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Volatile Capital Flows and a Route to Financial Crisis in South Africa

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Abstract

JEL Classifications: E44, E52

This is a review article; its purpose is to support a debate on the use of the *best available economic theory and evidence* in monetary policy in contemporary South Africa. In order to do so, I contrast South Africa's laissez-faire management of capital flows with the experience of other countries where the authorities have opted to use capital control techniques of one type or another. The empirical evidence is fairly substantial, capital control techniques can play a useful part in staving off fragility and financial crisis in the event of sharp surges in capital flows. The key idea is that capital control techniques would offer the authorities more freedom and flexibility in the management of capital flows and the pursuit of monetary policy. The article follows on from Mohammed (2010) who concludes that South African policy makers have not yet learned the relevant lessons stemming from their neoliberal embrace. This article takes up that theme and uses macroeconomic data to show that without capital controls South Africa courts a financial crisis that can be transmitted via any one of at least three channels.

Key Words: monetary policy, capital flows, capital controls.

Introduction

The main feature of the global political economy over the last thirty years has been the *financialisation* of the world economy. In most other countries financialisation is to be seen as an external imperative emanating from the needs of Anglo Saxon Capitalism, but in South Africa financialisation is also an internal phenomenon, emanating from the needs of the minerals-energy-complex (M-E-C) conglomerates in the post apartheid world. A direct consequence of financialisation has been the unprecedented rise in cross border flows of capital; today, capital is infinitely more mobile than at any other time in history. Thus for all developing countries there is now a new policy challenge – financialisation dictates that policy must be framed in a context where mobile capital can now exact a punishing price for the “wrong” policies. According to Koelble and LiPuma (2006): “...*the globalizing processes now in motion impose such powerful constraints especially on middle income countries that they motivate all but the most globally financially independent regimes (such as Iran) to adopt some variant of the Euro American neo liberal democracy. From our point of view, the ongoing transformation of capitalism is producing a global financial market and accompanying social institutions that engender economic constraints and threaten political consequences so powerful that they are coercing the entire gamut of regime types, from authoritarian to socialist, to adopt the neo liberal version of democracy favoured by markets.*”

Echoes of this line of argument are to be found in South Africa; Alec Erwin, a member of the ANC’s National Executive Committee (NEC) and former Minister of Trade and Industry, has argued that South Africa choices are limited to, “implement policy packages that are similar to those of other developing countries” (Marais; 2011, 112). And as long ago as 1997, Mandela himself had argued that integration of the capital markets “made it impossible to

decide national economic policy without regard for the likely response of the markets” (ibid). Yet it is clear that the response of the developing world to managing capital flows is far from uniform. For Marais (ibid), “...most promising emerging economies were violating many of the rules the South African government was straining to obey.”

This is a review article; its purpose is to contribute to an ongoing debate on the use of the best available economic theory and evidence in monetary policy formulation in contemporary South Africa. In order to do so, I contrast South Africa's laissez-faire management of capital flows with the experience of other countries where the authorities have opted to use capital control techniques of one type or another. The evidence is fairly substantial; capital control techniques can play a useful part in staving off fragility and financial crisis in the event of sharp surges in capital flows. The key idea is that capital control techniques would offer the authorities more freedom and flexibility in macroeconomic management. This article follows on from Mohammed (2010) who concludes that South African policy makers have not yet learned the relevant lessons stemming from their neoliberal embrace. This article takes up that theme and uses macroeconomic data to show that without capital controls South Africa courts a financial crisis that can be transmitted by at least any one of three channels.

The article is arranged as follows; part one describes South Africa's historical experience with respect to capital flows. It does so within the context of *financialisation* and tries to show that in South Africa's case, a confluence of international events and the local post apartheid reorganisation of the corporate world engendered a financialisation process with local origins. Hence in the South African case financialisation emanates from both local and international circumstances. Part two reviews some of the heterodox literature on financial crisis, and examines the way policy makers in selected countries have managed capital surges. Part three

reviews South Africa's macroeconomic statistics and places South Africa in the first route. Part four serves as the conclusion.

1.0 Financialisation and Capital Flows in South Africa

As far as South Africa is concerned there are two parts to the capital flows story. First there is the steady, substantial and persistent capital outflow connected with a flight of capital as chronicled by Mohamed (2009) and by Ashman, Fine and Newman (2011). The other part of the story is the sudden stop surges associated with short term portfolio flows described in Mohamed (2010), Harris (2009) and other writers. Turning first to capital flight; this form of the export of capital is not new in South Africa; it is at least five decades old. As a per cent of GDP, capital flight increased from 5.4% to 9.2% between 1980 and 1993. Between 1994 and 2000 the average outward flow was about 12% of GDP, and between 2001-2007 it increased further to a giddy 23% of GDP in 2007 (Mohamed and Finnoff, 2005; Newman, 2009).

South Africa's social history is obviously unique. The apartheid state of the Nationalist Party unravelled at the same moment that global financial arrangements were taking on a neoliberal character and the country's reintroduction into the world economy took place alongside and simultaneously with a *financialisation* of economic global economic relations. In 1994, with the birth of democratic South Africa, it is global financialisation that frames the context for economic developments in South Africa.

1.1 Financialisation

When the Bretton Woods system of fixed currency arrangements broke down in 1971, the collapse unleashed three interrelated processes: privatization, liberalization/deregulation, and financial innovation. "According to Kurtzman (1993: 60-1, in Nesvetailova 2007: 11),

*“Nixon transformed it [the dollar as a real symbol of tangible wealth] into something totally new, a currency without any underlying value whatsoever and without any limitations on the government’s (or private sector’s) ability to create it.” Without the gold parity anchor of Bretton Woods, exchange rates became susceptible to the volatility/fluctuations of the new free-floating regime. Thus the exchange rate risk previously assumed by the state was transferred to markets. The public risk of the state in this way became the private risk of financial market agents (Eatwell and Taylor 2000: 12). In place of Bretton Woods the policy framework came to be determined by the removal of capital controls, the deregulation of exchange and interest rate regimes, and the elimination of barriers to trade in local and international markets” (McKenzie, 2011). This liberalization and deregulation of trade and capital markets is therefore to be viewed as a concomitant process associated with the privatization of credit and financial risk (Nesvetailova 2007: 12). The key idea arising from the collapse of Bretton Woods is that institutional and structural change induced transformations of the financial sector that ultimately fanned out like tentacles across the globe, engulfing its inhabitants in the logic of a latter day laissez-faire competitive capitalism. These are the institutional origins of the *financialisation* that has come to be the defining feature of contemporary capitalism.*

The financialisation of the world economy frames the context in which the momentous transformation from apartheid to democracy takes place. Mohamed (2009, 2) argues that the end of apartheid led to a reorganisation of big business in South Africa where capitalists “... acted to move capital out of the country.” At the level of the global political economy South Africa was inserted into the periphery as a supplier of extracted minerals. Historically, South Africa has had a long and close relationship with the United Kingdom. South Africa has also had as lengthy a relationship with the United States. It’s no surprise therefore that Anglo

Saxon capitalism has come to define the local business arrangements. According to Roux (1991, in Mohamed, 2009, 6) this has led to an over emphasis on speculation at the expense of productive investment.

Internally the shape of business life in South Africa has been heavily influenced by the antagonism between English and Afrikaner capital. Mohamed (2009) argues that the competition between the two was partly eroded by cooperation between the apartheid state and English capital. Terreblanche (2002) argues that there was an, "*extraordinary politicization*" of the business sector during the 1970s as a result of close relationship with the government. "*The new working relationship between business and government was sealed at the Carlton and Goodhope conferences in 1979 and 1981. At those conferences the corporate sector was given an institutional role, within the reorganized state sector, of formulating and implementing "free market" economic policies. Ever since this politicisation took place, the corporate sector has regarded an active role in political decision making as a birthright*" (Terreblanche (2003, 74). As Mohamed (Ibid) puts it; "Big business worked to reform apartheid and the apartheid economy in a way that benefited their business interests."

During the 1980s six conglomerates came to dominate business and economic life in South Africa: Anglo American Corporation, Sanlam, SA Mutual, Rembrandt, Anglovaal and Liberty Life. All came from mining and insurance, and all owned merchant/investment banks. These conglomerates were subject to two waves of restructuring. In the 1980s there was a restructuring aimed at diversification. And in the 1990s another restructuring, this time aimed at concentration on core business functions. I follow Mohamed (Ibid.), during the apartheid struggle the idea of black majority rule was anathema for big business and the Nationalist Party, the unprecedented levels of capital flight post 1992, the rise in offshore

listings and the calls for financial deregulation are associated with South African businesses sense of a "loss of power," and the fear of a black African government appropriating large swathes of capital. Ashman, Fine and Newman (2010) in explaining the capital flight of the period point out that the end of apartheid coincided with important changes (financialisation) in the world economy. The big business of the minerals export complex (MEC) embraced the process and the whole period has come to be defined in terms of the export of domestic capital. Thus it is the confluence of these events that explains the very high levels of capital flight. Like the US and UK firms, "*South African corporations thus took the opportunity to internationalise their operations and to participate in the mergers and acquisition frenzy of the 1990s which also saw increasing concentration within many domestic sectors despite corporate unbundling.*" (Chabane, Goldstein and Roberts 2006 in Ashman, Fine and Newman 2010)."

By 1996, South Africa had been incorporated into the neoliberal order and from 1998 the ANC government recognised and approved the right of the big MEC companies to move capital out of South Africa and into overseas financial centres (London, New York, Geneva, Melbourne etc.). Residual controls that limit investors to 15% offshore investments remain, but the South African Reserve Bank's (SARB's) Voluntary Disclosure Programme (VDP) of July 2010 offers amnesty to, "*corporations and individuals disclosing their illegal expatriation of capital*" is seen by the SARB," as a first step to the complete liberalisation of outflows" (Ashman et al, 2011). This shift in policy has taken place alongside acute structural unemployment and declining domestic investment in the productive sectors of the economy. Thus insofar as South Africa is concerned neoliberalism has meant a financialisation process with a concomitant corporate restructuring where domestic macroeconomic policy is

sacrificed at the altar of "haute finance," deepening inequalities and perpetuating the development of underdevelopment on the ground in the local arena (see Ashman et al, 2011).

1.2 Capital Inflows

According to Mohammed (2010) most of the flows entering South Africa have been short term portfolio flows. These flows have been absorbed by the private sector in the form of easier credit. Easier credit in the private sector has supported rentier and other non-productive activities. The circumstances somewhat mirror those of the USA. Easier credit fuelled massive equity price inflation on the Johannesburg Stock Exchange, and then major house price inflation. Household consumption surged and with it import levels, to such an extent that the Balance of Trade has turned negative. Private household consumption was itself fuelled by an enormous build up of private household debt. Consequently there is a systemic tendency to financial fragility further weakening in the ability of the country to withstand external shocks.

One defining feature of capital flight story is the story of currency crashes. A currency crash is defined as a reversal in the nominal value of the currency of at least 15%. South Africa has had five of these crashes since 1996 - crashes that are brought about by surges and reversals in the flows of capital. The typical anatomy of a crash looks more or less like the 2001 rand crisis. *"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. ... 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% "* (Mohammed, (2010, 4). The transmission mechanism is

always the Balance of Payments and destabilisation may not reveal itself in the form of a sudden surge or sudden reversal crash. A persistent and significant inflow over a period of time poses its own problems. As foreign assets flow into a country they place upward pressure on the local currency. In time exports become uncompetitive and imports become cheaper. This vicious spiral can persist for quite some time if the flows themselves are persistent. But it can be transformed into a fully fledged crisis by a sudden reversal in the direction of the flows as experienced by South Africa in 2008.

In Oct 2008, the JSE saw a huge decline, 10% in the second week alone, the currency declined by 9% in one week and then a further 10% in the following week. Manufacturing, mining and retail were thrown into a tailspin and six months later government figures were to show a quarterly decline in GDP of 6.4%. By 2009, The Economist (Feb 25, 2009 cited by Bond, 2010) had ranked South Africa as the most risky of a list of seventeen developing countries. In the period 1992-2009 a huge balance of payments deficit opened up that Bond (ibid.) attributes to outflows of dividends and profits to London and Melbourne. In order to cover the deficit South Africa started on a borrowing spree - borrowing rose from \$25 billion in 1994 to almost \$80 billion in 2008. For Bond (ibid) the outflow of profits and dividends from the MEC firms is one of two reasons South Africa's current account deficit, "... has soared to amongst the highest in the world (in mid 2008 exceeded only by New Zealand)." The net result here is that South Africa is far more vulnerable to the vicissitudes of world financial markets. In South Africa's case, inward capital flows have been found to be "positively correlated with large scale capital flight from the South African economy" (Ndikumana and Boyce, 2002 cited in Mohammed, 2010). Such a correlation suggests that when there is a surge in net capital flows it is also accompanied by "a significant increase in capital flight" (Mohammed, 2010, 24).

In summary we may say that the surges in net capital flows via the increase in private credit have led to:

- a) A financial bubble as represented by the price inflation of equity stock on the JSE.
- b) A housing bubble as represented by the house price inflation between 2002 and 2008
- c) Persistent trade deficits
- d) Increased household debt
- e) A persistent current account deficit (the highest in the G20)

Contrary to orthodox interpretations instead of filling the investment gap we find that in South Africa's case these inflows have generally supported unproductive investment in shopping malls and car parks. Mohammed (ibid.) argues, *"Based on 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."* Instead of promoting a more robust South African economy, we find a tendency towards fragility as a direct consequence of the surges in portfolio investment.

2.0 Palma's Three Routes to Financial Crisis

Gabriel Palma (2000) examined the period between liberalization of the economy and the onset of financial crisis in selected countries and devised what may be called "three stylized routes" to financial crisis. The three routes approximate to actual country experience as analysed by Palma. Route 1 (R1) is drawn from the Chilean experience. Route 2 (R2) from Korea, and route 3 (R3) Brazil.

2.1 Chile

On the back of a huge financial crisis in 1980, Chile undertook a series of structural reforms which marks the country out as perhaps the earliest experiment in neoliberalisation. Reforms included gradual but progressive liberalization of the capital account, privatisation of public

enterprises, social security and trade liberalisation. For Chile there were three main policy objectives: a) to lower inflation while at the same time avoiding currency appreciation. b) To promote exports. c) To alter the composition of flows by discouraging and reducing short term inflows. According to Edwards (1999), short term inflows represented 95% of all inflows. Once again, the low interest rates prevailing in global markets coupled with the high interest rates needed to fight inflation domestically made for huge interest rate differentials and the hot money poured in. Edwards (Ibid) notes, gross private capital inflows increased from \$0.9 billion in 1988 to \$1.8 billion in 1990, to \$2.8 billion in 1997.

The URR was the main policy tool used. According to Cordero and Montecino, (2010), "... the URR was continually modified, increasing the rate and extending the types of credits subject to it." In 1991, the URR was 20%, and applied exclusively to, "foreign loans and fixed income securities. Any credits had to remain with the Central Bank for up to a year or up to a year without remuneration depending on the maturity" (Ibid.). The URR was raised to 30% and extended so as to apply to trade credits and loans related to FDI in 1992. Again in 1995, the URR was extended, this time so as to apply Chilean stock that traded on the New York Stock Exchange.

Chile had retained controls on FDI so that FDI was subject to minimum stay requirements and profit repatriation taxes. In 1990, the minimum stay period was defined as 3 years and then lowered to one year in 1992 at the same time as repatriation restrictions were dropped.

2.2 Korea

South Korea's growth performance over the last four decades of the 20th Century can only be described as stellar. In the period between 1960 and 2003 the country experienced negative

growth on two occasions, in 1980 and 1998 with growth itself averaging between 6% and 8% for the remaining years (World Development Indicators, 2004). Korea ran into difficulty when the opportunities for the type of emulatory technical catch up they had pursued were exhausted. This was growth via state-led industrial policy. There was quite an early emphasis on heavy industry, and later on, shipbuilding. In order to finance such large scale projects special public institutions were established and according to Nolan (2005,) private commercial banks were directed to make loans available to industrial policies “strategic” projects on a preferential basis.

In terms of R2 country experiences, Korea’s main Achilles Heel in 1997 that made it particularly vulnerable to events in Thailand and Malaysia was its low ratio of foreign exchange holdings to short term debt. Its reserves could only cover half of its short term liabilities (Palma; 2000). Both Palma (ibid) and Noland (2005) found that it was the Korean government itself through a system of perverse incentives to the corporate sector that was responsible for the build-up in short term debt.

2.3 Brazil

At the start of the 1990s Brazil faced two great macroeconomic challenges; it had a large fiscal deficit and stubbornly high inflation. The first response of the authorities was the Real Plan, which simultaneously sought to reduce the deficit (by cutting spending) and reduce inflation (Cordero and Montecino, 2010). The Real Plan was in effect a new monetary framework and it was based on two nominal anchors: an exchange rate anchor (pegging the local currency to the dollar) and a monetary anchor of “announced money supply targets intended to manage aggregate demand” (Ferrari-Filho and De Paula, 2003 in Cordero and Montecino, 2010). This new exchange rate system consisted of a daily crawling peg. To

defend the peg and contain inflation, interest rates had to be kept high. Once again this combination opened up large interest rate differentials. Again the hot money poured in. According to Cordero and Montecino (2010, 24), monthly private net capital flows increased by 25 times, from a monthly average of \$39 million in 1988 to \$970 million by 1995.

Two main problems ensued - first the appreciation of the real (making Brazil's exports uncompetitive) and the potentially destabilising effects of short term speculative capital. In 1992, these pressures intensified, the exchange rate appreciated markedly, and more and more short term capital found its way into Brazil such that by 1995 two-thirds of all capital inflows were short term (Ibid).

The authorities turned to capital controls, specifically;

1. The minimum average amortisation time period for financials loans was extended.
2. The use of trade credits was discouraged and the maximum time, "between when an export credit was received and the associated goods were shipped" was reduced from 360 days to 180. (Ibid)
3. The limit on Bank dollar denominated liabilities was lowered and the limit on dollar denominated assets was raised. Each bank's net worth defined the limit on its liabilities and this limit was cut by 50% while the limit on assets was increased from \$2million to \$10 million.
4. A special channel for the sale of fixed income securities and commodity funds was created. These were in turn subject to an initial entrance tax of 5% which was subsequently altered to become inversely related to the maturity of the security in order to further encourage longer term investments (Ibid).

The table below summarises Palma's findings:

Table 1: Three Stylised Routes to Financial Crisis

Route1: Chile, Mexico	Route2: Korea	Route3: Brazil
Explosion of credit to the private sector.	Explosion of credit to private sector.	Persistently high interest rates.
Low levels of interest rates (after stabilization).	Low levels of interest rates.	Fragility in the banking system as a result of the high interest rates.
Rapid revaluation of exchange rates.	High levels of investment.	Fragility in public finance as a result of the high interest rates.
Consumption boom.	Very high corporate debt/equity ratios.	Increase in the stock of public debt.
Asset bubbles in stock market and real estate.	Declining profitability across the economy.	Increasing short term debt.
Reduced level of savings.	Government incentives for corporate sector to borrow short.	Implosion of the real economy because of high rates.
Major deterioration in current account.	Major deterioration in current account.	
Low levels of residential construction.		
Increasing foreign debt.		

All R1 countries are characterized by a huge expansion in private consumer credit as countries try to absorb inflows. Route two (R2) countries are also characterized by a huge expansion in private credit, but this time, instead of an expansion in consumer credit, there is a huge expansion in private sector investment. Thus if the main similarity between R1 and R2 countries is the extraordinary expansion in private credit, the main differentiating factor is the use that this expansion is put to; in R1 countries there is a consumption boom, in R2 countries there is a striking expansion in private investment. Malaysia and Thailand are hybrid cases that share characteristics of R1 and R2 countries. Malaysia doubles its private sector investment from 15% in 1988 to 30% in 1995 (Palma, 2000).

What attracted the inflows in the first place? Palma argues that in R2 countries, “it is an endogenous pull for additional finance to bolster high levels of investment” and in R1

countries, “it is an exogenous push movement of foreign capital into these countries, which then has to create a need for itself.” Palma (2000, 12) goes on to argue that R1 countries can “...be viewed as a rather peculiar case of Says Law, in which supply creates demand through fuelling expectations and optimism regarding the future performance of the economy. The circle reinforces itself becoming a self fulfilling prophecy. “Easy access to credit fuels expectations regarding the future prospects of the economy, prospects which are improved by the extra spending brought about the expanded credit and available foreign exchange. Thus over borrowing and over lending are not only the result of closely interrelated processes, but one that has a clear direction of causality.”

According to Palma (ibid) Malaysia and Thailand each have one foot in both R1 and R2 experiences. The surges in inflows were so large that the credit to the private sector in Malaysia grew from 67% of GDP to 135%, and in Thailand from 64% to 142% of GDP¹. Thus they followed both routes simultaneously. First they followed R2 in that they needed high levels of external finance for their private investment programmes (mandated by ambitious industrial policies). But having satisfied these plans there was enough credit left over to fuel asset price inflation in both equities and real estate as in the R1 countries. In summary, in the R1 countries the expansion of consumer goods is enormous, “Not so in route 2 countries where the additional credit was directed towards investment”².

R1 countries are further characterized by a rising share of private consumption to GDP ratio. In Chile this share increases from 65% to 75%, and in Mexico there is a corresponding

¹ In these two countries credit expansion did not only fuel an increase in the share of consumption in GDP as it did in Latin America, but it was also associated with a decline in this share (in Thailand from 56.7% to 54.8% and in Malaysia from 49.4% to 45.9%).

² The corresponding figures for Malaysia and Thailand are low (annual rates of growth of these imports are 16% and 19%) as these countries direct additional credit towards investment (R2) and asset bubbles (R1) but not to consumption (R1).

increase from 68% to 78% of GDP. The share of savings to GDP ratio fell from 20% to 10% in Mexico, and in Chile this share stood at 1.7% of GDP.

Brazil is an R3 country. Here there is credit contraction as the authorities act to curtail expansion by placing an “iron curtain” around incoming flows. The iron curtain consists of increasing reserves, high degrees of sterilization and high interest rates. In Brazil, despite massive inflows the share of private investment in GDP was maintained at 15%, the share of consumption increased from 62.7% in 1994 to 64.4% in 1998 and the share of private savings fell from 18% to 14% between 1995 and 1998. In the case of Brazil mainly as a result of the high interest rate policy and a more cautious trade liberalization policy, imports of consumer goods did not grow anywhere as near as quickly as in Chile and Mexico. What distinguishes the R3 country from the others is that interest rates not only start at a much higher levels but they are not allowed to fall to anywhere near R1 or R2 levels.

According to Palma Brazil is an important case in a critique of the moral hazard explanations of the mainstream. According to that line of argument, “... *the main cause of agents losing their capacity to price risk is that external and internal moral hazards lead to artificially low interest rates; these in turn gave a false incentive to agents to accumulate excessive risk*” (McKinnon and Pill in Palma; 2000, 17). This just did not happen in the Brazil case.

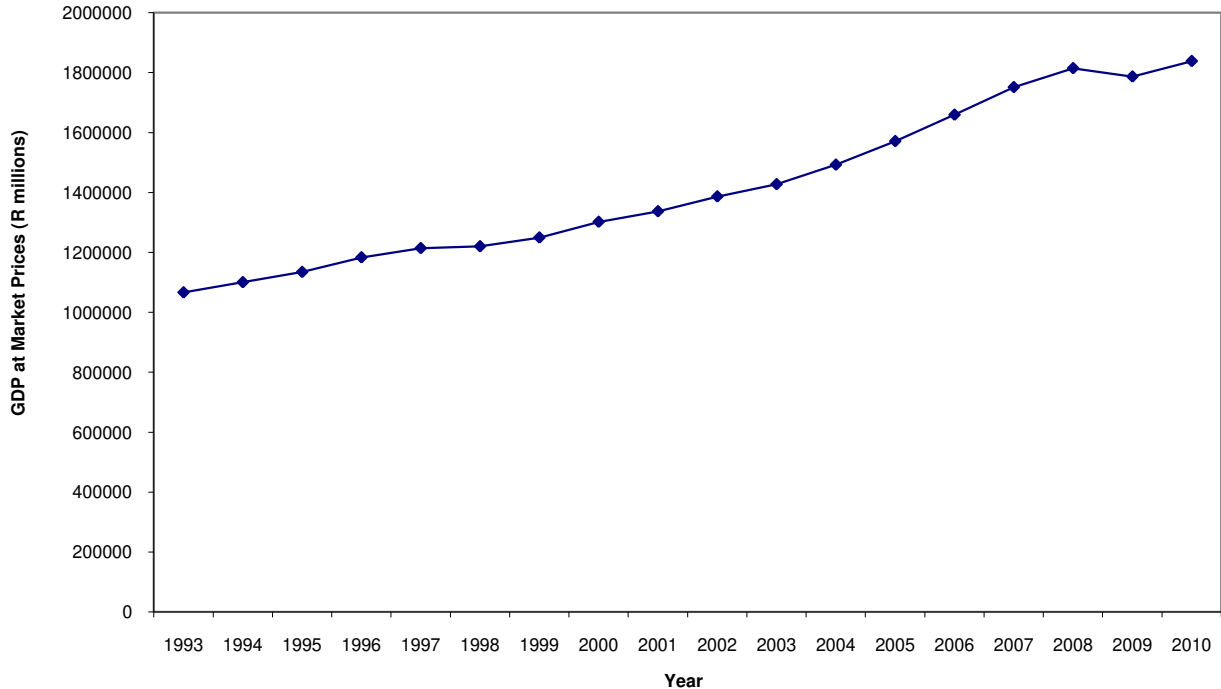
3.0 The South African Macroeconomic Data

Turning now to South Africa, an examination of the main macroeconomic data can show whether or not the local experience conforms to any of Palma’s three stylized routes. The value of the exercise from a South African point of view is that having identified a stylized path, policy prescriptions can be constructed that represents a *best practice* that is derived from the experience of other countries based on all the available theory and evidence.

3.1 Gross Domestic Product (GDP)

Figure 1 (below) shows South Africa's GDP from 1990 to 2010. In that period, the average quarterly GDP growth rate has been 3.3%. With the abandonment of the apartheid state and the transition to democracy, GDP growth peaked at 7.6% in December 1994, and in the aftermath of the Great Recession of 2008 it fell to its lowest point of -5.9% in March 2009. The average annual GDP growth rate in the period under consideration stands at 3.2%, it reached a historical high of 7.1% in December 2006 and a low of -2.6% in June of 2009. The performance is on the face of it unspectacular, but steady. But viewed from the point of view of the Growth, Employment and Distribution (GEAR, 1996, 3)³ document, the performance is short of the 6% (du Plessis and Smit, 2006).

Figure 1: GDP

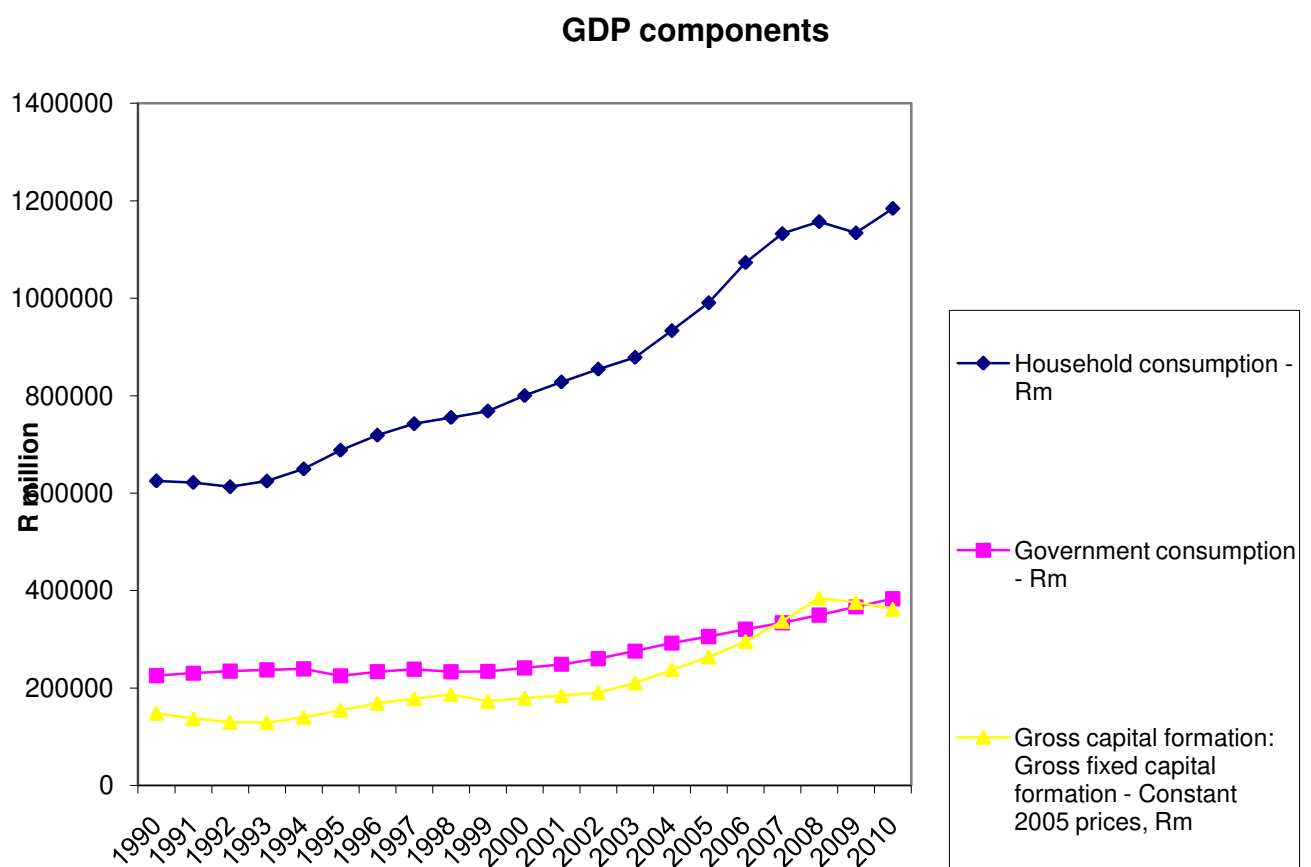


Source : (Quantec)

³ A neoliberal strategy introduced by ex Finance Minister Trevor Manuel covering the period 1996-2000.

Figure 3.2 below shows the composition of GDP. The clear trend ever since 1992 has been the expansion of household consumption. It is this private consumption which has been driving growth. A consumption that Mohamed (2009) argues has been financed with debt. The Gross fixed capital formation and government consumption components experience steady and gradual increase over the period.

Fig. 3.2 HERE



3.3 Unemployment rate

South Africa's unemployment rate (Fig 3.3, see below), stands at 25%. The South African

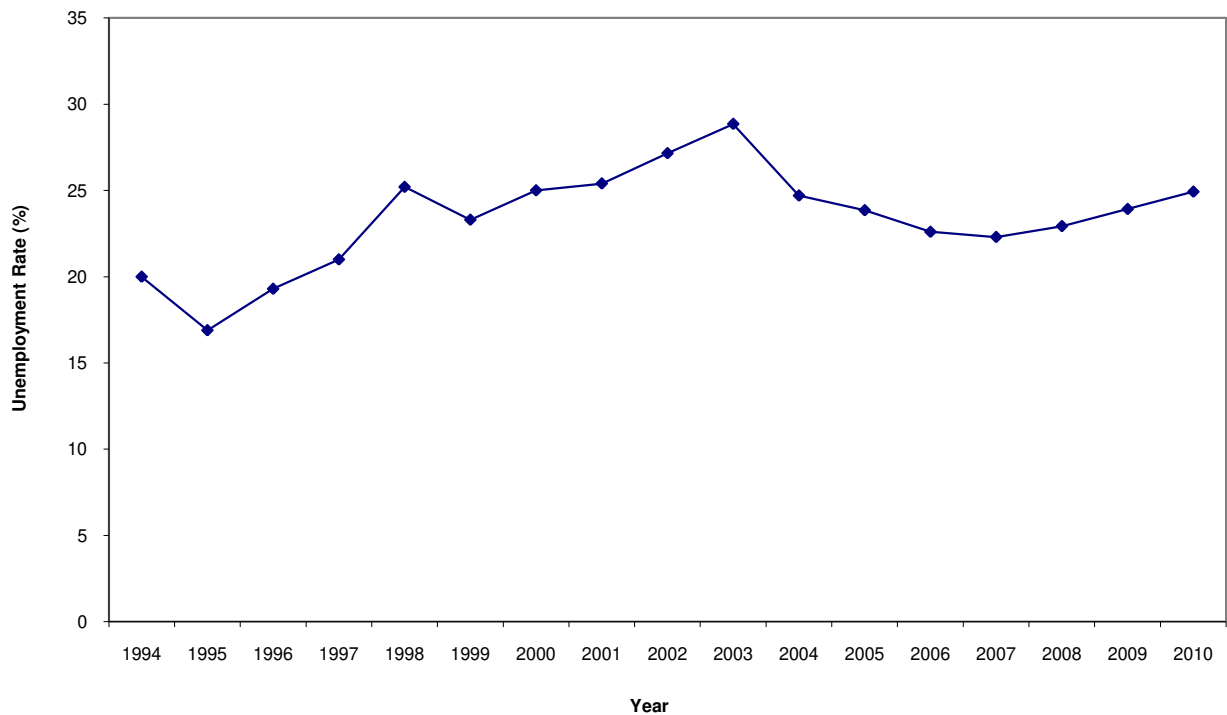
Authorities estimate that the economy has to grow at 6% per annum in order to halve

the countries unemployment rate by 2014. The average for the period stands at 26.3%

with the record high recorded at 31% in March 2003 and a low of 23% in September 2007.

Getting these stubbornly high rates of unemployment down is the focus of the New Growth Path (NGP); heterodox literature on the subject calls for reordering of priorities in order to decrease stubbornly high rates of unemployment⁴.

Figure 3.3 Unemployment Rates



Source : (Quantec)

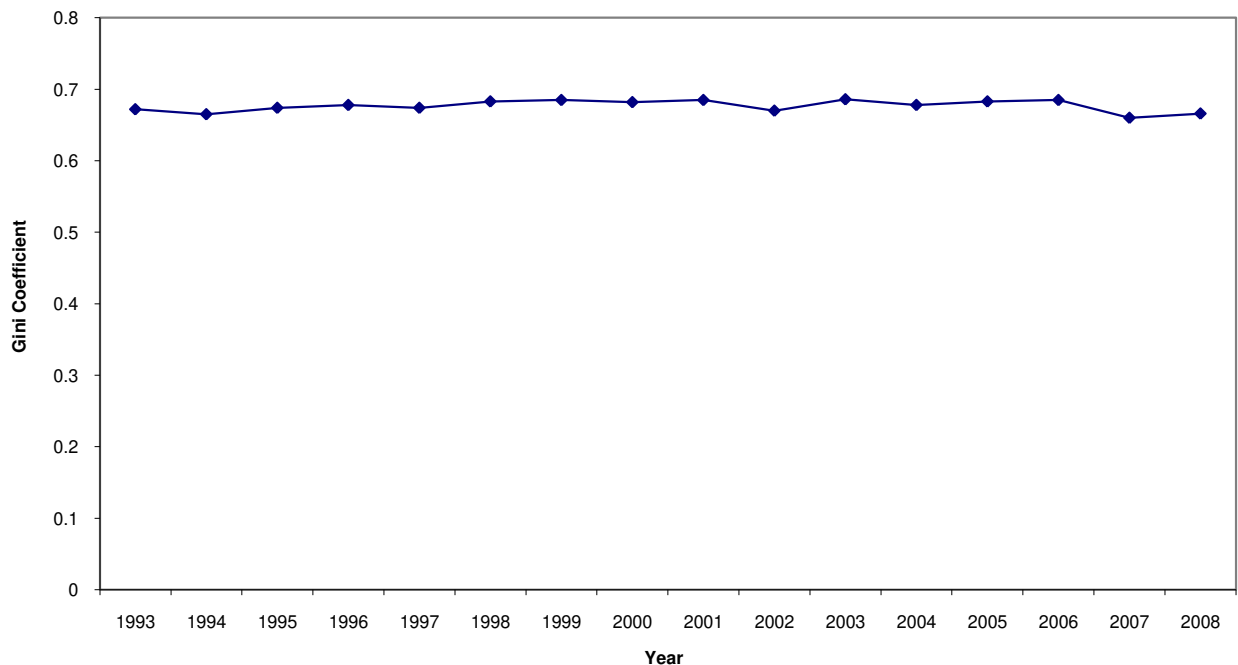
⁴ Such literature would include Epstein, 2003, 2004, Pollin, Ndikuma et al who generally argue that monetary policy in S Africa should be “employment generating.”

3.4 Gini Coefficient

The Gini coefficient measures the extent to which income (sometimes consumption) is distributed among agents in a country⁵. South Africa's Gini over the years under review (See Fig. 3.4) has remained virtually the same around 65. Obviously such a high coefficient makes South Africa one of the most unequal countries in the world. According to the World Bank the top 10% of income earners in South Africa have an income share of 57%. This inequity is closely related to the unemployment story and addressing one is by default to address the other.

The growth, unemployment and inequality statistics (together) speak to a *growth through inequality* strategy that can be said to characterize much of the period..

Figure 3.4: Gini Coefficient



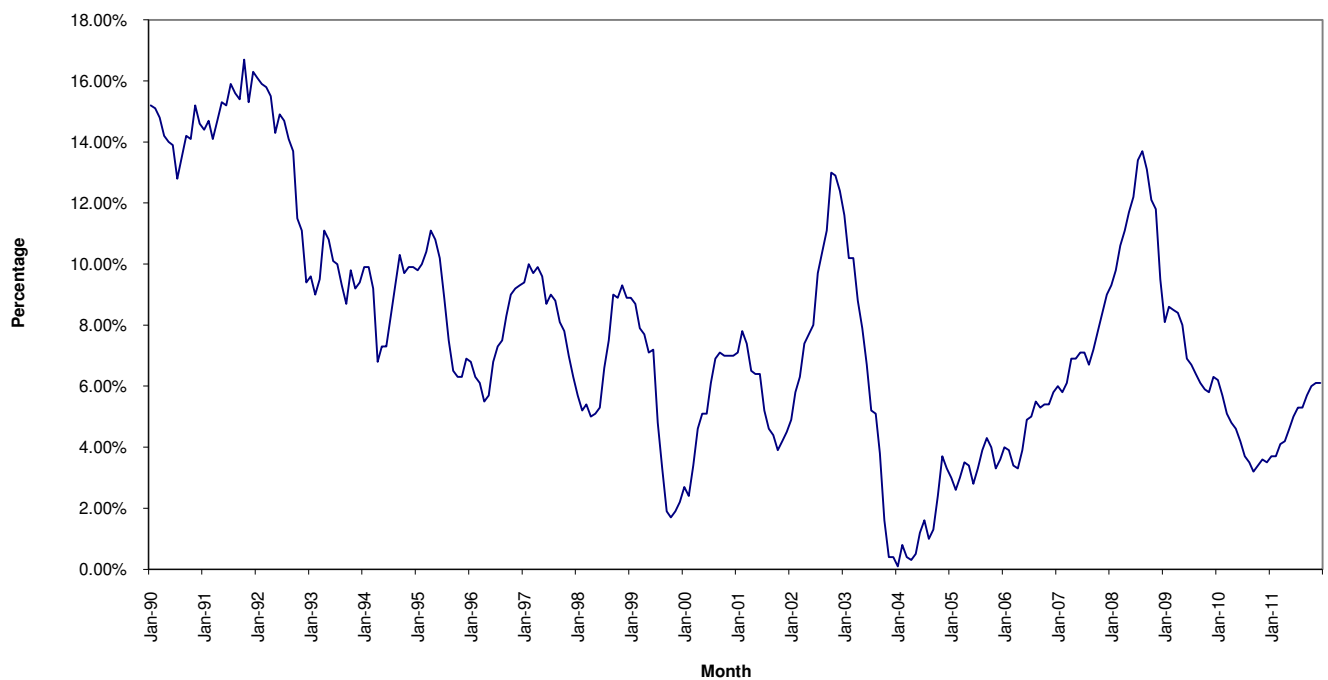
Source : (South African Presidency)

⁵ A coefficient of 0 would mean perfect equality and one of 100 would represent perfect inequality.

3.5 Inflation rate

For the period under review, South Africa's inflation rate (Figure 3.5 below) has averaged 10%. It reached its highest point of 17% in January 1992 and its lowest of 0.10% in January 2004. In 2000, South Africa formally adopted an *inflation targeting* approach. The aim was to bring double digit inflation under control. The target was set to keep inflation to a band between 3% and 6% of the Consumer Price Index (excluding mortgage costs) on an annual basis. Price stability has been the number one macroeconomic target and the authorities enjoy a fair amount of success in this regard. The line of demarcation between monetary economists lies in the approach to inflation and employment. The heterodox literature as represented by Crotty and Epstein (1996), Epstein (2003), Pollin et al (2007), has long since argued for a reordering of priorities where employment becomes the number one target. Mainstream orthodoxy has steadfastly advocated the primacy of price stability.

Figure 3.5



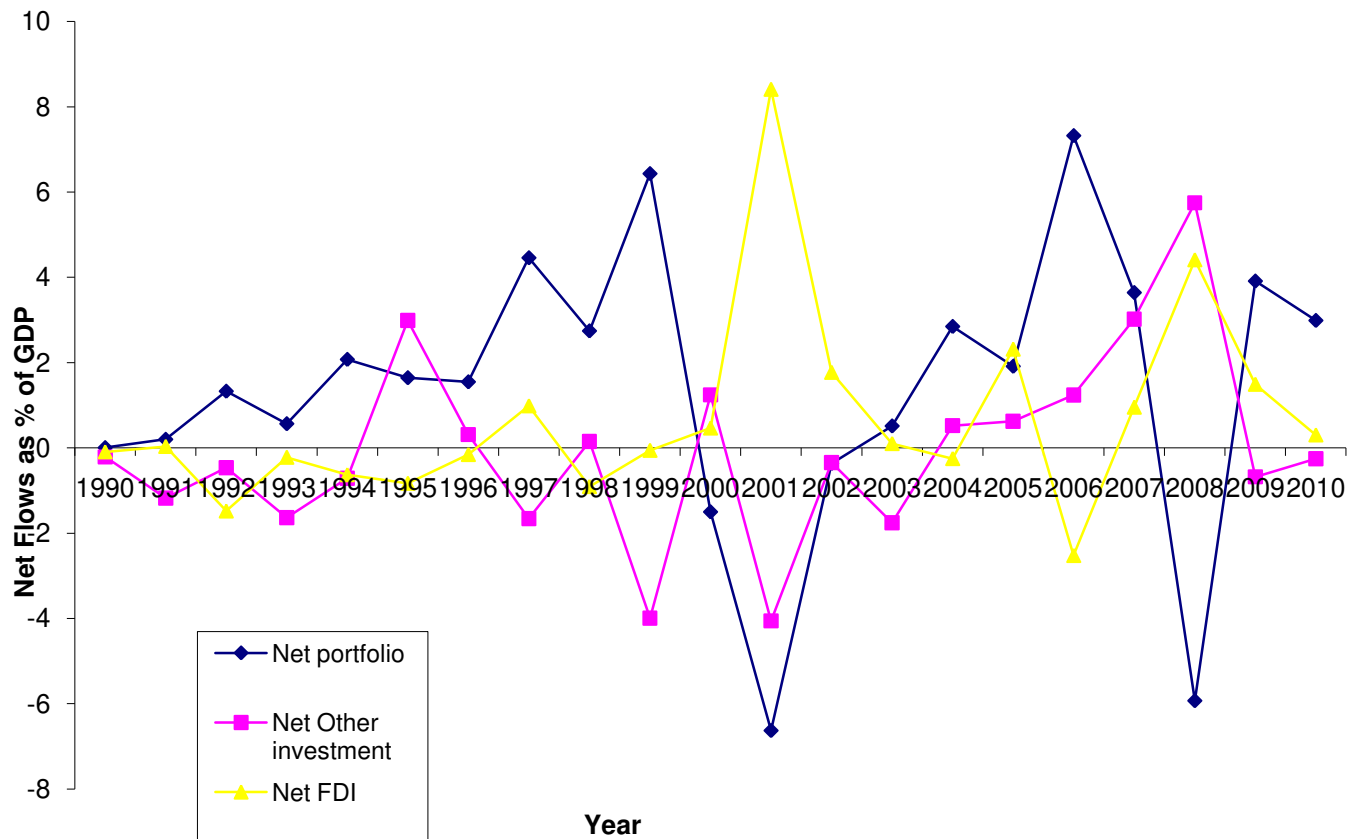
Source : (Quantec)

3.6 Net Capital Flows as a % of GDP

Figure 3.6 (below) shows the scale and magnitude of the surges and reversals that have come to characterize the current period. Financial account and other investment are the flows associated with capital flows into bank accounts (loans and other bank based products), and Portfolio Investment are the flows that come from buying and selling bonds and shares. These are the flows associated with capital account movements. Volatility begins in 1996 and intensifies thereafter. In 1996 net capital flows comprised less than 1% of GDP. By 2008 the swings are such that net portfolio flows (the most volatile of the components) could be plus or minus 8% of GDP in little more than a year (as we saw in 2008).

Portfolio investment is of course the most volatile component of the capital account. Between 1990 and 2010 there is first between 1990 and 1993 a period of small steady outflows. Starting in 1993 there is a significant decline; there is a sudden sharp reversal that takes us back to 1990 levels and lasts until the middle of 2003, when a another sudden sharp and deeper reversal takes hold and eventually finds a bottom near the end of 2006. A surge in inflows thereafter sees net portfolio investment reverse its direction and make all lost ground to peak in 2008 with a small positive net inflow (the only positive net inflow in the period under review. At this point there is another precipitous decline that continues to the end of the period. There can be no doubt that these surges and reversals are highly disruptive and destabilizing.

Fig.3.6

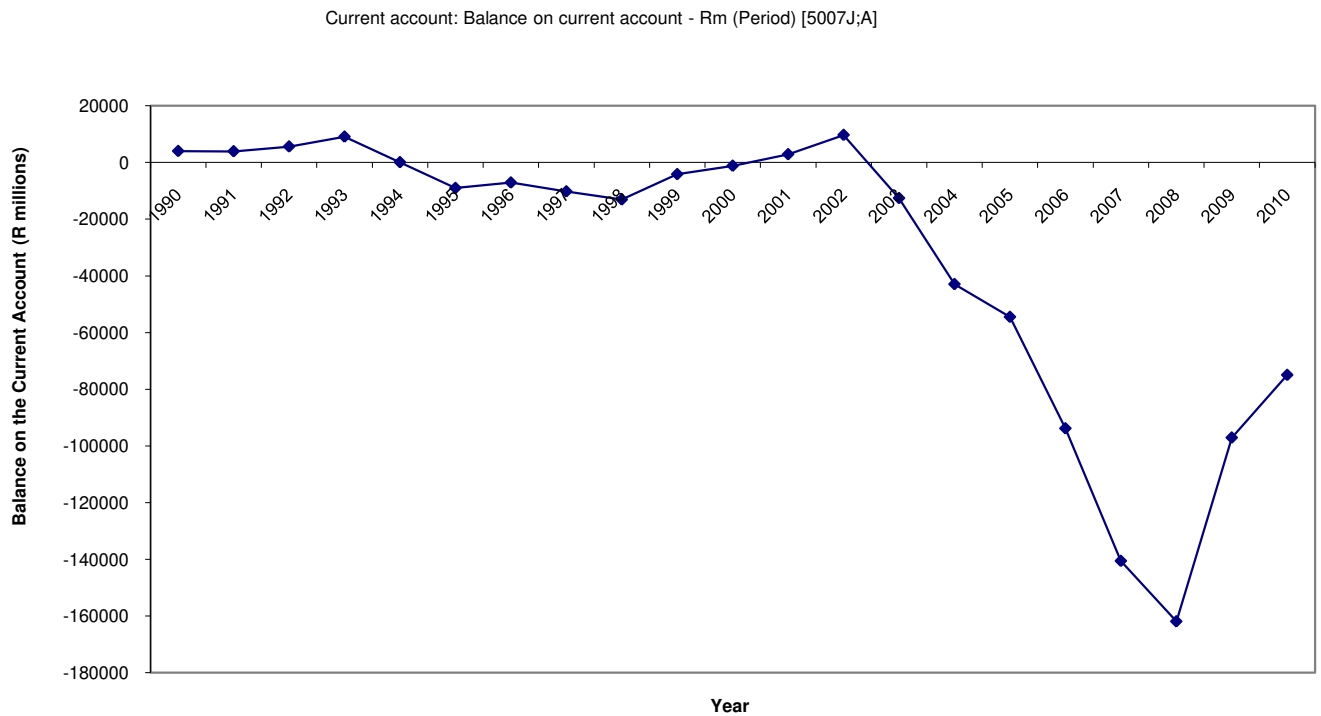


3.7 Current account Balance⁶

As Figure 3.7 (below) shows, the current account balance is a story in two parts. First there are relatively small and stable positive and negative balances until 2002, then starting in the middle of 2002 there is a precipitous decline to a deficit of R16.4 billion (or 7% of GDP) in December 2008.

⁶ This balance represents a nation's net income. It is the sum of the net balance of trade, plus net transfer payments, plus net factor payments.

Figure 3.7



Source : (South African Reserve Bank , Quarterly Bulletin)

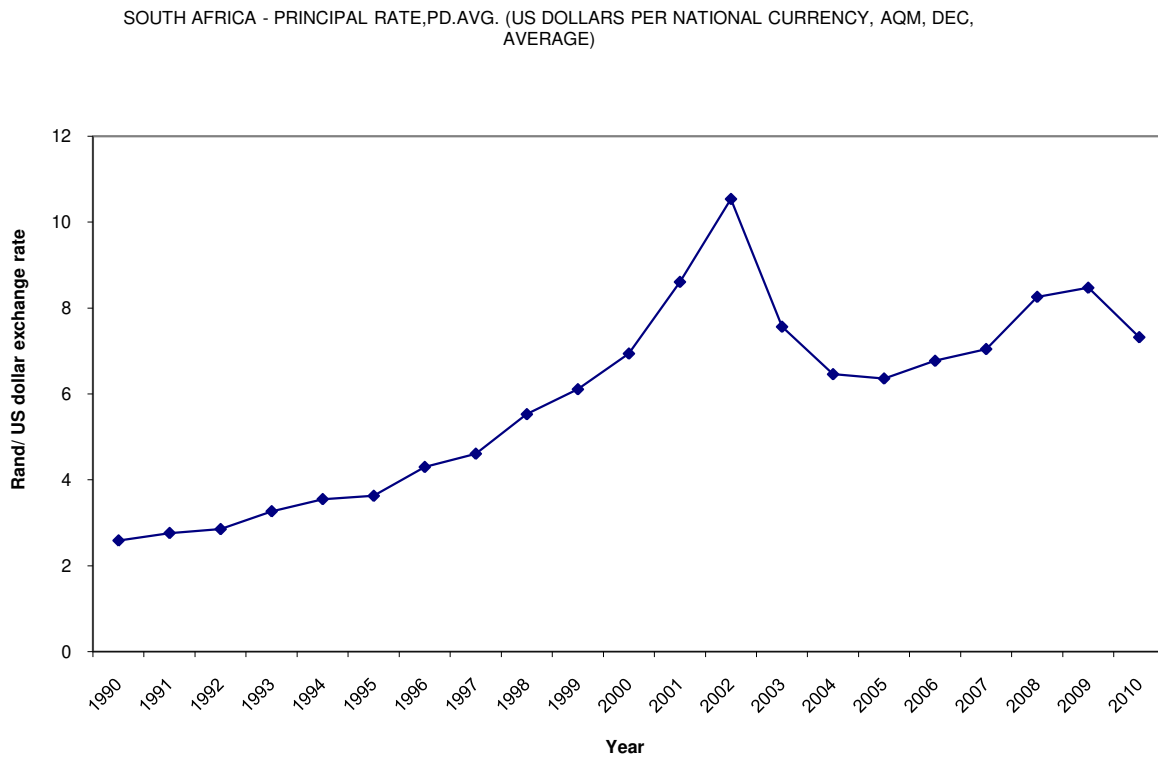
The early 1990's saw a period of moderate surpluses, as South Africa made its transition to democracy in 1994, South Africa's international stature grew and its surpluses turned to moderate deficits as more and more the country began to be perceived as a preferred destination for foreign investment. In 2001 and 2002 this pattern was interrupted as the events of 9/11 induced a period of financial contraction. Since then, the deficits have gone on to unprecedented levels to the extent that there is a serious question around sustainability.

3.8 Exchange rates

When a nation records a strong current account performance, its GDP is boosted by its export revenues. GDP expands and the currency appreciates against the countries major trading partners in the world. As Figure 3.8 shows starting from a low of just over R2 in 1990 there was a steady depreciation of the rand up to 2003. The US\$/ZAR exchange rate reached a high of 10.15. According to Frankel (2006), "the 2003-2006 real appreciation of the rand can be

attributed to the Dutch Disease. In other respects, the rand behaves like currencies of industrialised countries with well-developed financial markets.” During 2006-2010 the US\$ traded within a range just above R6.00 to R8.30. Starting in January of 2011, a 25% currency depreciation occurred in South Africa, and the Rand monetary area (Lesotho, Namibia and Swaziland) and also in Botswana. The depreciation is the direct consequence of the ongoing Eurozone crisis as investors pull back from emerging markets in general and South Africa in particular.

Figure 3.8



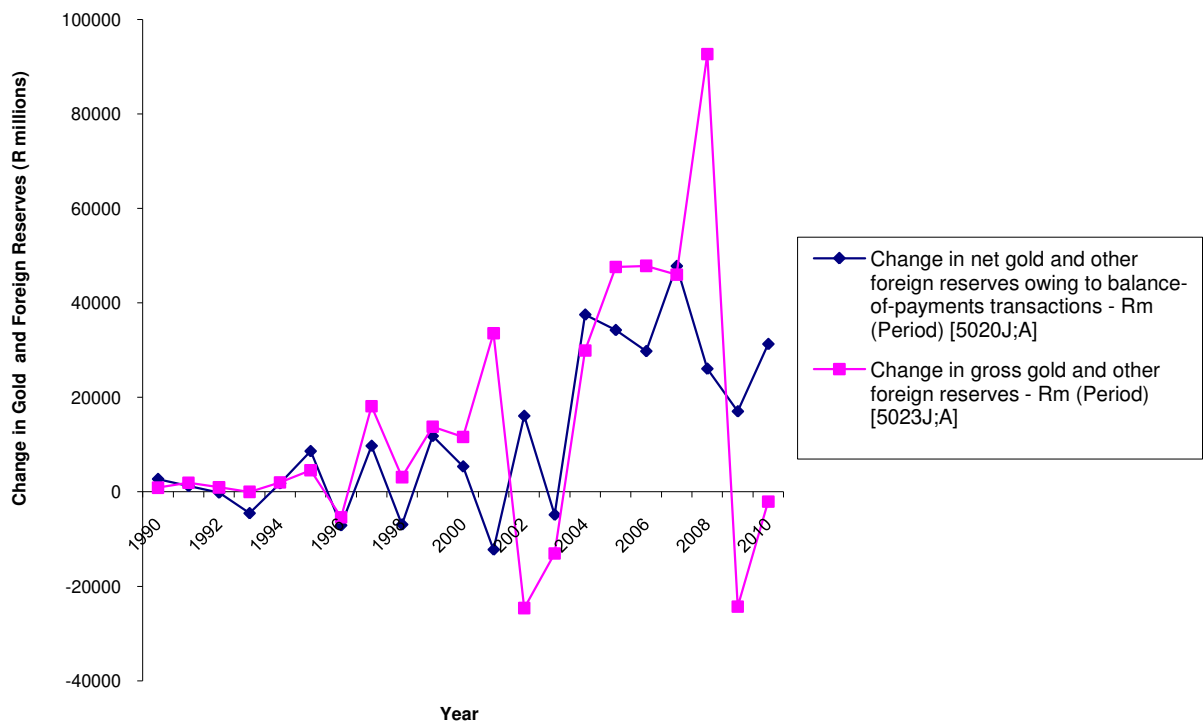
Source : (Quantec)

3.9 Reserve Position US\$

The reserve position (Figure 3.9) is the stock of all financial assets available to the SARB and government to meet South African balance of payments needs. It includes foreign currency, gold and holdings of IMF Special Drawing Rights (SDR's). The first half of the 1990s shows a period of relative stability and narrow fluctuations around zero. Starting in 1995, volatility

increases and the magnitude of divergence between the change in “gross” and “net” reserves assumes greater and greater magnitudes culminating in 2008.

Figure 3.9

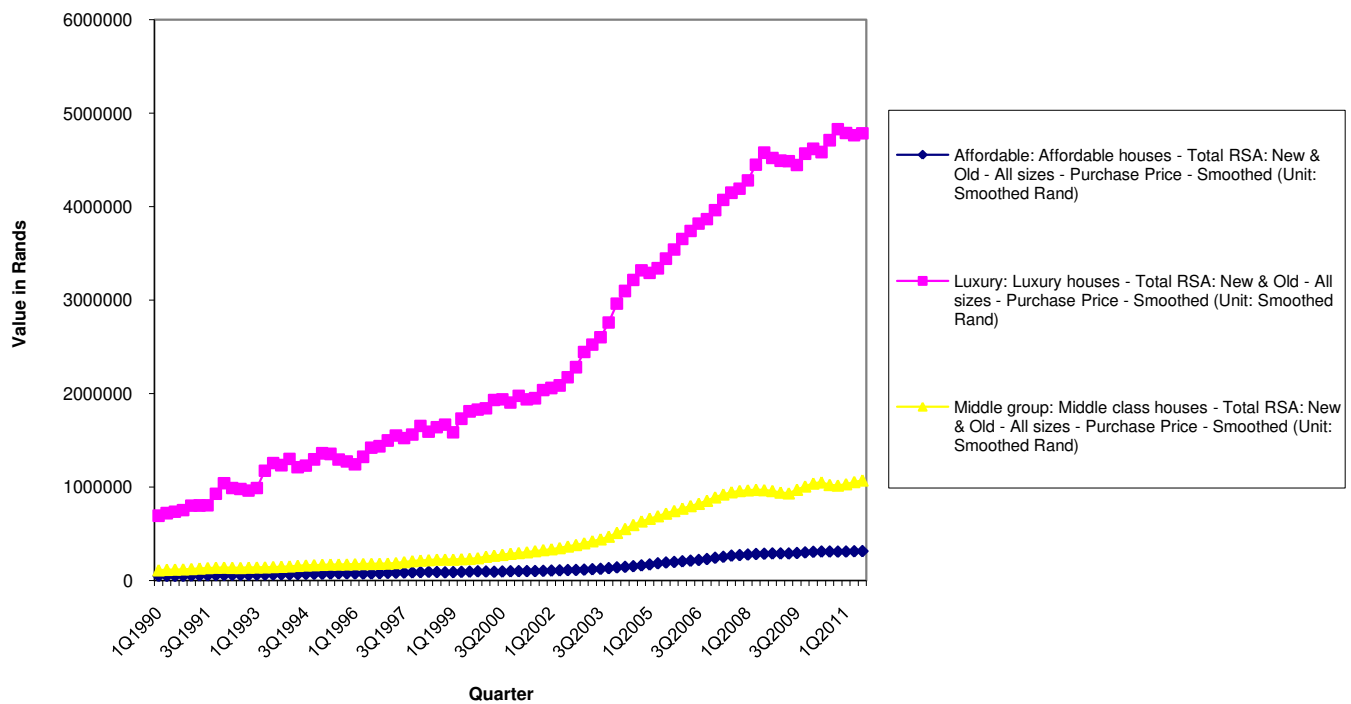


Source : (Quantec)

3.10 Absa House Index

The Absa House Index (Figure 3.10, below) evidences the real estate price inflation that has taken hold in South Africa. The steepest and most dramatic increase has been in the prices of luxury houses of the rich and affluent. But the middle income housing of the middle class shows a persistent increase. Low income housing has experienced a slight increase in price. Aggregated we have a considerable increase in the prices of homes over the period.

Figure 3.10

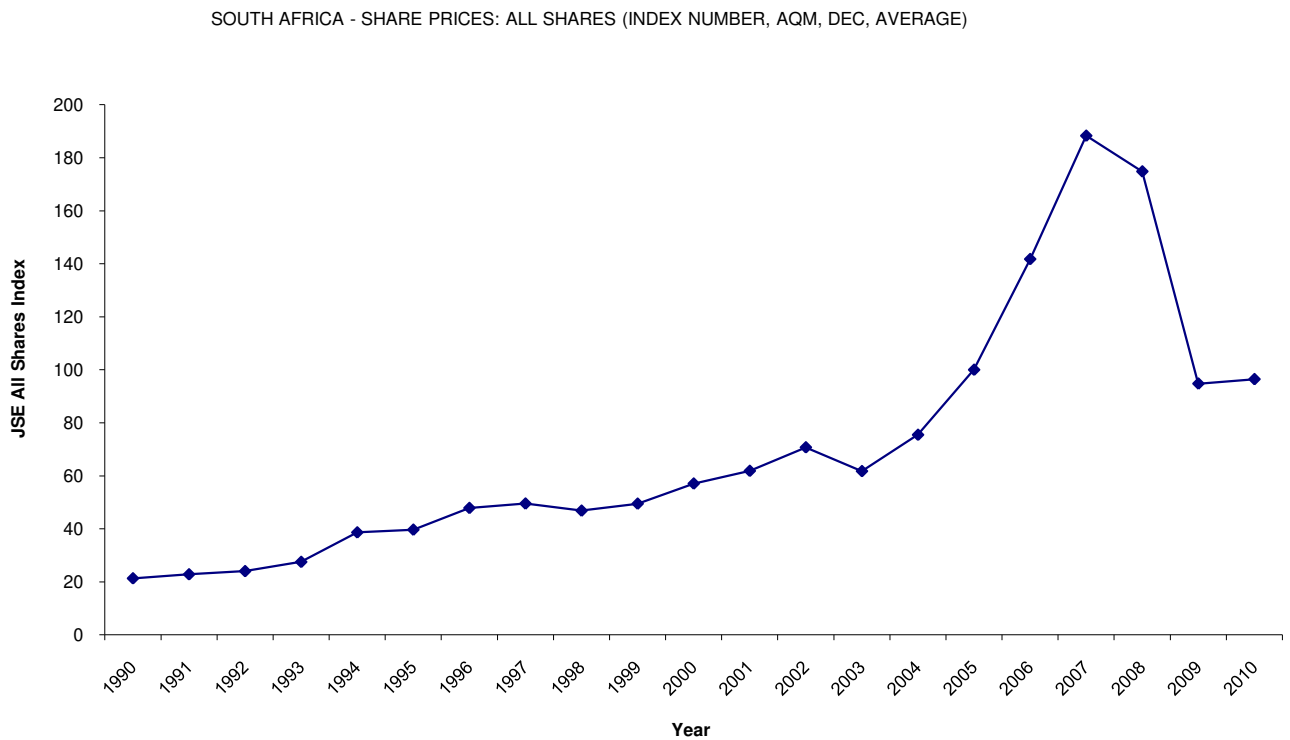


Source : (Quantec)

3.11 Johannesburg Stock Exchange (JSE) All Share Index

Figure 3.11 (below) shows the JSE index gradually increasing from just over 21.33 in 1990 to 70.44 in 2002. There then followed the only decline recorded for the period from 70.74 in 2002, to 61.77 in 2003. Thereafter there is a steep increase to 2007 when the index reached an all time high of 188.27. Over 2008 there was an equally steep decline to 94.77 in 2009. The index finished the period at slightly over 1996.

Figure 3.11

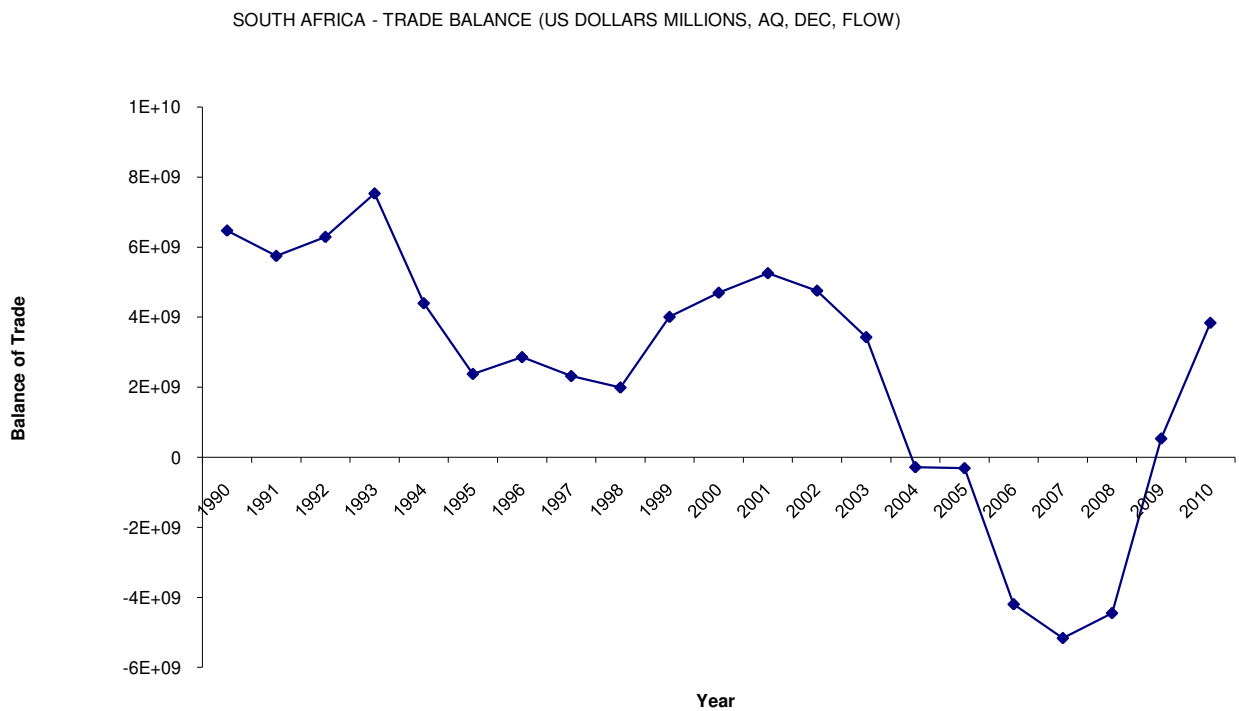


Source : (Quantec)

3.12 Balance of Trade

The balance of trade is the difference between the country's exports and imports on visible trade. It tells us what a country is earning on its exports and imports. Figure 3.12 shows that between 1990 and 2004, South Africa has a positive trade balance. In 2004, the trade balance goes into deficit; thereafter South Africa imports more than it exports. The decline comes to an end in 2007 when South Africa reports a trade deficit of US\$5160.5M. From 2007 the trade balance recovers to US\$3837.9M.

Figure 3.12



Source : (Quantec)

4.0 Conclusion – What are the Policy Lessons?

The foregoing review of South Africa's macro economic data reveal a number of economic phenomenon which closely parallel the R1 countries in Palma's stylized facts. Apart from volatility we see a deteriorating balance on the capital account, volatility in the balance on current account and the trade balance. The house price appreciation and huge increase in the JSE index all speak to the bubbles that we have seen elsewhere in the world and now represent a fairly constant feature of the financial crisis story. On balance we can conclude that South Africa sits (more or less neatly) into R1 of the three stylized routes to crisis. What are the policy implications?

As Chile is a R1 country its experience is particularly relevant⁷. Chile's use of capital controls is perhaps less controversial and more cut and dried in their outcomes than many others, and the evidence above suggests that South Africa should apply the same price based controls in its own monetary policy. None other than Joseph Stiglitz (1999) was to champion the use of "Chilean style" URR by developing countries seeking to avoid fragility and/or crisis as a result the mobility of capital (Cordero and Montecino, 2010). Also, there is a wide consensus that accepts that the Chilean authorities increased monetary policy independence and were successful in altering the composition of the inflows. Where there is disagreement it is on the extent to which the controls were able to suppress the appreciation of the currency and decrease the volume of the flows. Frenkel and Repetti (2010) report that the controls had a critical impact on Chile's ability to maintain a stable and competitive exchange rate while keeping inflation under control.

It may also be of some importance for South African policy makers to know that Chile employed capital controls, with no loss of its neo liberal credentials. The controls in the

⁷ Mexico is the other R1 country cited by Palma.

Chilean case were a pragmatic response to the destabilization of a looming crisis. This may help to loosen the current straight jacket that neoliberal alignment seems to have imposed.

Arising out of the review undertaken for this study it is clear that all countries that faced sudden surges and reversals in capital flows also faced a common set of related issues/questions; first, there is the question of the changing composition of capital inflows, second, the progressive deterioration in the term structure of loans, and last, what Palma calls, “attack from within.” If this article is the first step in the contribution to the debate on the use of the best theory and evidence in policy, then it follows that the wider and ongoing research programme should seek to develop in any one of these three directions around any or all of these three issues.

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