

## WHICH POLICIES CAN REDUCE THE COST OF CAPITAL IN SOUTHERN AFRICA?

*by*  
**Martin Grandes and Nicolas Pinaud**

- Lowering interest rates and, thus, the cost of borrowing in the rand zone (Lesotho, Namibia, Swaziland and South Africa) is a priority to promote investment and economic growth.
- Local-currency interest rates in these countries are driven by those on rand-denominated transactions. Reducing the level and volatility of the rand premium would help reduce financing costs in the region.
- Policies should promote: enhancing financial-market liquidity; easier access to South African financial markets for African entities; domestic saving capacity; and the improvement of international perception of the rand.
- Johannesburg could become a financial “hub” for the region, channelling cheap resources to its neighbours.

## **POLICY BRIEF No. 25**

# **Which Policies Can Reduce the Cost of Capital in Southern Africa?**

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## Capital Cost and Development

The weighted average cost of capital (WACC) – a combination of equity and debt costs paid by either public or private entities<sup>1</sup> – is an important determinant of economic growth [see IOSCO (2002) or Henry (2003)]. The WACC sets the proper *hurdle rate* to determine true, economic profits earned by a firm. In other words, when the expected returns to capital are lower than WACC, investment projects become unprofitable.

South Africa's cost of capital for an average<sup>2</sup> ungeared company (i.e. a firm without debt) as of July 2004 was about 15.5 per cent: a 10 per cent yield on the 10 year South African Government bond denominated in rand currency, plus a 5.5 per cent equity risk premium. The equivalent measure for a US company was 8.5 per cent (4.5 per cent on Treasuries plus an equity risk premium of 4 per cent) and the UK of 9 per cent (5 per cent on Gilts plus an equity risk premium of 4 per cent). This means that an ungeared South African company has to make a return of 15.5 per cent on its capital before it makes a true profit, whereas the equivalent return for an average US company is only 8.5 per cent and for an average UK company is only 9 per cent (Power, 2004).

As a consequence of such a high hurdle rate, many top South African corporations have left the local capital market in the search for a head-listing in the London or New York Stock Exchanges. Once this was achieved, they were able to lower their cost of capital and thereby increase their true profitability. Examples among these companies include: Anglo American, Billiton (now part of BHP Billiton), South African Breweries (now SABMiller), Old Mutual, Didata or Investec. In addition, a relatively high cost of capital gives South African companies a strategic disadvantage in the race for commercial opportunities in the global arena, for instance when bidding for assets in other African countries.

On aggregate, the considerable WACC differential facing South African firms has some extraordinary effects on the country and by extension on South Africa's neighbouring countries pegged to the rand, whose interest rates move in tandem with South Africa's one: investment is subdued, long-term growth remains sluggish and low in per capita terms, unemployment stays at socially unsustainable levels (near 41 per cent)<sup>3</sup> not least because resources are unallocated given the high cost of capital, and poverty reduction can not proceed as fast as required to achieve the Millennium Development Goals. The aim of this Policy Brief is to discuss policies to reduce the cost of capital in Southern African countries, in particular in countries participating in the Common Monetary Area (CMA), namely Lesotho, Namibia, South Africa and Swaziland<sup>4</sup>.

Typically, in developing countries when calculating the (risk-adjusted) *hurdle* rate at which the expected cash flows from an investment project are discounted, the country risk premium has to be added to the risk-free rate (4.5 per cent on US Treasuries or 5 per cent on UK Gilts), as in South Africa's case. Hence, a lower country risk premium makes a broader range of investment projects profitable as more of them will have a positive net present value. Thus, lower country risk supports domestic capital accumulation, a critical driver of long-term, sustained growth.

### **The Importance of the Bond Market**

Most developing economies have been traditionally reliant on short-term bank lending to finance investment projects at long maturities. While the equity market had generally accounted for most of the small, shallow capital market financing available in developing countries, bond finance has only recently increased its share in total finance for both sovereign and corporate borrowers in these countries (see BIS, 2002 or IOSCO, 2002) thanks to the development of domestic bond markets<sup>5</sup>. Moreover, and particularly in the case of corporations, the development of bond markets is seen as an alternative to bank lending for raising capital. At least four reasons underpin the positive link between capital (bond) market financing and lower cost of capital conducive to high, sustained economic growth.

- 1) Diversification of systemic risks. Excessive reliance on bank lending can expose the economy to the risk of systemic banking crisis, hence affecting economic activity suddenly and adversely because companies would find themselves credit-constrained and be forced to abandon investment spending, culminating in a reduction of aggregate demand through the multiplier effect. Thus, domestic bond markets can contribute to mitigating that risk bringing the overall cost of capital down.
- 2) Liquidity enhancement. The development of the domestic bond market may bolster liquidity, making investment in countries or corporations that otherwise would not be targeted more attractive for a wider array of investors. Thus, better liquidity conditions could also help reduce the overall cost of capital.
- 3) Lower intermediation costs. The development of domestic bond markets can also lower financing costs because they eliminate intermediation costs or at least reduce them given that underwriter costs are subject to competitive pressures which are often absent in the case of bank lending.

4) Avoidance of maturity and currency mismatches. Firms (but also the government) may tailor their asset and liability profiles to reduce the risk of maturity and currency mismatches on their balance sheets, thus reducing their currency and default risk and therefore the overall cost of capital. This again points to boosting long-term growth, as suggested above<sup>6</sup>.

### **Policy Relevance**

Reducing the cost of capital in African countries is a major developmental objective. This applies in the CMA as elsewhere, particularly because of the strong regional role these countries can play.

*First*, it stands out in the context of the post-Monterrey discussions on providing developing countries with cheaper and sustainable sources of financing for development. Indeed, freeing African countries from dependence on aid is a central, long-term target.

*Second*, there is already a serious resource shortage in Africa (especially in the context of achieving the Millennium Development Goals); NEPAD (the New Partnership for Africa's Development) has recently underscored the importance of increasing domestic savings in and foreign capital inflows to Africa as a mean of bridging that gap. In its section on the Capital Flows Initiative, the NEPAD policy document underlines the necessity of addressing "investors perception of Africa as a 'high-risk' continent, in particular with regard to security of property rights, regulatory frameworks and markets [...]". The Capital Flows Initiative also makes the case for "the deepening of financial markets within countries, as well as cross-border harmonisation and integration [...]" (NEPAD, 2001).

Reducing the cost of capital has also become a concern for the South African authorities, particularly in relation to the process of financial integration in Africa. The South African Minister of Finance, Trevor Manuel, was cited by the *Financial Times* of 19 February 2004 as declaring that South Africa would take action in 2004 to promote itself as "a regional financial centre able to cater more fully for the needs of the African continent".

## **Why is the Real Cost of Capital Relatively High in Southern Africa Compared with in OECD countries?**

### ***Financial Arrangements in the Common Monetary Area (CMA)***

The CMA is a monetary arrangement between Lesotho, Namibia, South Africa and Swaziland whereby Lesotho, Namibia and Swaziland's exchange rates are pegged to the South African rand at par, and the South African Reserve Bank acts as a lender of last resort for its partner central banks. Moreover, their national currencies must be fully convertible into the rand for current account and financial transactions (see Box I below for further information about the historical background and main provisions made by the CMA Treaty).

In the CMA full intra-zone capital mobility should be guaranteed so that domestic interest rates in rand currency and ultimately the real cost of capital should equalise across countries. As inflation rates have gradually converged to South African levels (Grandes, 2003), any interest rate differential between South Africa and its partners must be explained by default or jurisdiction risk premia as will be seen below. Ultimately the level and volatility of CMA interest rates are fundamentally driven by the developments in and the stance of South Africa's monetary and exchange policies.

Furthermore, as South Africa is by far the most developed capital market in the region, public and private entities from the neighbourhood should be tapping the Johannesburg financial centre to realise profitable investment opportunities at a given (and supposedly lower than in their "inexistent" financial markets) cost of capital.



**Box I. CMA in Practice**

The “rand monetary zone” has formally been in place since 1974, when South Africa, Botswana, Lesotho and Swaziland signed the Rand Monetary Agreement (RMA). This currency union had already informally existed prior to 1974 under British rule, using the pound as the common currency until 1961, when the rand replaced it. However, Botswana, Lesotho, Swaziland<sup>7</sup>, and later Namibia (1993), introduced and kept their own currencies at parity with the South African rand. The first major event after the RMA occurred when Botswana opted in 1976 to pursue independent monetary and exchange rate policies. Nevertheless, Botswana has since been linked to the rand through a currency basket where the rand weighs around 60 to 70 per cent<sup>8</sup>. With the signing of the Trilateral Monetary Agreement the CMA replaced the RMA in 1986. Namibia joined in 1992 shortly after gaining independence.

As reported in Grandes (2003) or Tjirongo (1995), the main provisions made by the CMA Treaty with regard to exchange controls and monetary policy are the following:

*a) Management of Gold and Foreign Exchange Reserves*

The respective monetary authorities have responsibilities over the management of gold and foreign exchange reserves of the countries. However, to enable the South African authorities to monitor the exchange control system of the CMA, each member state provides the South African Reserve Bank with a monthly statement reflecting the total balances of gold and foreign exchange, including rand held by the monetary authorities and authorised dealers in their respective areas.

*b) Access to South African Money and Capital Markets*

Articles 3 and 4 provide for the free flow of capital within the area. Both private and official capital flows are encouraged, provided such flows are neither disruptive to money and capital markets nor inconsistent with the management of domestic financial institutions. Furthermore, governments and private companies of the contracting parties have access to the South African capital and money markets. In order to underwrite the monetary stability of the area, the South African Reserve Bank acts as a lender of last resort to the monetary authorities of the LNS (Lesotho, Namibia and Swaziland) countries.

*c) Gold and Foreign Exchange Transactions*

Article 5 provides for South Africa’s partner countries to have access to South Africa’s foreign exchange markets.

*d) Compensatory Payments (Seignorage)*

Article 6 establishes the formula for computing compensation payments for seignorage on the rand currency circulating in South Africa’s partner countries. These payments are calculated on the basis of the annual yield on the most recently issued long-term South African government bond and an estimate of the volume of rand in circulation in South Africa’s partner country.

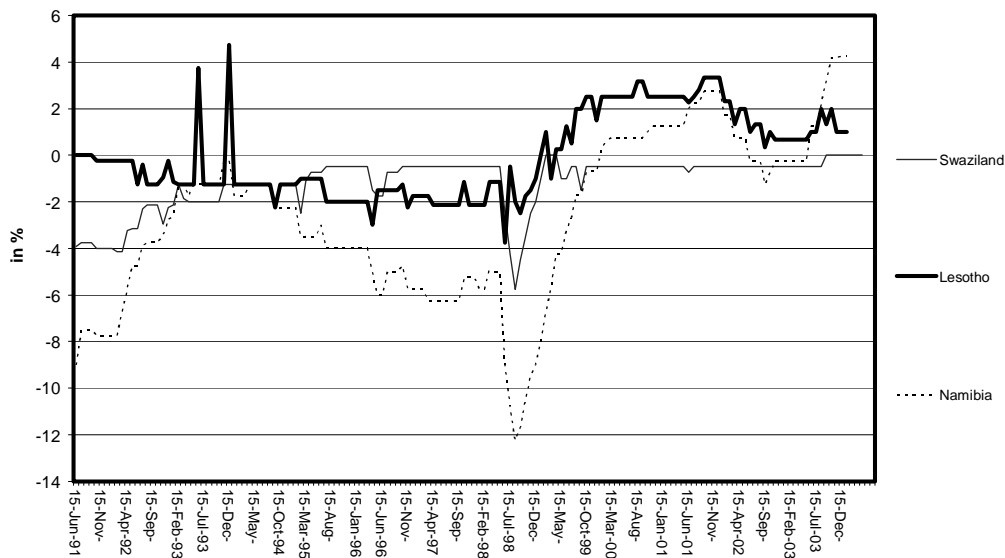
*e) Transfer of Funds within the Joint Monetary Area*

A contracting party shall not apply any restrictions on the transfer of funds (current and capital transactions) to or from the area of the contracting party. Restrictions can be only imposed in cases of investment or liquidity requirements that may from time to time be prescribed to domestic financial institutions, but such restrictions should not be discriminatory to any contracting party. Also South Africa’s partner countries may introduce measures relating to the investment of funds in domestic securities, to mobilise domestic resources for development in its area. Members also have obligations to work together to avoid disruptive capital flows arising as a result of measures taken in one area.

### Financing Costs: Where do CMA Countries Stand?

Borrowers in developing countries – be it the government itself or some large firms – which are able to tap international capital markets generally pay a considerable risk premium over a risk-free asset (such as US-Treasury securities) when issuing debt, bonds for example. In the case where these debt instruments are denominated in domestic currency, one of the main components of this risk premium is the currency premium, which reflects the risk of a depreciation or devaluation of the domestic currency. In the CMA case, this is attributable to the anticipated and non-anticipated rate of change in the e.g. rand-US dollar exchange rate. A second important component is the pure default premium, which reflects the financial health (solvency) of the borrower under consideration; i.e. the ability and willingness of the sovereign (or corporate) in question to repay its debt. The third component of this risk premium is a jurisdiction (or “onshore-offshore”) premium that is due to the differences between domestic (“onshore”) financial regulations and international (“offshore”) legal standards. In theory, as these regulations should be the same across CMA countries, any difference in their comparative total risk premia should amount to the difference in pure default risk<sup>9</sup>.

Figure 1. Interest Rate Differential between South Africa and other CMA Countries  
Lending Prime Rates, 1992-2004



Source: DATASTREAM and IFS.

Due to the incompleteness of financial markets in the region, the virtual inexistence of long-term government bond issuances, let alone private sector issuances, in countries other than South Africa, it becomes very difficult to compute bond yield differentials. As money market instruments are better developed in the CMA, Figure 1 plots the interest rate differential between South Africa and its partners on the basis of lending prime rates. Figure 1 shows that, with the exception of Namibia in 1994-1999, this interest rate differential has roughly been around zero (i.e. a very narrow spread has been observed). This preliminary finding supports the case that interest rates in the CMA are largely driven by South African rates (through the rand currency premium).

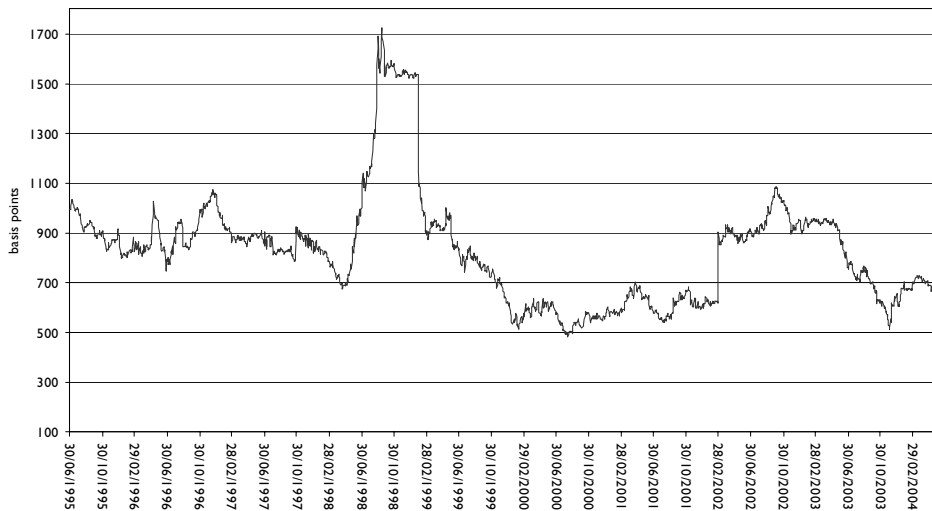
It has been shown that South African rates set the floor for CMA countries' interest rates, and because CMA countries are pegged to the rand, their domestic rates closely move in tandem with those of South Africa. In this context, the reason for high interest rates in CMA countries partly lies in the level of South African real interest rates which have remained themselves high over the last years.

In a context of disinflation in South Africa, the "risk free rate" in local currency (South Africa's government bond benchmark) has been on average relatively high in the period 1990-2004, making capital expensive in real terms or by international standards. The weighted average cost of capital (WACC) for South African corporations has indeed stood at high level over the period:

- Equity costs for an ungeared South African company are as of July 2004 about 15.5 per cent, which may itself be broken down into a 10 per cent government bond yield and an equity risk premium (ERP) of 5.5 per cent (see above).
- Local currency debt costs are even higher, not least because of little appetite of South African investors for bonds. South African investors have been traditionally overweight in equity and underweight in bonds. While bonds have almost constantly outperformed equity in the 1990s, South African financial institutions have kept on regarding equities as a better inflation hedge than bonds. This (misplaced) belief in the primacy of equities might be a "hang over of the prescribed assets era" (Power, 2004). During the apartheid era, it was compulsory for South African funds to invest massively in bonds, issued by the government, public utilities and state companies. In the 1980s however, these assets started to deliver falling (and sometimes negative) returns.

Figure 2 evidences that spreads (as measured by the MSCI index 1-year to 3-year) between South African Treasury rand-denominated bonds and US Treasury dollar-denominated bonds have never been less than 500 basis points over the period 1995-2004. On average, they have been close to 830 basis points.

**Figure 2. South African Total Risk Premium, 1995-2004**  
MSCI South Africa – MSCI US (1-year to 3-year maturity)  
In basis points (1 per cent=100 basis points)



Source: DATASTREAM and Morgan Stanley Capital International Inc.

### Why is the Cost of Capital So High in South Africa?

Even though the economic strategy conducted in South Africa since the mid-1990s has been largely positive overall, some elements of the macroeconomic policy framework might have had an impact on the real cost of capital in South Africa.

*First*, South Africa has suffered from structurally low savings. In particular, declining households' savings which have led to falling investment and rising real interest rates since 1980, have offset lower budget deficits from the early 1990s onwards, hence keeping domestic savings rates at low levels. It may be argued that South African tax policies have not been conducive to raising savings over the period. The level of personal income taxation in South Africa is high (the marginal tax rate levied on amount over ZAR 270 000<sup>10</sup> is 40 per cent) while the taxation regime applied to capital revenues is barely supportive of higher savings rates. Both capital gains and interest are subject to taxation<sup>11</sup>.

*Second*, monetary and exchange policies may have also contributed to keeping interest rates at a high level. The abolition of the dual currency regime in 1995 had to bring about a rise in real interest rates for the current account deficit to be adequately financed. Moreover, some "stickiness" of inflation expectations, i.e. their relatively slow responsiveness to monetary policy, has translated into a lagged response of nominal bond yields to the process of disinflation in South Africa. To some extent, this phenomenon has resulted in persistently high real interest rates since the mid-1990s. Nominal and real interest rates have only very recently started to come down (see also Farrell and Kahn, 2004), partly thanks to the convergence of the actual inflation rate (near 4 per cent) to values within the range set by South African monetary authorities (between 3 per cent and 6 per cent).

*Third* and more importantly, as evidenced by Grandes, Peter and Pinaud (2003), the South African spread on local currency denominated bonds has been essentially driven by the rand currency premium (at least at short and medium-term maturities, see Table I). A high currency premium (which accounts for more than 90 per cent of the South African total premium for short maturities) is indeed required by investors to hold rand denominated assets because they look upon the South African currency as a particularly risky and volatile asset. In this respect, the rand may be subject to a "peso problem"<sup>12</sup>. Investors' perception of the South African currency as a risky asset has been driven by both domestic factors and global determinants. While global determinants refer to global risk aversion and appetite for the emerging asset class, domestic factors encompass political risk, monetary policy, external liquidity indicators, and capital control regulations. The existence of a specific "Zimbabwe effect" accounting for the strong volatility of the rand has been statistically difficult to measure. Nonetheless, the fear of political instability (related to land issues) spilling over from Zimbabwe into its neighbours (Namibia and South Africa in particular) has undoubtedly had an adverse impact on the rand's stability (as evidenced by the collapse of the rand in late 2001) and may still be regarded as a culprit for the rand's "peso problem".

**Table 1. Decomposition of the South African Total Risk Premium**  
At 1-Year Horizon (Based on 1-year ZAR and USD interest rates)

	Total Risk Premium (TRP)	Currency Premium		Pure Sovereign Default Premium	
	Basis points	Basis points	In percentage of TRP	Basis points	In percentage of TRP
Average					
June 97 - Dec 02	805	742	92	63	8
Average					
May 99 - Dec 02	699	645	92	54	8
Average					
Aug 99 - Dec 02	694	644	93	50	7
Average					
Aug 00 - Dec 02	762	728	95	35	5

Source: Grandes, Peter and Pinaud (2003).

A high and volatile rand premium has a direct bearing on the cost of capital for countries which are pegged to the South African currency and are willing to issue local currency denominated debt. This is the case because the rand premium is the major component of CMA countries' yield spreads over a risk-free rate.

Finally, South African capital pools, albeit liquid by African standards, remain shallow compared to G7 countries' capital markets. The Johannesburg financial market exhibits lower market capitalisation and turnover (other things being equal) than developed-country markets and the liquidity premium associated with issuing securities in Johannesburg stays at high levels. On the supply side, the range of investible risk options open to investors is limited thus restraining the scope for risk diversification and limiting the tolerance involved in an individual risk opportunity (either in terms of price or quantity of assets held). On the demand side the limited aggregate amount of capital being available for investment restrains appetite for risks. As a result, the "liquidity premium" required by investors to hold assets issued in Johannesburg remains significant. While South African portfolio investments are limited by low domestic savings capacity, foreign investors still regard rand-denominated assets as risky, which in turn limit the expansion of the rand denominated-asset class and the deepening of the Johannesburg financial markets.

## **High Real Cost of Capital in Southern Africa: What Can Be Done About It?**

### ***Macroeconomic Policies in South Africa***

The absence of monetary autonomy for CMA countries and the strong co-movement between South African rates and those of its neighbours strongly make the case for reducing the cost of capital in South Africa. As mentioned above, lower interest rates in South Africa, in particular a less volatile and lower rand currency premium are essential to bringing down financing costs in neighbouring countries pegged to the rand.

For this objective to be achieved, the South African authorities should carry on with the sensible macroeconomic management which has prevailed since the mid-1990s. Sound macroeconomic policies have, indeed, allowed South African borrowers to preserve the fortunate specificity of issuing bonds denominated in local currency, at long maturities, with fixed interest rates and at a relatively (by developing-country standards) “affordable” spreads<sup>13</sup>.

In this respect, Grandes, Peter and Pinaud (2003) have found that the rand currency premium, the major component of the South African total premium is not only driven by global factors (“push-factors”)<sup>14</sup> but it is also and importantly related to domestic factors (“pull-factors”). Among these domestic factors, monetary policy indicators are found highly significant, namely:

- The level of the *Net Open Forward Position* (NOFP). The “NOFP” is the amount of forward sales of dollars by the central bank neither covered by equivalent forward purchases of the US currency nor by hard foreign currency reserves detained by the monetary authorities (the South African Reserve Bank (SARB)). The NOFP has been an instrument for supporting the exchange rate in the absence of an adequate level of hard currency reserves. However, it also causes the accumulation of contingent liabilities which materialise in case the domestic currency nose-dives (such as the case of Thailand after the July 1997 collapse of the baht). In order to lessen this source of vulnerability, SARB has built up hard currency reserves since 2002. As a result, the negative NOFP was eliminated (2003) and the negative forward book was balanced (February, 2004), hence contributing to lower and less volatile currency premia.

- The *deviation of the actual inflation rate from the initial inflation target*. The South African Reserve Bank moved to an inflation-targeting system in April 2000. As a result, price stability is the primary goal of monetary policy to which other variables – not least the exchange rate – are subordinated<sup>15</sup>. In this context, the achievement by the SARB of its inflation target may substantially affect the exchange rate. If SARB falls short of its commitments it risks losing credibility and failing to rein in inflation expectations. Markets may question the SARB's ability and resolve to curb inflation in the future. In line with the Purchasing Power Parity rule, the higher inflation expectations are, the larger the expected depreciation. In this regard, South African monetary authorities have succeeded to bring inflation down and actual inflation rates have remained within the target range since the second quarter of 2003, thereby adding to a lower a less volatile currency premium.

South Africa's sovereign ratings are the other essential determinants. Accordingly, it is essential that South African authorities keep on improving ratings and liquidity ratios to stem currency volatility. This requirement underlines the argument that the consistency of the South African economic management is not only critical to the domestic economy but has also, through the rand channel, a strong bearing on CMA economies, as they import credibility from the SARB.

Even though South Africa is able to issue long-term local-currency-denominated bonds at “affordable” spreads, the latter remain large notwithstanding the recent achievement of some important monetary policy objectives, as seen above. As evidenced by Table 1 and Figure 2, there is still scope for reducing the cost of capital in local currency by trimming down the currency premium. In this respect, the positive macroeconomic track record of the South African authorities since the late 1990s has proved insufficient (at least so far) to slash dramatically South African real cost of capital. Therefore, further policy actions are required to reduce the real cost of capital in South Africa and, by extension, to lower financing costs in CMA countries. These include:

- 1) The relaxation of regulations constraining capital outflows. The objective is to ease the listing of non-resident entities in the Johannesburg bond and stock markets and to allow them to repatriate resources raised in South Africa. As indicated by South African exchange control regulations, entities *outside the CMA* are defined as “non-resident”. They are not allowed to list on the South African stock and bond markets. Moreover, South African companies controlled by non-resident shareholders are subject to tight regulations regarding their access to local finance (credit, equity and debt finance): their local borrowing can not exceed 100 per cent of the rand value of funds introduced by non-resident shareholders (up to 300 per cent when borrowed resources aim to finance a direct investment in South Africa).



2) Further development of the domestic bond market and to enhance its liquidity. This can be achieved by the consolidation of municipal debt and its subsequent floating on the Johannesburg bond market; and by the development of Mortgage Backed Securities.

**Table 2. South Africa's Investment Relationship with Africa**  
(South African assets in and liabilities to Africa, in million rand)<sup>a</sup>

	Direct investment		Portfolio investment		Other investment	
	Assets	Liabilities	Assets	Liabilities	Assets	Liabilities
Africa	14 031	5 049	747	12 031	12 023	11 395
SACU <sup>b</sup>	1 547	1 381	261	11 707	4 312	5 720

a. Other investment chiefly refers to bank deposits.

b. SACU stands for the South African Customs Union, formed by CMA countries and Botswana.

Source: Based on Thomas (2004), *Quarterly Bulletin*, December 2003, South African Reserve Bank.

3) Propping up domestic savings by for instance reforming their taxation regime. A radical new look at the logic of taxing interest on savings should be considered<sup>16</sup>. This in addition to continuing to reduce the rand currency premium by addressing “unfinished business”<sup>17</sup>, i.e. stepping up structural micro and institutional reforms including labour market rigidities, skills shortage, delayed privatisations, etc.

### **Prospects for Regional Financial Integration**

The Johannesburg financial centre offers potential issuers from the CMA lower jurisdiction and liquidity premia than those required on securities issued on their respective domestic financial markets.

Indeed, South African financial markets operate in a comparatively reliable, stable and business-friendly legal and political environment. Therefore, the jurisdiction premium required by investors to hold assets issued and listed on the South African bond and equity markets remains lower than anywhere else in Africa. Moreover, *by African standards*, Johannesburg is endowed with liquid and sophisticated financial markets which are unrivalled on the continent and the technological infrastructures of which stand comparison with the most advanced emerging financial markets.

In addition, countries from the CMA, which already enjoy a potential access to the South African capital market, and Botswana would benefit from long-term finance in rand currency, i.e. their own anchor currency or, in the case of Botswana, a key element of its currency basket, thus avoiding potential disruptive balance-sheet effects stemming from a currency mismatch.

One may therefore envisage that the South African business centre could gradually become “a financial hub” not only for CMA countries but also for Africa as a whole. In this context, why do so few African entities (either sovereign or corporations) outside South Africa rely on the Johannesburg financial market?

Indeed, South Africa has been so far more of a magnet for portfolio investment from Southern African countries than a source of financing. (See Table 2).

South African capital control regulations (see above) make it impossible for *non-CMA African entities* to raise equity and debt finance on the South African capital markets. However, the South African Minister of Finance, Trevor Manuel, is contemplating the possibility of relaxing regulations limiting the access to South African financial markets by African entities located in *non CMA countries*. He has been recently quoted declaring that South Africa would take action in 2004 to promote itself as “a regional financial centre able to cater more fully for the needs of the African continent”<sup>18</sup>. The South African budget speech 2004 indeed states that “Measures will be implemented during the course of 2004 to enable foreign firms to list on South African capital markets, thus allowing them to raise debt and equity finance on the Johannesburg Securities Exchange (JSE) and Bond Exchange of South Africa (BESA). [...] It is envisaged that inward listings by African companies, institutions and governments should be encouraged through a special allowance for institutional investors, allowing them to invest up to an additional 5 per cent of their total retail assets in African securities listed on the JSE or BESA”.

This analysis does not hold for *CMA countries* which are allowed to raise equity and debt finance in South Africa and to repatriate it. In this context, why has South Africa not yet become a regional financial hub for its neighbours despite the full liberalisation of capital flows within the CMA?

The high cost of capital in South Africa may have contributed to not making the Johannesburg financial centre appealing to neighbouring countries. This difficulty emphasises the need for a lower rand premium. Not only would it result in lower interest rates on rand denominated assets including securities issued by

CMA countries, there are also other benefits to be expected beyond this direct impact. A more stable rand would make rand-denominated assets more attractive and the Johannesburg financial centre more appealing to foreign portfolio investors. As a result, the liquidity of South African capital pools might be bolstered, the Johannesburg liquidity premium would be curtailed (other things being equal) and it would be easier for CMA issuers to float equity and to issue debt in Johannesburg.

However, the main stumbling block on the way to further regional financial integration lies in the weaknesses of local financial systems in the CMA. Aziakpono (2004) for instance points to the minor role played by financial intermediation in the growth process in countries of the CMA and Botswana, with the notable exception of South Africa. Reasons for this insignificant impact of the financial sector on the growth momentum in Namibia, Lesotho, Swaziland and Botswana are likely to vary depending on countries. Botswana notwithstanding, South Africa's neighbours have two important features in common:

- low growth, where investment opportunities are scarce and where entrepreneurial investment-driven demand for financing remains anecdotal (set against consumption-oriented credit in particular);
- weak financial institutions and regulations acting as a major constraint on lending activity to CMA borrowers. Not only are lending opportunities very limited, but lending activity is also very risky. In the case of Lesotho for instance, Aziakpono writes: "There is also the perception of non-loan repayment culture and all the difficulties in pursuing defaulted debt" (idem, p. 17)

The trouble with the financial systems of countries like Lesotho, Swaziland and Namibia is not so much a shortage in the supply of capital and liquidities (the domestic banking systems record excess liquidity), but the lack of investment opportunities in countries endowed with weak legal environments (see Aziakpono, 2004; or Vollan, 2000, for the case of Namibia).

In this context, channelling cheap resources through a financial hub located in Johannesburg is unlikely to change the big picture for Southern African countries endowed with an inadequate institutional environment. Risk-management-related issues will remain high on the agenda of investors contemplating lending to entities located in CMA countries. The strengthening of local financial systems in CMA countries is therefore essential if the latter are to reap the full benefits of an enhanced regional financial integration and lower the cost of capital on the South African financial markets.

## Concluding Remarks

Considering its impact on investment and economic growth, the real cost of capital in countries participating in the CMA (Lesotho, Namibia, Swaziland and South Africa) remains high by developed-country standards. Lowering interest rates in these countries may be therefore regarded as a priority.

The currencies of LNS are pegged to the South African rand, so the rand currency premium (i.e. the premium required by investors to hold rand denominated assets prone to depreciation) is a key driver of local-currency interest rates within CMA countries. Stemming the rand premium volatility and bringing its level down would therefore help reduce financing costs in the region. Since the South African economic policy has a strong bearing on the rand premium, not only is its consistence an issue at the national level but it is also critical to all CMA countries.

Reducing the perception of rand-denominated securities as a risky asset class would also contribute to raising the profile of South African financial markets, drawing in more foreign investors and enhancing the liquidity of these markets. As a result, raising finance in Johannesburg would be made easier and cheaper for entities located in CMA countries (which already enjoy an access to South African financial markets). After some time, Johannesburg might even become a financial “hub” for the region channelling cheap resources to its neighbours.

In this context, bold policy actions need to be taken by the South African authorities, if they want to lower domestic local-currency interest rates. Measures to be implemented could include:

- Enhancing the liquidity of the bond market and easing the access of African entities (including from outside the CMA) to South African financial markets. This might require a gradual relaxation of remaining regulations constraining capital outflows, the consolidation of municipal debt and its subsequent floating on the Johannesburg bond market or the development of new instruments such as the Mortgage Backed Securities (MBS, often found in developed countries) could rank among the priorities;
- Boosting domestic savings for instance by reforming their taxation regime. The logic of levying a capital gains tax (CGT) on asset holdings together with taxing interest on savings at the (high) marginal rate of the personal income tax might be reassessed.

- Improving international investors' perception of the rand. This breakthrough may be achieved by stepping up structural micro and institutional reforms. A steadfast policy of regional risk containment by South Africa, the regional political and economic heavyweight, would also help reassure jittery markets.

However, South Africa has been so far more of financial “magnet” in the region (at least with respect to portfolio investment) than a “hub”. The poor quality of financial institutions and regulations in CMA countries, alongside the scarcity of lending opportunities, help explain this phenomenon. On a risk-adjusted basis, lending activity for financing investment in CMA countries remains unprofitable. This suggests that fostering financial integration in the region and turning Johannesburg into a regional financial hub would be no miracle recipe for CMA countries, in the absence of a consolidation of their financial sectors and the emergence of a local dynamic demand for capital.

## Notes

1. In the case of a corporation, its capital base is a blend of debt and equity. Therefore, the cost of capital for a corporation is the average (weighted by their respective share in the capital base) of equity and debt costs it faces.
2. “Average” in this context suggests that the company’s stock was 100 per cent correlated in its movements with the market’s progress.
3. This unemployment rate refers to the expanded definition of unemployment, which includes discouraged workers (see South African Reserve Bank Quarterly Bulletin, 232, June, 2004).
4. This Policy Brief builds on the lessons drawn from a research project being conducted at the OECD Development Centre. This is a project funded by the Swiss Agency for Development and Co-operation, entitled: “Understanding Debt Costs in South Africa: What Policies Can Narrow the Spread?”. Also see [www.oecd.org/dev/sa2004](http://www.oecd.org/dev/sa2004) for information on the conference (“How to Reduce Debt Costs in Southern Africa”) held in Johannesburg on 25-26 March 2004 as part of this project.
5. Though for some countries the foreign debt market has still provided the bulk of finance (e.g. Argentina in the 1990s).
6. See Levine (1997) for a general reference on the effect of financial development on economic growth.
7. During the 1960s these countries became independent and started running their own monetary institutions around those of South Africa.
8. It is also worth recalling that Botswana and the CMA countries form the South African Customs Union (SACU), so they have common external tariffs and hence a common revenue pool tilted to make up for the imbalances in tax collections that arise from asymmetric trade patterns.
9. However, in order to be able to compute a jurisdiction premium for any given CMA country, there should be financial assets denominated in the same currency, floated by the same borrower but in different jurisdictions, i.e. a country in CMA and another extra-CMA country (e.g. the United Kingdom or the United States). Unfortunately, this is generally not feasible (with the exception of a few South African parastatal companies which issue bonds in Johannesburg and London in the same currency) so the jurisdiction premium will be unavoidably embedded into the default premium.
10. ZAR 270 000 is equivalent to approximately USD44 415.

11. The portion of the capital gain (or inclusion rate) that is taxable (by way of inclusion in taxable income) is 25 per cent for an individual, special trusts and an insurer's individual policyholder fund and 50 per cent for all other taxpayers such as a company, or family trust. Gross interest income on assets holdings is aggregated to the individual taxable income and is therefore subject to the marginal rate of personal income taxation.
12. The "peso problem" refers to a systematic bias in the foreign exchange market's expectations of devaluation for a given currency.
13. South Africa can be dubbed a "no Original Sin country". According to Eichengreen and Hausmann (1999), a country suffers from "Original Sin" if it cannot borrow abroad in its own currency and/or if it cannot borrow in local currency at long maturities and fixed rates even at home. As a matter of fact, most emerging economies suffer from "Original Sin".
14. The impact exerted by global risk aversion and the monetary policy stance in developed countries on emerging market's spreads is also significantly estimated by Slok and Kennedy (2004).
15. This implies that the exchange rate is no longer targeted. However, albeit not a specific target, the course of the exchange rate is not disregarded by monetary authorities: it has indeed a strong bearing upon the inflation process.
16. Lawless (2004).
17. Gouws (2004).
18. See *Financial Times* (19 February 2004).

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The cost of borrowing in local currency in the rand zone (South Africa, Namibia, Lesotho and Swaziland) is excessive compared to that in the G7 countries. This hinders investment, slows growth and has a negative effect on poverty reduction in the region. This *Policy Brief* examines the policy choices that will tend to facilitate access by local economic actors to less burdensome sources of finance. In particular, it identifies conditions in which South African financial markets could play an enhanced role, not only in financing the home economy, but also those of the rand zone and continent-wide.

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