The impact of capital flows on the South African economic growth path since the end of apartheid

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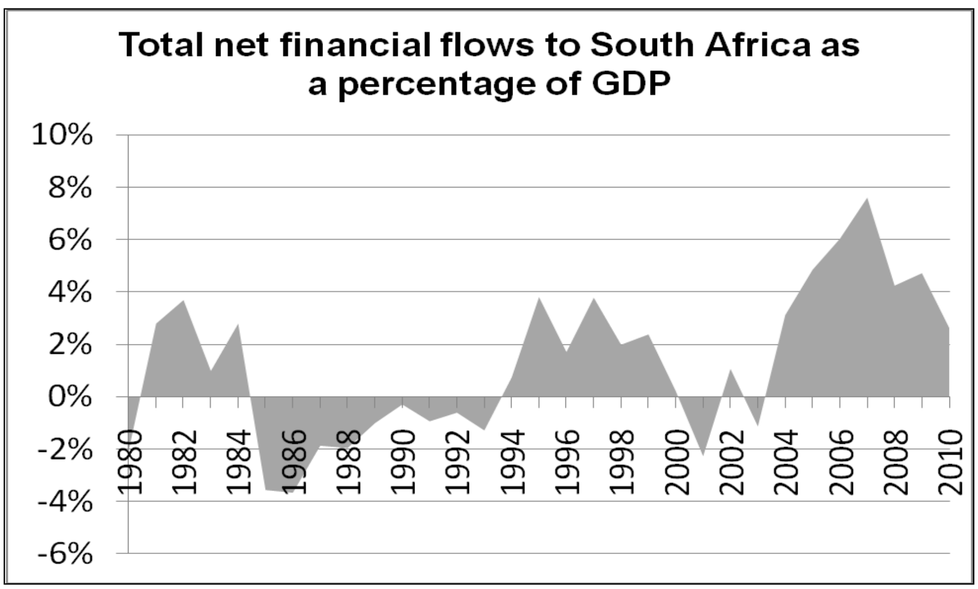
Introduction

This paper will consider international capital flows into and out of South Africa during the post-apartheid era. It will examine the types of flows that have been entering the country and how they were absorbed into the economy. It will consider the effects of these capital flows on the economy taking into account the broad range of literature that links financial crises to volatile surges in capital flows. It will also examine how capital flows have influenced South Africa's economic growth path since the end of apartheid.

The post-apartheid government has a policy of "gradual" liberalisation of exchange controls. They have significantly eased the ability of South African residents to withdraw capital from the economy. Non-residents are allowed virtually free movement of capital into and out of the economy. Current policies allow more and more South African capital to leave the country. The government hopes that a large share of the capital required for domestic investment, employment creation and development of the economy will come from foreigners. Within this approach, the government's policies on capital controls do not adequately differentiate between long-term foreign direct investments and short-term capital flows. Instead, senior government officials have argued that liberalisation of financial markets will lead to the deepening of financial markets. Even if this policy leads to more inflows of capital, will it lead to more and better investment?

This paper provides an assessment of the impact of capital flows on the South African economy over the past few decades. In so doing it contributes to international financial literature on South Africa because it is one of very few papers that examines the absorption of capital flows into the economy. It also extends the South African literature because it uses heterodox analyses of financial crises to examine volatility and instability caused by capital flows in the South African economy. Furthermore, it is one of very few economics papers on South African that links the country's economic growth path to financial liberalisation and the type of financial flows crossing the country's border.

Figure 1: Total net financial flows as % of GDP



Source: Calculated using South African Reserve Bank (SARB) online historical data

The end of apartheid and the relatively peaceful transition to democracy, combined with the introduction of financial market liberalisation in 1995, led to large increases in the amount of capital inflows into South Africa. Figure 1 shows net capital flows as percentages of GDP from 1980 to 2010. This paper examines the effects of more domestic liquidity as a result of the large net capital inflows and argues that surges in inflows are of concern because they increase potential for financial risk and instability in the economy. This aspect of the paper draws heavily from the analysis of financial crises in Palma (2003) who argues a ‘Kindlebergian’ proposition that the effects of massive surges in inflows on domestic liquidity are “key to understanding” financial crises. Many countries experienced financial crises since the mid-1990s.[1] Each of these countries had very different methods in which they absorbed the large increases in capital inflows. Palma convincingly shows that large capital inflows are the key to explaining financial crises in all these countries despite their different ‘absorption’ methods.

Foreign direct investment is an important element of the South African government’s economic policy. They seem to believe that their chances of attracting foreign direct investment will improve if they show investors that they are committed to maintaining orthodox macroeconomic fundamentals and other elements of the Washington Consensus. These attitudes have not changed since the 2008 to 2010 global financial crisis, even though former bastions of orthodox economic policies and advocates of financial liberalisation, such as the IMF and OECD, now admit that the destabilising role of uncontrolled, cross-border financial flows and concede that regulations to control flows may be justified in certain circumstances.[2]

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[1] Mexico, South Korea, Thailand, Indonesia, the Philippines, Malaysia, Russia, Brazil, Turkey, Argentina and Uruguay have been plagued by financial crises since the mid-1990s.

[2] See for example, the 2010 working paper of the IMF “Capital inflows: The role of controls” by Ostry, Ghosh, Habermeier, Mahvash, Qureshi & Reinhard, and the OECD’s 2011 Economic Outlook, “Chapter 6: Getting the most out of international capital flows”.

Notwithstanding the changing perspectives of proponents of economic orthodoxy, the South African Government does not seem overly concerned with the disruptive effects that capital flows can have on a country's financial system and economy. This lack of concern exists despite numerous financial crises in developing countries since the mid-1990s, South Africa's debt crisis in the mid-1980s and the South African currency crisis in 2001. Even the estimated loss of more than 1 million jobs as a result of the 2008 to 2010 global financial crisis has not deterred the Government from continuing its programme to further liberalise exchange controls.[3] The South African government has chosen to forsake controls over cross-border flows and instead to follow yet again the advice of orthodox economists and institutions such as the IMF to implement prudential regulation of finance and financial flows.

Most of the capital flows entering South Africa have been short-term portfolio flows. The bulk of these flows has been absorbed by the private sector. There has been an accompanying surge in private sector access to credit. The private sector has not utilised their improved access to credit for productive investment. Instead, easier access to credit has supported existing negative trends in the economy. For example, the exuberance in the stock market experienced from the early-1990s that led to higher share prices seems to have continued and to have been supported by easier private sector access to credit. The same applies to growth of imports and household consumption. In addition, capital flows are positively correlated with large-scale capital flight from the South African

[3] The loss of around 1 million jobs during the crisis was referred to by Finance Minister Pravin Gordhan in his preface to the 2011 document of the South African National Treasury called "A safer financial sector to serve South Africa better". The estimate is drawn for Statistics South Africa's Quarterly Employment Survey data.

economy. Therefore, the surge in capital inflows was not associated with economic activity that would lead to long-term growth in the economy. Instead, one may associate the surge in net capital flows with increasing exuberance that leads to higher share price indices, more imports, growth in private consumption and high levels of capital flight. The reversal of net capital inflows such as those after the 1997 Asian Financial Crisis, the 2001 Dotcom crash, and the most recent global financial crisis shows significant negative impacts on South Africa's economic performance.

The macroeconomic and financial instability associated with large movements of cross-border capital flows have weakened the economy over time. The liberalisation of cross border financial flows and the effect of the type of capital flows that entered the economy had a marked impact on the types of investment and the formation of capital stock in the economy since 1994. Therefore, the Government has not been able to achieve their stated economic goals to increase economic development, reduce unemployment and tackle the legacy of high inequality. Instead, the growth path of the economy has led it away from sustainable economic development, has been unable to even dent high unemployment and caused inequality to increase. Papers by Ashman et al (2010) and myself (Mohamed, 2010) have described the changes associated with financial liberalisation and deregulation of cross border capital flows in South Africa as part of the financialisation of the South African economy.[4]

[4] Mohamed (2010) and Ashman, Fine and Newman (2010) discuss financialisation of the South African economy. Note that Mohamed, Ashman and Newman were staff of the Corporate Strategy and Industrial Development Research Programme at the University of the Witwatersrand in 2010. Most (or more accurately almost all), of the recent literature on financialisation of the South African economy has come from CSID researchers).

REVIEW OF RECENT LITERATURE ON CAUSES AND CURES FOR FINANCIAL CRISES

The South African literature on capital flows and potential risks of financial crisis is very thin so most of this literature review refers to literature dealing with global trends in capital flows and financial crises. The South African government, which seems to be the major client for work on South Africa's position in international financial markets, continues to adhere to neoliberal solutions which imply that their thinking on financial crises is in line with mainstream neoliberal thinking. This may be a reason for the paucity of South African economic literature on this important subject. The government and SARB have accepted the mainstream argument that financial liberalisation is good for the economy. As a result, the government is pushing ahead with plans to further liberalise controls over the movement of capital by South African residents, despite their tacit acknowledgement that there has been large capital flight in the form of a foreign exchange amnesty.

According to Bruce-Brand (2002) the post-apartheid government from 1994 planned with reintegration of SA into the global economy. A relatively cautious approach to the liberalisation of international financial flows was planned but clear signals were sent to global financial markets that the government's intention was to liberalise. Bruce-Brand says that the following sequence of liberalisation was planned from 1994:

1. Abolition of exchange controls on all current account transactions;
2. Abolition of exchange controls on non-residents;

3. Gradual leniency in approval of applications for outward FDI;

4. Allowing domestic institutional investors to acquire more foreign assets to allow them to diversify their investment portfolios;

5. Progressive relaxation of all other controls on resident individuals;

6. Eventual release of emigrants' blocked funds in South African bank accounts.

The government has steadily relaxed controls and enforcement of controls, especially after the adoption of the South African Government's Growth, Employment and Redistribution programme (GEAR) was implemented in 1996. However, at times, especially after the currency crisis in 2001, the SARB tightened up on controls and chose to strengthen its increasingly lax enforcement of existing controls.

The currency crisis of 2001 that negatively affected growth and the recovery of the rand from 2002, which negatively impacted on exports and probably growth, and the debt driven consumption and increasing speculation for 2003 until the most recent global financial crisis, illustrate the type of uncertainty and volatility associated with financial openness in South Africa.[5] A few publications provide interesting insights that support arguments that the South African economy has become more volatile since the process of capital control liberalisation took off from the mid-1990s. These studies indicate the preferences of foreign investors and the volatility associated with openness. Wesso (2001) shows that the main determinant of direct investment into South Africa after 1994

[5] Frankel and Rose (1995) define a financial crisis as a situation where the nominal exchange rate of the domestic currency to the US dollar falls by 25%. By this definition South Africa had a financial crisis at the end of 2001. I break with this convention (maybe unwisely) to differentiate what happened in South Africa from the financial crises analyzed in Palma (2000). As a result I call the large decline in the value of the rand in 2001 a currency crisis.

was the swap agreement where South African firms were allowed to invest offshore if they could secure foreign investment into South Africa. This finding indicates that investors prefer to take short-term positions in South Africa. Wesso also finds that "Portfolio investors usually chase high-yield interest bearing securities" (p.75). He says that foreign investors tend to sell off South African equities when there is a significant decline in domestic interest rates relative to foreign country interest rates. Vassi (2003) in a World Bank Working paper discusses how asset swaps formed part of a phased liberalisation of cross border financial flows and were used to allow institutional investors to increase foreign assets in their portfolios before exchange controls were removed. Vassi argues that the use of assets swaps involved too much red tape for institutional investors and makes a case for more rapid exchange control liberalisation.

Farrel (2001) finds that "… the conditional volatility of South African exchange rates was lower during the financial rand period than in the contiguous periods when the exchange rate was unified, and that volatility in the financial rand did not impact on the commercial rand exchange rate". Aaron and Muellbauer (2002) say that nominal exchange rate shocks have less impact than monetary shocks on the economy in the short-run. However, they highlight their important findings that exchange rate volatility appears to be increasing as the economy opens. The three studies cited offer support for the contention that South Africa is more vulnerable to surges in inflows and outflows of capital or "hot money" and the damage these flows may inflict. However, I have not found South African literature calling for capital controls. Farrel and Todani (2004) provide a history of regulation of South African cross border financial flows. They recognise the instability caused by uncontrolled flows and argue that the liberalisation of exchange controls in South Africa was "… the correct option to choose in 1994, or at least not the incorrect option…." What Farrel and Todani are in fact saying is that the Government and SARB were correct (or not incorrect) to choose exchange control liberalisation in 1994 because that was the policy espoused by the IMF and orthodox economists.

SARB and South African Government economists (with support from the South African financial institutions) seem to continue to agree with the pre-Asian financial crisis views of orthodox advocates of financial liberalisation who made the claims that liberalisation of international capital flows (see for e.g., Dornbusch, 1998; Kim, 2000):

- Provides access to capital and resources (such as technology) to developing countries that they would not have domestically;
- Leads to efficiency and policy discipline in developing countries because the need to attract foreign capital flows causes maintenance of low inflation and fighting corruption
- Allows capital flows to be allocated by markets rather than government which means capital flows to projects with highest returns, ie. Most efficient allocation of capital

However, many mainstream economists like Bhagwati (1998), Stiglitz (2002), Krugman (1998) and Rodrik, (1998) have actively argued in favour of capital controls. Heterodox economists have taken the recent paper by Ken Rogoff (Economic Counsellor and Director of Research at IMF) and others as a major concession by the IMF in the debate over financial integration (see Prasad, Rogoff, Wei and Kose, 2003). This paper finds that “there is no proof in the data that financial globalisation has benefited growth" in developing countries. The paper also concedes that there are heightened risks of macroeconomic volatility associated with integration because “… cross country financial linkages amplify the effects of various shocks and transmit them more quickly across national borders” (p. 5). The IMF working paper by Ostry et al (2010), which says that capital controls could be justified in certain cases is seen as a more recent concession by orthodox economists in favour of controlling global financial flows.

Despite this recognition of increased volatility and the danger of financial crises associated with financial liberalisation and increased financial integration, most mainstream economists cling to neoliberal solutions and only grudgingly mention government regulation. The main neoliberal solutions are to increase prudential supervision and transparency in financial markets and to ensure market discipline. The Washington Consensus position, which espouses conservative macroeconomic policies (low fiscal deficits and tight monetary policy, including inflation targets) and open financial markets, is unsurprisingly also the mainstream solution for avoiding financial crises. There has been much criticism of IMF bailouts of countries in financial crises because these have come to the aid of financiers not borrowing countries. Eichengreen (1999, 2002) reflects the views of many mainstream economists when he argues for market discipline. He says that financiers that lend to or invest in countries with high risk (for Eichengreen and other mainstream economists this means unsustainable macroeconomic or financial policies) should “bear the consequences of their actions”. [6]

Underlying mainstream critiques of regulation of financial markets is the belief that information technology has made regulation passé. Eichengreen (2002) reflects mainstream conventional wisdom when he argues that strengthening regulation rather than market institutions will be ineffective because the regulators will always be a few steps behind the regulated. Therefore, for mainstream economists (and neoliberals in general) the solution is building self-regulating markets and institutions. Contrary to mainstream conventional wisdom, case studies of capital management techniques in many developing countries show that “capital management techniques can contribute to financial stability, macro and micro-economic policy autonomy, stable long-term investment, good current account performance and more stable currencies” (Epstein, Grabel and Jomo, 2003).

The reason mainstream economists cling to their Washington Consensus mantra as a solution for financial crises is because they are unwilling to accept the full consequences of uncertainty and asymmetric information. Full acceptance of these consequences would lead to a devastating critique of the economics underlying their macroeconomic prescriptions. All neoclassical and neoliberal macroeconomic models abstract from time

[6] Eichengreen (2002) provides an up to date review of mainstream literature on financial liberalization and the causes of financial crises as well as solutions. Blecker (2003) provides a good overview of heterodox perspectives as well as a review of mainstream literature. Blecker provides a number of solutions for financial crises.

and ignore uncertainty. They deal with uncertainty by assuming that they can develop a probability distribution of all future outcomes.

The ideas that shape heterodox economists' appeals for capital controls or capital management techniques are informed by the view that uncertainty and information asymmetries are important and together with psychological factors lead to phenomenon like panic and herding behaviour in markets.[7] The heterodox perspective on financial crises is also informed by the view that understanding institutions and history is important. For example, the unequal relationship between advanced industrial countries and developing countries is seen as important for understanding the financial system and causes of crises in developing countries. Therefore, colonial history and current forms of imperialism are taken into account. As a result, solutions offered by heterodox economists are specific to a country and tend to steer away from the type of blanket solutions offered by neoliberals. For example, when talking about capital management techniques, Epstein *et al* (2003) stress that there is "… no best practice". They say, "We have found a variety of strategies that work in countries with very different levels of state and bureaucratic capacities, depth and degree of liberalization of financial markets, different mixes of dynamic and static controls and different mixes of prudential controls on international capital flows" (p. 44).

Further, management of capital flows is necessary for successful implementation of policies aimed at promoting economic development. Heterodox economists persuasively

[7] For a heterodox perspective on financial crises see for example, Chang, 1998; Crotty and Dymski, 1998; Crotty and Epstein, 1999; Grabel 1999 and 2003; Palma, 1998 and 2003; Taylor, 1998; and Wade, 1998.

argue that capital management is necessary for development and is a central component of industrial policy (Crotty and Epstein, 1996; Amsden, 1989). Inadequate control of capital flows reduces the ability of the state and firms to implement development policy and increase value-added production (Chang, 2002). Many developing countries successfully use capital controls and prudential regulations to insulate their economies from financial contagion, maintain economic stability, support export competitiveness and to pursue industrial policy (Epstein et al, 2003).

SOUTH AFRICA RECEIVES A SURGE IN NET CAPITAL INFLOWS

Capital flows started improving to South Africa from 1992 during the negotiations period and really took off after the 1994 democratic elections (see Figure 1). After 1997 capital inflows seem to have been affected by the financial crises in East Asia and elsewhere. Net capital flows as a percentage of GDP decrease from 1997 to 1998 and then increase again in 1999. In 2000 there is a severe drop in the level of net capital flows and it drops again in 2001. After the 2001 currency crisis the net flows drop to back to the relatively low levels experienced before the 1994 democratic elections. In 2004 there is a large increase in net capital flows of 4.4% of GDP from -1.2% of GDP in 2003 to 3.2% of GDP in 2004. Net capital flows as a percentage of GDP increased to 4.9% in 2005 and continue to grow to a peak of 7.6% of GDP in 2007. As a result of the global financial crisis net capital flows decline to 4.2% of GDP in 2008 and down to 2.6% of GDP by 2010.

Three Routes to Financial Crises

Palma (2002) describes three routes to financial crises using Mexico, Korea and Brazil (routes 1, 2 and 3 respectively) to illustrate the different routes to financial crises. The different routes are related to how countries absorbed the sudden large capital inflows experienced after liberalisation. Palma provides a framework for thinking about how large capital inflows may have affected South Africa.

In route 1 countries, the inflows were passed on as massive increases in the amount of credit available to the private sector. As a result foreign debt increased tremendously and the term structure of the debt was heavily weighted towards short-term debt. The inflows led to reduced interest rates and revaluation of the currency. The combination of increased credit availability and interest rate reductions led to a consumption boom, a stock market bubble and real estate bubble, and a decline in savings. The consumption boom led to a massive increase in imported consumer goods that resulted in a huge deterioration of the current account. Foreign lenders soon realised that the situation in Mexico was unsustainable and as soon as some asset holder started pulling their funds out of Mexico (or selling their Mexican assets) the herd followed and the result was a major financial crisis.

In Korea, the massive surge in short-term inflows was also passed on as a surge of low interest credit to the private sector. Unlike Mexico, the credit did not go into consumption but was used to sustain high levels of investment. Korean chaebol had an ambitious investment programme related to increasing their share of international sales in many key but highly competitive industries like electronics and automobiles. One problem with this strategy was that levels of profitability were in decline because of high levels of competition in these industries. In order to remain competitive in these industries it was necessary to continually invest huge amounts into maintaining technological superiority. As a result, large Korean corporations, which absorbed most of the surge in inflows, were hugely over-borrowed. At the same time the Central Bank of Korea maintained low levels of foreign reserves. The result was that foreign lenders soon lost confidence in Korea when it suffered some low growth despite its history of high levels of growth and productivity. The withdrawal of finance led to a major financial crisis.

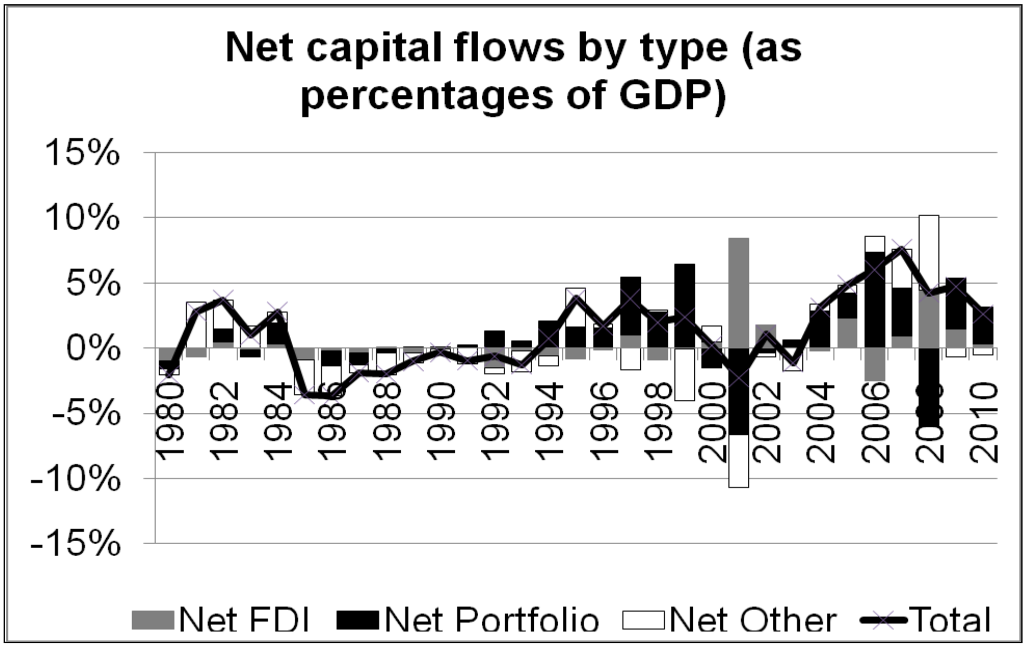
Malaysia and Thailand had elements of both route 1 and route 2 when they had their crises. Their massive inflows of short-term capital were also directed to the private sector. However, unlike route 1 they did not revalue their currencies, did not have consumption booms and lower savings. The experience of stock market and real estate bubbles financed with short-term foreign debt was similar to route 1 countries. Like route 2 countries, the increased access to credit went into investments in the productive sector. Unfortunately, the economies of Malaysia and Thailand were attempting to break into value-added new markets in competition with countries that they had previously subcontracted for. At the same time, China emerged as an important competitor in many of the markets that Malaysia and Thailand depended on for their exports. The result was that they had low growth at a time when their foreign borrowings were very high. So despite a strong track record of high growth and productivity these countries were affected by financial crises when managers of short-term funds embarked on panic-ridden flight from their economies.

The massive short-term inflows in Brazil, route 3, did not lead to consumption or investment booms. Fear of spiraling inflation caused the Brazilian authorities to increase interest rates. Learning from the Mexican experience, the Brazilian authorities maintained high interest rates to avoid a consumption boom and stock market and real estate bubbles. However, this strategy led to big problems in their public finance sector and lots of fragility in the private banking system. At the same time, due to the very high interest rates, public debt was increasing faster than revenues and returns on foreign exchange reserves. The high interest rates negatively affected industry and the tax revenues of government declined even further. However, Brazil could not reduce interest rates because of internal politics, lack of public sector reform and the need to maintain their exchange rate. A decline in the value of their currency may have deepened the financial problems of the banks that had big foreign debt. These obvious problems in Brazil led to a quick loss of confidence that led to a withdrawal of finance causing a major financial crisis.

Palma concludes with the insight "So, the moral of the story of the 'three routes' is that no matter how LDCs facing sudden and massive surges in capital inflows have handled their absorption, they have ended up in major financial crises" (p.32).

The Nature of Capital Flows into South Africa

Figure 2: Net capital flows by type (as % GDP)



[Source: SARB]

The change in the composition of net capital flows is of interest when considering South Africa. South Africa was affected by the reluctance of banks to lend to developing countries after international debt crisis of the 1980s. In Figure 2, one observes that before the 1985 moratorium on short-term debt and the five-day suspension of foreign exchange, net other investment flows, which includes bank lending, was the largest part of net capital flows.[8] Net other investment flows and net capital flows did not recover in Latin American countries after the debt crisis. South Africa was similarly affected. Net other investment flows seem to have been replaced by a surge in net portfolio investment flows and to a lesser extent net direct investment flows (related to privatisation) in Latin American countries during the 1990s as a result of growth in international liquidity.

[8] South Africa received increase net flows of other investment flows (mostly short-term bank loans) once the countries of Latin America had defaulted. The international banks seem to have turned to South Africa when lending opportunities elsewhere dried up. However, the surge in capital flows very quickly led to financial instability in South Africa and in 1985 the government announced a debt moratorium.

South Africa also experienced a surge in portfolio flows and some increases in direct flows (some of it also related to privatisation).

From 1986 to 1993 net capital flows as a percentage of GDP are negative and only show signs of recovery when South Africa has democratic elections in 1994. There is growth in net portfolio flows as a percentage of GDP from 1990. During the 1994 to 2000 period direct investment was a small proportion of total capital inflows in South Africa. In 2001 when there is a significant drop in net portfolio flows, net direct investment is a more significant portion of total capital inflows. In 2001 net direct investment is large[9] and net portfolio and net other capital flows relatively small. The instability in net capital flows during the 1990s is related to the movements of short-term, portfolio flows. This movement seems closely related to changes in sentiment towards developing countries in global financial markets, contagion resulting from financial crises in other parts of the world and economic slowdown in developed economies. As is illustrated in Kindleberger's history of financial crises, surges in short-term capital flows greatly increases a countries vulnerability to financial crises. This will be discussed in more detail below.

The process of neoliberal global integration since the breakdown of the Bretton-Woods arrangements in the 1970s escalated during the Reagan-Thatcher era in the 1980s. By the end of the 1980s, most countries, including developing countries, had moved towards full convertibility of their currencies and the push for liberalizsation of financial markets was

[9] A large part of the surge in direct investment as a percentage of GDP in 2001 was because a large South African corporation moved its primary listing outside of the country. The result was the corporations investments in South Africa became classified as foreign direct investment.

well under way. The apartheid government was also influenced by the drive towards neoliberal integration and had attempted financial liberalisation, starting with an attempt to end the dual currency exchange rate system in 1983. This experiment failed because, in addition to financial fragility caused by the surge in short-term bank lending, a number of foreign banks, spooked by heightened internal resistance to apartheid in 1985 and pressure by the international anti-apartheid movement, decided to withdraw or not renew lines of credit. The rand exchange rate dropped significantly forcing the government to suspend trading on the foreign exchange market and the Johannesburg Stock Exchange securities market. This suspension lasted five days: from August 28 to September 1, 1995. Ironically, one of the tasks of the new government after the first democratic elections in 1994, once political stability seemed to have been attained, was to renew this process of financial liberalisation starting with the abolition of the dual exchange rate system.

The end of apartheid coincided with a period when there was a lot of liquidity in international markets. There was huge growth in the value of the assets of institutional investors. According to Palma, the average increase for the G7 group of countries between 1988 and 1996 was about 40% of GDP and the growth in the US was 60% of GDP while in the UK it was as high as 80% of GDP (Palma, 2000, p. 9). Palma adds that massive international liquidity was an important contributing factor to the massive increase in flows to some developing countries but not the only reason. He argues that some developing countries play the role of “market of last resort”, especially when an increase in international liquidity occurs at a time when there is slow growth in OECD countries. After the democratic elections South Africa became an important option for institutional investors looking to expand their portfolios to include Sub-Saharan Africa. It is the strongest economy in the region with the most developed industrial sector and a wealth of mineral resources.

Another reason for movements of capital to certain developing countries is the belief by investors that economic reforms (such as those suggested by the Washington consensus) would lead to environments where they could earn good returns on their investments. The new South African government made a concerted effort to attract capital flows by assuring credit rating agencies, financiers and potential investors that it would maintain strong macroeconomic fundamentals and implementing other reforms such as trade liberalisation. The government's problematic assertion that GEAR is non-negotiable is obviously part of this effort to gain and maintain credibility.

Some developing countries are relatively more attractive to foreign investors because of opportunities for profit, such as undervalued asset markets (especially stocks and real estate), high interest rate spreads and the expectation that there will be a real appreciation in exchange rates. Palma argues that some developing countries will artificially develop these attractions to gain inflows (ibid, p. 10). South Africa was relatively attractive to foreign investors due to the existence of relatively undervalued assets as a result of years of international isolation and high real interest rates. The interest rate spread was kept relatively high at 4.7% in 1994 and increased to 5.3% by 2000.

Table 1: Net portfolio flows as a percentage of GDP

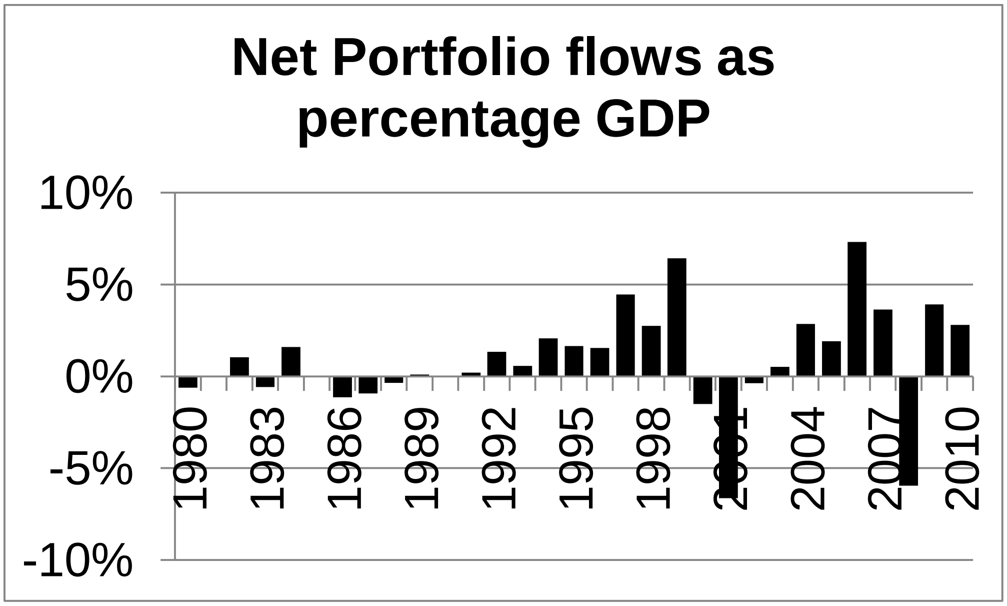
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Argentina	-1.0%	0.0%	2.1%	14.2%	3.2%	0.7%	3.6%	3.4%	2.9%	-2.4%	-0.8%
Korea	0.1%	1.1%	1.9%	2.9%	1.5%	2.4%	2.9%	3.0%	-0.4%	2.3%	2.6%
Mexico	-1.5%	3.9%	5.3%	7.0%	1.8%	-3.6%	4.2%	1.1%	-0.3%	2.1%	-0.2%
South Africa	0.0%	0.2%	1.3%	0.6%	2.1%	1.6%	1.6%	4.5%	2.8%	6.5%	-1.6%
Thailand				4.4%	1.7%	2.4%	2.0%	3.2%	0.3%	0.1%	-0.6%

Source: own calculations using the IMF's International Financial Statistics and South African Reserve Bank data for South Africa[10]

The huge inflows into developing countries are an important cause of financial crises in the neoliberal era. Since the end of apartheid, South Africa has joined the club of developing countries experiencing relatively large net capital inflows. A large proportion of the inflows are short-term, highly volatile inflows. Table 1 shows net portfolio flows as a percentage of GDP for a number of countries affected by financial crises during the 1990s and for South Africa. Mexico and Argentina had financial crises during 1994-5. Mexico received large net portfolio flows from 1991 and Argentina got large net portfolio flows from 1992. By 1993 these flows had grown massively to 14% of GDP in Argentina and 7% of GDP in Mexico. In 1994, the year the crisis started, these flows collapsed.

Figure 3: Net portfolio flows as percentage of GDP

[10] A blank space indicates that IFS data was not available for that year.



Source: Calculated using SARB data

Figure 3 shows the rapid rise in portfolio capital flows into South Africa after 1994. For example, in 1999 net capital flows were 42% of exports and 6% of GDP. The flows to South Africa were later and smaller in volume than those to Mexico, Brazil and the East Asian countries for a number of reasons. South Africa became available as suitable destination later than these countries and many institutional investors had committed funds to the other countries. The institutional investors were less interested in Sub-Saharan Africa and had dedicated fewer resources to research investments there. There was confidence with respect to the economies of Mexico, Brazil and East Asia and in some of these countries speculative bubbles emerged. These investment bubbles probably limited the amount of funds that could be diverted to investing in South Africa and limited interest in South Africa. The South African economy was just emerging from a period of instability and the new government faced huge challenges in reducing poverty and improving the lives of a highly politicised citizenry. Therefore, despite the new South

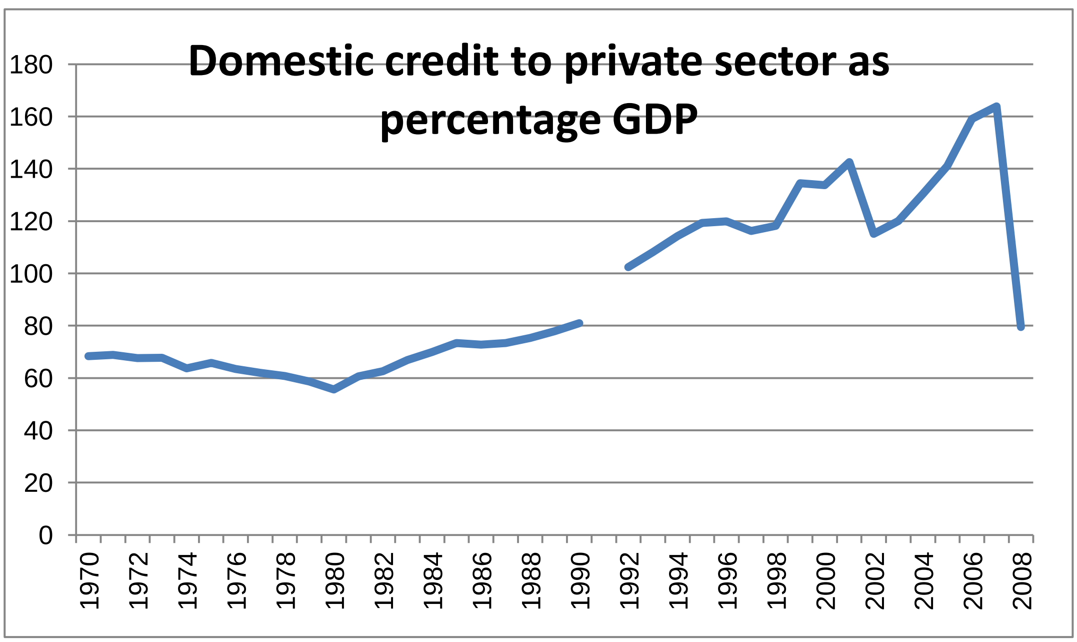
African government's overtures towards the Washington Consensus, foreign investors may have chosen relative restraint when making decisions to invest in South Africa. Despite this relative restraint the net capital flows were huge compared to previous inflows into South Africa. Further, the net portfolio flows were relatively volatile and were affected by changes in global liquidity and sentiment. The increases in portfolio flows during the 1990s and from 2003 to 2007 were related to growth in global liquidity and levels of debt leverage. The large drops and periods of negative portfolio flows were a result of contagion from and negative sentiment associated with crises elsewhere in the global economy. The decline in 1998 was due to the Asian financial crisis, the negative net flows in 2001 occurred at the time of the Dotcom crash and a period of negative sentiment towards South African financial assets in global financial markets, and the 2008 negative net flows were associated with the global financial crisis. Historically most portfolio investment inflows (liabilities) into South Africa went to the public sector. During the post-apartheid bulk of portfolio inflows went to the private sector.

It is interesting to note that there was an increase in net other flows from 2004 to 2008. These flows are negative for most of the period 1990 to 2003. In 2003 net other flows were close to -2% of GDP in 2004 it grew to 0.5% of GDP. By 2008 net other flows was 5.7% of GDP. The increase from 2004 is due to increased carry trade activity in South Africa where speculators were taking advantage of the high level of interest rates in the South African economy. The large level of net other flows in 2008 helped to offset the sharp drop in net portfolio flows to South Africa and may have helped shield the South African financial institutions from the effects of the global financial meltdown.

HOW THE SURGE IN CAPITAL INFLOWS WAS ABSORBED BY THE SOUTH AFRICAN ECONOMY

Palma's (2003) description of the different routes to financial crises highlights the importance of the manner in which surges in capital flows are absorbed by a country. It does make a difference whether surges in capital flows are used for productive purposes or feeds consumption and speculative acquisition. When capital inflows are used wastefully it weakens the economy because a country's liabilities are increased but there is no growth in productive assets. This type of behaviour is unsustainable and constrains a country's ability to raise foreign capital for productive purposes in the future.

Figure 4: Domestic credit to private sector (% of GDP)



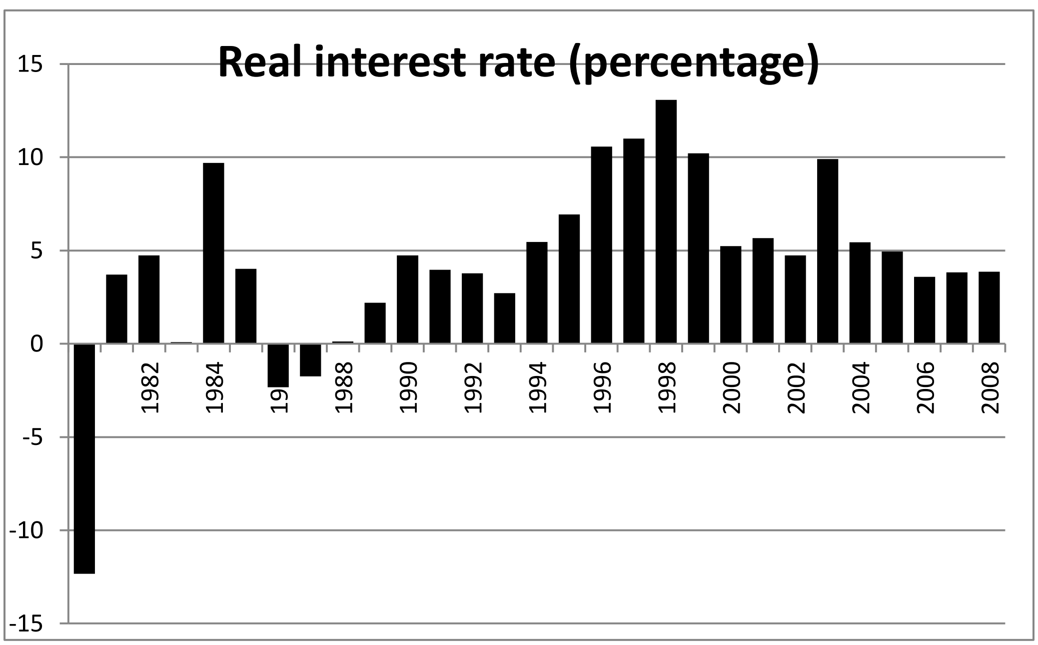
[Source: calculated using World Bank's World Development Indicator (WDI) data]

There was a rapid increase in domestic credit to the private sector associated with the rapid increase in portfolio capital inflows during the 1990s. Figure 4 shows domestic credit to the private sector as a percentage of GDP from 1980 to 2003. The lowest level of domestic credit to the private sector for the period 1970 to 2003 was 1980 at 56% of GDP (calculated from SARB data). By 1984 domestic credit to the private sector as a percentage of GDP recovered to 1970 levels of close to 70% and grew to 81% by 1990 (ibid.). Therefore, from 1980 to 1990 there was rapid growth of domestic credit to the private sector. As a percentage of GDP this growth was 25% of GDP.

Portfolio capital flows increased during the 1990s domestic credit and was associated with growth in the extension of credit to the private sector. Domestic credit to the private sector as a percentage of GDP grew 18% from 1990 to 1995. Between 1995 and 1998 there was no growth. Then in 1999 South Africa received a huge increase in portfolio inflows. The growth in portfolio capital inflows as a percentage of GDP grew from 7% of GDP to 10% of GDP. Domestic credit to the private sector as a percentage of GDP increased 18% in one year from 119% in 1998 to 137% in 1999. It then continued to grow through to 2001 to 147% of GDP, even though there was large decline in portfolio capital inflows at this time. Palma (2003) shows that before their crises, Mexico had domestic credit to private sector of about 50%; Chile’s was just less than 60%; and Korea’s less than 80%. Brazil chose not to expand credit to the private sector by attempting massive sterilisation. South Africa’s level of domestic credit private sector was high compared to countries that had financial crises. An important factor that reduced South Africa’s financial fragility was that it had a relatively low level of foreign denominated debt. By 2007 domestic credit to the private sector as a percentage of GDP had grown to 164%.

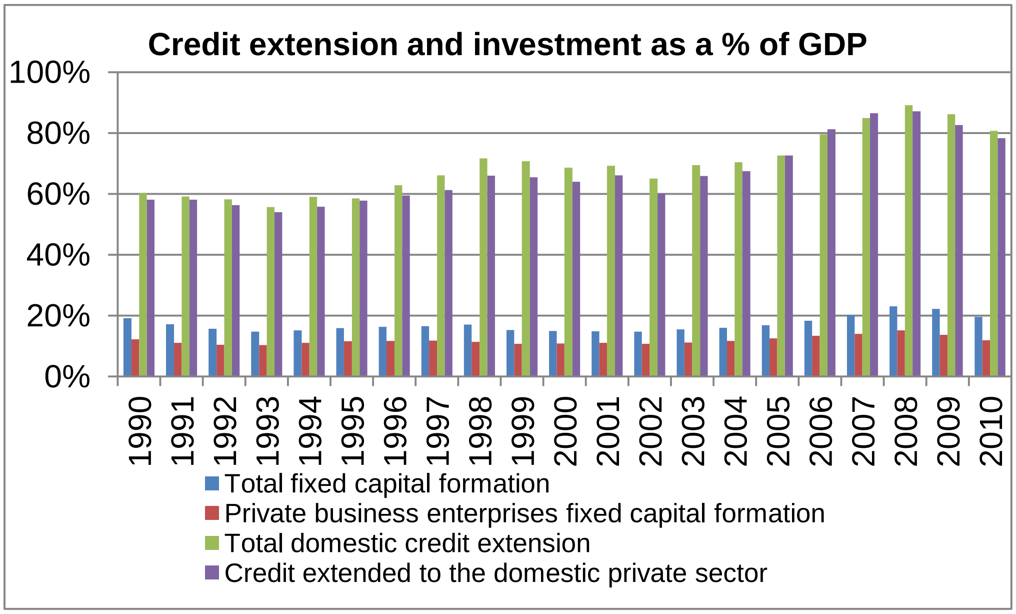
South Africa seemed to be a relatively safe emerging market after the financial crises in Asia in 1997 and managed to maintain relatively high levels of net capital flows until 1999. Figure 5 shows that the surge in net capital flows in 1997 was followed by a reduction in real lending rates from 1998 (except for 2003). There seemed to have been a process where increased net capital flows led to more liquidity and reduced the real cost of capital. As shown in Figure 4, there was an associated rapid increase in domestic credit available to the private sector. The question that remains to be answered is how the private sector in South Africa utilised the increased capital available to them.

Figure 5: Real interest rates



[Source: WDI]

Figure 6: Credit extension and investment (% GDP)

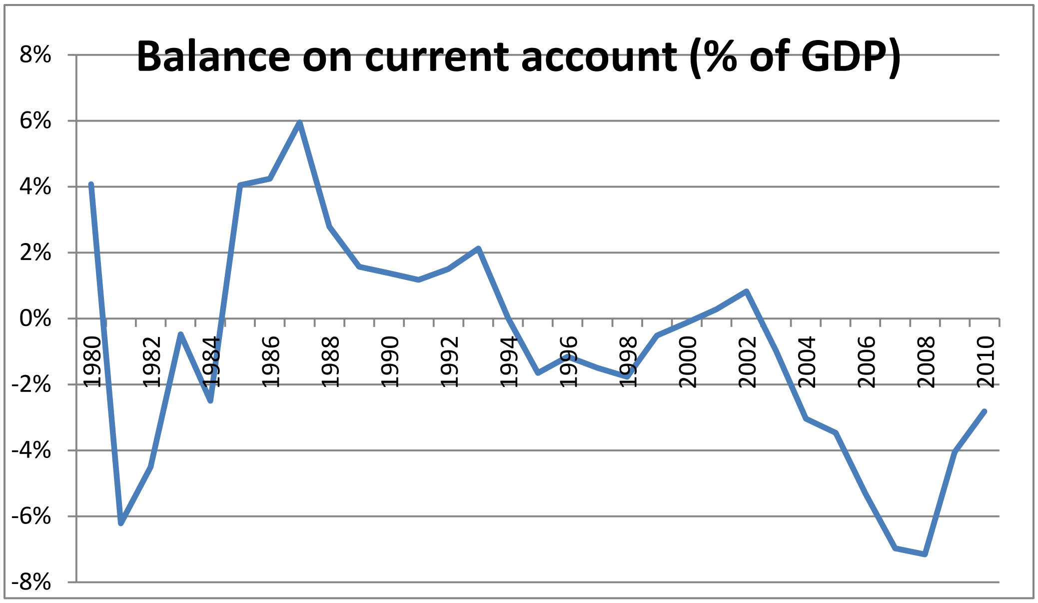


Source: Calculated from SARB data

Figure 6 shows that private fixed investment as a percentage of GDP was below 12% from 1994 to 2004. From 2005 private fixed investment increased by over 12% and by 2008 reached 15% of GDP and then declined back to below 12% of GDP in 2010. Therefore, gross private fixed investment did not increase significantly at a time when there was a large increase in domestic credit to the private sector. The increase from 2005 to 2008 will be discussed below.

On the whole, private GFCF was poor during the 1990s and the surge in net capital inflows that translated into more credit to the private sector did not lead to the private gross capital formation levels of the 1980s. Therefore, the surge in capital flows in South Africa was unlike those in East Asian countries but more like that of countries in Latin America. In countries like South Korea, Malaysia and Thailand the surge in inflows was associated with demand for capital to maintain high levels of investment during a period when their profits were falling rapidly.[11] In countries like Mexico, Argentina and Chile the surge in capital flows was as a result of external supply rather than domestic demand (Palma, 2003).

Figure 7: Balance on current account (% GDP)



[Source: SARB]

Figure 7 shows the balance on the current account as a percentage of GDP for the period 1980 to 2000. From 1981 to 1984 there was a trade deficit as a result of the growth in the gold price and the surge in short-term bank lending. From 1985 until 1993 there was a surplus on the current account. After the 1985 debt crisis, capital flows to South Africa dried up and it was necessary for the country to run a trade surplus because it did not have foreign exchange to finance a trade deficit. As portfolio flows into the country resumed from the early 1990s it became possible to run a deficit again. From 1995 there

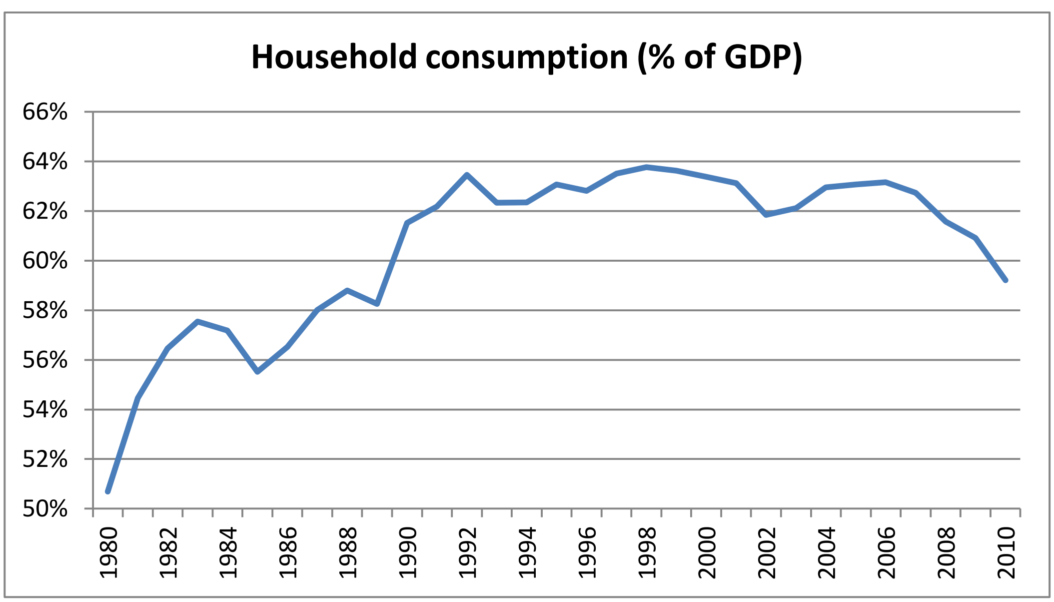
[11] This is not to say that the surge in net capital flows did not lead to exuberant behaviour in the East Asian countries. Malaysia and Thailand had such large surges that they had real estate and stock market bubbles related to the increase in availability of capital.

was a trade deficit until 1999. In 2000 when portfolio capital flows collapsed there was a trade deficit once again. From 2003, at the same time when portfolio flows returned, the trade deficit returned as well and grew very fast. By 2005 the trade deficit was 4% of GDP and declined even further to 7.2% of GDP by 2008. This rapid growth in the trade deficit was associated with growth in consumption and imports of consumer goods. Based on the import data it is possible to say that the increase in portfolio flows is associated with increased imports. Since investment levels did not increase at the same pace as import levels one deduces that there was increased imports of consumer goods. The rapid growth in imports from 2003 to 2008 will be discussed further below.

Figure 8 shows that there was a huge increase in final household consumption expenditure as a percentage of GDP throughout the 1980s that continued into the early-1990s – until 1992 (from 51% of GDP in 1980 to 63% of GDP in 1992). Real household final consumption expenditure (in 2000 prices) increased about 29% during that period, from about R344 bn in 1980 to R445 bn in 1992. By 1990, household expenditure had recovered to the 1970s level. The growth in consumption as a percentage of GDP remained at the 62% to 63% of GDP level from 1993 to 2007 and dropped to just below 60% of GDP in 2010. The effect of the debt driven consumption and tighter debt took its toll after 2008.

The growth in final household consumption expenditure during the 13 years 1993-2005 is 61% an average of 4.7% per annum. At the same time, the growth in real GDP per capita for the period is 17%, an average of 1.3% per annum. The savings to disposable income of households decreased from 4.5% in 1993 to 0.2% in 2005. Household debt as a percentage of disposable income was 58% in 1993 it increased to 61% in 1997 as portfolio inflows increased and dropped to 53% in 2000 when there was a collapse in portfolio flows. Household debt as a percentage of disposable income dropped to 50% by 2002, probably in response to the 4% increase in interest rates in that year. However, by 2003 when portfolio inflows returned it increased to 52%, then increased sharply to 56% in 2004 and even more to 62% in 2005. The change in portfolio flows is associated with changes in household consumption and savings patterns. The mechanism for explaining how increasing portfolio flows lead to increases in household spending and increasing debt is through the increase in credit to the private sector and downward pressure on real interest rates. As shown above, the real interest decreased from 1998 after the surge in capital flows during 1997 and again in 2000 after the surge in 1999. The real interest rate decreased from 14% in 1998 to 7% in 2000.

Figure 8: Household consumption (% GDP)



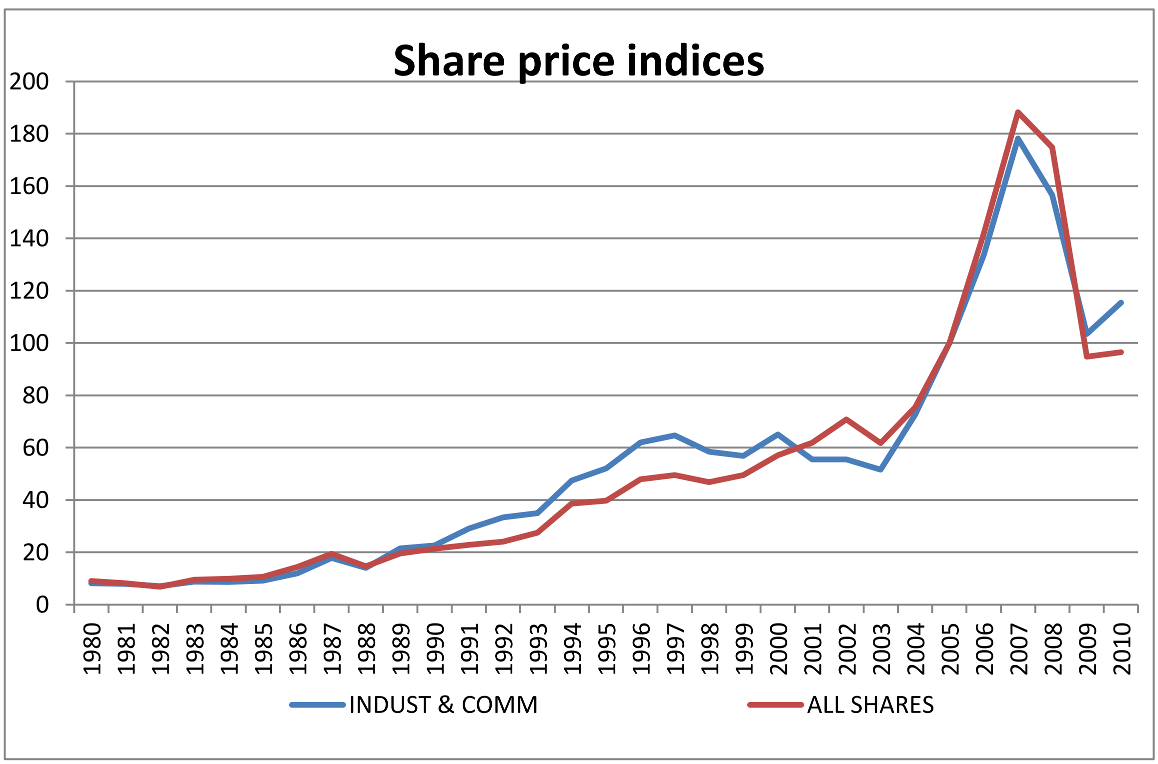
[Source: SARB]

The declining investment as a percentage in GDP from the early-1980s was an important reason that there was a strong increase in household consumption as a percentage of GDP.[12] It is important to notice that the growth in household consumption during the 1980s occurred when there was a big decline in imports. The high level of household consumption was maintained during the 1990s through to 2002 when imports increased significantly. Therefore, after 1994 high levels of consumption, of which a rapidly increasing component seems to have been imported goods, occurred at a time when there were large net flows of capital into South Africa. The large net capital flows allowed consumption to remain at a very high level at a time when a rapidly increasing proportion of consumption was imported goods. The increase in net capital flows may have helped maintain the high levels of consumption and consumption of imports by offsetting the declining real effective exchange rate of the rand and exerting downward pressure on real interest rates. Therefore, there was growth of consumption of imported goods associated with the increase in portfolio flows during the 1990s. From 2002 to 2005 there was rapid growth in consumption expenditure by households; there was a 1% of GDP increase in those two years. At the same time, there was a trade surplus of 0.6% of GDP in 2002 and a trade deficit of 4.2% in 2005 (and 6.5% in 2nd quarter 2006). The increased consumption was associated with an even larger increase in the trade deficit. A trade deficit that relied on continued inflows of potentially uncertain portfolio capital inflows.

[12] National income (GDP) is composed of household consumption, investment, government spending and net exports).

The increase in portfolio flows of the 1990s and the associated increased credit to the private sector and decreases in real interest rates led to a housing price bubble in South Africa during the period 2002 to 2005. The currency crisis of 2001 led to a 35% depreciation in the rand to dollar exchange. The rand price of imports increased and inflation increased, as a result the real interest rate continued to decline from 6.8% in 2000 to 5.5% in 2001 and 5.2% in 2002. After the 4% increase in the repo rate in 2002 the real interest increased to 8.5% in 2003. House prices increased by an average of nearly 40% from 2002 to 2005 as homeowners saw sharp declines in nominal interest rates. As in the US, the collapse of the dotcom bubble drove capital into the housing market in South Africa, which contributed to the rapid escalation in house prices.

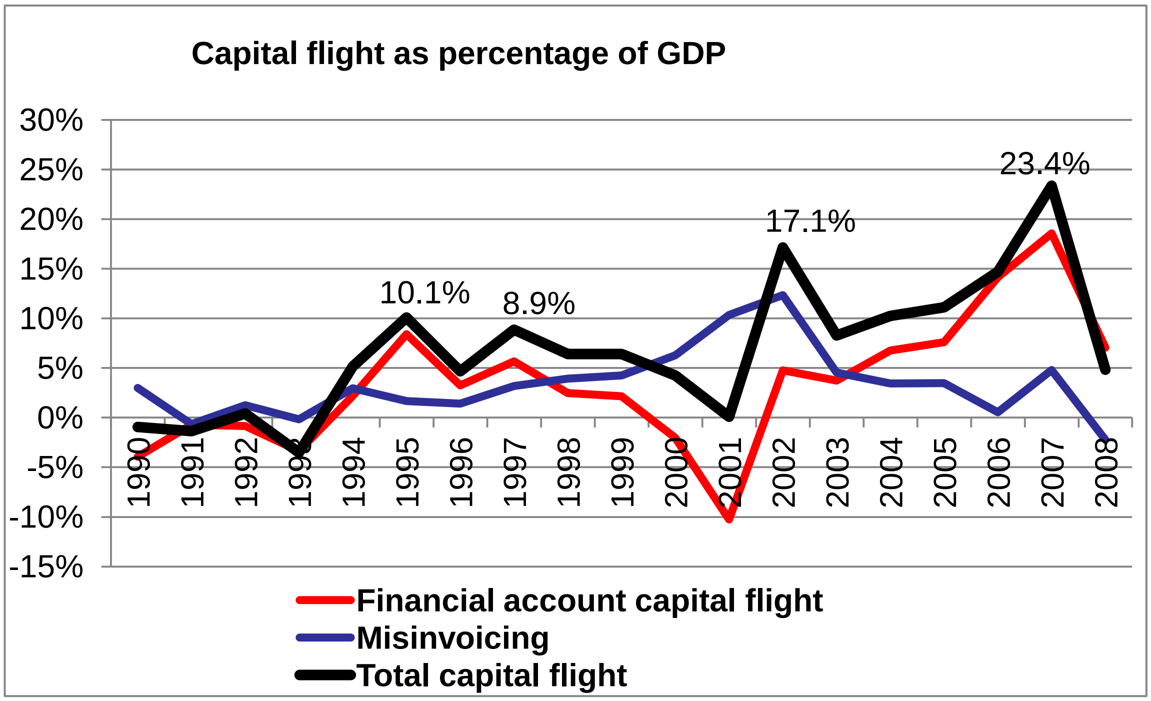
Figure 9: Share price indices (1995 = 100)



[Source: IMF's IFS]

Figure 9 shows the index of all shares and the industrial and commercial share prices on the Johannesburg Stock Exchange. There was fast growth in prices throughout 1990s. There was very slow growth during the early-1980s with a relatively sharp drop in prices in 1986 and a slow recovery until 1990. The sharp growth in share prices during the 1990s, probably fuelled by the international exuberance for information technology stocks, coincides with the surge in net capital flows from 1994. The price index increases from 66.5 to 120 from 1993 to 1997. After 1997 the index remains over 100 until 2001 despite the instability in international financial markets. From 2004 to 2007 the all shares index grows from 62 to 188 showing acceleration in speculative activities in South Africa. There was exuberant growth based on easy access to credit in the private sector. Estimates of capital flight from South Africa for the period 1986 to 2000 are presented in Figure 10 (Mohamed et al, 2010) These preliminary estimates indicate that capital flight from South Africa increased a lot after the democratic elections in 1994. After 1994 there is a very strong similarity in the trends of both capital flows and capital flight. Ndikumana and Boyce’s (2002) investigation of capital flight from certain countries in Southern Africa (excluding South Africa) shows that there is a significant positive relationship between increase of debt into Southern African countries and capital flight. The similar time trends in net capital flows and capital flight indicates that this may be the case in South Africa as well. During a period when there was a surge in net capital flows that increased the availability of credit to the private sector there was also a significant increase in capital flight. The increased access to credit by the private sector as a result of increased flows of capital into South Africa seems to be associated with increases in capital flight.

Figure 10: Capital flight as percentage GDP



Source: Mohamed et al (2010)

Examination of how the surge in net capital flows was absorbed by the South African economy shows that contrary to mainstream thinking more access to capital may actually weaken the South African economy. This sad situation arises because the surges have not contributed to investment in productive capacity that will lead to future growth in the economy. Instead, the net surges have reinforced existing exuberant trends by providing easier access to credit for pushing up the share price index and increasing consumption and imports. There has also been substantial capital flight since 1994 that may have been fueled by increased capital flows during the same period. In addition, along with the sharp increase in imports, the increased level of net capital flows has led to a need to increase foreign exchange reserves. Reserves are necessary but they are idle assets and there is an opportunity cost to the economy when maintaining relatively high levels of reserves. Therefore, the surge in capital flows was associated with activities that may have increased the liabilities in the South African economy without accompanying investment that could have lead to growth in assets and the future productive base.

South Africa's economic growth path and capital flows

The implications of relatively uncontrolled movements of capital into and out of the South African economy have had a huge impact on the nature of economic growth. These financial flows have played a significant role in reshaping the South African economic growth path since the onset of the transition to democracy during the early 1990s. South Africa had achieved its democracy and change in Government at a time of important changes in the global economy where the liberalisation of trade and financial markets were leading to rapid and increasing integration of these markets globally.

The apartheid Government had begun liberalising finance and trade during the 1980s but their efforts were hampered by internal struggles, international isolation, including economic sanctions and divestment, and the repercussions of the international debt crisis of the 1980s and a South African debt crisis in 1985. The new democratic Government chose to continue the economic liberalisation and integration with global trade and financial markets of their apartheid predecessors. Unlike their apartheid predecessors who were pursuing exploitative and oppressive racist policies, the post-apartheid

Government said that they were introducing these policies to address the inequality, poverty and unemployment legacy of apartheid. In doing so this new Government ignored many of the lessons of countries, such as Japan, South Korea and other Asian tigers, that achieved rapid state-led economic development that reduced unemployment, poverty and inequality through industrial development. Instead, the new South African Government followed Washington Consensus-type policies, which they believed would send a signal to global financial that they were following credible economic policies in the hope of attracting foreign investment.

Fine and Rustomjee (1996) argue that the South African economy developed around a minerals and energy complex (MEC). The institutions and infrastructure that existed in the country favoured the mining and minerals sectors and economic sectors with close linkages to these sectors. For example, there are strong linkages between the coal and electricity generation and the oil from coal and chemicals industries. In addition, there has historically been a strong relationship between mining and finance in South Africa. The apartheid state and business developed a close relationship with the state playing the role of investor, operator of state owned enterprises and business partner to the private sector while also providing financial and risk mitigation services to business. The MEC is, therefore, more than just mining and minerals processing sectors but described by Fine and Rustomjee as a system of accumulation, The institutions, infrastructure and spatial development of the country, including the economy, were very much shaped by the interaction of the racist policies of the apartheid regime and the interaction of these policies with the MEC system of accumulation until the democratic transition during the1990s.

The liberalised financial markets and the financialisation of South African corporations have affected and played a significant role in reshaping the economic growth path since the 1990s.[13] The changes due to policy decisions to allow relatively free movements of capital into and out of South Africa have transformed the economy, which Fine and Rustomjee (ibid.) described as centered on an MEC during the 1990s.

Most of the surges in foreign capital inflows were short-term and, therefore, most of the increased liquidity in the South African economy was directed to short-term use, such as consumption and speculation. The role and structure of the South African financial institutions, which were modeled on the British market-based system rather than the German-style bank-based system, meant that the increased capital inflows were directed towards short-term unproductive activities. The route 1 type of absorption of capital (to use Palma's classification) into the South African economy since the mid-1990s meant that the large increased flows of hot money into the economy favoured the growth of services sectors linked to increased debt driven consumption and financial and real estate speculation and led to decline in manufacturing sectors and productive services.

In Mohamed (2010), I argue that the large corporations that dominated the South African economy were affected by financialisation of the South African economy and the restructuring of global corporate structure as a result of global financialisation. These

[13] I discuss the impact of financialisation on South African corporations in Mohamed (2010).

changes occurred during the 1990s at a time of political transition from apartheid to democracy in South Africa. The large corporations had worked closely with the apartheid Government and many had been included in the apartheid security apparatus.[14] They had tried to maintain apartheid or reform it but were opposed to a sudden transition to democracy where the black majority elected the new Government.

One response of big business to the change in political power was to move their assets abroad. There was growth in capital flight after the 1994 democratic elections.[15] Another response was that a number of the largest, most important corporations moved their primary listings abroad and embarked on a process of restructuring. Another major response to the political change by the large corporations was to include parts of the black political elite in their businesses or to sell unbundled parts of their restructured businesses to black owned holding companies.

The restructuring of the largest corporations was also much influenced by the global corporate restructuring. This restructuring was motivated by efforts to control larger shares of global markets and global value chains. Nolan (2003) explains that the shareholder value movement played an important role in this global corporate restructuring. Millberg (2008) says that financial institutions were still able to benefit from the activities of large US corporations, even though they had relocated and

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[14] See Terreblanche (2002) for the alliance of big business with the apartheid state during the 1980s when the struggle against apartheid intensified on all fronts – the international anti-apartheid movement, internal struggles by community organisations, student organisations and trade unions, increased activities by the African National Congress's armed wing and struggles on the South African border with Mozambique and Angola.

[15] My coauthor and I calculated, in Mohamed and Finnoff (2005), that capital flight (illicit movements of money out of the country) from 1994 to 2000 was higher than the period of intensified political struggle from 1980 to 1993.

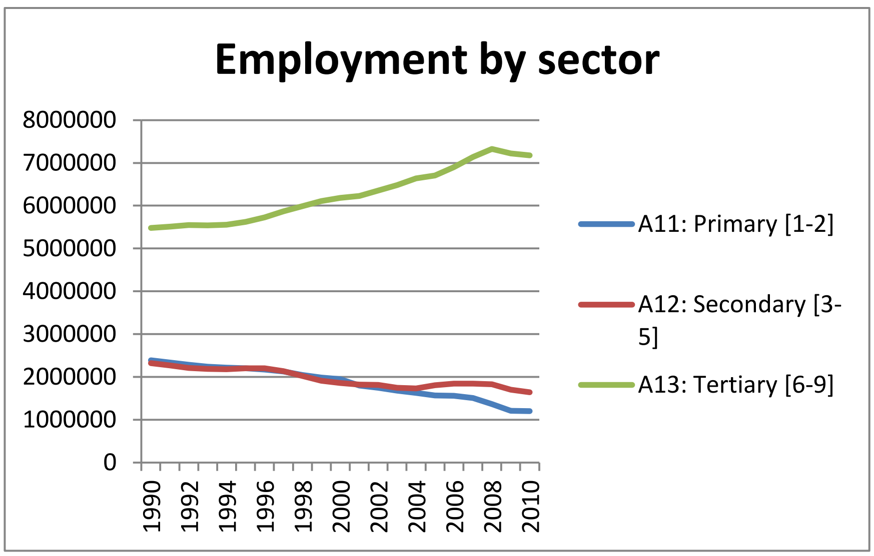
outsourced large parts of their production to other countries. Milberg argues that through increased control over global production value chains these US corporations were able to profit from cheaper raw materials and labour costs in other countries. The institutional investors that owned the bulk of shares in these corporations benefited from their control of the global value chains. At the time when they were intent on moving their assets away from the control of the new, democratic Government of South Africa, the large corporations were also involved in the process of global corporate restructuring attempting to secure a share of global markets that were becoming increasingly concentrated.

One important aspect of the shareholder value movement influenced, global corporate restructuring was an effort to focus on core business. Many of the large diversified conglomerates that dominated the South African economy became focused on core business activities and growing these businesses globally. They unbundled unrelated South African businesses, which were left without the managerial and financial support of their large corporate parents. Sectors of agriculture, mining and manufacturing were particularly negatively affected by this corporate restructuring and internationalisation of large South African corporations.

As mentioned above, the sectors of the economy that thrived as a result of the surges in short-term capital flows from the mid-1990s were those that serviced debt-driven consumption and speculation in real estate and financial assets. The bulk of the growth was in services but there were sectors such as construction and a few subsectors of manufacturing, including heavy transport equipment and furniture that benefited as well.

I show the changes in employment and capital stock related to these shifts in the South African economy related to this developing new economic growth path.[16] Figure 11 shows employment by sector. Employment in the primary sector almost halved between 1990 and 2010 and there was a large decline in employment in the secondary sector as well. Employment in the tertiary sector grew substantially during this period.

Figure 11: Employment by sector



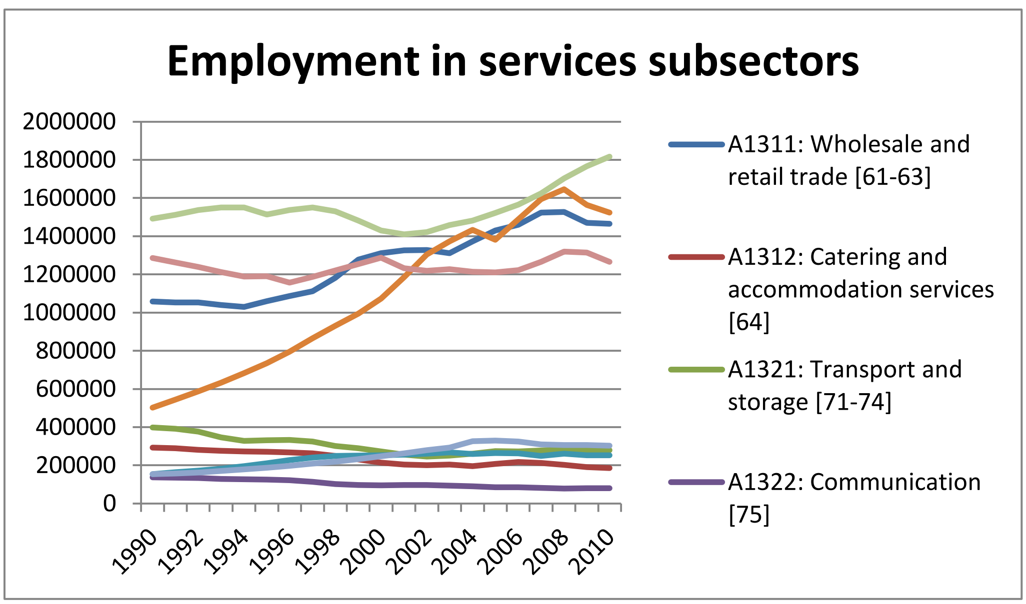
Source: Quantec

An argument that has become popular in the South African media and popular discourse is that there is a shift out of primary and manufacturing activities towards increased

[16] Changes in technology and increasing mechanisation of certain economic sectors would have played a role in some of these changes as well.

services in countries that grow affluent and develop. They argue that South Africa is a middle income country with a relatively large middle class and that their demand for information and telecommunications services, health services, and education services would grow. They explain the growth in services to GDP and employment in services as related to this economic shift in South Africa. However, the growth in value added and employment can be shown to be related to speculation in financial markets and debt-driven consumption due to increasing extension of credit to the private sector which was associated with increased levels of short-term foreign capital inflows during since the early-1990s.

Figure 12: Employment in subsectors of services



Source: Quantec

Figure 12 shows that during 1990 to 2008 there was significant employment growth in only 2 services sectors, wholesale and retail services and business services. In addition the employment in the broad category government and personal services has grown significantly since 1994. The growth in wholesale and retail services is associated with growth in household consumption and indebtedness. The growth in business services employment is largely a result of growing outsourcing of cleaning and other activities. These are jobs that have been classified as manufacturing and mining jobs in the past but are now services jobs. The increase in these unskilled and low-skilled services jobs is related to increased growth in labour broking and informalisation. Workers that had previously been permanent employees with benefits and union protection have become casualised and informalised and many have lost union membership. The growth in private security services is another large component of the growth in employment in business services. The other services sector where there has been some employment growth is transport and storage services, which may have grown as a result in growth in wholesale and retail services. Growth in employment in other services sectors, including financial services have been low and negative.

Figure 13: Employment in subsectors of manufacturing

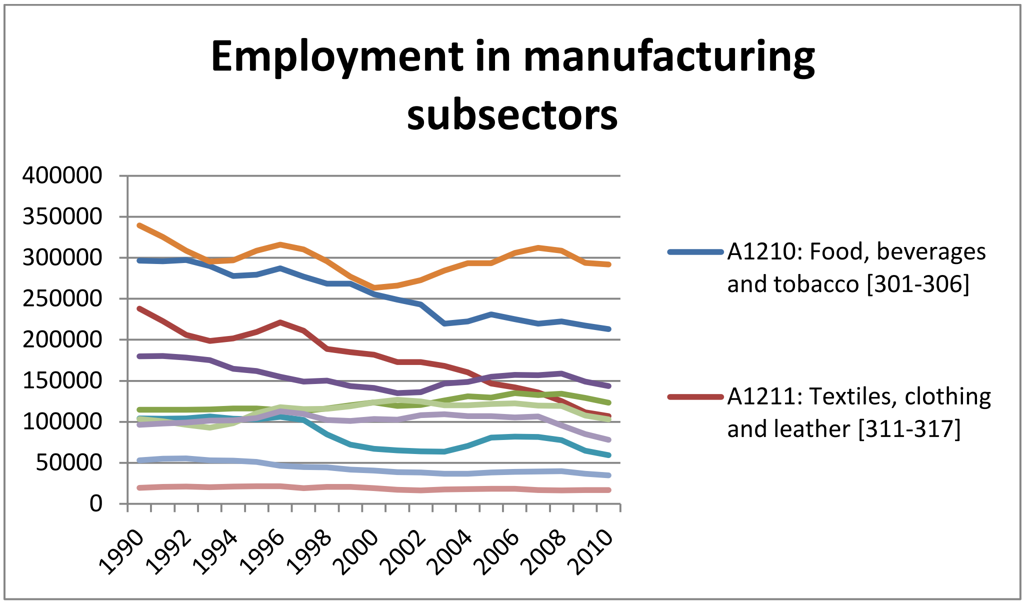


Figure 13 shows that there is no significant employment creation in manufacturing but job losses in almost all manufacturing sectors. When we consider investment and growth in capital stock we find that most investment and capital stock creation was in the services sectors and that capital stock growth was very low and more likely to be negative in manufacturing sectors (see figures 14 and 15 below). A comparison of capital stock changes from 2000 to 2006 (using Quantec data) showed that capital stock declined in 17 and grew in 11 manufacturing sectors. The sectors where capital stock grew were more likely to be sectors where there were strong economic linkages with the mining and minerals industries. The sectors experiencing loss in capital stock we often sectors with weak linkages to mining and minerals processing and were often sectors that were more labour intensive. The current South African growth path is one that favours services sectors linked to debt driven consumption and increased financial speculation. It is also one where there is declining investment in manufacturing and increased dependence on sectors linked to the MEC.

Figure 14: Capital stock in mining and quarrying, manufacturing and services (real 2005 Rmillions)

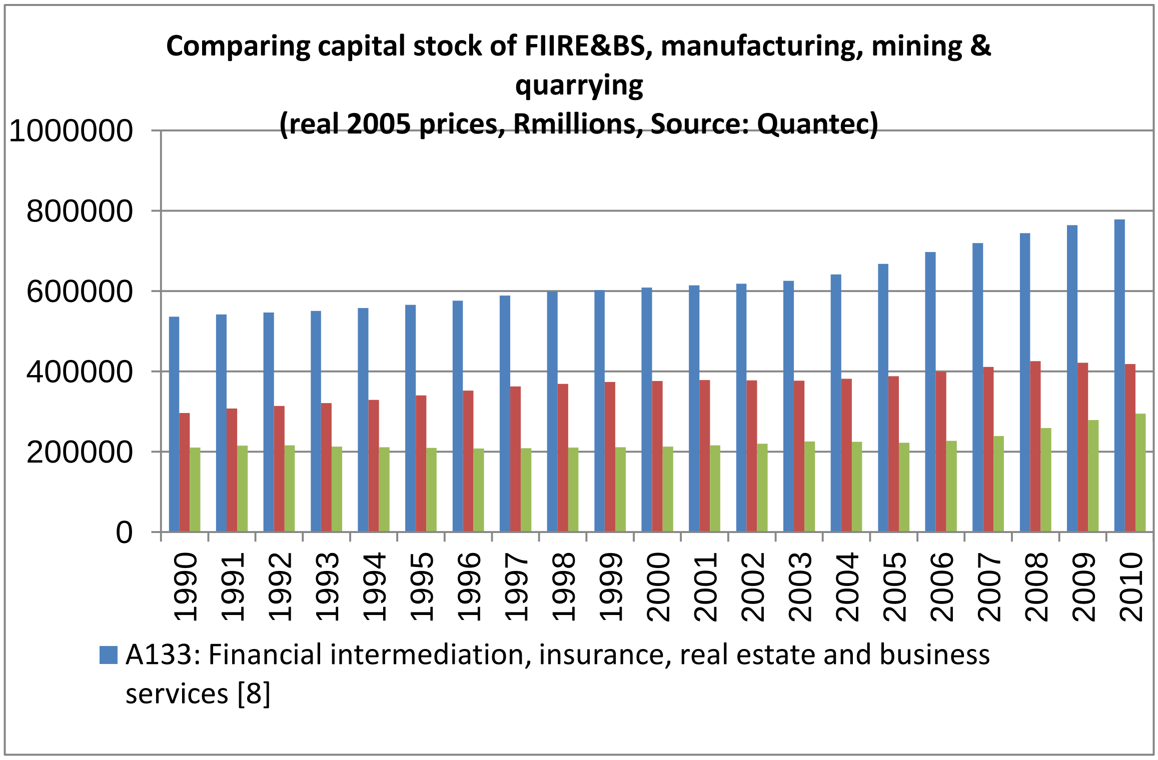
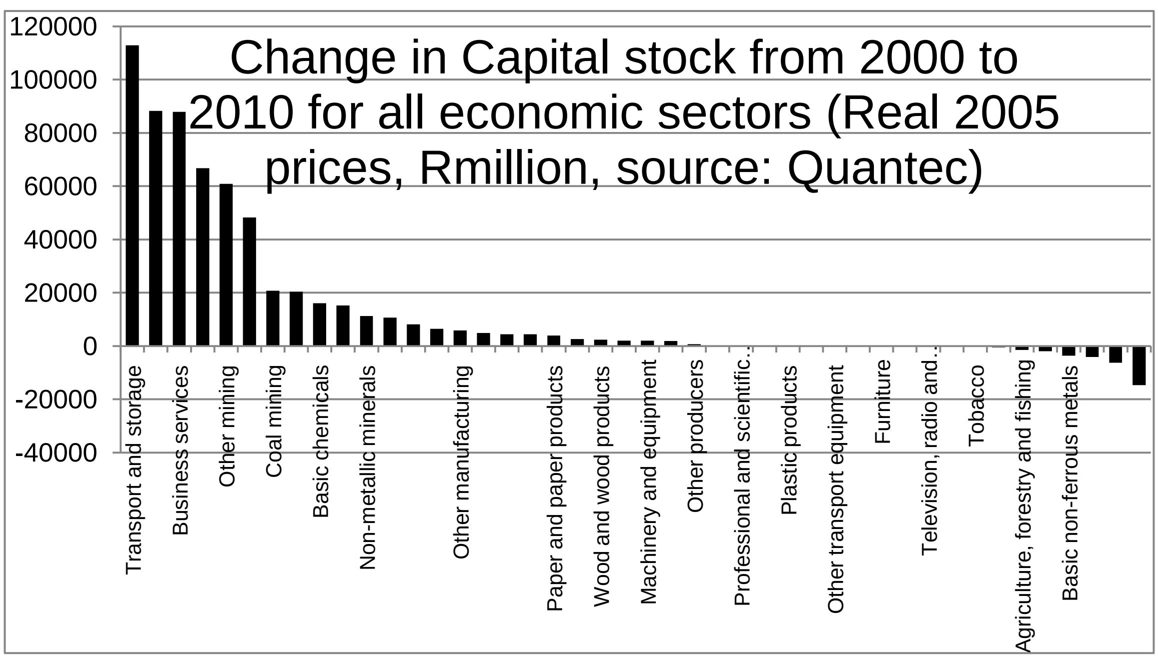


Figure 15: Change in capital stock of all subsectors - 2000-2010



CONCLUSION

The manner in which the significant increases in foreign capital flows were absorbed by the South African economy since 1994 should have raised alarm bells for South African policymakers. There were significant costs to the economy in terms of economic growth, investment and employment when increases in liquidity were channeled towards increasing consumption, imports, share prices and capital flight.

The lessons of surges in capital flows, capital absorption and financial crises in other developing countries were not heeded or possibly were not understood by the Government and the Reserve Bank. The short-term cost of the 2001 currency crisis was an important signal that South Africa should have considered more effective capital management techniques and have looked beyond orthodox solutions to financial market instability. Unfortunately, even after the global financial crisis the South African Government and Reserve Bank continue to favour open capital markets. They seem relatively unmoved by the fallout from the global financial crisis on the South African economy: Statistics South Africa’s data shows that the economy lost over one million jobs from 2008 to 2010, there was a recession during 2009 and reports from the national credit regulator showed that home foreclosures and car repossessions increased.

The longer-term impact of the increased liberalisation of financial markets and uncontrolled flows of volatile foreign capital was not only increasing macroeconomic and financial instability and fragility that created instability and uncertainty for long-term investments and employment creation in productive sectors of manufacturing and services. The longer-term impact was also that the economic growth path shifted towards allocating capital, infrastructure and skills towards speculation, consumption and unproductive services and led to deindustrialisation. The experience since 1994 has been that capital stock and employment growth have occurred in services sectors that benefited from debt driven consumption and speculation in real estate and financial markets but that capital stock and employment in manufacturing has declined.

The South African economy entered the democratic era with a legacy of inequality, high unemployment and an industrial structure that was relatively undiversified and focused on mining and minerals. The economic policy choices and behaviour of industry has not helped to address that legacy but instead seemed to have exacerbated the economic problems of the country. The economic growth path influenced by uncontrolled foreign capital flows, misallocation of capital and financialisation and internationalisation of the large South African corporations may steer the economy in the direction of more dependence on volatile, short-term capital inflows, more dependence on mining and minerals sectors, further deindustrialisation and job losses in manufacturing and productive services, increasing precarious work and growing poverty and inequality. Not all these problems can be solved by regulating and managing the movement of capital into and out of South Africa, but based on the evidence presented in this paper we believe that these policy changes would be an important part of an economic policy package to support economic and industrial development in South Africa that addresses the legacy of apartheid and the challenges of financialisation.

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