

The impact of international capital flows on the South Africa economy since the end of apartheid

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Abstract

The paper critiques the post-apartheid government's adoption of neo-liberal-style financial liberalization. The paper shows that the surge in net capital inflows from the early-1990s was not associated with increased investment, and therefore employment. Instead, it was associated with increased speculation in equities, higher levels of consumption, more imports of consumer goods, and increased capital flight.

The end of apartheid and the relatively peaceful transition to democracy, combined with the introduction of slow-paced neo-liberal-style financial market liberalization from 1995, led to large increases in net short-term capital inflows into South Africa. The paper examines the effects of increased domestic liquidity as a result of accelerated net capital inflows since the end of apartheid. The paper argues that the surge in inflows is cause for concern because of the potential for instability it produces in the economy. 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.

The paper also argues that the surge in capital flows during the 1990s culminated in a currency crisis in 2001 as a result of a reversal of the surge in net capital flows from 2000. Therefore, the lack of adequate capital management techniques increases the volatility of the economy and the fragility of financial markets.

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1 INTRODUCTION

This paper will consider international capital flows into and out of South Africa during the post-apartheid era.¹ It will examine the types of flows that have been entering the country and how they are absorbed into the economy. In addition, it will consider the effects of these capital flows on the economy taking into account the broad range of literature that link financial crises to volatile surges in capital flows.

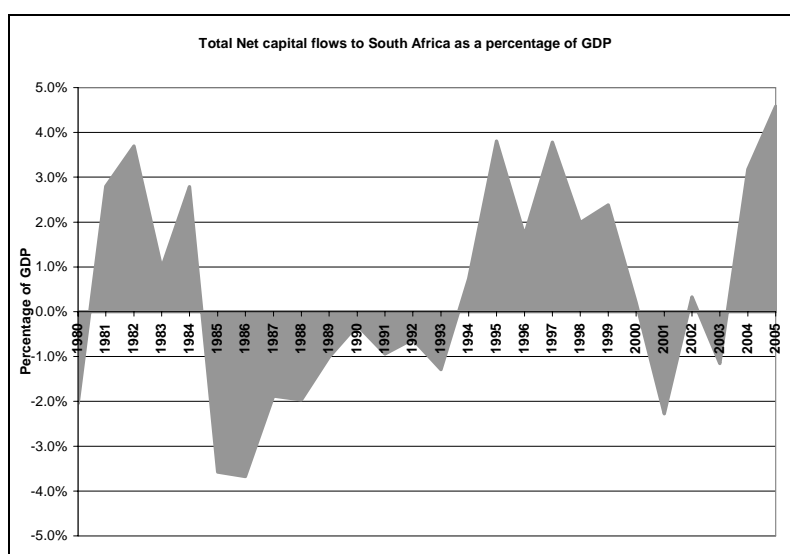
The post-apartheid government has a policy of “gradual” liberalization of exchange controls. They have significantly eased the ability of South African residents to withdraw capital from the economy. Nonresidents are allowed virtually free movement of capital into and out of the economy. Current policies 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 differentiate much between long-term foreign direct investments and short-term capital flows. Instead senior government officials have argued that liberalization of financial markets will lead to deepening of financial markets. Even if this policy leads to more inflows of capital, will it lead to more and better investment and employment creation?

This paper will provide an assessment of the impact of capital flows on the South African economy over the past few decades. This paper contributes to international financial literature in South Africa because it is the first 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.

The end of apartheid and the relatively peaceful transition to democracy, combined with the introduction of slow-paced financial market liberalization in 1995, led to large increases in the amount of capital inflows into South Africa. Figure 1 shows net capital flows from 1980 to 2005. 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.

¹ This paper considers recorded capital flows as reported by the South African Reserve Bank. The period examined is from 1990 to 2005. The period includes 1990-3, which is still during the apartheid era but negotiation between the apartheid government and the liberation movement over a new constitution had begun. Economic isolation of South Africa eased from 1990 probably in anticipation of the democratic change. Capital flows to South Africa also started increasing during the early 1990s.

Figure 1



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

This 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.² 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 these 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 and more access to capital will improve if they show investors that they are committed to maintaining orthodox macroeconomic fundamentals and other elements of the Washington Consensus. They do not seem overly concerned with the disruptive effects that capital flows can have on a country’s financial system and economy as a whole despite numerous financial crises in developing countries since the mid-1990s and the South African currency crisis in 2001. This indicates that they may be more convinced by the explanations of financial crises offered by neoliberal or orthodox economists than those offered by heterodox economists.

Most of the capital flows entering South Africa have been short-term portfolio flows. The bulk of these flows have been absorbed by the private sector. There has been an accompanying surge in private sector access to credit. The private sector has not utilized their

² Mexico, South Korea, Thailand, Indonesia, the Philippines, Malaysia, Russia, Brazil, Turkey, Argentina and Uruguay have been plagued by financial crises since the mid-1990s.

improved access to credit for productive investment and employment creation. 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 economy. Therefore, the surge in capital inflows was not associated with economic activity that would lead to long-term growth and more jobs in the economy. Instead, one may associate the surge in net capital flows with maintaining exuberance that leads to higher share price indices, more imports, growth in private consumption and high levels of capital flight. All of these factors have the potential to weaken the economy over time. The 2001 South African rand currency crisis provides a good example of how the factors associated with surges in short-term flows have the potential to weaken the economy.

Foreign exchange reserves before the 2001 currency crisis increased in response to more imports, rising levels of short-term debt and probably precautions due to the 1997 Asian financial crises. However, the investment in growing reserves was not enough to deter a currency crisis at the end of 2001. Net portfolio flows as a percentage of GDP declined temporarily after the Asian financial crisis and reached a record high (6.5% of GDP in 1999) before turning negative in 2000 and crashing to a record low (-6.6% of GDP) in 2001. Despite the recent previous growth of reserves relative to short-term debt, the sharp reversal in portfolio flows in 2000 led investors and currency speculators to realize that a drop in the value of the rand was imminent. This led to flight from rand-based assets that in turn led to panic and more flight. By the end of 2001 portfolio inflows crashed and the rand to US dollar exchange rate dropped by 35%. Depreciation of the rand relative to the major currencies contributed to a rise in inflation. The South African Reserve Bank increased interest rates by 4% in 2002 in an attempt to meet inflation targets, further hurting an already bruised economy.

The lesson of the surge in net capital flows from the early 1990s and the 2001 currency crisis is that uncontrolled capital flows have been very disruptive for the South African economy. A second lesson is that the surge in net capital flows was not absorbed into productive activities but reinforced negative trends present in the South African economy, such as growing imports and consumption, rising share price indices and capital flight. The policy lesson is that there should be adoption of effective capital management techniques that include not only prudential regulations but early warning system and different types of temporary and permanent capital controls (see Grabel, 2001 and Epstein, Grabel and Jomo, 2003).

The next section of this paper provides a literature review that investigates recent debates between orthodox and heterodox economists on the causes and cures for financial instability and crises. The South African literature on capital flows and currency or financial crises was found to be thin and reference is made to a few papers that provide insights into capital flows in South Africa. The third section examines the surge in net capital flows and provides a global context and conceptual framework for examining these flows. The fourth section examines how the surges in net capital flows were absorbed by the South African economy. This section focuses on the private sector because this sector received most of the growth in inflows. The conclusion is the final section of the paper.

2 REVIEW OF 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. According to Bruce-Brand (2002)³ the post-apartheid government from 1994 initiated plans for financial reintegration of SA into global economy. A relatively cautious approach to the liberalization of international financial flows was announced but clear signals were sent global financial markets that the new government's intention was to liberalize. The government has steadily relaxed controls and enforcement of controls, especially after the adoption of its Growth Employment and Redistribution (GEAR) economic programme in 1996⁴. 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.

A few publications provide interesting insights that support arguments that the South African economy has become more volatile since the process of capital control liberalization 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 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.

³ Head of the exchange control department at the SARB.

⁴ Much of the macroeconomic aspects of the GEAR seem heavily inspired by the Washington Consensus.

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 finding 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 much South African literature calling for capital controls.

Neo-liberal advocates of financial liberalization make the claims that liberalization 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, i.e., 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 globalization 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).

Despite this recognition of increased volatility and the danger of financial crises associated with financial liberalization 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”.⁵

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 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.⁶ 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).

⁵ Eichengreen (2002) provides a 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.

⁶ For a heterodox perspective on financial crises see for example, Chang, 1998; Crotty and Dymksi, 1998; Crotty and Epstein, 1999; Grabel 1999 and 2003; Palma, 1998 and 2003; Taylor, 1998; and Wade, 1998.

Grabel (2001, 2003) provides a useful outline of the risks that countries face due to “neoliberal financial integration”. She categorizes the following types of risk:

- Currency risk: this risk is present whenever a currency is fully convertible.
- Flight risk: this risk is related to the herding behaviour of investors. Countries are vulnerable because those holding their liquid financial assets could sell them off en-masse. Flight can lead to herd behaviour that then turns into a self-fulfilling prophecy causing the value of assets to decline.
- Fragility risks: this is when there is a danger that the public and private financial borrowers will be unable to meet current obligations. This may be because of maturity (financing long-term obligations with short-term debt) or locational (financing debt in a foreign currency potentially causing problems when there is devaluation in domestic currency) mismatch.
- Contagion risks: risk due to instability emanating in another country or region when a country is relatively open. The extent of the danger of contagion depends on how susceptible a country is to currency flight and fragility risks.

Grabel adds that vulnerability to the above risks means that a country also suffers from risks to their sovereignty. Sovereignty risk is the risk that a country facing a financial crisis will be unable to pursue independent actions and may have to agree to certain conditions to receive help from the IMF or World Bank.

Blecker (1999, p.90) lists some solutions heterodox economists propose to deal with short-term capital flows (i.e. “cooling down hot money”):

- Measures that will slow down short-term international capital using taxes on foreign exchange transactions, e.g. the Tobin Tax;
- Capital and exchange controls in developing countries;
- Regulation of capital flows in industrialized countries such as prudential regulations on capital outflows and restrictions on short-term inflows to discourage the inflow of capital from developing countries when there is panic or contagion.

A critique of neoliberalism is inherent in the policy options offered by heterodox economists. The predominant role of financial capital within the global economy is cause for concern to many heterodox economists. For example, within post-Keynesian literature the idea that the relative size of the financial sector to the size of the rest of the economy is an indicator of the instability of the economy is generally accepted and the role of financial speculation is seen as negative for an economy (Singh, 1999), Shiller, 2000). The conclusion of Keynes in The General Theory (1937), and many of his followers, is that the state should play an important role in directing capital expenditure through controlling much of investment in a country

either through directly investing itself or influencing where the private sector invests. In this way, aggregate demand can be kept at a level that maintains full employment and the instability inherent in capitalist economies, which is enhanced by the growth of the financial sector, can be tamed (Block, 1978, Helleiner, 1994).

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

3 SOUTH AFRICA RECEIVES A SURGE IN NET CAPITAL INFLOWS

Capital flows started improving 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 and 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 4.6% in 2005.

3.1 Three Routes to Financial Crises

Palma (2002) describes three routes to financial crisis 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 liberalization. Palma (2002) provides a framework for thinking about how large capital inflows 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 of imported consumer goods that resulted in a huge deterioration of the current account. Foreign lenders soon realized 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 withdrawal of finance causing a major financial crisis.

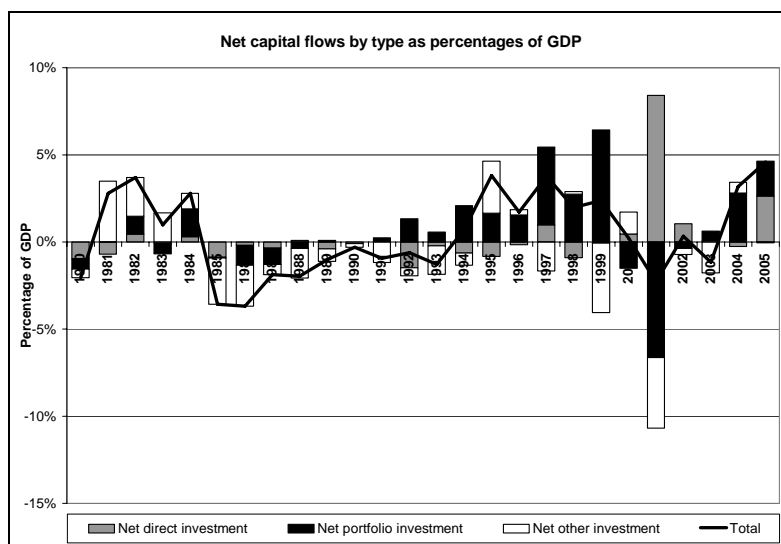
Palma concludes with the insight “So, the moral of the story of the ‘three routes’ is that no matter how LDCs facing sudden and massive surges in capital inflows have handled their absorption, they have ended up in major financial crises” (p.32).

3.2 *The Nature of Capital Flows into South Africa*

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.⁷ 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 privatization) in Latin American countries during the 1990s as a result of growth in international liquidity. South Africa also experienced a surge in portfolio flows and some increases in direct flows (some of it also related to privatization).

Figure 2

⁷ 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.



Source: SARB

From 1986 to 1993 net capital flows as a percentage of GDP were negative and only showed signs of recovery when South Africa had democratic elections in 1994. There was 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 was a significant drop in net portfolio flows, net direct investment was a more significant portion of total capital inflows. In 2001 net direct investment was large⁸ and net portfolio and net other capital flows were relatively small. The instability in net capital flows during the 1990s was related to the movements of short-term, portfolio flows. This movement was closely related to changes in sentiment towards developing countries in global financial markets, contagion from financial crises in other parts of the world and economic slowdown in developed economies. As is illustrated in Kindleberger's (1978) 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 liberalization of financial markets was well under way. The apartheid government was also influenced by the drive towards neoliberal integration and had attempted financial liberalization, 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

⁸ 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.

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 liberalization starting with the abolition of the dual exchange rate system.

The end of apartheid coincided with a period of high 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 (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 increases in international liquidity occur at times of slow growth in OECD countries. After the democratic elections South Africa became an attractive 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 (usually in line with 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 liberalization. The government’s problematic assertion that their Growth Employment and Redistribution (GEAR) economic programme adopted in 1996 was nonnegotiable was 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%

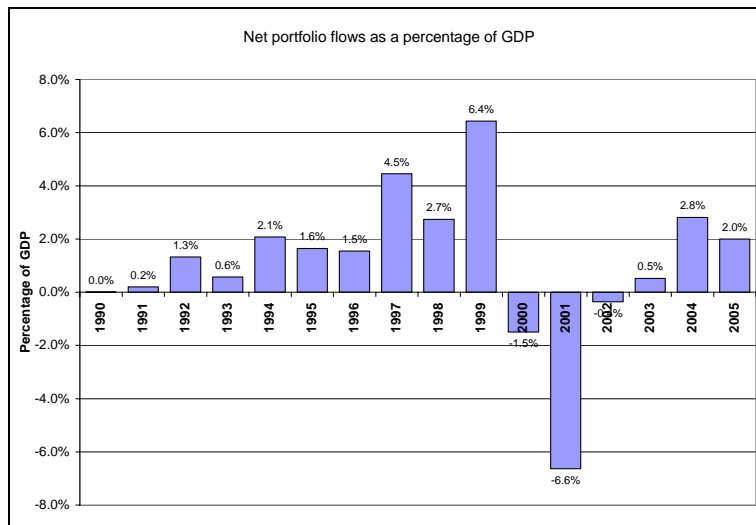
Source: own calculations using the IMF's International Financial Statistics and South African Reserve Bank data for South Africa⁹

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 and highly volatile inflow. 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 shows rapid rise in portfolio flows into South Africa after 1994. At its peak in 1999, net portfolio flows were 42% of exports and 6% of GDP. Historically most portfolio inflows (liabilities) into South Africa went to the public sector. During the period 1995 until the 2001 currency crisis the bulk of portfolio inflows went to the private sector. In figure 4 we see that from 1994 the share of portfolio investment inflows to the “private non-banking sector” increased steadily and as early as 1995, the “private non-banking sector” share of portfolio flows was larger than the share to the public sector (i.e. public authorities and public corporations).

⁹ A blank space indicates that IFS data was not available for that year.

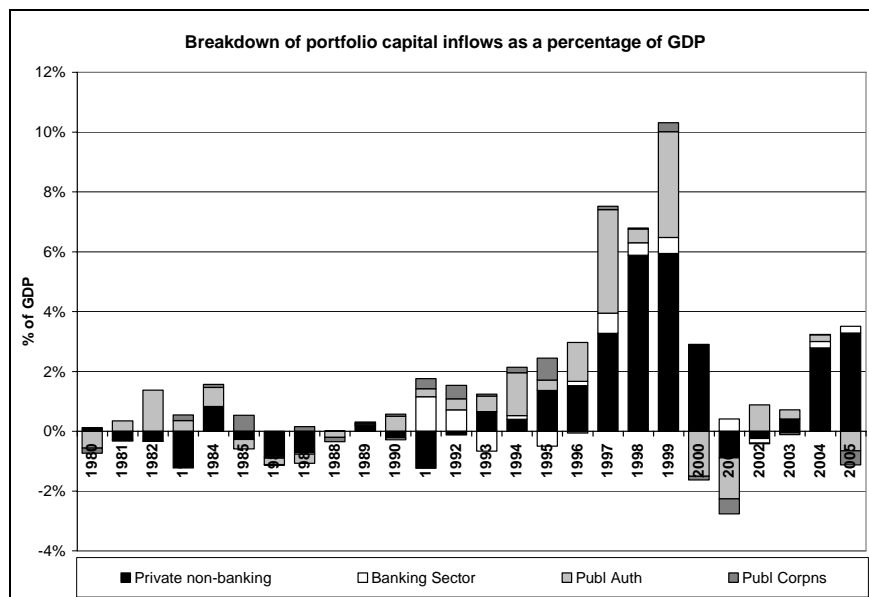
Figure 3



Source: Calculated using SARB data

The share of portfolio flows to the private sector was much larger than the share to public sector until 2001 when the portfolio inflows to both public and private sector were negative. In 2002 portfolio inflows to the private sector were still negative and flows to the public sector had improved a bit. By 2003 the portfolio inflows to the private sector are positive again and by 2004 and 2005 they have grown much larger than portfolio inflows to the public sector.

Figure 4



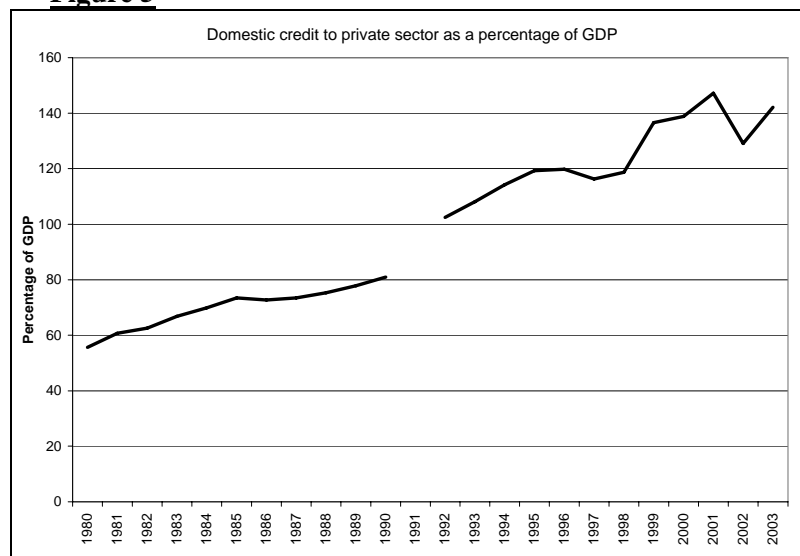
Source: calculated using SARB data

4 HOW THE SURGE IN CAPITAL INFLOWS WAS ABSORBED

Palma's 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. The experience of Latin American countries with financial crises provides an important lesson because they have gone through surges of other flows in the 1980s, portfolio flows in the 1990s and direct flows related to privatization from the mid-1990s. During the 1980s and 1990s the surges in capital flows seem to have been absorbed by more wasteful and fewer productive activities. Now these countries have limited inflows of other investment and portfolio investment and have little left to privatize. They may face a situation where they have very low capital inflows in the future. Therefore, it is important that policy towards capital flows in South Africa guard against huge surges in capital and ensure that capital inflows into the country are invested in growth and not used wastefully.

4.1 Increased access to credit by the private sectors

Figure 5



Source: World Bank's Global Development Indicators (GDI)¹⁰

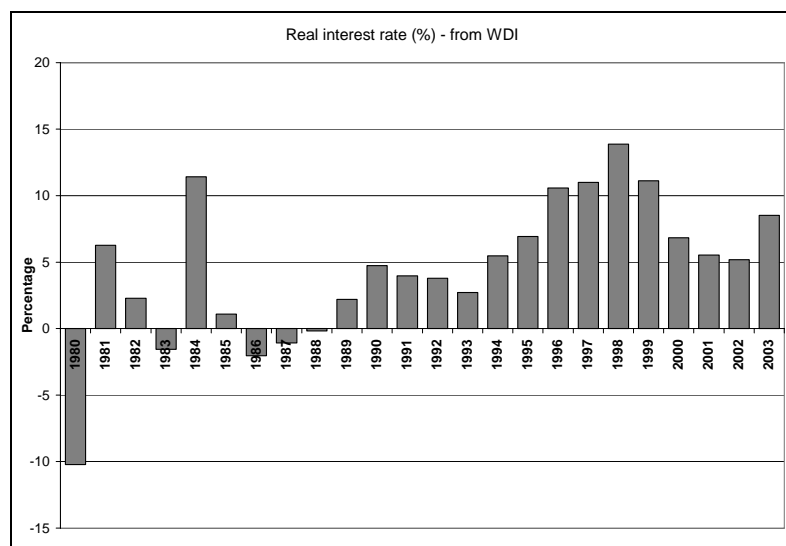
There was a rapid increase in domestic credit to the private sector associated with the rapid increase in portfolio capital inflows during the 1990s. Figure 5 shows domestic credit to the private sector as a percentage of GDP from 1980 to 2003. 1980 was the lowest level of

¹⁰ The figure for domestic credit to private sector for South Africa for 1992 is not given in the GDI data.

domestic credit to the private sector for the period 1970 to 2003 at 56% of GDP. 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. Therefore, from 1980 to 1990 there was a fairly rapid growth of domestic credit to the private sector as a percentage of GDP of 25%. As portfolio capital flows increased during the 1990s domestic credit to the private sector proceeded even more rapidly than the recovery from 1980 to 1990. Domestic credit to the private 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, despite a 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 sterilization. South Africa's level of domestic credit private sector is high compared to countries that had financial crises. An important factor that reduced South Africa's financial fragility is that it has a relatively low level of foreign denominated debt.

Figure 6



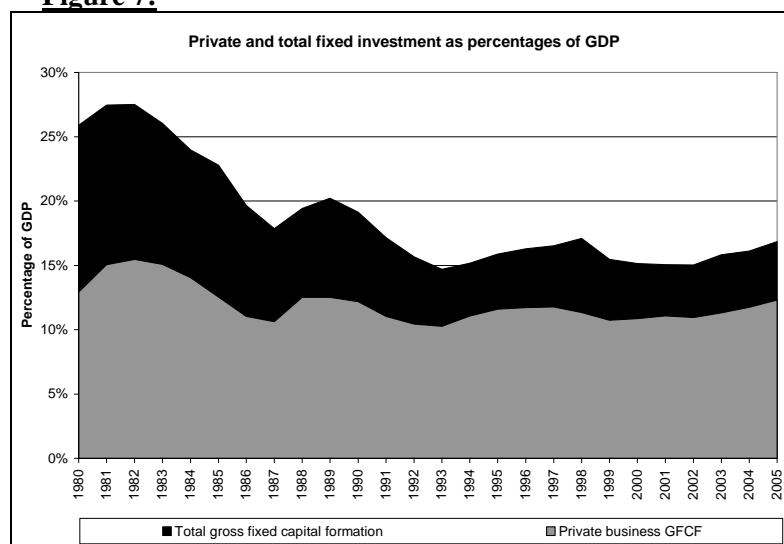
Source: WDI

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 6 shows that the surge in net capital flows in 1997 was followed by a reduction in real lending rates from 1998. 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 5, 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 utilized the increased capital available to them.

4.2 The surge in portfolio flows and investment

Figure 7:

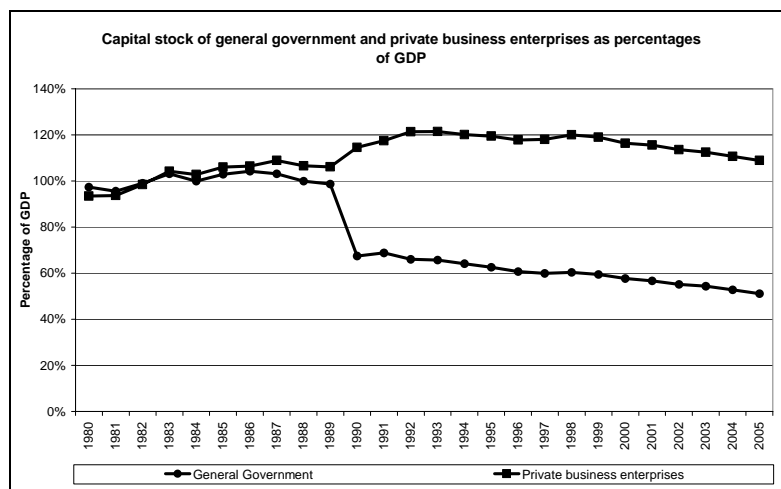


Source: Calculated using SARB data

Figure 7 shows the trends for total and private gross fixed capital formation (fixed investment) as percentages of GDP. Figure 7 shows that the surges in net capital flows and large increases in credit to the private sector were not associated with any significant growth in total or private investment. There was a collapse in fixed investment in South Africa during the 1980s. Much of this collapse was due to a decline in government investment but there was also a decline in private sector investment. The decline in private sector investment had begun during the 1970s. The negative net capital flows to South Africa after the 1985 debt crisis may have contributed to this decline in investment but was not the cause. The decline in investment was partly due to political instability. It was also partly due to a decline in state investment due to their conversion to neoliberal thinking that there should be less state involvement in the economy by the 1980s. The surge in net portfolio flows during the 1990s led to a relatively small increase in GFCF as a percentage of GDP but on the whole investment levels as a percentage of GDP stayed low. The increases in total GFCF from 2003 to 2005 were associated with increases in investment in the finance and retail sectors, partly due to rapid growth in household consumption and debt (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 early 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.

Figure 8



Source: SARB

Figure 8 shows capital stock of general government and private businesses as percentages of GDP in South Africa. The declining levels of private and government investment from the 1980s and poor investment performance during the 1990s led to declining levels of capital stock in the country. These declines mean less infrastructure and capital equipment to support future economic growth. At the same time, most of the increases to investment levels during since 2003 are related to growth in household debt and consumption. These trends indicate that the situation may become even more precarious.

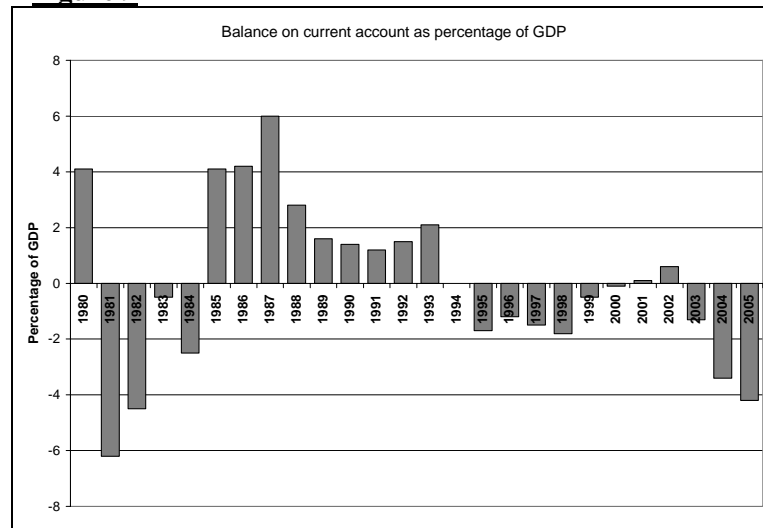
4.3 Increasing portfolio flows and the current account

Figure 9 shows the balance on the current account as a percentage of GDP for the period 1980 to 2000. From 1981 to 1994 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

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.

necessary for the country to run a trade surplus because they did not have foreign exchange to finance a deficit.

Figure 9



Source: SARB

As portfolio flows into the country resumed from the early 1990s it became possible to run a deficit again. From 1995 there was a trade deficit until 1999. In 2000 when portfolio capital flows collapsed there is a trade deficit once again. From 2003, at the same time as when portfolio flows returned, the trade deficit returned as well and grew very fast. By 2005 the trade deficit was 4% of GDP. This rapid growth 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 was 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.

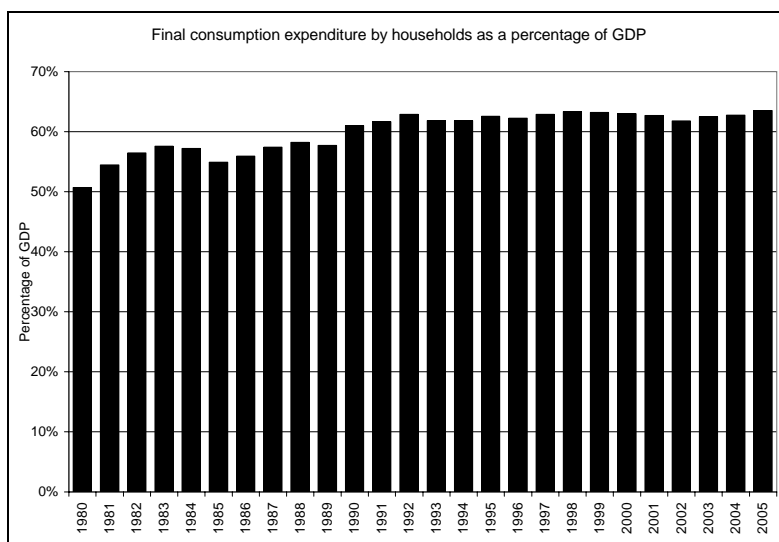
4.4 Household consumption trends

Figure 10 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 its 1970 level. The growth in consumption as a percentage of GDP remained at the 62% to 63% of GDP level from 1993 to 2005. The growth in final household consumption expenditure during the 13 years 1993-2005 was 61%, an average of 4.7% per annum. At the same time, the growth in real GDP per capita for the period was 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 was associated with changes in household consumption and savings patterns. The mechanism by which increased portfolio flows led to increases in household spending and increasing debt was through the increase in credit to the private sector and downward pressure on real interest rates. As shown above, the real interest rate 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 10



Source: SARB

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

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

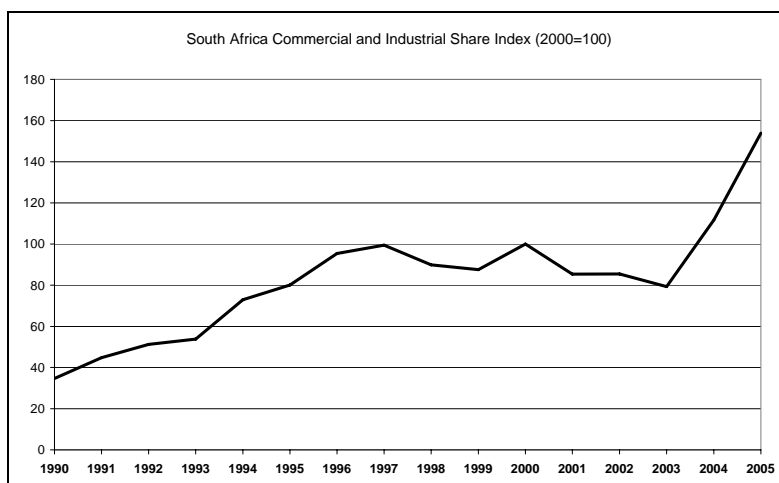
increase in net capital flows may have helped maintain the high levels of consumption and consumption of imports by offsetting the declining real effective exchange rate of the rand and exerting downward pressure on real interest rates. Therefore, there was growth of consumption of imported goods associated 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 now relies on continued inflows of potentially uncertain portfolio capital inflows.

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.

4.5 Growth in share prices and speculation

Figure 11 shows the index of industrial and commercial share prices on the Johannesburg Stock Exchange. There was fast growth in prices throughout 1990s. The sharp growth in share prices during the 1990s, probably fuelled by the international exuberance for information technology stocks, coincides with a surge in net capital flows from 1994.

Figure 11



Source: IMF's International Financial Statistics

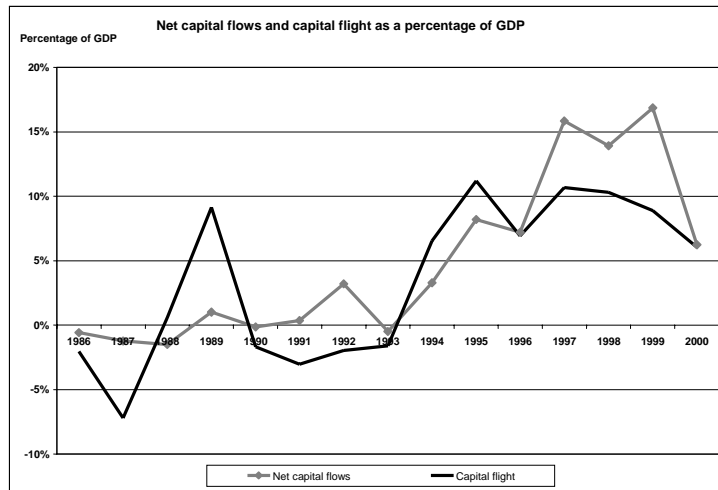
The price index increased from 53.8 to 99.4 from 1993 to 1997. After 1997 there was a decline in the share index associated with the impact of the Asian crisis in 1997, which also caused reduced flows of portfolio inflows into South African equities. There was a surge in capital flows in 1999 which caused a surge in the index in 2000 but when portfolio inflows collapsed from 2000, the index dropped nearly 15 points from 100 in 2000 to 85.4 in 2001. This decline continued down to 79.3 in 2003. From 2003 to 2005 there was unprecedented growth from 79.3 to 153.9 linked to the popularity of commodity stocks and the huge profits of commodity corporations during this period due to increased demand for raw materials, which seemed to have been driven by growth in Chinese demand. At the same time, there was a recovery in portfolio flows into South Africa. There does seem to have been exuberant growth based on easy access to credit in the private sector during the 1990s and a commodities boom recently. The effect of the recent commodities boom driven inflow of portfolio flows seems to be the driving force behind the house price boom as well.

4.6 Capital flight during the 1990s

The South African government offered an amnesty to residents who had violated South African exchange controls indicating that they were concerned about capital flight. Estimates of capital flight from South Africa for the period 1986 to 2000 are presented in figure 12.¹³ These estimates indicate that capital flight from South Africa increased a lot after the democratic elections in 1994. Figure 12 compares capital flight as a percentage of GDP and net capital flows as a percentage of GDP for the period 1986 to 2000. We see that after 1994 there was a very strong similarity in the trends of both capital flows and capital flight. In fact, there is a positive Pearson correlation between adjusted capital flight as a percentage of GDP and capital flows into South Africa as a percentage of GDP for the period 1986 to 2000 of 77%.

Figure 12

¹³ I estimated capital flight with my coauthor Kade Finnoff in a chapter in Epstein (2005). These estimates use the methodology to calculate capital flight used by Boyce and Ndikumana (2002).



Source: SARB and Mohamed and Finnoff (2005)

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 strong correlation between capital flows and capital flight in figure 8 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.

5 CONCLUSION

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 unfortunate situation arises because the surges have not contributed to investment in productive capacity and employment creation that will lead to future growth in the economy. The poor levels of investment have actually led to a decline in capital stock in both government infrastructure and private sector productive capacity. At the same time, the net surges reinforced existing exuberant trends by providing easier access to credit. This increased access to credit was associated with rapid growth in the commercial and industrial share price index, a house price bubble and increasing consumption and imports (and the trade deficit). 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 of the South African economy without accompanying investment that could have lead to growth in assets and the future productive base.

Recent economic growth in South Africa has been driven by consumption and debt creation without adequate investment and building of infrastructure and productive capacity. The inflows of portfolio capital have contributed to this recent consumption-driven economic growth. The portfolio flows and associated increased access to credit has created an unrealistic sense of optimism in the economy that may have contributed to increased household consumption levels, record car sales and the housing price boom. At the same time the current account deficit has reminded government that the current economic growth trajectory is unsustainable. However, there is determination by government to stick to its neo-liberal macroeconomic policies, to accept exchange rate volatility and to maintain and probably further liberalize international capital flows.

The lessons of surges in capital flows, capital absorption and financial crises in other developing countries should have made South Africa's economic policymakers weary of the huge potential for disaster associated with liberalization of capital controls. The short-term cost of the 2001 currency crisis should have been an important signal to the government to seriously consider effective capital management techniques and to look beyond orthodox solutions to financial market instability to which they currently prescribe. Furthermore, the manner in which increases in capital flows since 1994 were absorbed by the South African economy provides an important lesson for South African policymakers. The absorption of flows was similar to Palma's "route 1" countries where there was little or no investment but consumption and asset price bubbles that increased financial fragility. In South Africa, even if there will not be a future financial crisis, the manner in which uncontrolled flows are absorbed in the economy, with its preexisting, serious structural and institutional weaknesses, undermines the post-apartheid, democratic government's development agenda. Unfortunately, South African policymakers are not willing to learn these lessons yet.

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