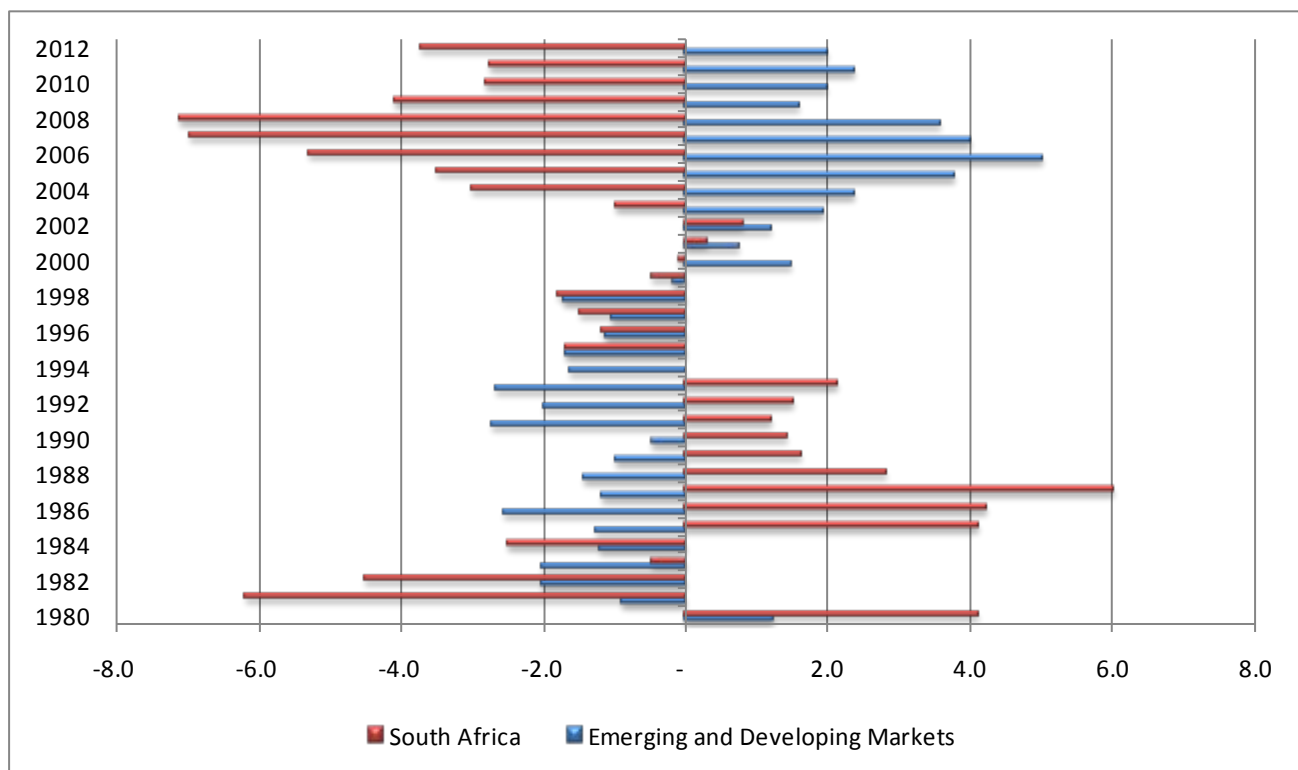
Figure 4.2: Annual inflation rate



Source: IMF (2010a; 2011b)

Inflation in South Africa reduced considerably to single digits after liberalisation in 1994, for example, in 1984 the annual inflation rate was 11,2 per cent, while the inflation rate of other emerging and developing markets was 40,70 per cent. In 1994 South Africa's inflation reduced to 8,8 per cent lower than the emerging and developing market economies' rate of 88,52 per cent. In 2009 South Africa's inflation was recorded at 7,2 per cent and in the same year, other emerging and developing markets' inflation stood at 5,2 per cent. As confirmed by Figure 4.3, South Africa's inflation rate still remains low. At the time of writing (September 2011), inflation was sitting at 5,7 per cent, well within the target range of 3 to 6 per cent.

Figure 4.3: Current-account balance as a percentage of GDP



Source: IMF (2010a; 2011b)

South Africa's current-account balance as a percentage of GDP was positive during the period 1985–1994, contrary to the total for emerging and developing markets, which was negative during this period. This was mainly due to the large outflows that required a sustained surplus during sanctions. However, after 1994 the current-account balance as a percentage of GDP reflected variations in the deficit, for example, in 1998 both South Africa and emerging and developing market economies' balance was at negative 1,8 per cent. However, in 2011 emerging and developing markets' balance was positive 2,4 per cent, while South Africa's current-account balance as a percentage of GDP remained negative at 2,8 per cent.

4.2.1.2 Foreign direct investment inflows

The restoration of international contact led to large inflows of capital from other countries, which consisted largely of portfolio and shorter-term investments. According to SARB data (SARB, 2001b; 2010c), calculations of FDI inflows at current prices were at 0,279 per cent of GDP per annum in the period 1994, while net portfolio inflows totalled about 2,135 per cent of GDP. However, ten years after the termination of sanctions, FDI inflows in 2004 were at 0,369 per cent of GDP at current price and net portfolio inflows were at 3,31 per cent of GDP. Furthermore, capital inflows into South Africa were exceptional for most of the period after sanctions had been abolished; recording direct investment inflows of R5,1 billion in 2004, R42,2 billion in 2005, -R3,5 billion in 2006, R40,1 billion in 2007, R74,4 billion in 2008, and R48,2 billion in 2009 (SARB, 2010c). This progress in the economy shows significant improvements as, just after the transition period, South Africa's economy was faced with deep-rooted burdens of the past, including high inflation and poor economic growth.

4.2.1.3 Exchange controls

One of the reasons for maintaining foreign-exchange controls was to maintain the exchange rate of the currency at a stable level. The introduction of foreign-exchange controls in 1961 in terms of the Currency and Exchange Act 9 of 1933 was to prevent the flight of capital from the country and to protect foreign reserves. The controls had the following broad impact on individuals and companies (Van der Merwe, 1996:8–11):

- South Africans as well as non-residents were not allowed to move capital abroad.
- Institutional investors such as insurers, pension funds and unit trusts were also unable to transact abroad. However, in 1995 asset swaps were introduced, which allowed these institutions to invest a portion of their assets globally. Companies including banks that

wanted to engage in offshore direct investments outside the Common Monetary Area (CMA) (i.e., South Africa; Lesotho; Namibia and Swaziland) were required to seek approval from the [SARB] and demonstrate benefits to South Africa such as job creation, huge foreign exchange earnings, etc.

These rules were implemented to prevent large capital outflows. However, Mohamed and Finnof (2004:2) argue that

from 1980 to 2000 on average, capital flight as a percentage of GDP was 6,6 per cent a year. During the last 13 years of apartheid, from 1980 to 1993, average capital flight as a percentage of GDP was 5,4 per cent a year. Post-apartheid, from 1994 to 2000 capital flight rose to an average of 9,2 per cent of GDP per year

which is higher than in the apartheid era. They explain that this was due to the “structural weaknesses of the South African economy that limited diversification and stifled investment” (p. 18).

South Africa, with its growing economy and international diversification, and in an attempt to reform the economy, began to relax exchange control. The aim was to get rid of certain bottlenecks, encourage growth of businesses and reduce the cost of doing business. This approach was part of the liberalisation process. South Africa had taken a gradual approach to exchange control liberalisation since 1994. In 1995 the dual exchange rate system was also eliminated. The reformation of exchange controls impacted on corporates, financial institutions and private individuals, which meant that they were now allowed to invest abroad. The progress that has been made towards exchange control relaxation is shown in Table 4.3.

Table 4.3: Relaxation of exchange control

The gradual relaxation of exchange controls since 1995	
<p>A. Foreigners</p> <ul style="list-style-type: none"> • 1995: The financial rand abolished (exchange controls on foreigners also abolished). 	<p>D. Companies (including banks)</p> <ul style="list-style-type: none"> • 1997: Offshore direct investments allowed up to R30 million, and R40 million for the Southern African Development Community (SADC). • 1998: Offshore direct investments increased to R50 million abroad and R250 million in SADC. • 2001: Offshore direct investments increased to R500 million abroad and R750 000 in SADC. • 2002: Offshore direct investments increased to R2 billion for Africa; allowance to be used to fund approved expansion of existing offshore direct investments. • 2003 Budget: Offshore investment increased to R1 billion abroad (excluding Africa); allowance to be used to fund approved expansion of existing offshore direct investment. Foreign dividends could be repatriated to South Africa and be re-exported subject to approval. • 2004 Budget: Offshore direct investment limits retained, but percentage of excess costs to be funded from South Africa raised from 10 to 20 per cent. Foreign entities could list on the South African stock and bond exchanges. • 2004 Medium-Term Budget Policy Statement (MTBPS): Limits on offshore direct investments removed (but application still required). South African corporates allowed to retain foreign dividends offshore. • 2005 MTBPS: South African banks allowed to hold foreign assets up to 40 per cent of domestic regulatory capital; non-African assets could only make up to 20 per cent of the 40 per cent of domestic regulatory capital, while African assets could make up the total 40 per cent. • 2006 Budget: Outward direct investment ownership lowered from controlling interest (50 per cent +1) to 25 per cent for investments in Africa. Developments finance institutions could issue loans to non-residents without the requirement of a 50 per cent South African content. • 2007 Budget: Enabled the JSE Limited to develop a Rand Currency Futures Market, enabling South Africans to speculate on the currency for the first time. Outward direct investment ownership lowered from controlling interest (50 per cent +1) to 25 per cent for investments outside Africa. CFC accounts streamlined. • 2009 Budget: Outward investment raised to R500 million from R50 million.
<p>B. Individuals</p> <ul style="list-style-type: none"> • 1997: Offshore allowance of R200 000 introduced. • 1998: Offshore allowance increased to R400 000. • 1999: Offshore allowance increased to R500 000. • 2000: Offshore allowance increased to R750 000. • 2003: South African emigrants allowed to transfer offshore amounts in excess of R750 000 subject to a 10 per cent exit levy. Amounts up to R750 000 were exempt from any change. • 2006 Budget: Offshore allowance increased to R2 million. • 2009: offshore allowance increased by a further R2 million. 	
<p>C. Institutional investors</p> <ul style="list-style-type: none"> • 1995: Asset swaps introduced to enable foreign exposure up to 5 per cent of total assets. • 1996: Foreign exposure limit increased from 5 to 10 per cent of total assets, and institutions could acquire offshore portfolio investments up to 3 per cent of the net inflow of funds in the previous year. • 1997: 10 per cent foreign exposure limit maintained, and the above 3 per cent dispensation was extended to investment managers. • 1998: Foreign exposure limit of 10 per cent increased to 15 per cent, and 3 per cent pertaining to foreign-currency transfers was increased to 5 per cent (based on previous year's net inflow of funds). • 2000: Foreign exposure limit of 20 per cent and 15 per cent on total assets for collective investment schemes and for the rest of institutions respectively. • 2001: Asset swaps system abolished. • 2003: Restriction based on prior year's inflow of funds removed. • 2005 MTBPS: Foreign exposure limit for collective investment schemes and investment managers increased from 20 per cent to 25 per cent and from 15 per cent to 25 per cent, of total retail assets respectively. • 2009: abolishment of 180 day rule which entailed businesses changing their foreign currency into rand. • 2011: Inward listed shares on the JSE are classified as domestic. 	

Source: National Treasury (2006); *Financial Mail* (2006).

Further liberalisation of exchange controls was implemented in 2009. This included the following (National Treasury, 2009;26):

- Foreign offshore allowance for individuals was raised by R2 million, and the single discretionary allowance raised by R250 000.
- South African businesses are permitted to invest in Southern African Development Community (SADC) member countries through offshore intermediaries.
- Outward investment by companies has been raised to R500 million from R50 million.
- Doing away with the 180-day rule which entailed that businesses had to change their foreign currencies into rand. However, proceeds received from exports should be sent back to South Africa.
- Abolishing the advance payment rules for import trades.
- South African businesses can engage in foreign banking without prior consent.

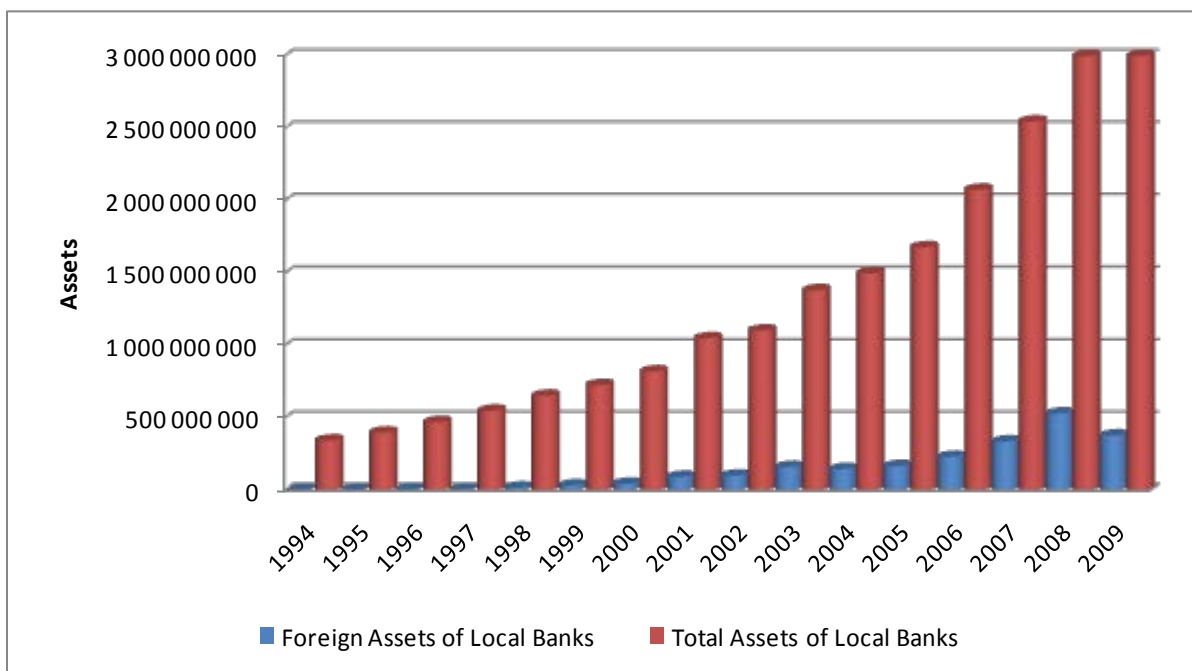
The intention of the gradual abolition of exchange control was to make South Africa more visible to foreign investors, thus making the country more attractive for foreign investment. It was also aimed at ensuring that the exchange control framework was in line with current times. A recent change to exchange controls can be seen in the inward listing policy. Previously, the inward listing policy prohibited South African trusts and companies from investing in inward listing entities. This was because South African corporates were not allowed to undertake foreign portfolio investments. However, in 2011, the Minister of Finance (Pravin Gordhan) announced that all inward listed shares on the stock exchange, the JSE Limited (JSE) would be classified as domestic. This proposal would boost investments into Africa through new listings on the JSE and companies concerned were likely to experience increased trading in their shares which would, in turn, improve liquidity.

Although South Africa has made major improvements in removing controls, the foreign-currency hedging requirement policy still remains. This policy requires that South African businesses trade their foreign currency hedging requirements exclusively through accredited local banks and not through overseas financial institutions. This puts South African businesses at a disadvantage because (i) the local banks are not price-competitive and (ii) they operate within South African business hours. For this reason, South African businesses cannot trade with their overseas counterparts outside South African business hours.

4.2.2 The South African financial banking landscape

As mentioned earlier, banks were also affected by the sanctions that were imposed on the country. However, once all restrictions were lifted in 1994, foreign banks were once again permitted to operate in the country. During that time, South African banks consisted of 35 finally registered banks, 2 mutual banks and 4 provisionally registered banks, with minimum capital requirements at 8 per cent and prime overdraft rates resulting in a reduced 16,25 per cent. Total bank assets in 1994, some of which included money, loans and advances, non-financial assets, investment portfolio, non-bank advances and so forth amounted to R344,1 billion (Figure 4.4). By the end of 1994 international participation in the local banking sector (i.e., foreign holdings of local banks) was at 1,16 per cent of banking sector assets. South African banking competition was on the verge of unfolding as local and foreign banks began growing their business on either side of the border.

Figure 4.4: Growth of total assets and foreign assets in South African banks



Source: SARB (2010a, b)

Ten years after liberalisation, confidence in the financial sector had grown. This is evidenced by the foreign composition of total bank assets rising to 9,79 per cent in 2004.

In 1999 a banking crisis erupted in small banks where a number of them exited the banking sector or were placed under curatorship. This was due to pressures from the East Asian financial crises in 1997, the Russian financial crisis in 1998, liquidity pressures and a lack of depositor confidence. The crisis, however, did not negatively impact the local banks' foreign assets since total foreign assets grew by 81 per cent from R3,9 billion in 1994 to R34,4 billion in 1999. The crisis faded away quite quickly due to the quick action taken by regulators and the prudent behaviour of bankers. More importantly, this did not have any negative systemic implications for the economy. By 2004, total assets of banks amounted to R1 498,6 billion, a huge increase of R1 154,5 billion since 1994 and prime overdraft rates were further reduced to 11 per cent. The banking sector eased from a state of fragility during the 1990s to a more

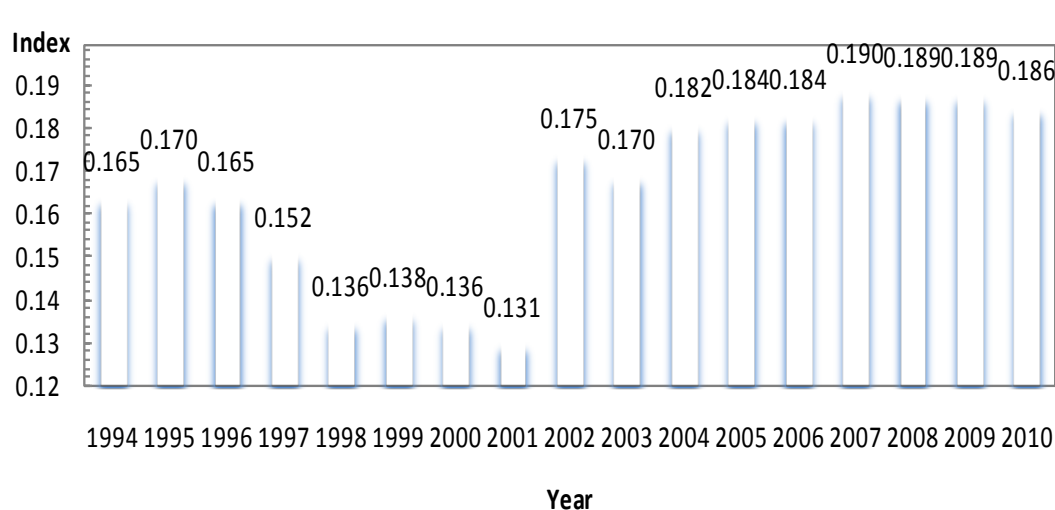
resilient one in 2004 with a capital adequacy of 13,5 per cent (which is above the minimum requirement of 10 per cent) and a total of 36 banking institutions. In 2009 South Africa had a total of 31 banking institutions with total assets of the banks amounting to R2 962,6 billion and foreign assets of local banks amounting to R378,2 billion.

Furthermore, to have a clearer perspective of the concentration of the banking industry, the SARB has implemented the Herfindahl–Hirschman Index (H-Index), which takes into consideration the number of banks in a system and its size to measure concentration in the banking system. A small H-Index indicates greater competition and lower concentration in the banking sector, while a high H-Index means weaker competition and higher concentration of a banking system. Oligopoly concerns are raised when the index reaches a level of 0,18 (SARB, 2001a). According to Figure 4.5, in 1994 the H-Index was at 0,165 with the number of bank institutions averaging 41. In comparison, by the year 1999, the H-Index was at 0,138, reflecting a moderate concentration in the banking system, even though some small banks had exited the financial system during the period of the financial crisis. The number of finally registered banks was 41 and local branches of foreign banks amounted to 12 in that year. However, ten years after liberalisation, that is, in 2004, the index was at 0,182, reflecting a large deterioration from the year 1994 to 2004.

This is due to the number of registered banks decreasing to 18 institutions, with 4 of the largest banks dominating the banking sector and representing 83,7 per cent of the total banking sector. It is obvious that the index of 0,182 exhibits weaker competition. Business is increasing in the 4 major banks and decreasing in the smaller banks, which therefore leads to the higher concentration in the banking system. In 2009 the H-Index was at 0,189, which reflects an almost oligopoly supremacy by the 4 major banks in the country. These banks hold a total of 84,6 per cent of total banking sector assets. Unfortunately, nothing is being done about the dominance of

these large banks. Because the four banks hold such a large part of the total bank assets, even if all the small banks were to amalgamate, their total asset value would not match up to the large banks.

Figure 4.5: H-Index for South African banking system (1994–2009)



Source: SARB (2004b, 2009a, 2010d, 2011).

4.2.2.1 Further financial reforms

In view of the adjustments that South Africa experienced, liberalising the domestic financial sector meant improving regulations and complying with best practices. Since 1994, the regulatory framework has changed as banking activities advanced. The following is an explanation of the underlying reasons as to why the regulatory framework has changed:

a) International pressures

As mentioned earlier, owing to political isolation, international banks were forced to terminate their operations in South Africa. After sanctions had been dropped, the Banks Amendment Act 26 of 1994 was amended to allow international banks, and representative offices,

subsidiaries and branches of these banks to be established in South Africa. As before, these banks would have had to start a subsidiary or maintain a representative office.

b) Four-pillar policy

The four-pillar policy used in South Africa seeks to ensure that the four big banks (which are called 'pillars') do not merge. This is to prevent anti-competitive behaviour and to minimise risk. Similar policies are implemented in countries such as Australia and New Zealand. The four-pillar policy in South Africa originated when Nedcor made a bid for Stanbic. In order to ensure a minimum number of significant banks in the country, in 2004 the Minister of Finance announced that South Africa would maintain a four-pillar policy.

c) Access to finance

Banks deny many poor South Africans access to finance because of the high levels of risk the banks face, such as inadequate securities of individuals, high costs of granting microloans and bad debts. Previously, these unbanked South Africans saved money through mostly *stokvels*, burial societies, village banks and credit unions. In order to ensure that the low-income group of the market was incorporated into the mainstream economy, the regulatory framework was amended to broaden access to finance, and to meet the needs of the unbanked and lower end of the market. In 2004 the National Treasury responded by publishing draft legislation in the form of (i) a Dedicated Banks Bill and (ii) a Cooperative Banks Bill. These Bills deal with the needs of the unbanked.

d) Dedicated Banks Bill

The aim of the Dedicated Banks Bill (RSA 2004) is to provide affordable banking to the poor, and to enhance savings and competition. It addresses the issue of a second-tier banking institution and comprises a savings bank, and a savings and loans bank. According to the Bill, the difference between a savings bank, and a savings and loans bank is that the savings banks

may accept deposits from the public and open a savings account on behalf of the depositor in which he or she can deposit money, withdraw, transfer or make payments, while the savings and loans bank will provide all of the functions of the latter, but may include opening a money market account, and granting secured and unsecured loans within limits. Furthermore, the entry requirements and prudential regulation for these banks are not harsh because they are intended to create an enabling environment and to encourage entry into the banking system.

e) Cooperative Banks Bill (now Cooperative Banks Act 40 of 2007)

The aim of the Cooperative Banks Act 40 of 2007 is to regulate community banks such as the *stokvels* and village banks, so that they can be aligned with the formal banking system. There are three tiers to cooperative banks, as stated in the Act:

- a. *Primary cooperative banks*: These will comprise the savings co-operative bank, as well as savings and loans cooperative bank. The savings cooperative bank may accept deposits; open a savings account and borrow money from its members; make, draw, accept, indorse, or negotiate negotiable instruments; provide trust or custody services to members; and invest money deposited. The savings and loans cooperative bank may provide all of the functions of the latter, including granting secured and unsecured loans to its members, and may perform extra banking services and invest depositors as approved by the Minister.
- b. *Secondary cooperative banks*: May provide all of the functions of the savings and loans cooperative bank and, furthermore, may trade financial instruments and open a foreign currency account.
- c. *Tertiary cooperative banks*: May provide services as the primary savings and loans cooperative bank and the secondary cooperative bank. However, included in these services, the Minister or supervisor may give advice to the approach in which they want the bank services referred to above to be performed.

f) Anti-money laundering

'Money laundering' can be defined as money that has been obtained illegally, usually through an act of crime (i.e., terrorism) and where the source of the funds is unknown, appears to be legal in the financial system. It is, in other words, illegal money moving through the financial system unnoticed. Money laundering is regarded as a threat internationally and as a hindrance to the banking system. This is because banking institutions get involved in criminal activities unknowingly and this can weaken public confidence, thus threatening the stability of the global and domestic banking sector. In keeping abreast of international concerns, South Africa implemented the Financial Intelligence Centre Act (FICA) 38 of 2001 to address these offences and in 2003 became a member of the Financial Action Task Force (FATF), which is a body that develops policies to combat money laundering.

The Financial Intelligence Centre (FIC) (2008/9:11) assists

in the identification of the proceeds from unlawful activities and the combating of money laundering activities and, more recently, the financing of terrorism and related activities. FICA also introduces a regulatory framework of measures concerning client identification, record-keeping, reporting of information and internal compliance structures, which apply to a broad range of financial and non-financial institutions such as banks, as well as define the anti-money laundering responsibilities of supervisory bodies.

In order to maintain the integrity of the financial system and to ensure compliance with FICA, banking institutions have made a commitment to implementing the anti-money-laundering measures. The SARB issued its first anti-money-laundering circular in December 2002, which provides banks with guidelines on how to prevent the movement of illegal proceeds. In 2004 further consultations between the banks and the Registrar of Banks took place to investigate

section 21(2) of FICA which states that accountable institutions are not allowed to transact with clients after 30 June 2004, if the client's identity has not been verified. However, for low money-laundering risk clients an exemption was made until 30 September 2006 for identification verification. Banks have to submit detailed reports of suspicious transactions to the FIC, while the SARB monitors the progress of anti-money-laundering measures. The FIC then makes referrals to the law enforcement authorities on suspicious transactions so that further investigations are conducted. In 2008–9, for example, the total number of suspicious transactions amounted to 112 829, with a 22 per cent increase in recommendations to law enforcement authorities. These referrals had a value of about R6 billion (FIC, 2009). In 2010–11 suspicious transactions increased to 179 230 with the majority of the transactions emanating from financial bodies. The FIC froze over R6,7 million in bank accounts (FIC, 2010–11).

Furthermore, in 2006 the BCBS revised Principle 18 of its Core Principles on Banking Supervision (Core Principles) to include aspects of anti-money laundering and the fight against the funding of terrorism. Compliance with Principle 18 requires guidelines for the supervisors in monitoring or managing the banks' internal controls (SARB, 2008).

g) National Payment System

In the past South Africa operated its settlement system manually. South Africa's reintegration into the global markets exposed the country to risks associated with the payment system, such as credit and liquidity risks. South Africa was therefore obligated to ensure that its payment and settlement system conformed to international best practice. Hence, a settlement system with real-time gross settlement (RTGS) was developed, which provides a facility for banks and customers to settle their obligations immediately. The South African Multiple Option Settlement (SAMOS) System was developed in 1998, which put the country in line with the most modern

and sophisticated payment systems globally, and ensured that it could transact with ease, even at an international level.

Stemming from this, the South African Reserve Bank Act 90 of 1989 had to be amended to include section 10(1)(C) so that it could officially oversee the national payment system (NPS). In addition, an NPS legal framework was developed resulting in, among other things, the NPS Act 78 of 1998 which assisted with the regulation, supervision and management of the payment and settlement system. At an international level, the payment and settlement system transacts through the Continuous Link Settlement System (CLS). The aim of the CLS is to settle foreign-exchange operations across various time zones in CLS currencies. According to the SARB (2005:18), "CLS currencies include Australian dollar, Canadian dollar, Danish krone, Euro, Hong Kong dollar, Japanese yen, Korean won, New Zealand dollar, Norwegian krone, GB pound, Singapore dollar, Swedish krona, Swiss franc and US dollar". The NPS Act was amended in 2004 to include the rand as part of the CLS currencies. The value of transactions associated with the rand has improved since 2004, showing a 17 per cent growth rate. However, by the end of 2008 the number of transactions decreased to 7 per cent due to the recent financial crisis. In 2008, owing to volatility, the transactions that were settled averaged R296 billion (SARB, 2009b:36).

h) Basel II

The regulatory framework also changed due to the upgrade from Basel I to Basel II. South Africa decided to implement Basel II in 2008, not only because it was necessary to adhere to international rules, but also because of the changing environment such as globalisation, the development of new financial products and technological advances. In addition, the implementation of Basel II will ensure better supervision, risk management, transparency, and

the safety and soundness of the banking system. Furthermore, South Africa will gain economically through its international position and credibility.

Before the implementation of Basel II, in order to ensure effective execution of Basel II, the SARB created an Accord Implementation Forum (AIF) consisting of a Steering Committee and subcommittees. These subcommittees addressed the impact of Basel Pillars 1, 2 and 3 in the economy, and were responsible for developing a new regulatory framework to integrate Basel II. The AIF put forward revisions to the Banks Act 89 of 1990 (the Banks Act, 1990) and amendments to the Regulations under the Banks Act, 1990 to the Minister of Finance for his approval. Some of the amendments to the Banks Act, 1990 are as follows:

- Supervisory responsibilities and publication of information of the Registrar of Banks: where, for example, the Registrar is responsible for the publication of specific resolution that applies to bank submissions in terms of the Banks Act 1990 and maintaining a record of all banks details which previously was not a requirement.
- Minimum share capital and reserve fund: Where bank laws ensure that capital requirements as per Basel II is adhered to.
- Shares, debentures and negotiable certificates of deposit (NCDs): Because NCDs and promissory notes have like qualities and attributes; included in the Banks Act 1990 section 79 and Section 79(1)(C) are the words “negotiable certificates of deposit, promissory notes or instruments of similar characteristics” to make better distinctions when issuing securities.
- Approval of eligible institutions: Where credit rating agencies should get consent from the Registrar of Banks before their evaluations are used by the banks to estimate regulatory capital.
- Verification of information: Where the Registrar of Banks may require information submitted by banks to be validated. (SARB, 2007:52–3.)

Overall, in order to comply with international standards, South Africa has implemented Basel II through the Banks Amendment Act 20 of 2007 so that capital in relation to risks can be managed effectively; in other words, the Banks Amendment Act 20 of 2007 necessitates the execution of Basel II by ensuring the following:

- Clarity on the roles and responsibilities of the members of the banking institutions, such as the board of directors
- Effective reporting and disclosure standards
- Banks should have a choice when estimating minimum capital requirements for market risk, operational risk and credit risk exposures
- Management has reserved adequate capital for all the business risks of the bank beyond minimum requirements.

i) How did Basel II affect the banks?

- **No existing skills base and upgrade of data**

Implementing Basel II meant that there should be consistency in the approach to risk management among all banks, both internationally and domestically. As a result, banks' data needed to be improved in the sense that the quality and level of detail of their data had to be enhanced. Previously, the data that banks used for their operations was adequate, but with the execution of the new accord, the data had to be upgraded so that they could be used for the purpose of analysis. Implementing Basel II was not only a costly affair for the banks, but also an agonising experience. There was no existing skills base that the banks could exploit due to, in some cases, the new leading-edge technology that needed to

be used. As a result, local skills had to be enhanced and developed on the job with the aid of international experience during the implementation of Basel II.

- **The three pillars**

As mentioned earlier, in South Africa Basel II was implemented in January 2008 so that banks could use the capital-adequacy framework to benchmark their capital and risk management practices. What follows is an indication of how the banks responded to Basel II according to the three pillars:

Pillar 1: Minimum capital requirement: As a minimum, capital requirement focuses on risk to economic loss, the four big banks obtained accreditation from the SARB and adopted the following risk approaches in 2008:

Table 4.4: Risk approach by the four big banks

Risk	Nedbank Group	Absa Group	Standard Bank Group	FirstRand Banking Group
Credit risk	AIRB	IRB	AIRB	AIRB
Market risk	VaR	Internal model	Internal model	Internal model
Operational risk	Standardised approach	AMA	Standardised approach	Standardised approach

Sources: Absa Group (2007, 2008, 2009, 2010); FirstRand Banking Group (2007, 2008, 2009, 2010), Nedbank Group (2007, 2008, 2009a, 2009b, 2010), Standard Bank Group (2007, 2008, 2009, 2010)

To recap on the various risk measurements from Chapter 3:

- *IRB approach:* In this method banks use an individual risk model to determine the probability of default.
- *AIRB approach:* In this approach banks use their own internal measures of credit risk as primary inputs to capital calculation.
- *VaR:* Is used to determine risk of loss of a particular asset.

- *Standardised approach*: Is used for minimum operational risk exposure.
- *AMA*: Is more risk-sensitive and caters for internationally active banks and banks that are largely exposed to operational risks.

As can be seen in Table 4.4, for credit risk, most of the banks adopted the AIRB approach. The AIRB is most complex and ensures that banks use their own methods for calculating credit risk. For market risk only, the Nedbank Group uses the VaR method and only the Absa Group uses the AMA method for operational risk. All in all, the four big banks have successfully adopted Pillar 1 of Basel II.

Pillar 2: Supervisory approach (capital-adequacy ratio): Since all registered banks are compelled to comply with the SARB regulations, one of the requirements is for banks to adhere to a minimum capital-adequacy ratio, which is a ratio of the bank's capital to its risk-weighted assets. This ratio is measured via Core Tier 1 Capital; Tier 1 Capital and Total Capital. The Nedbank Group (2009a) defines these capitals as follows:

- Tier 1 Capital is defined as primary capital consisting of issued ordinary share capital and perpetual preference share capital, qualifying perpetual callable hybrid capital, retained earnings and reserves, less regulatory deductions.
- Core Tier 1 Capital is defined as primary capital less any amount on non-core Tier 1 capital, being perpetual preference share capital and qualifying perpetual callable hybrid capital.
- Total Capital is defined as the capital adequacy ratio, which includes unappropriated profit at year-end.

The minimum requirements for the capital-adequacy ratio lie in the Tier 1 capital ratio of 7,0 per cent and total capital ratio of 9,5 per cent. In South Africa all four of the big banks have successfully adopted Basel II and are well capitalised. This is evidenced by Table 4.5, which reflects how the four big banks were capitalised before and after Basel II:

Table 4.5: Capitalisation of the four big banks in South Africa

	Actual Tier 1 ratio					Total capital-adequacy ratio				
	2007	2008	2009	2010	2011*	2007	2008	2009	2010	2011*
Nedbank Group	7.90%	9.80%	11.70%	11.70%	12.40%	6.80%	8.00%	9.60%	10.10%	10.70%
Absa Group	9.20%	11.60%	12.70%	12.80%	13.90%	13.10%	14.10%	15.60%	15.50%	16.70%
Standard Bank Group	8.50%	9.30%	10.60%	11.50%	12.40%	11.70%	12.20%	14.10%	14.90%	14.80%
FirstRand Banking Group	10.70%	11.10%	12.33%	13.50%	15.00%	13.60%	13.70%	14.57%	15.60%	16.50%

Sources: Absa Group (2007, 2008, 2009, 2010, 2011); FirstRand Banking Group (2007, 2008, 2009, 2010, 2011), Nedbank Group (2007, 2008, 2009a, 2009b, 2010, 2011), Standard Bank Group (2007, 2008, 2009, 2010, 2011)

* June interim annual results

Table 4.5 shows that even during the adoption of Basel I, three of the four big banks' capital-adequacy ratio was above the minimum requirement of 8 per cent. For example, in 2007 FirstRand Banking Group's Tier 1 capital ratio was 10,7 per cent and its total capital-adequacy ratio was 13,60 per cent. Nedbank Group's total capital-adequacy ratio at that time was 6,80 per cent, which was below the minimum requirement. However, the majority of the major banks took the stance to provide an extra capital buffer which instilled confidence in their clients. During 2008, when Basel II was first implemented, banks were capitalised above the regulatory capital. For example, Absa Group's Tier 1 capital ratio was 11,60 per cent and Standard Bank Group's total capital adequacy was 12,20 per cent. In 2009 all four banks' Tier 1 ratio and total capital-adequacy ratio was more than

the required minimum. Overall, the four big banks are well capitalised and in a good position to guard against risks. As regards Basel III requirements, in 2010 Tier 1 capital for all four major banks was above the new Basel capital requirements on a pro forma basis: for example, Nedbank Group's and FirstRand Banking Group's Tier 1 capital ratio was 11,7 per cent and 13,5 per cent respectively, and Absa Group's and Standard Bank Group's total capital-adequacy ratios were 15,5 per cent and 14,9 per cent respectively. The 2011 interim results for all four banks also shows that the banks are preparing for the implementation of Basel III within the timelines required. This will ensure that the financial markets are sound and that financial stability is enhanced. The Standard Bank Group, for example, has participated in the SARB's Basel III quantitative impact study which shows a reduction in the group's capital-adequacy ratios. However, the group is currently working towards being well capitalised for the full Basel III implementation.

Pillar 3: Market discipline: The aim of Pillar 3 of the Capital Accord is to support Pillars 1 and 2 so that key information is assessed and is in line with the other two pillars. According to the banking regulations (RSA, 2008), banks have to disclose certain information publically. Regulation 43(1)(e)(ii) of the Regulations relating to Banks states that information to be disclosed to the public should include

- primary capital, including the primary capital adequacy ratio;
- total capital, including the total capital adequacy ratio;
- the components of capital;
- the total required amount of capital and reserve funds; and
- any risk exposure or other item that is subject to rapid or material change.

All four of the big banks comply with Pillar 3 of Basel II and ensure that their information is disclosed to the public semi-annually. Some banks, for example Absa, sometimes disclose information beyond the requirements of the Regulations relating to Banks.

The implementation of Basel II is a success in the South African financial system. Although there was a slowdown in economic activity due to the subprime mortgage crisis, on the whole, the banking business remained robust, generating strong financial performance. With the implementation of Basel II, banks agreed that it brought about a more cyclical nature in capital requirements compared to Basel I. “The cyclical nature is driven by external factors that affect the banks’ risk measures across various portfolios which eventually drive its capital requirements” (FirstRand, 2009:23). As a result, banks ensure that they are well capitalised by even going beyond their required minimum: for example, the implementation of Basel II had a small impact on FirstRand Group’s capital ratio; hence it increased its target capital ratios from 9,25 to 10 per cent. Furthermore, Basel III now addresses procyclicality through a capital conservation buffer of 2,5 per cent and a countercyclical buffer of 0 to 2,5 per cent. However, the Basel III liquidity rules (discussed in Chapter 3) is a concern to banks as it can derail a bank’s business model due to the large sum of liquid assets it will have to hold, as too-large an amount can lead to the collapse of the bank’s business.

j) Basel III

Although the IMF (2010c:4) has commended the SARB for its “early adoption and full implementation of the Basel II framework in an emerging market environment on

1 January 2008, and its continuous efforts to remain in line with subsequent international developments”, the implementation of Basel III is putting pressure on banks in South Africa. Previously, with Basel II, banks were assessed using only one capital ratio, but the implementation of Basel III now requires banks to be assessed using up to seven capital ratios. Banks are further pressurised by the threats of rising costs which is driven mostly by the looming economic environment, complex information technology systems and the need for more staff and profitability squeeze. Basel III also calls for risk management and sound compliance programmes on an enterprise level. Thus banks need to ensure that they have the correct systems to support compliance. But compliance within the banks is also proving to be challenging due to different management of the same data across different division in the same bank. The need to manage data adequately is now more important because of the number of capital ratios that needs to be implemented across multiple jurisdictions and across individual banks. Compliance with Basel III requires large amounts of data thus banks need to break down the silos and homogenise data. This will in the long term, improve the efficiency of the banks business and prevent risks and will offset the strain on profits as a result of Basel III and make the implementation of Basel III easier.

k) Twin peak regulation

As mentioned in Chapter 1, twin peak regulation is when prudential regulation and market conduct regulation are separated, in that the central bank oversees potentially systemic institutions, and the oversight of the payment and settlement systems, while the business regulator is responsible for the conduct of business across the financial system. In his 2011 budget speech the Minister of Finance, Pravin Gordhan, announced that South Africa’s financial regulation should be reformed to include a twin peak system of regulation. Thus “South Africa will adopt a system-wide approach to financial stability and regulation, bolster the supervision of individual institutions, and ensure better coordination and information sharing. The scope of

regulation will also be extended to cover presently unregulated financial activities that have the potential to create systemic risks to financial stability” (National Treasury, 2011:23).

I) National Credit Act 34 of 2005

Before the implementation of the NCA South African consumers were exploited by microlenders, debt collectors, credit providers and so forth. Consumers were burdened with over-indebtedness, soaring cost of credit and outdated legislation. To address these issues, the NCA was promulgated in 2005 which replaced the old outdated South African consumer credit legislation. This legislation replaced the Usury Act; the Credit Agreements Act 74 of 1980: and the Exemption Notices, 1992 and 1999, which regulated microlending transactions.

The aim of the NCA is to regulate institutions that provide credit and to control credit transactions in order to curb reckless behaviour by credit providers. Most importantly, the NCA ensures that consumers are protected and well informed when entering into a credit transaction. Accordingly, the purpose of the Act is to encourage a transparent, observable, competitive and responsible credit market by

- promoting the development of a credit market that is accessible to all South Africans, and, in particular, to those who have historically been unable to access credit under sustainable market conditions;
- ensuring consistent treatment of different credit products and different credit providers;
- promoting responsibility in the credit market;
- promoting equity in the credit market by balancing the respective rights and responsibilities of credit providers and consumers;
- addressing and correcting imbalances in negotiating power between consumers and credit providers;
- improving consumer credit information and reporting and regulation of credit bureaux;

- addressing and preventing over-indebtedness of consumers, and providing mechanisms for resolving over-indebtedness based on the principle of satisfaction by the consumer of all responsible financial obligations;
- providing for a consistent and accessible system of consensual resolution of disputes arising from credit agreements; and
- providing for a consistent and harmonised system of debt restructuring, enforcement and judgment, which places priority on the eventual satisfaction of all responsible consumer obligations under credit agreements. (RSA, 2007.)

All institutions that provide credit will have to comply with the NCA, which came into effect in 2007; this also includes banks. Many banks invested in resources to ensure compliance with the Act: for example, banks invested in training for the purpose of educating consumers and limiting over-indebtedness. In addition, banks ensure that customers who are over-indebted are rehabilitated, first via counselling, advice and debt consolidation, instead of taking corrective actions against them. According to the NCR (2009), 130 000 consumers had applied for debt counselling and the total value of new credit granted declined by 1,83 per cent from R51,87 billion in March 2009 to R50,93 billion in the second quarter ended June 2009. Table 4.6 shows the credit standing of consumers since the inception of the NCA.

Table 4.6: Consumers' credit standing

Credit Standing of Consumers Credit Bureau Monitor- National Credit Regulator

	Jun-09	Sep-09	Dec-09	Mar-10	Jun-10	Sep-10	Dec-10	Mar-11	Jun-11	Sep-11
Good standing	9,94m	9,92m	9,89m	9,84m	9,73m	9,86m	9,90m	9,97m	10,04m	10,27m
Good standing	55.9%	55.1%	54.7%	54.0%	53.1%	53.7%	53.5%	53.6%	53.3%	53.8%
Impaired records	7,85m	8,09m	8,18m	8,37m	8,59m	8,49m	8,61m	8,63m	8,80m	8,83m
Impaired records	44.1%	44.9%	45.3%	46.0%	46.9%	46.3%	46.5%	46.4%	46.7%	46.2%

Source: NCR (2011)

Credit-active consumers are consumers who have a credit obligation in the form of payments in arrears for three months or more (i.e., impaired records) and those whose credit account is on par with payments or those who have not missed more than one or two payments (i.e., good standing). In June 2009 the total number of credit-active consumers amounted to 17,79 million. However, this number grew to 19,10 million in September 2011. Of the credit-active consumers, impaired records increased from 44,1 per cent in June 2009 to 46,2 per cent in September 2011. In addition, consumers with good standing decreased from 55,9 per cent in June 2009 to 53,8 per cent in September 2011. This effect is due to many causes, such as the increase in food prices, high electricity prices and increases in fuel prices, which made it difficult for households to pay their debts. Furthermore, banks increased their credit requirements due to increased risks of bad debts as a result of the recession.

The NCA generally contributes to a more efficient credit market, which ensures that consumer credit information is maintained. This contributes to more responsible credit granting. The NCA also ensures that consumers are conscious of their rights and are not deceived by credit providers.

4.3 Conclusion

The implementation of sanctions in South Africa had affected the country's economic performance. It led to large withdrawals of foreign capital and disinvestments by foreign companies. Since South Africa's reintegration into the global economy, the country has improved its economic policies, amended its legal and regulatory framework, and developed its financial infrastructure in order to strengthen the domestic and financial sector, and to be in line with international best practice.

However, South Africa adopted its policies in a structured fashion where it reformed existing policies first before opening up the economy to foreign competition. The idea behind this was to allow existing financial institutions to be familiar with the changes in the economy, to safeguard systemic stability and to boost growth opportunities within the economy.

The new reformed policies that South Africa implemented, such as the NPS, anti-money laundering and the Basel accords, were implemented with prudence: for example, banks adopted a cautious stance by running Basel II parallel with Basel I before the final implementation of Basel II in 2008. Although the implementation of Basel III will be a challenging one, financial institutions are already testing their capabilities through early participation of the quantitative impact studies set by the SARB and BIS. Furthermore, the transformation of the financial sector to adoption of the new twin peaks regulation will contain systemic risks through enhanced regulation.

The liberalisation of exchange control, as illustrated in Table 4.3, was executed in a sequential manner. The new policies were seen as a method to boost domestic and global competition, and to widen the scope for FDIs, the result of which led to better FDI inflows, GDP performance and trade.

South Africa's experience of implementing reformed policies has proved that this method of implementing policies has contributed to enhancing macroeconomic stabilisation and reducing the effects of shocks in the economy. Through policy adjustments South Africa has therefore managed to bring about a better-regulated financial system, eliminate macroeconomic imbalances and ensure efficient financial institutions.

Although South Africa has made major improvements in its liberalisation strategy, the country is still not completely liberalised due to a few bottlenecks that prevail, such as the foreign currency hedging requirements as governed by exchange control regulations. However, it is hoped that in due course the gradual abolition of exchange controls will ensure complete liberalisation of the country.

Nevertheless, the effects of liberalisation in South Africa were positive. South Africa's financial markets have moved from being government-led to being market-led, reaping the benefits of liberalisation. This is as a result of the timely and gradual implementation of policies as well as the opportunity of global firms to access the domestic financial markets and vice versa.

Chapter 5

Findings, recommendations and conclusions

The findings of this research show that the need for regulation is important in any economy but the manner in which it is conducted determines how the financial system is managed: for example, repressive financial policies lead to limited economic growth, increased market inefficiencies and heightened economic costs. More market-friendly policies can lead to greater competition and more efficient markets.

Patnaik's (2011) detailed definition of financial liberalisation states that

the term financial liberalisation is used to cover a whole set of measures, such as the autonomy of the central bank from the government; the complete freedom of finance to move into and out of the economy, which implies the full convertibility of the currency; the abandonment of all "priority sector" lending targets; an end to government-imposed differential interest rate schemes; a freeing of interest rates; the complete freedom of banks to pursue profits unhindered by government directives; the removal of restrictions on the ownership of banks, which means de-nationalisation and full freedom for foreign ownership.

Ghosh (2005) associates financial liberalisation with "measures that are designed to make the central bank more independent, relieve 'financial repression' by freeing interest rates and allowing financial innovation, and reduce directed and subsidized credit, as well as allow greater freedom in terms of external flows of capital in various forms".

Taking into consideration the definition of liberalisation, why is policy updates so important in liberalisation?

Liberalisation is important in an economy even though there are signs that the after-effects can destabilise an economy. Financial liberalisation in some emerging market economies has proven to be disastrous if proper measures such as prudential regulation and supervision, and new policies for regulation are not considered before liberalisation, as in the case of the East Asian crisis. Thus financial liberalisation, combined with a lack of policy and procedures, has brought about a more careful consideration of regulation and standards.

Financial liberalisation introduces increased competition in an economy. Safeguarding systemic stability is therefore important. Thus better corporate governance, transparency, risk management techniques and sounder institutions are key to a more efficient and robust market. In addition, macroeconomic reforms should be combined with prudential and supervisory rules to ensure a resilient domestic financial system.

Even though liberalisation has positive benefits, which include wider competition in the markets, an increase in economic growth, FDIs, implementation of best practices, better institutional frameworks and higher living standards, negative effects also exist. If liberalisation is not properly implemented, then the outcome results in undernourished domestic industries (which are a consequence of the presence of powerful foreign institutions), instability within the financial sector, excessive risk-taking, unfamiliar practices, risk of contagion and volatility in the domestic markets.

However, the long-term gains of liberalisation certainly supersede its short-term instability. Accordingly, liberalisation should be focused on a long-term view. Therefore, when making the regulatory changes and preparations for opening up the market, it should be done in an orderly, timely and well-sequenced manner with adequate structural reforms, such as the

implementation of robust regulatory and supervisory frameworks, which work hand in hand with the country's specific environment and which will also limit the impact of a crisis.

Thus for more effective financial liberalisation the following measures should be adopted:

- Sequencing, which will strengthen the market structure and ensure a less-complicated liberalisation process.
- Appropriate macroeconomic reforms and exchange rate policies should be in place before liberalising capital accounts, and capital flows should be long term and not easily reversible to avoid crises.
- A flexible exchange rate can be more effective and better able to absorb shocks if it is accompanied by good fiscal policies and inflation targeting.
- Monetary policies should be aimed at stabilising inflation and preventing volatile markets, and central banks should be transparent and accountable so that the public is aware of the goals of monetary policy.
- Policies should be flexible so that new developments, technology and structural changes are not stifled and competition is promoted.

But these steps to liberalisation do not guarantee that countries will not experience a financial crisis unless regulation is constantly updated on the domestic front and policies are harmonised on the international front. South Africa is a good example of this where on the domestic front it reformed existing policies first before opening up the economy to foreign competition to allow existing financial institutions to be familiar with the changes in the economy, to safeguard systemic stability and to boost growth opportunities in the economy. On the international front, South African banks, for example, adopted a cautious stance by running Basel II parallel with

Basel I before the final implementation of Basel II in 2008 which was beneficial during the global economic crisis.

What is interesting to note is that regulatory practices, combined with the efforts made to liberalise, have ensured that developed and emerging market economies have integrated more closely. However, the question now arises whether these practices will provide more protection from crises than in the past. New policies and updates to the financial safety net calls for supervisors and managers to be more prudent in order to prevent problems such as that of the East Asian and the US subprime mortgage crisis. Financial crises have transformed from “country crises” to “systemic crises”, as can be seen from the occurrence of the Asian crises and the more recent subprime crisis. As regards the East Asian crisis, liberalisation was one of the factors that contributed to the impact and spread of the crisis. In the US subprime mortgage crisis bad monitoring, and a lack of risk management and regulation exacerbated the crisis. In the recent global economic crisis, although some countries (e.g., the US and EU) had been liberalised decades ago, their inconsistencies with international policy updates led to the financial crisis.

Thus it is clear that financial liberalisation, combined with a lack of updated financial policies, has brought about a more careful consideration of regulation and standards. Liberalisation and a continuous update on regulation due to changing times are important means to maintain systemic stability within any economy.

For further research, since banks have the ability to cause instability in the economy as in the case of the East Asian crisis and current global economic crisis, the implementation of Basel III is not going to be plain sailing in most emerging market economies. Moreover, compliance with Basel III requires large amounts of data because of the number of capital ratios that need to be

implemented. In South African banks, since many of the big banks' data are in silos, the same data seems to be managed differently across different divisions in the same bank. To safeguard systemic stability and avoid any disappointment, banks need to break down the silos and homogenise data thus ensuring better management of banking data, banking businesses and processes.

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Abbreviations

AIF	Accord Implementation Forum
AIRB	advanced internal ratings-based
AMA	advanced measurement approach
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
CDO	collateralised debt obligation
CGFS	Committee of Global Financial Systems
CLS	Continuous Link Settlement System
CMA	Common Monetary Area
CPI	consumer price index
EU	European Union
FATF	Financial Action Task Force
FDI	foreign direct investment
FIC	Financial Intelligence Centre
FICA	Financial Intelligence Centre Act
FSAP	Financial Sector Assessment Program
FSF	Financial Stability Forum
G-7	Group of Seven
G-20	Group of Twenty
GDP	gross domestic product
H-Index	Herfindahl–Hirschman Index
HSBC	Hongkong and Shanghai Banking Corporation Limited
IAASB	International Accounting and Auditors Standards Board
IADI	International Association of Deposit Insurers
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IIF	Institute of International Finance

IMF	International Monetary Fund
IRB	internal ratings-based
MFP	Monetary and Financial Policies
MTBPS	Medium-Term Budget Policy Statement
NCA	National Credit Act
NCD	negotiable certificate of deposit
NPS	National Payment System
OECD	Organisation for Economic Co-operation and Development
PwC	PricewaterhouseCoopers
ROSC	<i>Report of Observance of Standards and Codes</i>
RTGS	Real-time gross settlement
SADC	Southern African Development Community
SAMOS	South African Multiple Option Settlement
SARB	South African Reserve Bank
SIV	structured investment vehicle
UK	United Kingdom
US	United States
VaR	value at risk

Glossary

Basel I	<i>International Convergence of Capital Measurement and Capital Standards</i>
Basel II	<i>International Convergence of Capital Measurement and Capital Standards: A Revised Framework</i>
Basel III	A global regulatory framework for more resilient banks and banking systems, Basel Committee on Banking Supervision
Core Principles	Core Principles on Banking Supervision
Repo	repurchase