

## **PART III**

### **EXTERNAL OPENNESS AND STRENGTH**



# 8

## Liberalizing Trade and Capital Transactions: An Overview

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In the ten years since the end of apartheid, the South African government has taken significant steps to liberalize trade and capital transactions. As a result, the volume of trade and gross international capital flows has increased significantly. This chapter describes the main steps and sequencing of this liberalization process. Later chapters will discuss particular aspects of the functioning of the liberalized trade and capital account regime, such as the determination of the real exchange rate, the role of reserves, and so on.

The overall conclusion of this chapter is that the liberalization process has been successfully managed: the gradual reduction of external tariffs and the progressive opening of the capital account have allowed the domestic markets to adjust relatively smoothly to the new opportunities and challenges. South Africa's approach to both trade and capital account liberalization has been careful yet determined, aimed at maintaining a reasonable balance between internal economic development and external liberalization. In the international arena, South Africa has urged that multilateral trade liberalization be undertaken so as to increase the benefits to a broad range of developing countries. It has, for example, advocated an increase in the access to industrial countries' markets for agricultural products.

### Gradual Reduction of Trade Barriers

Until the process of trade liberalization began in the early 1990s, South Africa's trade regime was characterized by a high and complex tariff structure and extensive import controls. Attempts to liberalize trade in the early

1980s were halted in the mid-1980s because of intensified balance of payment pressures and culminated in a moratorium of debt payments in September 1985. Instead, attempts were made to revive external trade through export-promotion schemes. By the end of the 1980s, South Africa had a very restrictive trade regime, with an unweighted average tariff rate of 25 percent, a battery of import controls that covered some 15 percent of tariff lines, and a large export subsidization scheme. South Africa's trade regime was also considered highly complex, with the highest number of tariff lines and widest range of tariff rates in the developing world.<sup>1</sup>

The early 1990s brought a sea change to South Africa's trade relations with the rest of the world. As it became clear that the apartheid regime was losing its support in the early 1990s, trade sanctions were rapidly removed. In 1994, the new government announced its intention to surpass the commitments made in the Uruguay Round, and a tariff rationalization process, aimed at reducing and simplifying the tariff structure, was formulated in 1996. The same year, the United States granted Generalized System of Preferences (GSP) status to South Africa.

The liberalization of the trade regime consisted of the replacement of quantitative restrictions with ad valorem tariff lines, a simplification of the tariff regime, accompanied by a gradual but significant reduction in tariff rates, and a phasing out of a substantial export subsidization scheme. The simple average tariff on manufacturing goods was reduced from 21.0 percent in 1992 to 15.6 percent in 1997 and about 11.5 percent in 2002,<sup>2</sup> and the number of tariff lines was reduced from over 13,000 in 1993 to about 7,900 in 1998. Virtually all quantitative restrictions had been eliminated by 1998 (Table 8.1).

In addition to multilateral trade liberalization, South Africa's trade reform has also engaged in a number of bilateral or regional trade agreements. The Southern African Customs Union—comprising South Africa, Botswana, Lesotho, Namibia, and Swaziland—provides for tariff-free trade inside the union and allows for the extension of any preferential tariff granted to any one of the members to the other members. South Africa joined the Southern African Development Community (SADC)<sup>3</sup> in 1994 and a trade protocol, envisaging the creation of a free-trade zone over eight years, was signed in 1996. Preferential market access to the major trading blocks was also granted:

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<sup>1</sup>See Subramanian (2000) and Belli, Finger, and Ballivian (1993).

<sup>2</sup>As reported in General Agreement on Tariffs and Trade (1993) and World Trade Organization (1998 and 2003).

<sup>3</sup>The SADC members are Angola, Botswana, the Democratic Republic of the Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, and Zimbabwe.

**Table 8.1. Trade Regime**  
(In percent, unless otherwise indicated)

	1990	1998	2002
<b>Manufacturing</b>			
Maximum tariff	1,389	72	60
Average unweighted tariff	30	14	12
Standard deviation	43	18	13
Number of tariff lines <sup>1</sup>	> 13,000	7,814	7,909
Percent of tariff lines with non-ad-valorem duties	28	26	25
Import surcharge bands	10, 15, and 40	Eliminated	Eliminated
<b>Agriculture</b>			
Average tariff	25	9	10
Average import surcharge	8	0	0
Export subsidy	17	Eliminated	Eliminated
<b>Export taxes</b>			
Diamonds	15	15	15
Quantitative restrictions on imports <sup>2</sup>	15	Virtually eliminated	Virtually eliminated
Quantitative restrictions on exports	Diamonds 21 agricultural goods	Diamonds	Unprocessed tigers eye
<b>Memorandum items:</b>			
Trade tax revenue as share of total revenue	7.9	4.0	3.5
Import taxes as share of imports	10.8	4.1	3.4
Export taxes as a share of GDP	0.3	0.0	0.0

Sources: General Agreement on Tariffs and Trade (1993); World Trade Organization (1998 and 2003); Industrial Development Corporation South Africa; and Belli, Finger, and Ballivian (1993).

<sup>1</sup>The figure for 1998 refers to June 1997.

<sup>2</sup>As percent of total tariff lines (other than those maintained for health, security, and environmental reasons). The figure for 1990 refers to 1992.

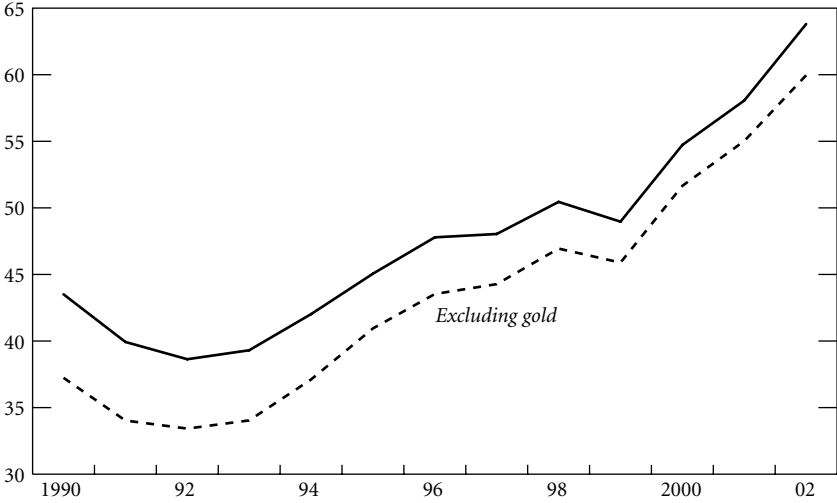
in October 1999, South Africa negotiated a bilateral agreement with the European Union which involved a liberalization of bilateral tariffs over a 12-year period, and, the following year, the United States granted free access to a range of manufactured products under the African Growth and Opportunity Act (AGOA). Negotiations on a permanent bilateral free trade agreement with the United States have been initiated.

As a result of the trade liberalization, South Africa's combined external trade as a share of GDP has expanded rapidly over the last ten years (Figure 8.1). Excluding gold, the share of gross trade<sup>4</sup> in GDP increased from its lowest level of about 33 percent in 1992 to about 60 percent in

<sup>4</sup>Imports plus exports.

**Figure 8.1. Trade Openness**

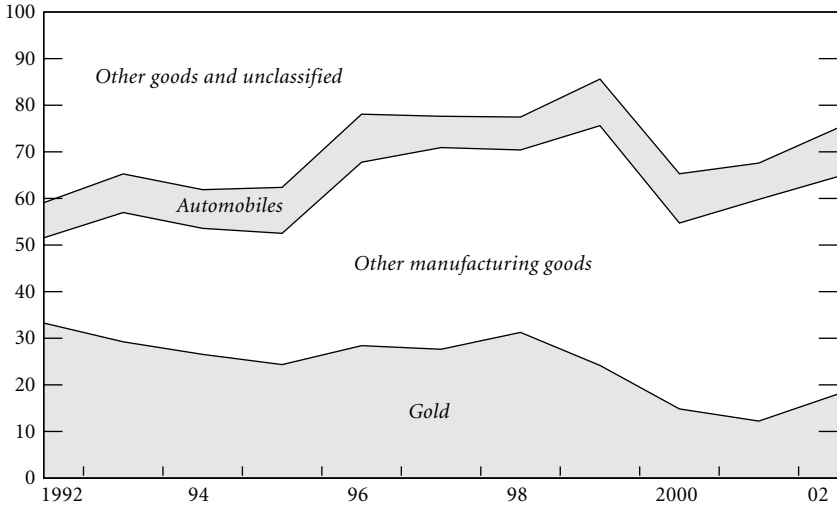
(GDP ratio of goods and nonfinancial services exports and imports; in percent)



Source: South African Reserve Bank.

**Figure 8.2. Composition of Merchandise Exports**

(In percent)



Source: United Nations, Commodity Trade Statistics database (COMTRADE).

**Table 8.2. Direction of Trade<sup>1</sup>**

	Exports			Imports		
	1992–94	1995–97	1998–2001	1992–94	1995–97	1998–2001
United States	9.1	6.6	10.6	15.8	12.5	12.5
Japan	7.5	6.5	6.4	12.3	8.7	7.1
European Union	34.1	38.5	39.7	47.1	43.7	42.6
Of which:						
United Kingdom	9.2	12.8	11.1	2.8	2.8	3.5
Switzerland	11.8	1.9	1.1	2.6	2.4	1.9
Africa	12.8	17.3	17.9	2.8	2.8	3.5
Developing Asia	13.4	14.9	12.3	12.4	13.3	15.1
Other	11.0	14.3	11.9	7.0	16.5	17.2

Source: IMF, *Direction of Trade Statistics*.

<sup>1</sup>Adjusted for trade flows without reported destination.

2002. Reflecting a larger degree of export diversification, South Africa has also become gradually less dependent on primary commodities (Figure 8.2). The geographic orientation of trade has remained quite stable, except for a secular drop in the share of exports to Switzerland and an increase in the export share to other African countries (Table 8.2).

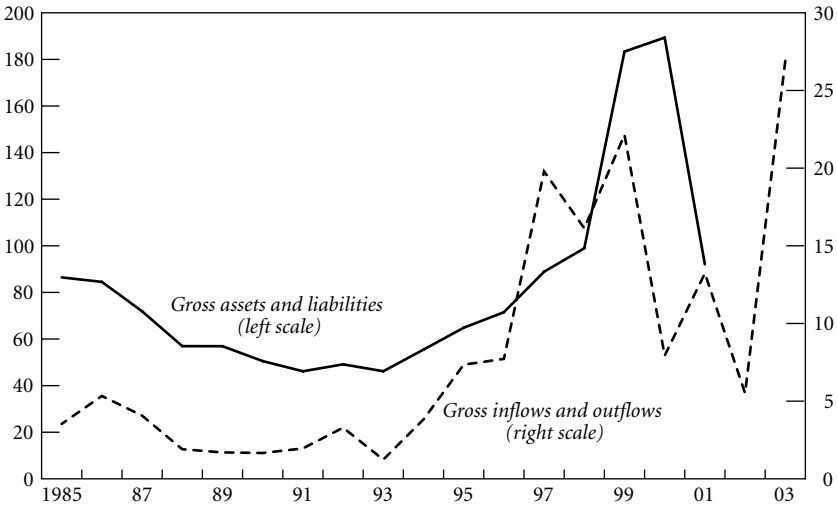
Trade liberalization is, moreover, likely to have had a substantial positive impact on South Africa's growth rate. In a cross-section analysis based on 24 manufacturing industries, Jonsson and Subramanian (2000) show that as much as 3 percent of the annual growth rate of the manufacturing industry can be ascribed to the effect of trade liberalization during the 1990s, with average price reductions of about 14 percent.

## Relaxation of Exchange and Capital Controls

With the removal of the financial rand in 1995,<sup>5</sup> virtually all exchange restrictions on nonresidents were removed and South Africa was free from any restrictions on current payment transactions.<sup>6</sup> After this initial “big

<sup>5</sup>Introduced in September 1985, the financial rand constituted a multiple exchange rate regime that obliged nonresidents to deposit proceeds from the sales of their investments in South Africa into separate accounts, called “financial rand accounts.” The result was a price difference between the financial rand and the commercial rand of more than 20 percent for most of the period the regime was in effect.

<sup>6</sup>With the unification of the exchange rate, South Africa eliminated the single exchange restriction that was subject to IMF jurisdiction under Article VIII of the IMF Articles of Agreement (pertaining to restrictions on current international transactions), arising from the requirement that emigrants' remittances of earnings in excess of R 350,000 be made through the financial rand.

**Figure 8.3. External Financial Openness***(Gross external assets and liabilities; inflows and outflows in percent of GDP)*Sources: IMF, *International Financial Statistics* and *World Economic Outlook*.

bang,” the opening of the remaining restrictions on the capital account has been more gradual. In general, existing limits have been increased without altogether eliminating the restrictions and when residents have been allowed to engage in new types of foreign exchange transaction, this has always been done in a step-wise manner with tight limits put on the transaction initially allowed. Thus, while a decreasing number of residents are likely to feel constrained by the regulations, the current system still put strict, albeit generous, limits on residents’ ability to invest or borrow in foreign currency and direct investment is subject to specific ceilings. Of some importance, nonfinancial institutions are still not allowed to engage in external portfolio investment, thus all external portfolio investment has effectively to be channeled through the institutional investor sector. Box 8.1 outlines the key steps toward a more open capital account during the last ten years.

Although a number of steps toward liberalization of the capital account have been taken over the last ten years, it is hard to make an objective assessment of the relaxation in binding constraints on capital transactions. Gross capital account flows, in terms of the stock of inward and outward investment, does, however, provide an indirect estimate of the restrictiveness of the capital account restrictions. Depicting the sum of the GDP share of gross external financial assets and liabilities, Figure 8.3 indicates



### Box 8.1. Key Dates of Capital Account Liberalization, 1994–2003

*March 1995.* The dual exchange rate system was abolished, eliminating virtually all restrictions on nonresidents. Residents remained strictly limited in their ability to borrow or lend in foreign exchange and to invest abroad. Exports proceeds had to be surrendered within seven days of accrual or within six months of the shipment date.

*July 1995.* Institutional investors could be permitted to invest in foreign assets through swap arrangements with nonresidents amounting to 5 percent of total assets. In June 1996, this limit was increased to 10 percent and allowed institutional investors to purchase foreign exchange to transfer abroad assets amounting to 3 percent of net inflows in the previous year.

*June 1996.* Offshore investment expansion by domestic corporations was permitted, provided that the investment was financed from profits generated abroad or financed abroad. The limit on domestic credit extended to foreign controlled companies was increased to 100 percent of total shareholders' investment.

*March 1997.* The surrender requirement period was increased from 7 days to 30 days. All quantitative limits on current payments and transfers were abolished with the exception of limits on travel, study abroad, and gifts.

*March 1998.* The surrender requirement period was increased from 30 days to 180 days. Direct investment by domestic corporations outside of the SADC countries were allowed with a limit set at R 30 million.

*February 1999.* The limit on institutional investors' external assets was increased to 15 percent of total South African assets, with the limit of foreign exchange purchase increased to 5 percent of previous year's inflows (other assets would still have to be acquired through an asset swap with a nonresident).

*February 2001.* The limit on unit trusts' external assets was increased to 15 percent of all assets, subject to a limit amounting to 10 percent of net inflows in the previous year. The possibility to acquire external assets through asset swaps was discontinued. The limit on outward direct investment was increased to R 500 million (outside of Africa).

*May 2003.* Institutional investors were allowed to invest up to their maximum limits of 15 percent for long-term insurers, pension funds, and fund managers and 20 percent for unit trusts; the restriction based on annual inflows was abolished. The limit of funds transferred abroad to finance outward direct investment was doubled and some other measures were introduced to relax the restriction on outward direct investment.

that the degree of restrictiveness of the capital account restrictions has indeed fallen significantly since 1996, with the most rapid change taking place in the early years (1996–99).

The background for focusing the capital restrictions on residents' capital account was to some extent based on the concern that, after the end of apartheid, wealthy white residents would leave the country, thus draining the country, not only of skills but also of financial wealth. The emigration statistics clearly illustrate the potential for such a drain: between 1994 and June 2003 about 17,000 college students, 3,000 teachers, and 8,000 managers left the country.

### **Sequencing: The South African Experience**

The South African experience with the opening of the capital account contrasts favorably with several other emerging market economies where the liberalization was more rapid. Despite large fluctuation in the currency and swings in capital flows, South Africa has been spared from the disruptive crisis experienced, for example, in Mexico and Korea. Research highlights the importance of a strong and market-based domestic financial system as a precondition for a successful capital account deregulation (see, e.g., Ishii and others, 2002). In the case of South Africa, the banking system underwent a comprehensive reform in the second half of the 1980s. The financial system was at this time consolidated into a few large banking groups and a system of effective prudential supervision and regulation was created. This was supported by an already highly developed accounting regime and legal system. Thus, when South Africa removed capital account restrictions on nonresidents, the domestic financial system was already strong and well prepared to deal with the increased volume of transactions and heightened price volatility.

The deregulation process is also likely to have benefited from strong macroeconomic policies. In particular, the remarkable turnaround of the fiscal situation (see Chapter 6) contributed significantly to stabilizing the macroeconomic environment. Stability-oriented monetary policy aimed at low inflation (see Chapter 12) is also likely to have helped in reducing unnecessary macroeconomic fluctuations. Finally, corporations, households, and the financial sector weathered the high level of exchange rate volatility quite well, reflecting to large extent tight statutory limits on net foreign currency exposures that virtually ruled out any significant unhedged foreign exchange exposure.

It is also noticeable that the authorities have been able to sustain a gradual and controlled removal of restrictions without large-scale avoidance. The enforcement of the regulations may have been facilitated by the fact that it

nearly only applied to residents, which, in the case of a breach, could be sanctioned more easily.

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