

FESSUD

FINANCIALISATION, ECONOMY, SOCIETY AND SUSTAINABLE DEVELOPMENT

Working Paper Series

No 142

Financialisation and Development: South African
Case Study

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ISSN 2052-8035

Financialisation and Development: South African Case Study

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Abstract: This paper explores the consequences for development of the financialisation of the South African economy. It does so by unpacking the relationship between financialisation and growth, volatility, crises and distribution. Central to this are patterns of capital flows, domestic credit allocation and domestic investment. The paper illustrates the deleterious effects of financialisation in the South African context.

Key words: Financialisation, Finance, Development, South Africa, Developing Countries

Date of publication as FESSUD Working Paper: May, 2016

Journal of Economic Literature classification: E11, E12, E22, E44, F21, F32, F60, F62, F63, F65, G10, G15, O11, O16, O23, O40, O55, P16,

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Acknowledgement: The research leading to these results has received funding from the European Union Seventh Framework Programme (FP7/2007-2013) under grant agreement n° 266800.

Website: www.fessud.eu

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1 Introduction

This paper unpacks the consequences for development of the financialisation of the South African economy as one case study comprising Deliverable D6.07 under the EU FP7 FESSUD grant. FESSUD, *Financialisation, economy, society and sustainable development*, aims to understand how finance can better serve economic, social and environmental needs and to develop a comprehensive policy agenda for changing the role of the financial system. Work Package 6 of FESSUD (within which this paper falls) focuses on, amongst other things, the consequences of the changing global financial and monetary system for developing and emerging markets.

The topic of this paper poses numerous challenges. Both “financialisation” and “development” are contested notions with varying competing definitions. Even more complex is trying to trace the “consequences” of the former on the latter. Teasing apart casual relations is a fraught exercise, and can be best be undertaken by micro analysis of individual firms where annual reports and the like can offer insight into why certain decisions where made, or econometrically. However, even econometric techniques, which this paper cites at various points, mainly tell us that two variables correlate and which occurs before the other; in many cases descriptive statistics can tell us the same thing. However, sufficient firm level studies to make economy-wide conclusions and a plethora of econometric analyses are beyond the scope of this paper.

In light of this, the paper offers a sweeping and comprehensive overview of the relationship between financialisation and development by drawing extensively on the international literature and South African descriptive statistics. In each section the international evidence – drawing from both the financialisation and more orthodox financial deregulation / liberalisation literature – regarding how

specific changes in the financial system elsewhere in the world have impacted on development, is given. This is followed by evidence on the South African case suggesting whether similar consequences are likely based on local financial developments. In doing so the paper uses fifteen different datasets with hundreds of variables.

The paper proceeds as follows. Section 2 provides a background to the concept of financialisation and the more mainstream notions of financial liberalisation and deregulation. This is followed by an overview of financialisation in South Africa in Section 3. Section 4 is the heart of the paper and provides rich data on the depth and dynamics of financialisation in South Africa comparing those to the international experience and the developmental consequences thereof. Section 5 concludes.

2 Financialisation and the promise of financial liberalisation and deregulation

The notion of “financialisation” has gained prominence within the political economy, heterodox economics, sociological and geographical literature over the past fifteen years, and is increasingly referred to within the mainstream. It arises out of, and is characterised by, the predominance of the influence of financial markets over more and more spheres of economic, political and social life and the subjugation of these to the logic, dictates and imperatives of financial markets. More deeply, it refers to a particular restructuring of capitalist productive and social relations over the last four decades. Financialisation is inherently a globalised phenomenon, spurred by the internationalisation of production and shaped by the transnational flows of finance capital.

Financialisation is witnessed via a range of indicators. Finance has grown as a share of economic activity with a proliferation of financial actors, markets and products, the latter purportedly allowing for the diversification of risk. Large institutional investors have arisen playing central roles in financial markets and as shareholders of non-financial corporations (NFCs). These NFCs have become subject to the imperatives of financialisation with the emergence of a new “market for corporate control” where investors buy and sell companies as bundles of assets, the prioritisation of “shareholder value” orientation and via their increasing participation in financial market activity.

Financialisation has also deeply affected households, with households' financial assets – such as pension funds – and liabilities – such as mortgage and credit card debt – ballooning. Financialisation has constrained government policy, while also being actively supported by certain policy choices, and has shaped relations between states and markets, making states (willingly or unwillingly) subject to the whims of financial markets. This is acutely felt in developing countries where cross-border capital flows, which have grown enormously over the past few decades (see below), play a crucial role in charting economic development. Financialisation can be conceived of as a central feature of the neoliberal period during which it became received wisdom that “human well-being can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by strong private property rights, free markets, and free trade” (Harvey 2005, p. 2).

Through all these means capitalist productive and social relations – between financial institutions and households, non-financial institutions and the state, within corporates themselves, between states, and so on – have been reconfigured. In the 1970s and 1980s growing financialisation assisted in the resurgence of the hegemony of capital and in reigniting profitability and

accumulation. However, financialisation, like all phases of capitalist development, is subject to its own internal contradictions, which became clear as it evolved, in this case the 'conspicuous combination of restrictive and dynamic tendencies, namely weak accumulation on the one hand and financial expansion on the other' (Müller 2013, p. 4).

This makes financialisation a far more expansive and complex characterisation of transformation in contemporary capitalism than is often found within the mainstream economics literature. Nevertheless constituent parts of that orthodox literature refer to important trends that are deeply articulated with the process of financialisation. Most pertinent is the push for, and analysis of, financial deregulation and liberalisation that has occurred since the 1970s. In considering the impact of financialisation on development in this paper, we draw from both the orthodox analyses of the consequences of financial liberalisation and deregulation and the more complex restructurings captured by financialisation, of which liberalisation and deregulation are a key drivers.

The 1970s saw the escalation of attempts to loosen constraints imposed on the financial sector in the wake of the great depression and as part of the post-World War II Bretton Woods agreement; constraints that had been contested since their imposition. Such changes were spurred by the internationalisation of production which called forth greater need for international finance, a drive by the financial sector to increase profitability and its share of value added, and the crises of the 1970s and attempts to restore profitability and reinvigorate capitalist accumulation (Cohen 1977, Palloix 1977, Helleiner 1996, Panitch and Gindin 2009, Panitch and Konings 2009). This was assisted by theoretical developments within academia and subsequent policymaking and was an important turning point in how financial regulation in the developing world, and between the developed and developing world, was conceived.

Central to this was the work of McKinnon (1973) and Shaw (1973) who 'ascribed the poor performance of investment and growth in developing countries to interest rate ceilings, high reserve requirements and quantitative restrictions in the credit allocation mechanism', essentially 'government restrictions on the banking system restrain the quantity and quality of investment' (Arestis and Sawyer 2005, pp. 2, 6, 10). Despite their disagreements over the mechanisms, both argued that the expansion of the real money stock leads to an expansion of investment and therefore growth. Both also argued that in developing countries the real money stock was low because of low interest rates due to policies of financial repression and high inflation. The solution was financial liberalisation, in particular free-floating interest rates which would expand the monetary base and allow the efficient reallocation of resources especially to more marginalised sectors such as agriculture and small and medium enterprises (SMEs). As a result, and in tandem with debt management difficulties which culminated in the 1982 debt crisis, financial liberalisation gained prominence as part of development policy, actively promoted, for instance, by the IMF and World Bank as part of structural adjustment programmes (Bonizzi 2013a, pp. 2–4).¹

Within the mainstream of economic theory, various theoretical and empirical critiques have been levelled against these propositions. Most important: are whether higher interest rates or financial liberalisation in general, actually increase savings with widespread agreement that the effects are at least ambiguous; that such liberalisation increases susceptibility to crisis; and that the financial liberalisation paradigm does not take account of market failures. Following this, pre-conditions for, and the sequencing of, successful implementation of financial liberalisation came to be emphasised. On the theoretical side, a new literature on financial development emerged as part of endogenous growth theory, giving a more comprehensive account of the how advances in financial intermediation can positively impact growth. In particular

financial development was argued to increase the fraction of savings turned into investment; improve the efficient allocation, and thus productivity, of capital; and increase the savings rate (Bonizzi 2013a, pp. 4–6). These would all positively impact on growth (Arestis and Sawyer 2005, p. 7).²

In addition to removing controls on the interest rate, the literature on financial liberalisation called for the withdrawal of the state from financial intermediation; easing conditions for the participation of firms and investors in the stock market; breaking down the wall between retail and investment banking activities; expanding the sources from, and instrument through which, firms of financial agents can access funds; and liberalising the rules governing the kinds of financial products and instruments that can be issued and traded (Ghosh 2005, pp. 2–3).

Gradually arguments against financial “repression” came to be applied to any restriction on the mobility of domestic or international financial capital. There was therefore a push towards capital account and exchange control liberalisation. According to the neoclassical economic theory advanced, savings should flow from capital-abundant (developed) countries (with high capital-to-labour ratio) to capital-scarce (developing) countries (with low ratios) because of differentials in expected capital returns. Financial openness theoretically allows foreign savings to financial investment and consumption at lower cost in developing countries thus smoothing shocks, and facilitating higher specialisation and productivity. In addition it supposedly reduces risk through asset diversification and helps correct balance of payment problems by allowing flexible adjustments of domestic demand. Finally, such flows would result in international finance serving as a disciplining force on domestic economy policy (see Cooper 1999, pp. 20–21, Prasad *et al.* 2006, p. 2, 2007, p. 119, Paineria 2009, p. 6, Bonizzi 2013a, p. 29). This resulted in “external” (i.e. between domestic and foreign markets) deregulation and liberalisation which

allowed foreign residents to hold domestic financial assets (and visa-versa, thus easing the possibility of capital flight); greater freedom for domestic firms to undertake external commercial borrowing; dilution of controls on the entry of new (local and international) financial firms; and measures which allow foreign currency to be freely held and traded within the domestic economy (Ghosh 2005, p. 3).

Financial liberalisation and deregulation has not been confined to the developing world and the policy choices described above have spurred and interacted with the process of financialisation more generally. Financialisation in the capitalist core has been driven both by the internationalisation of productive capital from the 1950s onwards, which required international finance to facilitate its expansion, and by financial capital, which in pursuit of its own appropriation of the social surplus flexed, and eventually burst, the strictures placed upon it under Great Depression legislation and the Bretton Woods system.

The same logic, forces and interests which has spurred financialisation in the capitalist core and grown in strength because of it, have driven financial deregulation in the developing world and the liberalisation of capital flows between the developed and developing worlds. At the same time, the increasing financialising of developing country economies has been a product of the process of financial liberalisation and deregulation. In addition, the purported benefits assumed to flow from such policy choices have partially failed to materialise and developing countries have become more exposed to the vagaries of international financial markets and attendant crises.

3 Financialisation in South Africa in brief

The South African economy has undergone sweeping changes since the easing and removal of international sanctions in the late 1980s and early 1990s and the transition to democracy post-1994. The most notable changes include the deconglomeration and internationalisation of six massive conglomerates which in 1990 controlled 84% of shares on the Johannesburg Stock Exchange (Chabane *et al.* 2006, p. 553) and their streamlining into reformed corporate entities with strong shareholder value maximisation orientation. These changes – often an extension of pre-existing trends – also include liberalisation of both trade and capital markets including massive legal and illegal capital flight, a prioritisation of price stability via inflation targeting, fiscal discipline, the promotion of Black Economic Empowerment (BEE) and lacklustre industrial policy (see Isaacs 2014 for a discussion of South African macroeconomic policy).

We shall see throughout that many of the economic trends which we have pointed to begin between 1994 and 1996. This corresponds to a period of financial liberalisation which includes: the government's return to international capital markets; the abandonment of the financial rand; lifting of restrictions on foreign bank entry and foreign participation on the Johannesburg Stock Exchange (JSE); easing limits on institutional investors' financial trading, locally and abroad; and relaxing FDI requirements (Harvey 2015). This was followed later by inflation targeting and further market liberalisation.

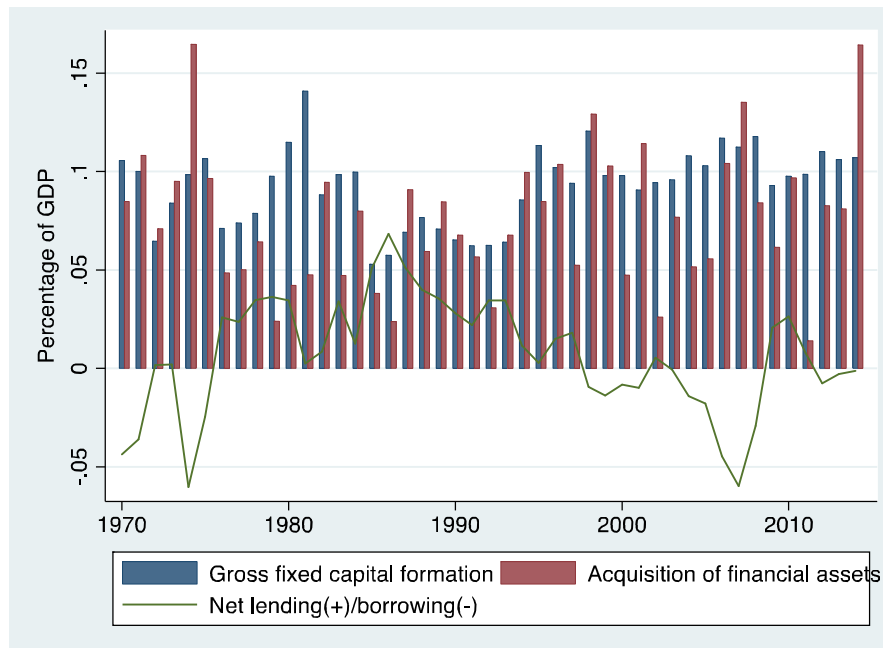
The broader process of financialisation has underpinned many of these transformations. In the past two decades the gross value added (GVA) of finance, insurance, real estate and business services has grown at a rate of 4.7% compared with GDP growth of 3.1% and the share of GVA that these sectors comprise has grown from approximately 13% under apartheid (1950-1993) to approximately 19% in the last twenty years (1994-2014) (SARB 2015a).

Financial markets, already deep and relatively liquid by the end of apartheid, have experienced significant expansion, including market capitalisation to GDP rising from 123% in 1990 to 291% in 2007 and subsequently declining to 160% in 2012 alongside strong growth in currency and derivative exchanges. Institutional investors play an important role in the economy but the lions' share of net lending and financial investment remains mediated via banks, with the traditional distinctions between banks, merchant banks, instalment credit houses and building societies having dissolved. The banking sector remains highly centralised within four dominant commercial banks that enjoy comparatively high net interest margins (Beck *et al.* 2010).

Non-financial firms have also become subject to the imperatives of financialisation with the emergence of a new “market for corporate control,” the prioritisation of “shareholder value” orientation and their increasing participation in financial market activity. This has occurred in tandem with their internationalisation and listing on foreign stock markets, which has been accompanied by significant legal and illegal capital flight. Internationalisation has led to their insertion into already financialised global markets and global value chains. This and the general liberalisation of the economy have also meant the importation and imposition of financialised business norms on South African businesses as a whole.

One key consequence of the altered investment patterns, as elsewhere in the world, has been the steady rise in the acquisition of financial assets with the concomitant decline in gross capital formation; this is shown for the private non-financial corporate sector in Figure 1. Investment patterns form a central part of our forthcoming analysis.

Figure 1: Net capital formation, net acquisition of financial assets, net financial investment (flows) (1970 - 2014)



Source: SARB [Source: 2012]

Financialisation has also deeply affected households. Under apartheid the banking system developed a sophisticated range of financial services largely for the white privileged minority. This has been expanded to incorporate the black majority but in 2012 approximately 30% of adults (16 years and above) remained “unbanked” and 18% “financially excluded”³ despite a steady increase in “access” to financial services. The last decade has witnessed a resurgence of mortgage financing (still skewed against the poor) and expanding consumer credit together with a marked rise in both the assets and liabilities of households with housing having an overall negative net financial position. Together these have led to an astronomical real estate bubble and a consumption boom that is widely recognised to have driven the economic growth of the mid-2000s. This has all been fuelled in large part by short-term foreign capital inflows (as against long-term outflows) which are also discussed below.

The South African Government has supported financialisation. On a policy level, significant financial liberalisation in the 1990s spurred financialisation while

monetary policy has continued to favour, and accommodate, open capital accounts, with the exchange rate and interest rates dominated by global capital flows. Inflows have been largely “market-seeking” and have predominately ended up in stock market trading, property markets or onward lending to households. There has also been a significant increase in international debt issues rising from just over 3% of GDP in 1988 to just shy of 9% in 2009 (Beck *et al.* 2010). Outflows have consisted of FDI, particularly in Africa, dividend disbursements to overseas shareholders with many companies now registered on foreign exchanges and various forms of legal and illegal capital flight. The patterns of these flows are discussed further below.

Despite these significant transformations political and economic power remains concentrated within large (predominately white-owned) mining, mining-related, and finance capital; what Fine and Rustomjee (1996) termed the Minerals-Energy Complex (or MEC) two decades ago. This concentration, together with the process described above, has retarded industrialisation and the emergence of a strong manufacturing sector, particularly in industries unrelated to mining. This has been closely connected with the internationalisation of large former conglomerates as they turn their eyes and investment abroad.

With this theoretical framework and empirical context in mind we turn now to the body of the paper, a discussion of the developmental impacts of financialisation with particular application to the South African case study.

4 The consequences of financial liberalisation and deregulation and financialisation for development

The notion of “development” is highly controversial and heavily critiqued, however, delving into these critiques is beyond the scope of this paper. Here we use the term fairly generically and focus on particular indicators or facets of development. In each section we weave together the international theoretical literature and empirical findings and empirical evidence from the South African case.

First, we question the relationship between finance and economic growth (generally measured by some version of GDP growth). The general finding is that financial “development” and “liberalisation” is not proven to be growth enhancing and is often growth retarding, furthermore the broader process of financialisation is also growth retarding. Second, if the recent expansion of finance is not growth enhancing then what accounts for this? Here, we argue that financialisation has resulted in particular patterns of investment and movements of capital (between and within states). These patterns, which reflect underlying productive and social relations, while originally functional to reviving capitalist accumulation, result in various contradictions which cause instability and undermine accumulation. This is true internationally and in South Africa. Given the centrality of these patterns considerable time is spent on this analysis. Third, we trace the relationship between financialisation and distribution and show that through direct and indirect channels, financialisation has played a pivotal role in growing levels of inequality and poverty witnessed generally, and in South Africa in particular.

4.1 Finance and growth

Both the mainstream and financialisation literature have attempted to unravel the relationship between finance and growth, with contested results. The mainstream approaches this predominately through regressing measures of domestic financial depth or financial openness against measures of growth.

The financialisation literature supplements this via analysis of how financialisation has played a determining role in shaping overall growth paths.

Regarding domestic “financial development” five broad mainstream approaches dominate. First, there are those who argue that financial institutions play a “supply-leading” role promoting growth in the real economy, most simplistically by mobilising savings for the most productive investment (see for example Gurley and Shaw 1955, Goldsmith 1969, King and Levine 1993a, 1993b, Levine and Zervos 1998, Beck *et al.* 2000, Levine *et al.* 2000, Xu 2000).⁴ Second, an alternative argument is that financial development is “demand-following”, that is that economic growth generates demand for financial services and so the expansion of the financial sector follows that of the real economy (see for example Kuznets 1955, Robinson 1982, Al-Yousif 2002, Ang and McKibbin 2007). To confuse matters, some suggest that the casual relationship depends on which financial development indicator is used (see for example Arac and Ozcan 2014) or that causality runs in both directions (Huang 2011). Third, a range of studies have argued that a correlation may exist between financial development and growth but that there is no casual relationship (see for example Graff 1999, Favara 2003). Fourth, it is argued that the effects of financial development are heterogeneous, varying between developed and developing countries,⁵ based on country characteristics such as the “quality” of institutions (for example Owen and Temesvary 2014), when differentiating between the short and long run (for example Loayza and Ranciere 2006) at different points in time (for example De Gregorio and Guidotti 1995, Rousseau and Wachtel 2011), and whether it is bank- or market-based (for example Ergungor 2008). Different studies focusing on heterogeneity have however yielded opposing results.

Finally, building on earlier work which indicated a non-linear and possibly non-monotonic relationship between financial development and economic growth

(see Deidda and Fattouh 2002, Favara 2003, Shen and Lee 2006, Ergungor 2008, Huang and Lin 2009), a body of literature has recently emerged which argues that the relationship between growth and financial development is U-shaped, that is, that after financial development exceeds a certain threshold level the effects are negative. Theoretically this proposition can be traced back at least to Minsky (1974) and Kindleberger (2005) which makes it even more interesting that it has entered the mainstream. This literature is a significant advance over early studies because the methodologies employed in most of the earlier work do not allow for a non-monotonic relationship, this threshold turning point is therefore excluded by definition. Arcand et al. (2012, p. 7) note that 'this vanishing effect is not driven by a change in the fundamental relationship between financial depth and economic growth, but by the fact that [previous] models that do not allow for a non-monotone relationship between financial depth and economic growth are miss-specified'. It is worth taking a closer look at this literature.⁶

Cecchetti and Kharroubi (2012), in a Bank of International Settlements paper, find a parabolic (U-shaped) relationship between three measures of financial sector growth – private credit to GDP, private credit of banks to GDP, and the financial sector's share of total employment – with turning point estimates at roughly 100% of GDP, 90% of GDP, and 3.9% of total employment respectively. Below these values the effect of financial developed on growth is positive, and above it is negative; all findings are statistically significant to at least the 5% level and robust to the addition of various controls. Arcand et al. (2012), in an IMF paper *Too Much Finance* – using a range of regression specification(s) and tests, with the ratio of total credit extended by the financial sector to GDP as a measure for financial development during the period 1960 and 2010 and various sub-periods within this – find similar results. Their turning point estimates for the credit-to-GDP ratio are concentrated between 75% and 100%. Importantly, they also show that in general the relationship is statistically insignificant at

intervals close to the turning point estimates, ranging from 42% to 124%, but significant further away.

Law and Singh (2014) use a dynamic panel threshold model, which they contend is the most precise, on a panel of 87 developed and developing countries in the 1980-2010 period. They estimate using three ratios – private credit to GDP, liquid liabilities to GDP, and domestic credit to GDP – with turning point estimates of 88%, 91% and 99% respectively. For two of the measures the positive relationship below the thresholds are not statistically significant at the 5% level and in two the negative relationship is statistically significant, also at the 5% level. Most other relationships are statistically significant at the 5% level and all are robust to various controls. Finally, Samargandi et al. (2015), run similar regressions on 23 upper middle-income countries and 29 lower middle-income countries using the ratio of M3 to GDP as the indicator of financial development and also find a U-shaped relationship. Their dynamic panel threshold model yields turning point estimates of 92% of M3 to GDP for MICs and UMICs and 43% for LMICs.

Interestingly, Arcand et al. (2012) argue that using more recent data weakens the positive aspect of the relationship between financial depth and growth, speaking to the changes that have occurred within the financial sector over the last three decades. This is consistent with De Gregorio and Guidotti's (1995) and Rousseau and Wachtel's (2011) findings that the positive correlation between credit to the private sector and GDP growth weakened in more recent decades. This is congruous with the financialisation analysis.

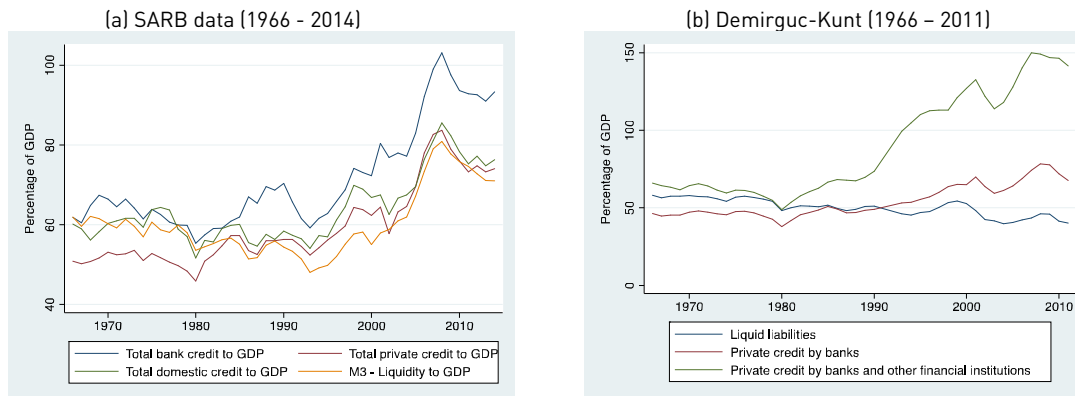
What is clear in the studies cited above is that when allowing for non-monotonic relationships, financial development has a negative effect after credit or liquidity (measured in a variety of ways) exceeds between 75% to 100% of GDP, and a statistically insignificant impact on either side of this. Law and Singh offer

three possible explanations for the presence of such a threshold. First, that the relative magnitude of the types of loans provided by the financial system may play a crucial role with investment loans promoting growth and consumption and non-productive loans impeding it. This is in line with Ang and McKibbin (2007) who note that the return from financial development depends on the mobilisation of savings and allocation of funds to productive investment projects. This is investigated further in Section 0. Second, that financial development may help countries to 'catch up to the productivity frontier, but has limited or no growth effect for countries that are close to or at the frontier'. Third, that the financial sector attracts too much "young talent" away from the rest of the economy (Law and Singh 2014, pp. 40–41). Cecchetti and Kharroubi make a similar point arguing that the 'financial industry competes for resources with the rest of the economy' with respect to physical capital and skilled workers, while Arcand et al. (2012, p. 5) positively reference Tobin (1984) who 'suggested that the social returns of the financial sector are lower than its private returns and worried about the fact that a large financial sector may "steal" talents from the productive sectors of the economy and therefore be inefficient from society's point of view'. These factors no doubt play a role, but the authors fail to situate their findings in a cogent political economy analysis of finance in the way that the financialisation literature does.

The South African data shows that the thresholds established in the international literature have been reached. We observe in Figure 2 that from around 1996 onwards – coinciding with financial liberalisation – credit as a share of GDP by a variety of measures increases significantly. These peak at between 80% and 104% of GDP in 2008, precisely the threshold levels established in the literature. Demirguc-Kunt et al.'s (2013) prominent Financial Development and Structure Dataset shows private credit by banks and other financial institutions peaking in 2008 at just shy of 150% of

GDP; this dataset shows liquid liabilities and private credit of banks at lower than the SARB (2015a) data.

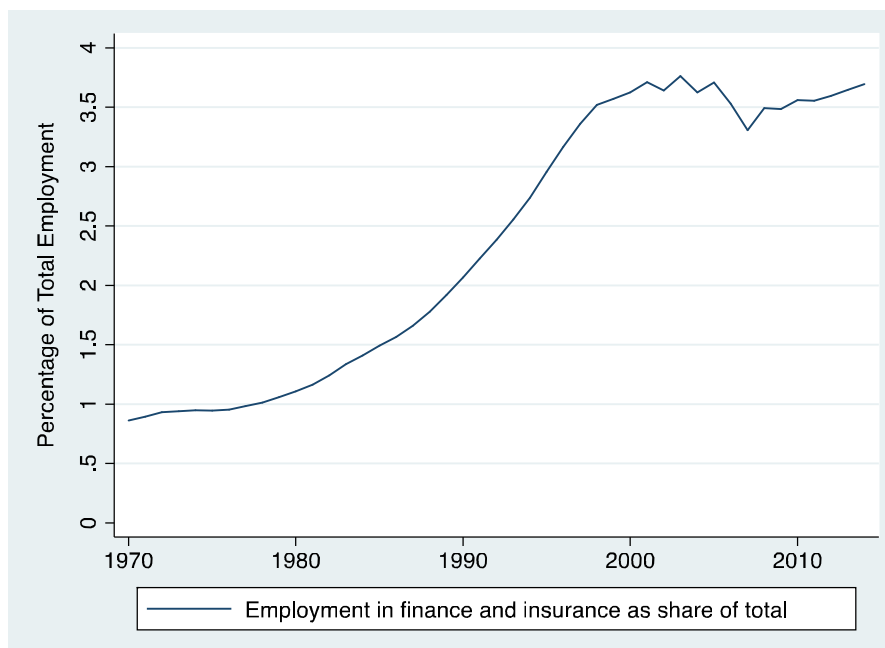
Figure 2 Financial development: Credit as a percentage of GDP



Source: SARB (2015a), own calculations and Demirguc-Kunt et al. (2013)

Similarly, Figure 3 shows that employment in the finance and insurance sector has grown enormously, from under 1% in 1970 to over 3.5% in 2014. The turning point for negative growth effects found by Cecchetti and Kharroubi (2012) internationally is 3.9%. In 2014 South Africa sat marginally below this at 3.76%. This combined evidence suggests that South Africa may very well suffer from “too much finance” and the attendant negative growth effects.

Figure 3 Employment in the financial and insurance sector as a percentage of total employment (1970 - 2014)



Source: Quantec (2015), own calculations

A substantial body of literature has also compared the relationship between financial “openness” or “integration” (difficult to measure but essentially external liberalisation) and growth, also with contested conclusions. Theoretical arguments advance that capital flows can benefit both source and recipient countries through improving resource allocation, reducing financing costs, increasing competition and accelerating development of domestic financial systems (King and Levine 1993a, Schmukler 2004a, 2004b, Mishkin 2009). There is some evidence to support very specific positive benefits such as increased FDI (see Section 4.3), temporary growth gains (Henry 2007), and positive relationships between stock market liberalisation and growth (Bekaert *et al.* 2004a) and between financial integration and productivity (Bonfiglioli 2008).⁷

However, the evidence is overwhelming, as witnessed by a range of individual studies and meta-analyses (see, for example, Rodrik 1998, Prasad *et al.* 2007, Kose *et al.* 2009, see also Obstfeld 2009) that financial integration is neither a necessary nor sufficient condition for rapid economic growth, nor is there a predominant statistically significant relationship between changes in financial openness and growth when other growth determinants are controlled for.⁸ This is particularly the case with developing countries, for which Demir notes that the net effect of financial liberalisation is: ‘higher real interest rates, persistent credit rationing, lack of long-term credit (Demir 2004; Economic Intelligence Unit 2003a, 2003b; Fanelli, Rozenwurcel, and Simpson 1998), and increasing risk and uncertainty in key macro prices (Calvo, Leiderman, and Reinhart 1993; Frenkel and Rozada 2000; Gabriele, Boratav, and Parikh 2000)’. Further there is ‘increasing evidence suggesting that during this period, “financial markets lowered growth, eroded profitability, and shortened the planning horizons of

the large NFCs” (Crotty 2005: 7; see also Demir 2007)’ (Demir 2007, pp. 353–354).

Like with domestic financial development, this non-relationship has led proponents of financial market integration to blame market “distortions” (Arestis and Sawyer 2005, pp. 11–12) and emphasise threshold effects and the need for: appropriate sequencing, a supportive macroeconomic environment, and good governance and institutions in order to reap the purported benefits from liberalisation (Arteta *et al.* 2001, Edwards 2001, Kose, Rogoff, *et al.* 2003, Prasad *et al.* 2004). They also stressed various collateral benefits such as efficiency gains and the imposition of “market discipline,”⁹ which take place through indirect channels – such as institution building – and take time to accrue, their impact therefore is not always immediately obvious (Kose *et al.* 2009).

None of these post-hoc theoretical revisions are without difficulties and few have yielded much empirical substantiation with all essentially premised on some notion of the presence or possibility of perfect and efficient markets, that according to Stiglitz ‘is grounded neither in fact nor in economic theory’ (1994, p. 20 cited in Arestis and Sawyer 2005, p. 33).

In addition to the absence of positive impacts from liberalisation, some studies have found that forms of financial repression may be beneficial. Arestis *et al.* (2002), for example, review the impact of liberalisation on capital productivity in fourteen countries between 1955 and 1996. While the effects vary significantly across countries, interest rate restraints and reserve requirements are found to have a positive effect on capital productivity in many countries, whereas restrictions on capital inflows are found to be positive in five countries and negative in seven (see also Arestis, Demetriades, Fattouh, *et al.* 2002). Such findings led Stiglitz (1998, p. 33) to argue that:

'[T]here are a host of regulations, including restrictions on interest rates or lending to certain sectors (such as speculative real estate), that may enhance the stability of the financial system and thereby increase the efficiency of the economy. Although there may be a trade off between short-run efficiency and this stability, the costs of instability are so great that long run gains to the economy more than offset any short term losses.'

Further, negative impacts of financial liberalisation on growth and other macroeconomic indicators have been observed and are attributed to the propensity of financial liberalisation to lead to: instability, volatility and crises; sudden reversals of capital flows; inequality; and a dysfunctional allocation of capital both internationally and nationally. These topics are dealt with in forthcoming sections. Indeed, financial liberalisation has been the primary channel through which financialisation has been transmitted to developing economies.

Despite this relatively conclusive evidence of the effects of financial liberalisation, the best way to measure such openness is still debated. Generally these are divided between *de jure* measures – which reflect legal restrictions (or lack thereof) on capital mobility – *de facto* measures – which reflect the actual extent of capital mobility – and hybrid measures. Quinn et al. (2011) review the most prominent datasets (see also Clark 2012) and here we use six of those and one other to assess the level of openness of the South African economy.

Interestingly according to *de jure* measures, most of which use the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions* (AREAER), the South African economy is relatively closed. In Quinn and Toyoda

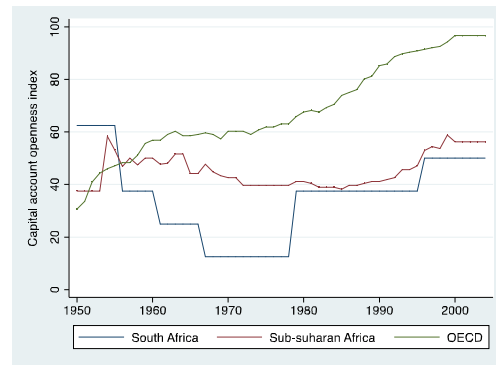
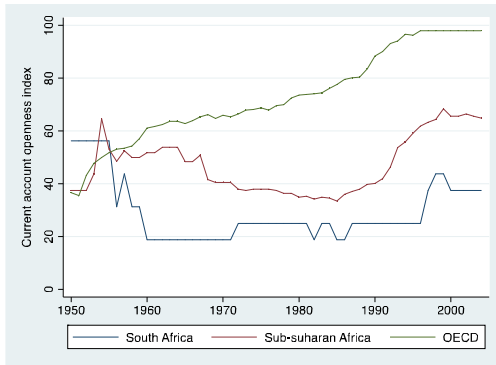
(2008) (1950 – 2004) South Africa is less open than all regional averages for almost all years. Similarly in Chinn and Ito's (2006) (1970-2013) and Fernández et al.'s (2015) (1995 – 2013) indexes, South Africa is more closed than middle-income averages. Not all *de jure* analyses yield identical results, for instance, using a weighting system Yu (2014) shows that South Africa is the ninth most open economy of the G20 countries.

When it comes to *de facto* measures South Africa appears relatively open. In Lane and Milesi-Ferretti (2007) (1970 – 2011) which is Kose et al.'s (2009) preferred measure of *de facto* openness, cross border capital flows shoot up in the late 1990s and from the mid 2000s South Africa shows as more financially liberalised than the middle-income country average. The timing of this jump is congruent with capital account liberalisation which accelerates from 1996 onwards (Harvey 2015). UNCTAD's (2015) (1970 – 2014) measure of FDI inflows as a percentage of GDP is also used to measure liberalisation. Here, South Africa is close to, but just below the middle-income country average for most years. This, however, says more about the composition of capital flows than the level of liberalisation. Using the World Development Indicators (1970 – 2013) we can see that when you take account of net FDI inflows and net portfolio and debt flows as a percentage of GDP, South Africa, for most years since the mid 1990s, exceeds the middle income country average. However, the Lane and Milesi-Ferretti's actual flows index (mentioned above) is a more comprehensive *de facto* measure. Finally, in KOF's (Dreher 2006) hybrid index (1970-2012) South Africa, in 2012, ranked 62 in level of "economic globalisation" – a composite of *de jure* and *de facto* measures – and was consistently more liberalised than the middle-income country average.

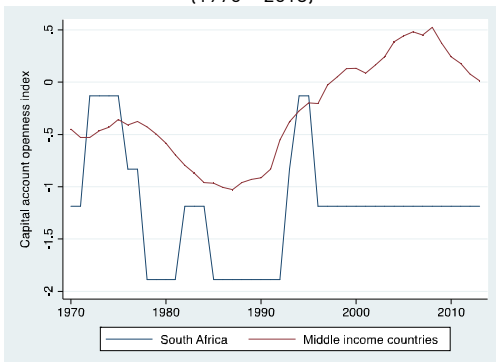
Figure 4 De jure measures of financial openness

(a) Quinn and Toyoda – Current account openness
(1950 – 2004)

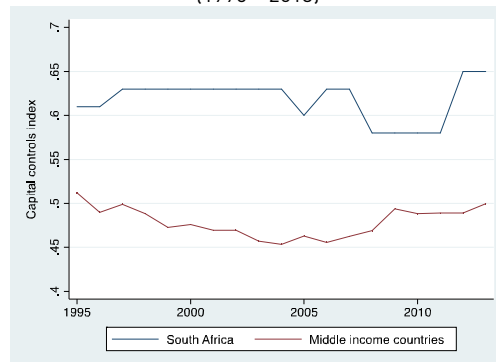
(b) Quinn and Toyoda – Capital account openness
(1950 – 2004)



(c) Chinn and Ito – Capital account openness (1970 – 2013)



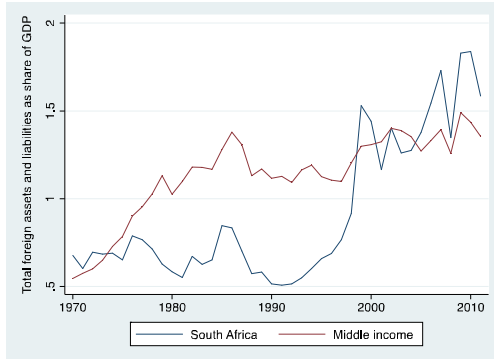
(d) Fernández et al. – Capital control index (1995 – 2013)



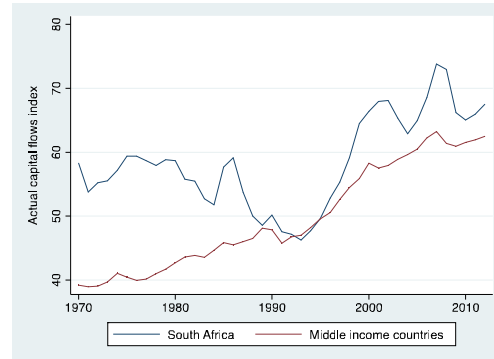
Source: (a) and (b) Quinn and Toyoda (2008); (c) Chinn and Ito (2006) updated to 2013; (d) Fernández et al. (2015)

Figure 5 De facto measures of financial openness

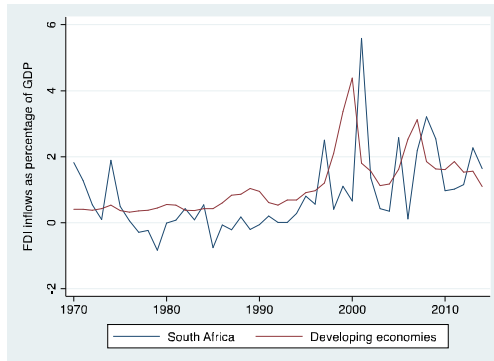
(a) Lane and Milesi-Ferretti – Openness Indices
(2007 – 2011)



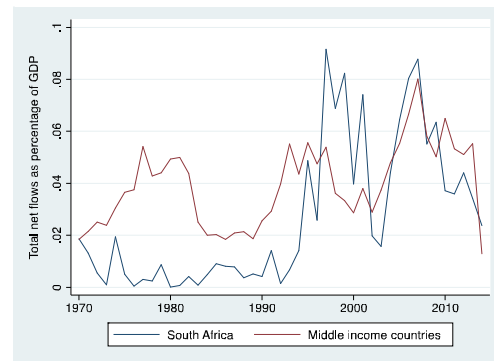
(b) KOF – Actual capital flows index
(1970 – 2012)



(c) UNCTAD – FDI inflows index (1970 – 2014)



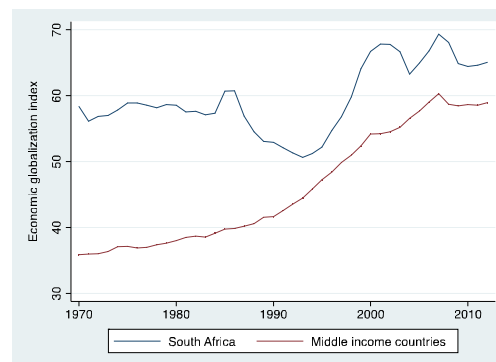
(d) WDI – Total net flows index (1970 – 2014)



Source: (a) Lane and Milesi-Ferretti (2007) updated to 2011; (b) Dreher (2006) updated to 2012; (c) UNCTAD (2015); (d) World Bank (2015a).

Figure 6 Hybrid measures of financial openness

(a) KOF – Economic globalization index (1970 – 2012)



Source: (a) Dreher (2006) updated to 2012

The discrepancy for South Africa between *de jure* and *de facto* measures is not surprising given high levels of legal and illegal capital flight, permission given to be exempt from restrictions, and potentially other means of flouting restrictions in place.

Our preceding analysis clearly demonstrated that the evidence that financial liberalisation has positive growth consequences is extremely weak. Give this, South Africa's high level of openness, the result of the financialisation of the economy, is likely to have had deleterious developmental consequences.

4.2 Volatility and Crises

One possible explanation for the lack of positive growth effects from increasing financial liberalisation and deregulation and the development of the financial sector is that these can lead to volatility and instability, both in the financial system and macro-economy more generally, and ultimately to crises. There is a substantial body of literature which supports this thesis.

In a panel of 28 developed and developing countries between 1960 and 2005 Aizenman et al. (2013) show that periods of accelerated growth in the financial sector are more likely to be followed by abrupt financial contractions than periods of slower growth, and that the majority of real sectors are adversely affected by these while they are not positively impacted by expansions; causality is verified. These negative impacts are almost exclusively the result of financial openness; reserve accumulation serves as a buffer. In the study by Cecchetti and Kharroubi (2012) they show that there is a clear negative relationship between the speed of financial development and productivity growth, as they note: '[F]aster growth in finance is bad for aggregate real growth. One interpretation of this finding is that financial booms are inherently bad for trend growth.' (Cecchetti and Kharroubi 2012, p. 1).

Diaz-Alejandro (1985), Kaminsky and Reinhart (1996) and Kose et al. (2003) all show that liberalisation yields macroeconomic volatility.¹⁰ Demirgüç-Kunt and Detragiache (1998) find financial liberalisation has a statistically significant positive effect on the likelihood of banking crises increasing the probability of banking crises by up to five times; the effect is more pronounced in developing countries. Similarly, Kaminsky and Reinhart (1996) find that financial liberalisation and/or increased access to international capital markets have played a significant role in banking and currency crises, fuelling boom and bust cycles. Weller (1999) (for 27 emerging economies, 1973-1999), Noy (2004) (for 61 non-OECD countries, 1975-1997) and Arteta and Eichengreen (2000) (75 emerging markets and developing countries, 1975-1997) all make similar findings. Reinhardt and Rogoff (2008), examining the determinants of banking crises from 1800 to 2008, find a strong correlation between periods of capital mobility and banking crises and the opposite during periods with low financial mobility. Since the ardent pursuit of financial liberalisation (1980s onwards) over 90% of IMF member countries in Africa, Asia and transition economies in Central and Eastern Europe have suffered from at least one incidence of banking difficulties (Arestis 2005).

Developing countries are particularly vulnerable to these deleterious effects because of sudden reversals in flows (see, for example, Reinhart and Calvo 2000, Hutchison and Noy 2002, Calvo *et al.* 2004, Kaminsky 2008, Furceri *et al.* 2011) and exposure to contagion within financial markets. Importantly, and contrary to the argument that the destabilising effects of liberalisation are short lived and the benefits permanent, Stiglitz (2000) shows the harm to output can be long-lasting. The volatility of short-term flows also has a profound impact on public and private levels and patterns of investment. In a study of Argentina, Mexico and Turkey, Demir (2006) finds that a 10% increase in the volatility of capital inflows reduces fixed investment by real sector firms by 1%

to 1.7%, 2.3% to 15.1%, and 1% in the three countries respectively. Further, despite financial liberalisation, increased flows, and foreign bank penetration,¹¹ credit rationing persists with a lack of long-term credit available to real sector firms. Similarly, Moguillansky (2002), in a panel of 16 Latin American countries, finds that the volatility of short-term capital flows has a statistically significant negative effect on fixed capital formation. In other studies, financial liberalisation, in general, is found to have mixed, negative or neutral impacts on investment (Gelos and Werner 2002, Agrawal 2004, Koo and Shin 2004, Toole 2012, Orji *et al.* 2014)

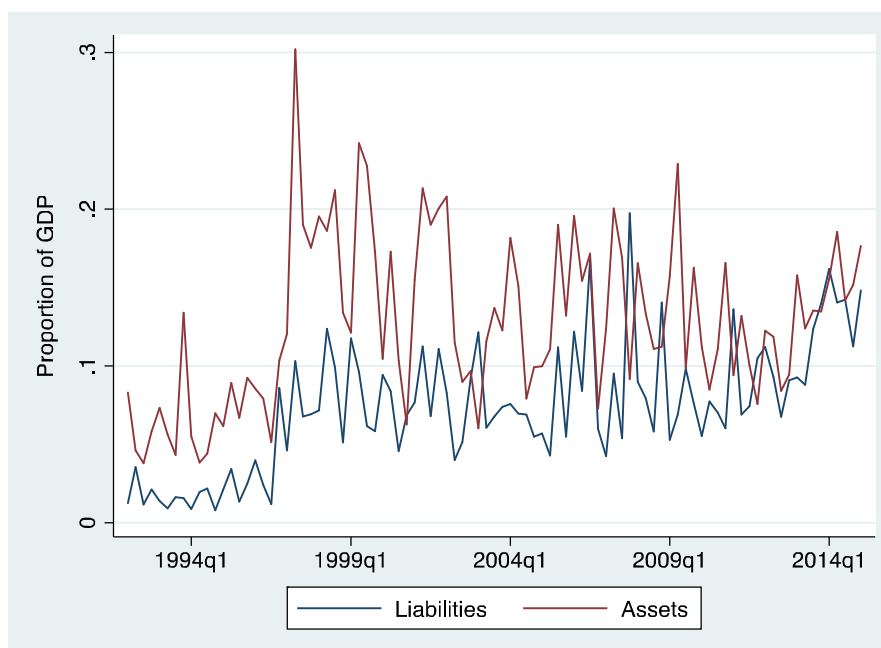
Demir argues the micro and macroeconomic transmission channels for this impact on investment are via fluctuations in: 'a) domestic interest rates and credit availability, b) real exchange rates, and nominal exchange rate expectations, c) domestic absorption, d) systemic risk from uncertainty regarding future profitability and macro environment, and, e) liquidity premium and opportunity cost of fixed investment' (Demir 2006, p. 15). In support of this, a range of other studies (cited in Demir 2006, p. 13) show that price distortions which result – via the real exchange rate, relative prices of capital goods and inflation (discussed in more depth in Section 4.3) – have been shown to have a statistically significant negative effect on investment and growth. Importantly, the effects are asymmetric with outflows depressing output more than an equal inflow raises it (FitzGerald 1997). The pro-cyclical nature of capital flows also have an adverse impact on consumption volatility in developing countries (Prasad *et al.* 2003, p. 43).¹²

Similar results have been found regarding domestic financial depth with Easterly *et al.* (2000) showing that the relations between financial depth and volatility was convex and non-monotone; their point estimates indicate that output volatility starts increasing when credit to the private sector reaches 100% of GDP. We have seen in the South African case, in

Figure 2 above, that South Africa has reached this level of financial depth.

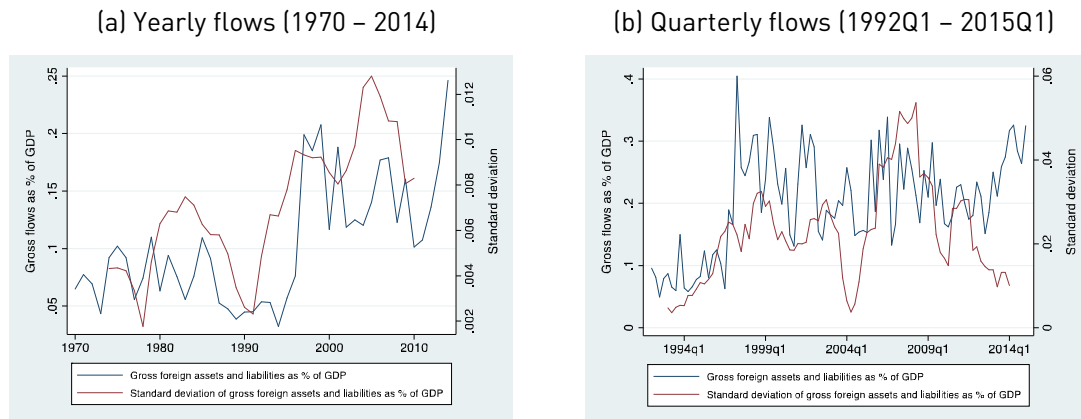
We observe in South Africa significant increases in the volatility of capital flows since 1996. Figure 7 shows the absolute value of the foreign sector's gross incurrence/acquisition of domestic liabilities and assets.¹³ Unsurprisingly we see a large increase in flows in 1996. Using a longer, albeit less finely disaggregated, dataset also from the SARB (via Quantec 2015), we see that capital flows were considerably lower and more stable between 1985 and 1996. In Figure 8, we show changes in gross flows (both assets and liabilities) and, as a measure of volatility, the standard deviation from the rolling mean¹⁴ of gross absolute capital flows as a percentage of GDP (as laid out in Broto *et al.* 2008, p. 13). The standard deviation is not necessarily the most refined measure of volatility (see Broto *et al.* 2008), but one which is widely used, including in publications from the World Bank (Claessens and Ghosh 2013) and IMF (Ghosh *et al.* 2014).

Figure 7 Absolute value of the foreign sector's gross incurrence / acquisition of domestic liabilities and assets and share of GDP (1992 - 2015)



Source: SARB (2015b) Flow of Funds, own calculations

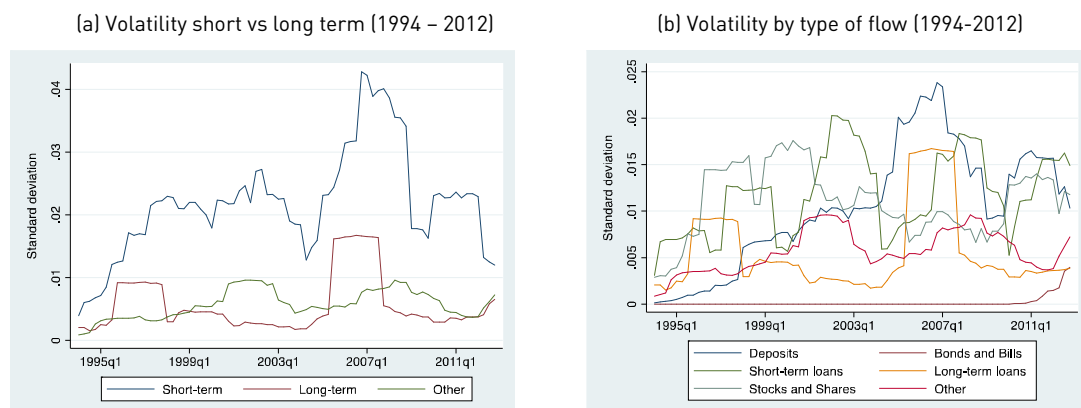
Figure 8 Capital flows and volatility of capital flows as a share of GDP (shown by standard deviation from a rolling mean)



Source: SARB (2015b) Flow of Funds, own calculations

We see in Figure 8 that volatility has increased significantly from 1996 and peaked during the 2007/8 global financial crisis. The main driver of this volatility has been short-term flows, as shown in Figure 9, themselves driven by short-term loans, deposits and stocks and shares. This is congruent with findings from the other SARB time series dataset which shows portfolio flows as driving volatility (not shown graphically here). This predominance of short-term flows is taken up again in the next section.

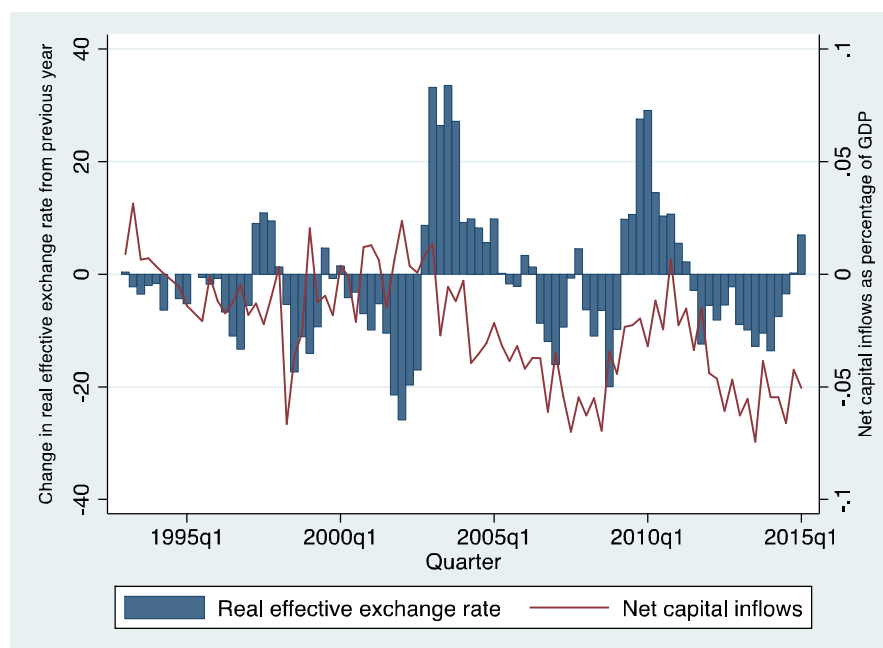
Figure 9 Volatility of capital flows by types of flows (shown by standard deviation over rolling mean)



Source: SARB (2015b) Flow of Funds, own calculations

Volatility in South Africa has not led to banking and financial crises as in some other emerging markets but has manifested in exchange rate crises. Figure 10 shows the change in the real effective exchange from the previous year against net capital inflows. We see the dramatic fluctuation in the South African exchange rate and that all but one major period of depreciation has been accompanied by substantial negative net capital inflows, that is, substantial outflows.¹⁵

Figure 10 Change in real effective exchange rate and net capital inflows (1993 - 2015)



Source: IMF (2015a), International Financial Statistics via Quantec and SARB (2015b) flow of funds, own calculations

South Africa, we have seen, is subject to substantial volatility which has increased since liberalisation. The international literature indicates that such volatility in capital flows has harmful consequences on growth and output. We have also seen that South Africa has suffered a number of exchange rate crises and that these have been concurrent with strong capital outflows. From this it appears that liberalisation has exposed the South African economy to significant risk. We now unpack the nature and consequences of international capital flows more closely.

4.3 International patterns of flows and investment

While the evidence is weak at best that financial deepening and liberalisation has been growth-enhancing there are still strong theoretical reasons to believe that finance, and debt in particular, is, in principle, crucial for growth. This is argued in the mainstream neoclassical “supply-leading” literature cited above but is also a principle advanced by Keynes. In his *A Treatise on Money* Keynes (1930, quoted in Arestis and Sawyer 2005, p. 6) Keynes argues that bank credit is ‘the pavement along which production travels, and the bankers if they knew their duty, would provide the transport facilities to just the extent that is required in order that the productive powers of the community can be employed at their full capacity’. In his view the financial system should endogenously respond to demand requirements. Here Keynes is building on early views advanced by, amongst others, Bagehot (1833) and Schumpeter (1911), the latter who argues that production requires credit to materialise (cited in Arestis and Sawyer 2005, p. 6).

Arguably the most compelling theoretical argument in favour of this view comes from the Marxist literature on the circuit of capital (discussed in Capital Volume II). Basu (2011) and dos Santos (2011), extending Foley (1982, 1986), illustrate the necessity of credit in on-going accumulation. Essentially, the famous circuit of capital through which money is augmented via production and realisation, resulting, if successful, in more money than at the outset ($M - C - P(MP, LP) - C - M'$) is impossible without the money supply expanding. Essentially, production cannot expand without augmented capital and this must be achieved via the extension of productive credit and/or via consumer credit to enable sufficient aggregate demand.¹⁶ Such expansion is the historic and present function of private banks and private credit (albeit today somewhat mediated via the central bank). This insight overlaps with the Keynesian

understanding that it is not savings which create investment but investment which generates savings.

If finance is critical in capitalist accumulation then the question arises as to why there is no conclusive casual evidence between an expanding financial sector and growth. This is best answered by appreciating that not all finance is created equal so to speak. This is where the heterodox literature on finance and financialisation offers a critical contribution. The type of debt and financial expansion and hence the flow of investment and the channels through which this flows, appears to be what mediates the role of finance in growth and development. This refers to the allocation of capital on a global scale, the type of credit extended, and the local use to which credit is put, and hence the patterns of investment that occur. This section looks at the global allocation of capital while the next two trace its domestic form and use.

First, the aggregate patterns of flows since the 1980s have directly contradicted the original growth argument that financial integration would lead to a more efficient international allocation of capital, capital deepening and international risk sharing. Since 1996 gross cross-border capital flows have precipitously risen (Obstfeld 2010). At a similar time we have witnessed a role reversal between rich and poor countries vis-à-vis the direction of the flow of capital; poor countries have become net exporters of capital and rich countries importers of capital, the so called "capital flows paradox" (Prasad *et al.* 2006). A further peculiarity emerges in that when capital does flow to poorer countries it is not flowing to those that are growing fastest, that is, presumably those with the best investment opportunities, this has been dubbed the "allocation puzzle" (Gourinchas and Jeanne 2007). Contrary to the theoretical predictions, it is surplus countries that have grown fastest.

These imbalances have been driven by the extraordinary accumulation of foreign reserves by developing countries.¹⁷ These have emerged as a means through which to smooth balance of payment flows, allow for intervention in currency markets to stabilise the exchange rate through the purchase or sale of domestic currency, and to mitigate against sudden reversals in capital flows by assisting the monetary authorities in the provision of domestic liquidity.

Reserve accumulation is however not costless. The reserve bank must, of course, balance increased assets with greater liabilities. In general, what has been observed is a widening gap between currency in circulation (M1, or even M2 and M3) and assets held by the reserve bank. The reserve bank must then decide to either expand its domestic liabilities by increasing lending (largely to the banking sector). This may put downward pressure on short-term interest rates, and conflict with the use of interest rates as the primary lever in inflation targeting. Instead, the reserve bank may pursue “sterilisation” by offsetting increases in reserves against other changes in their balance sheet. Certain “non-market” interventions, such as increasing bank reserve requirements, have become more widely used. However, market interventions, largely different forms of domestic borrowing (including selling domestic assets or issuing their own securities), remain most common (BIS 2009). The result is a build-up of domestic debt; both at the reserve bank and in the private sector as the private sector borrows to acquire these. This creates potential currency and maturity mismatches (Turner 2008, Paineria 2009).

Further, reserves represent funds that the government could be spending to support national development. Countries continue to borrow short-term on international markets paying higher rates of interest on these loans than the yield of international reserves. Rodrik (2006) estimated that this amounted to an annual loss to developing countries of close to one percent of GDP. Alternatively one could argue that there are more profitable investments

available to countries should they wish to invest surplus funds than low-interest T-Bills in which the majority of foreign exchange reserves are held (Jeanne 2007). Consequently the costs and risks are born publicly whilst the gains remain private.

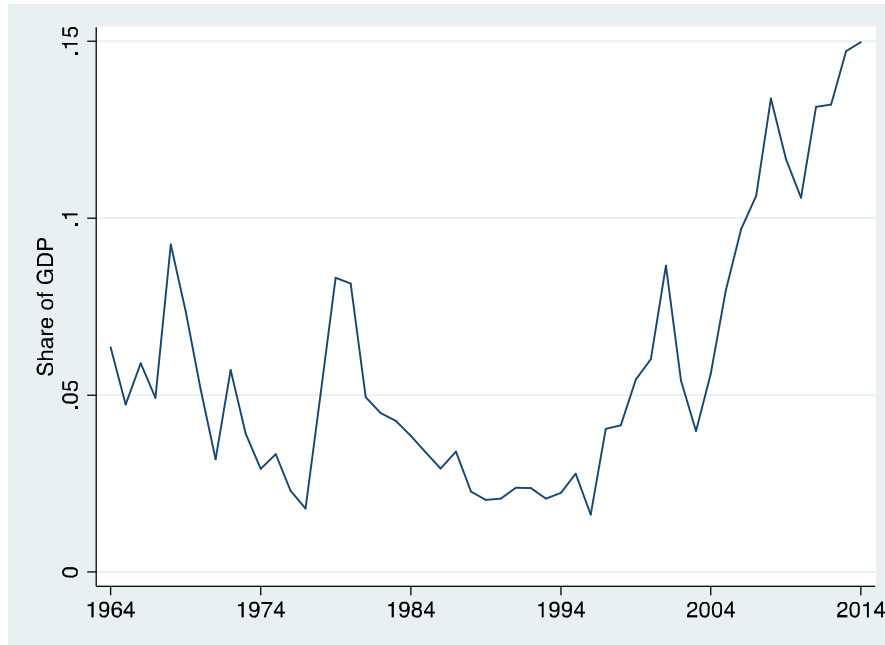
Even setting these costs aside it is far from clear that reserves offer a perfect policy response. Governments may be reluctant to use them during crises as their presence serves to reassure investors. It is also unclear what would constitute sufficient reserves. Further, when reserves are sold this can have adverse effects on other markets. Finally, reserves do not offer authorities the same scope for policy autonomy that greater monetary and fiscal policy independence would.

Reserve accumulation in South Africa has followed similar trends to elsewhere in the developing world. Figure 11 shows the build-up in reserves which has accelerated dramatically from 2000, a period following the East Asian financial crisis. In Figure 12(a) we see that reserve assets are not balanced on the SARB balance sheet by currency in circulation and that this divergence is marked from the early 1990s (methodology adopted from BIS 2009, p. 50). Related, Figure 12(b) shows that net lending/borrowing by both the monetary authority (SARB) and the domestic economy enters negative territory in the 2000s. This indicates that domestic borrowing is being undertaken in order to finance the build-up in reserves.

Recently, there has been a diversification in both the currency denomination and type of assets held as reserves (Wooldridge 2006), however, a substantial share of reserves internationally remain in US Federal Reserve Treasury Bills. In Figure 13 we see the Treasury Bill rates for the United States and South Africa diverge markedly, beginning in the late 1980s, with the spread averaging at just under 7% in the post-apartheid period. This is the difference between

the interest earned by the South African Reserve Bank on reserves and the interest it must pay to holders of its own treasury bills, a steep cost indeed.

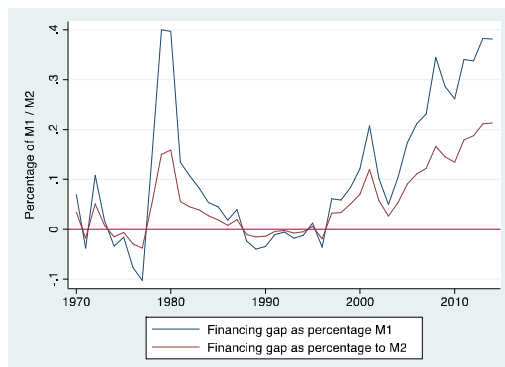
Figure 11 Reserves as a share of GDP (1964 - 2014)



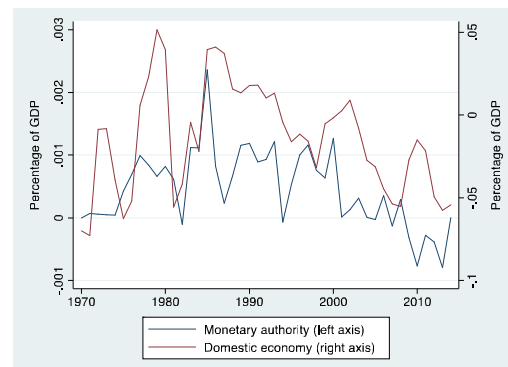
Source: SARB (2015a), macroeconomic time series data, own calculations

Figure 12 Financing gap and borrowing (1970 - 2014)

(a) Foreign exchange reserves held by SARB minus currency in circulation as a percentage of money supply (1970 - 2014)

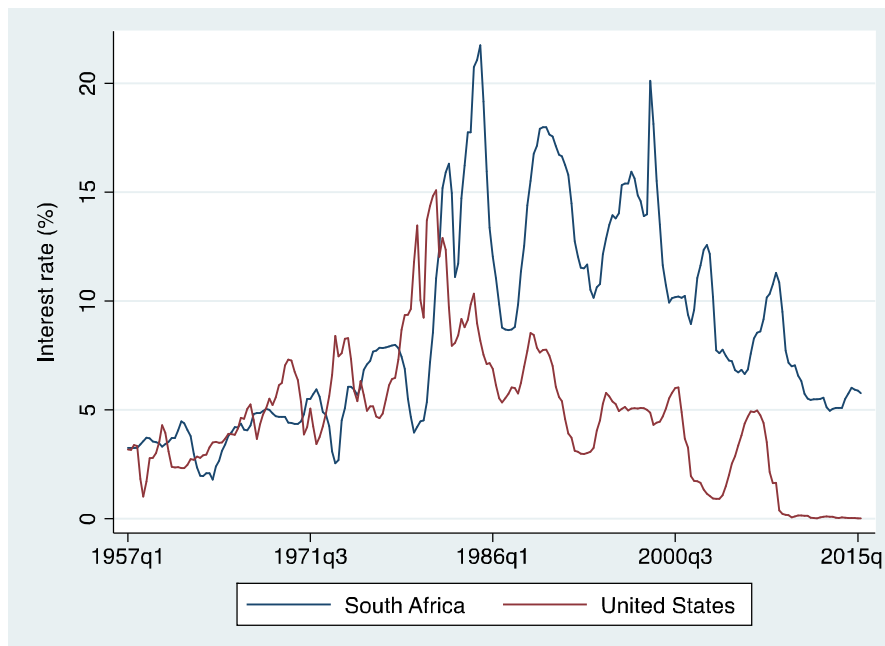


(b) Net borrowing (+) / lending (-) (flow) (1970 - 2014)



Source: (a) Quantec (2015), own calculations (b) SARB (2015b) Flow of Funds, own calculations

Figure 13 Treasury Bill Rates - South Africa and the United States
(1957 - 2015)



Source: IMF (2015a), International Financial Statistics via Quantec, own calculations

This cost, and risk, is exacerbated by fluctuations in the Rand-Dollar exchange rate which we saw in Figure 10.

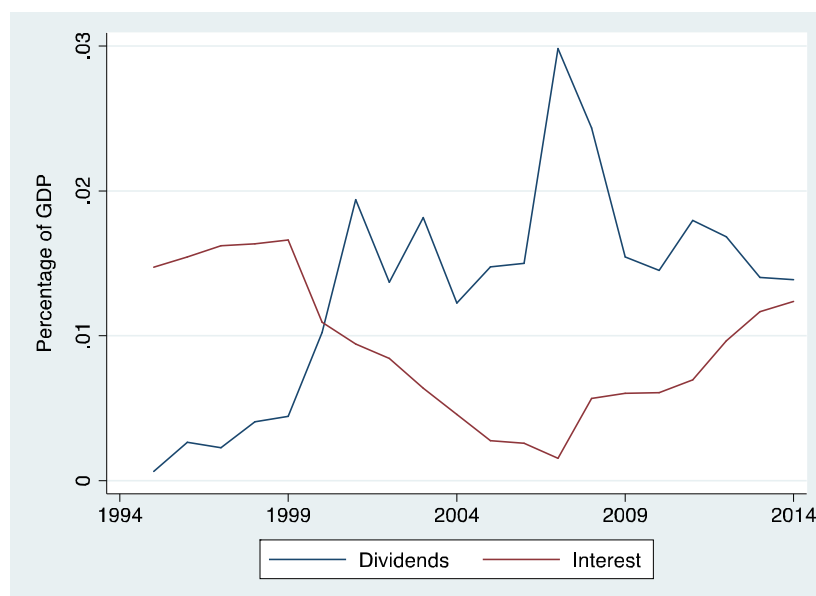
Second, others forms of capital drain are common. Legal and illegal capital flight from emerging markets has become prevalent with net outflows amounting to \$540billion in 2015, the first year since 1988 that net flows are negative (Wheatley 2015). This occurs due to residents investing abroad, reversals in capital inflows, and interest and dividend payments to foreign owners of domestic financial assets. In addition, in view of 'the challenges in intervening and sterilising the persistent inflows, some EM policymakers have adopted measures to encourage institutional capital outflows as a complementary policy tool to ease appreciation associated with capital inflows' (BIS 2009, p. 101).

Tax avoidance and evasion has also become a global scourge (see Farny *et al.* 2015 for a discussion of these terms). The Tax Justice Network (2011)

estimated in 2011 that global tax evasion was in excess of \$3.1trillion per year or 5.1% of global GDP with between \$21 and \$32 trillion of private wealth sitting, in 2012, in tax free havens (Henry 2012).

South African corporates, since the fall of apartheid, have moved considerable funds offshore. This has occurred through legal means such as the (primary or secondary) listing of corporations on overseas stock exchanges including by some of South Africa's largest corporations like Billiton, SAB, ACC and Old Mutual (Chabane *et al.* 2006, p. 559). In tandem with this has been voluminous legal and illegal capital flight which Ashman et al. (2011, p. 9) calculate at an average of 12% of GDP between 2001 and 2007, peaking at 23% in 2007 (see also Mohamed and Finnoff 2004, Mohamed 2008), and the internationalisation of these corporations investments and operations. Foreign ownership has lead to considerable net dividend and interest outflows as seen in Figure 10.¹⁸

Figure 14 Net interest and dividend payments to rest of world as percentage of GDP (1995 - 2014)



Source: Quantec (2015), own calculations

The IMF's (2015b) Coordinate Portfolio Investment Survey (CPIS) data tells an interesting story. In December 2014 a staggering 37% of all reported South African assets held abroad sat in low-tax jurisdiction, up from 24% in December 2001.¹⁹ Of the top ten countries in which South African assets abroad are held, in December 2014, seven of them, as shown in

Table 1, where low-tax jurisdictions accounting for 35% of total foreign assets.

Table 1 Top 10 countries in which South African assets are held abroad (December 2014)

	Country	Amount	Percentage of total
	Value of Total Investments	\$154 865	
1	United Kingdom	\$62 920	41%
2	United States	\$25 638	17%
3	Luxembourg	\$22 740	15%
4	Ireland	\$15 727	10%
5	Bermuda	\$9 851	6%
6	Guernsey	\$3 592	2%
7	Jersey	\$1 728	1%
8	Canada	\$1 394	1%
9	Malta	\$1 325	1%
10	India	\$964	1%
	Low-Tax Jurisdictions	\$54 963	35%

Source: IMF (2015b), Coordinate Portfolio Investment Survey (CPIS)

Third, the composition of flows is critical; foreign direct investment (FDI), portfolio equity flows, portfolio bond flows, bank and trade credits, official flows and remittances all have different dynamics. Leaving aside the final two (not considered here) the others are often divided between long-term flows –FDI

and long-term debt – and short-term flows – portfolio and bond flows, short-term debt, and trade credit all with maturities of less than a year. At best the evidence on their impact can be summarised as:

'To summarize, across different recent studies surveyed here, FDI is one form of capital inflows that tends to be found positively associated with domestic investment and domestic growth in a relatively consistent manner. Other forms of capital inflows could also have a positive relationship, but their effects tend to be less robust or less strong.' (Prasad *et al.* 2003, p. 33)

The supposed benefits from FDI derive from: "spillover effects" into local industry that improve technology, efficiency, capital accumulation and human resource development; enhanced international trade; and because they are more stable and long-term.²⁰ However, the evidence is contested. This conventional assumption of the positive benefit of FDI on growth and/or investment has been born out in a number studies (Bosworth *et al.* 1999, Baharumshah and Thanoon 2006, Aizenman *et al.* 2011, Choong 2012) but others show only a small (Ibarra 2013) or no unqualified statistically significant relationship between FDI and economic growth and/or investment (Aitken *et al.* 1994, 1997, Carkovic and Levine 2002, Mencinger 2003). Sometimes the relationship is found to be negative, for instance one study showed that in China FDI crowded out domestic investment and that a higher degree of deregulation and liberalisation intensified this effect (He 2012). A large body of literature shows a contingent relationship dependent on country-specific characteristics or absorptive capacity.²¹ However, given the evidence on the deleterious effects of "too much finance" there is no doubt a fine line between the requisite level of financial development and an overly financialised system.

If FDI is not always growth enhancing then short-term capital flows, both debt and equity, which are often larger than long-term flows are positively harmful. This is often attributed to the volatility of such flows and their propensity to suffer from “sudden reversals” earning them their status of “hot money”; such flows have become increasingly large and volatile since the mid-2000s (Chuhan *et al.* 1996, Ananchotikul and Zhang 2014). While some research shows that FDI is relatively stable²² the overwhelming evidence indicates that short-term flows, to varying degrees, suffer extreme surges and sharp reversals (Sula and Willett 2006, Levchenko and Mauro 2007).²³ This means an unstable or negative relationship between short-term flows and growth and/or investment and/or savings and/or the current account (Baharumshah and Thanoon 2006, Aizenman *et al.* 2011), raises the likelihood of crises and worsens the ensuing credit crunch (Tong and Wei 2009).

The negative role of surges in (short-term) capital inflows is that they often fuel booms in stock and real estate markets, reckless lending, and lead to an appreciation of the exchange rate.²⁴ In addition high interest rates are maintained in order to maintain inflows and costly sterilisation activities undertaken (see above). Currency appreciation pressures, as with emerging markets between 2002 and 2007, can shift relative consumption between tradables and nontradeables, in favour of the latter, leading to a loss in relative export competitiveness, worsening the current account balance, crowding out manufacturing activity and leading to a “Dutch-Disease-type phenomena” that can be costly to reverse (Demir 2006, Chandrasekhar 2007, Milesi-Ferretti and Blanchard 2009, p. 5). These inflows can also create inflationary pressure, which in the context of inflation targeting monetary policies (explicit or tacit) could lead to higher interest rates. High interest rates can, in turn, depress economic activity and may increase banking fragility (FitzGerald 1997, pp. 9–10, Khan and Khan 1998).

When these flows reverse, asset prices drop, the currency depreciates and a credit crunch may ensue. Depending on the level of debt and the extent to which it is denominated in foreign currency, the currency depreciation can lead to a rise in its real value that is unsustainable. Fragility in the financial sector results, lending may dry up, and bankruptcies, in both real and financial sectors, may follow allowing foreign acquisitions of domestic firms at bargain prices (FitzGerald 1997, Eichengreen and Hausmann 1999, Chandrasekhar 2007).²⁵ A “double drain” on official resources may occur as demand for foreign exchange depletes reserves (as took place in Argentina in February and March of 1995) and the domestic authorities are forced to step in as leaders of last resort; this may spark further investor panic and flight (Obstfeld *et al.* 2008). Finally, interest rates may be hiked to try and maintain inflows further depressing domestic economic activity. Crises are often the result of these surges and reversals.

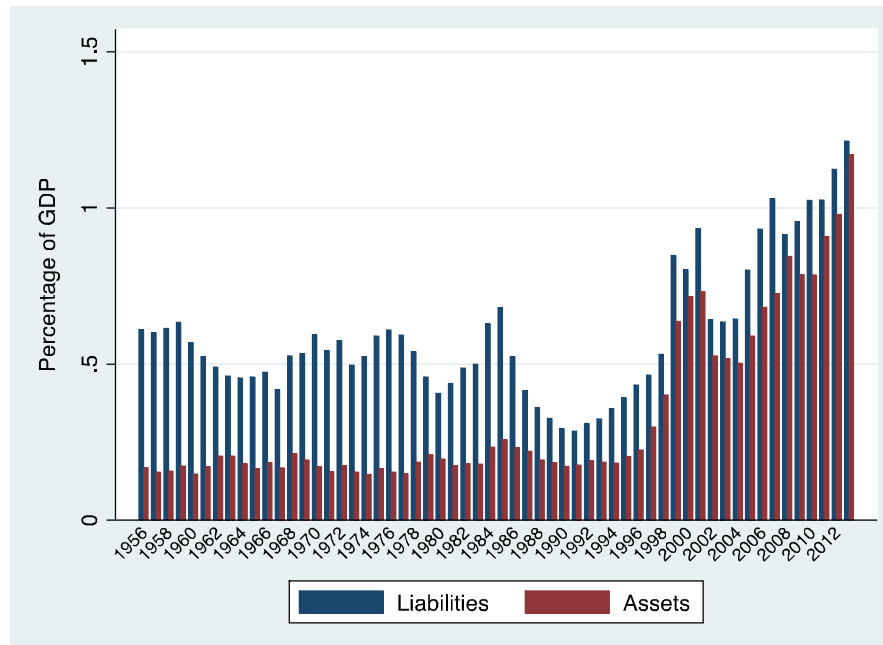
FitzGerald (1997) argues these negative effects may result from a distortion in resource allocation, negative business expectations, increased uncertainty, decreased foreign fixed investment, a negative impact on the availability of bank credit, and abrupt aggregate demand fluctuations due to changes in the money supply caused by shifts in reserve holdings and monetary intervention. Importantly, he also shows a negative fiscal impact whereby government borrowing costs increase due to exchange rate movements and high real interest rates and extra pressure is placed on fiscal policy in light of reduced room for monetary policy manoeuvring. The main pressure, however, is felt through the local bond market ‘not so much through the interest rate itself as through market perception of fiscal solvency, which is in effect a form of credit rationing’ markets (FitzGerald 1997, p. 12). This means that government borrowing may be unreasonably constrained by bond markets leading to a reduction in investment and spending.

There is mixed evidence on the impact of flows on asset prices in emerging markets during non-crisis times. Kim and Yang (2011, p. 11) show that in the case of emerging Asian economies 'a surge in capital inflows or portfolio inflows has positive effect on asset prices. Stock prices increase immediately as capital inflows hit directly. The land price increase is more delayed, which may be explained by a spillover effect.' Despite this, such inflows do not explain the majority of asset price fluctuations. However, the correlation between swings in asset prices and surges and reversals in equity and bond flows was amplified five to ten times during the recent financial crisis when emerging market's indexes fell sharply and bond yields rose to historic highs (Ananchotikul and Zhang 2014). Further, Rodrik and Velasco (1999) demonstrated that the greater the level of short-term foreign debt the more severe the crises are when capital flows reverse and that the short-term debt to reserve ratio is a robust predictor of financial crises. Such resultant banking crises have been shown to reduce investment (Ho and Yeh 2014).

In South Africa we have seen a dramatic increase in the stock of foreign assets and liabilities as a percentage of GDP over the last twenty years (Figure 15). As seen in Figure 16(a) and Figure 16(b) the growth in both assets and liabilities was driven by an enormous increase in portfolio assets/liabilities with derivatives making a contribution in recent years. FDI as a foreign asset underwent a precipitous decline as a share of total assets in the late 1990s and the relative share of long-term debt as a share of total liabilities, declined from 1990 onwards. All together in both assets and liabilities the short-term components – portfolio flows, derivatives and short-term loans and deposits/debt – make up the overwhelming majority of the stocks of foreign assets and liabilities. For assets this change occurs in the mid-1990s whereas for liability the shift happens in the mid-1980s. The centrality of short-term capital flows is confirmed in the SARB (2015b) flow of funds data (Figure 18) which shows that short-term flows dominate as a share of total flows. This

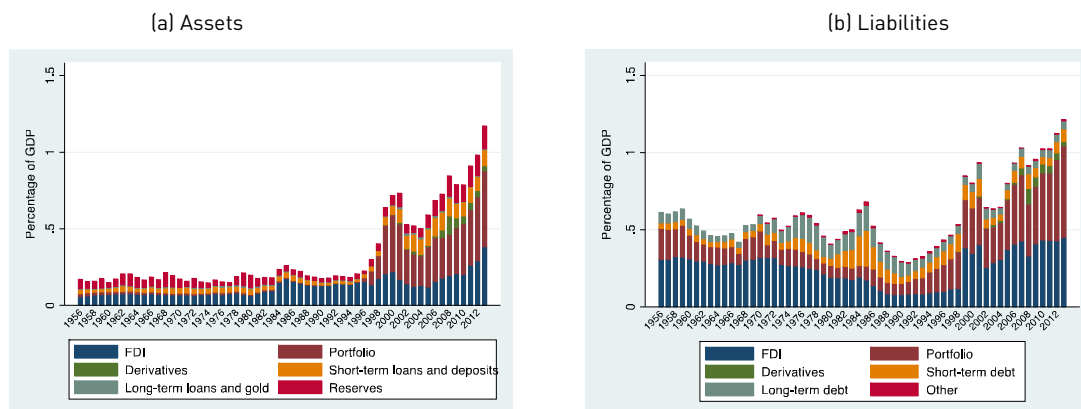
growing predominance of short-term flows should not surprise us given the increased volatility of flows we observed above.

Figure 15 Stock of foreign assets and liabilities (1956 - 2013)



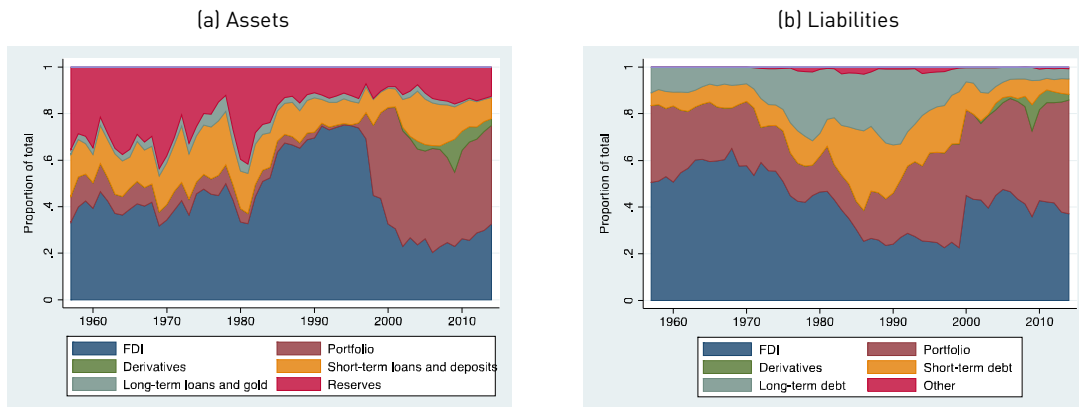
Source: Quantec (2015), own calculations

Figure 16 Stocks of foreign assets and liabilities by type as percentage of GDP (1956 - 2013)



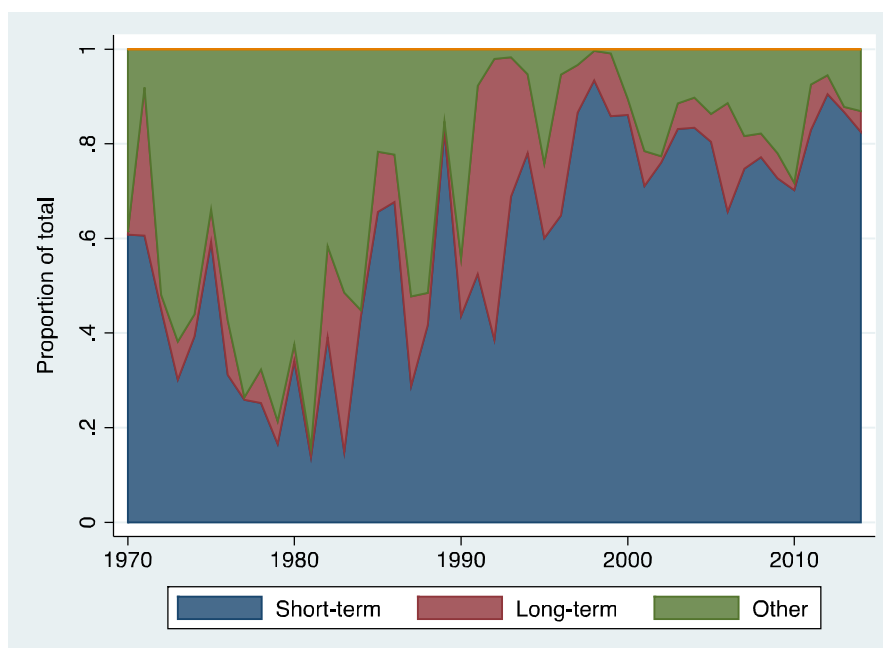
Source: Quantec (2015), own calculations

Figure 17 Proportional stocks of foreign assets and liabilities (1956 - 2013)



Source: Quantec (2015), own calculations

Figure 18 Proportion of total flows (1970 - 2014)

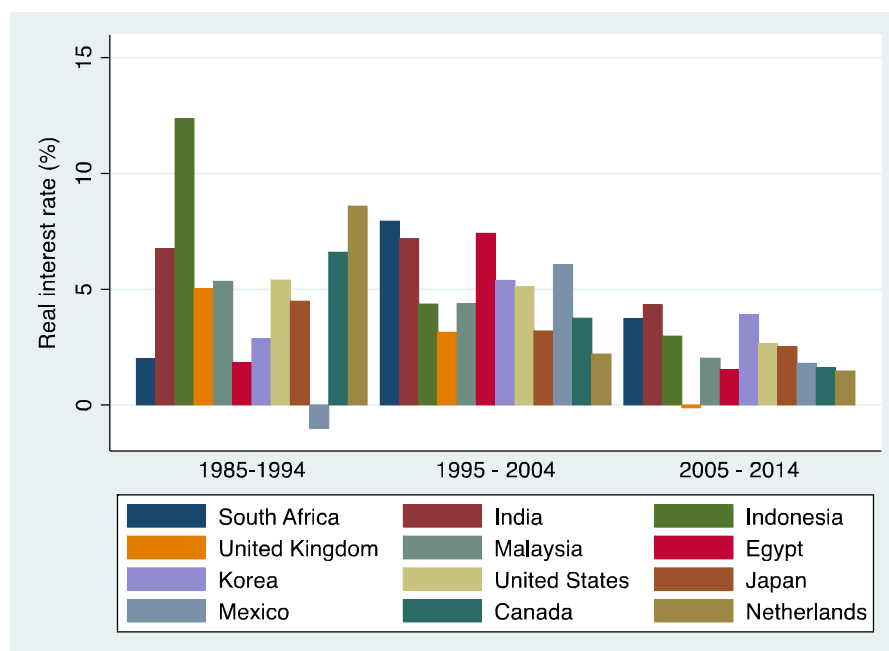


Source: SARB (2015b) Flow of Funds, own calculations

It is worth noting that South Africa remains a net borrower from the rest of the world, at odds with the emerging market trend and despite a significant increase in the holding of foreign reserves (Figure 11). We see this in Figure 20 in which it is also clear that inward portfolio flows play an important role. It has been argued (Ashman *et al.* 2011) that such inward flows are necessary to cover for illegal capital flight. We also saw, in Figure 13, that South Africa has

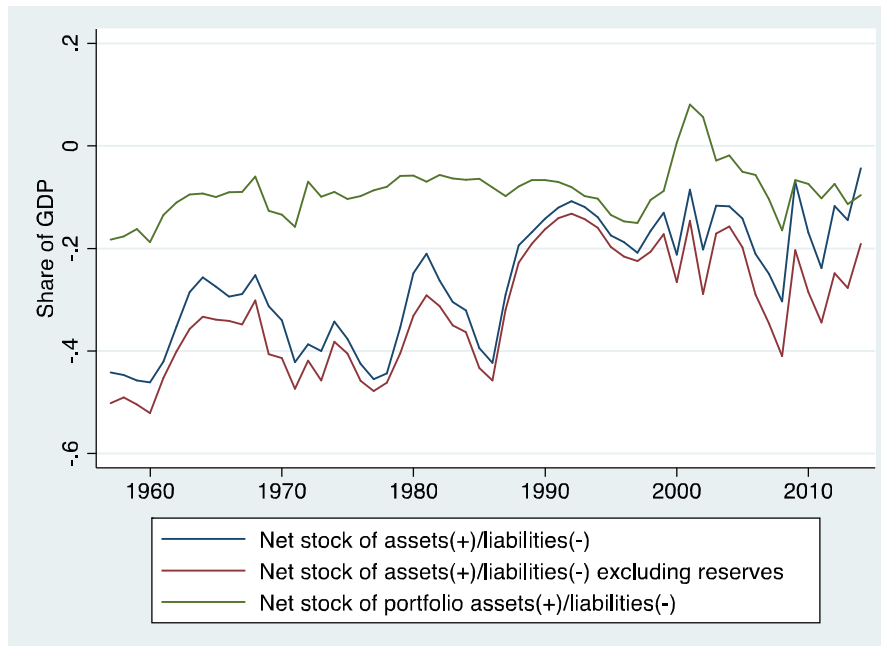
had to maintain high interest rates in order to sustain these capital inflows. Figure 19 shows that in the post apartheid period these rates have been high when compared to a sample of both developed and developing countries. The pro-cyclical nature of capital flows means that increases to interest rates are likely during hard times in order to continue to attract capital with the potential to further exacerbate the downturn by constraining domestic investment.

Figure 19 Comparative real interest rates (1985 - 2014)



Source: Quantec (2015), own calculations

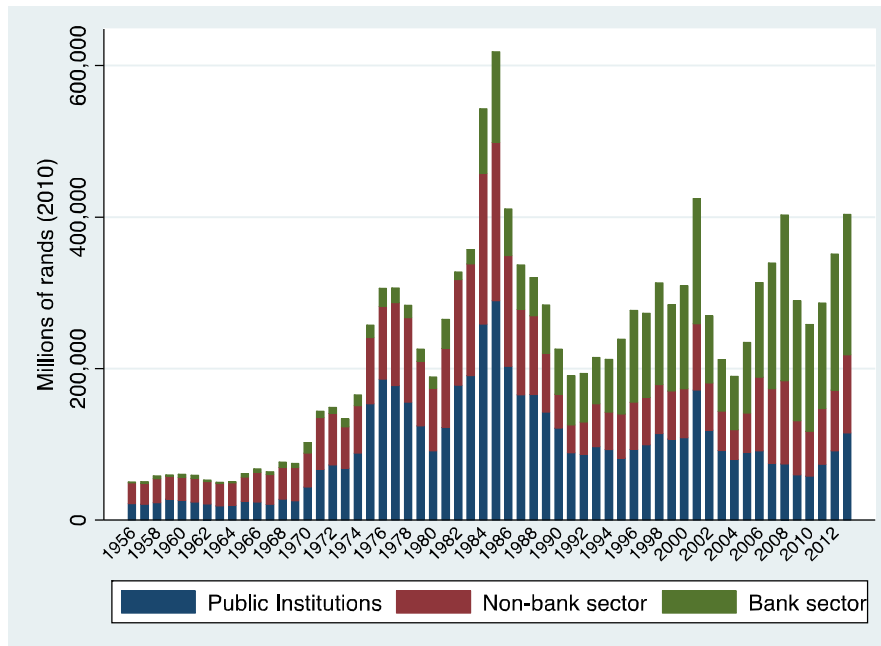
Figure 20 Net foreign position and net portfolio stock (1956 - 2013)



Source: Quantec (2015), own calculations

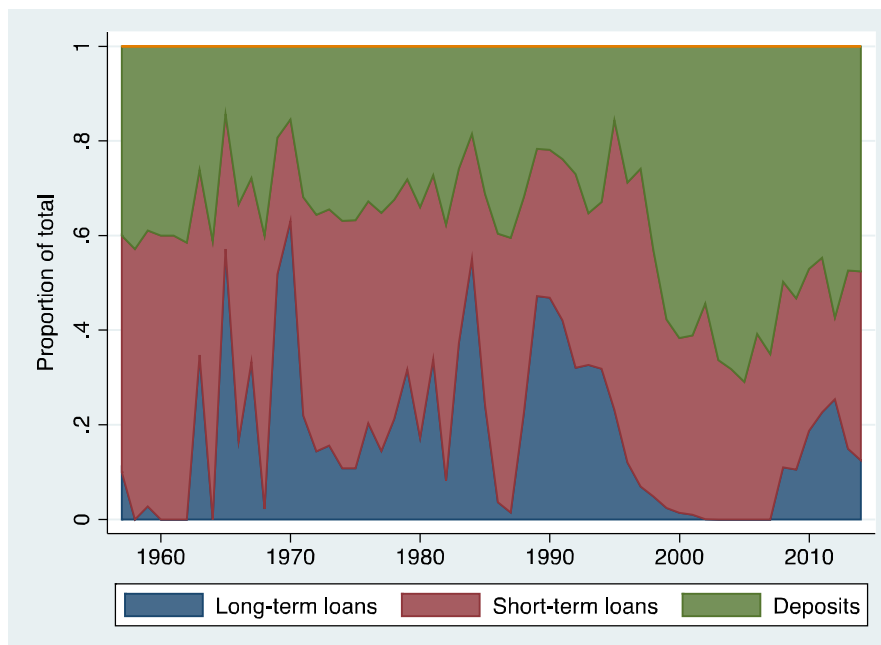
Foreign liabilities held by the banking sector have increased rapidly in the post-apartheid period leaving this sector the most exposed with the highest share of foreign liabilities, as shown in Figure 21. Once again, as shown in Figure 22, short-term flows, in particular deposits, dominate these liabilities. Fortunately, the majority of debt is now held in domestic currency – with domestic currency debt shifting from 30% of total debt in 2003 to over 50% from 2010 onwards – although it is not clear whether the private or public sector is driving this (World Bank 2015b). If the risk of currency mismatches is therefore decreased, banks are still exposed to potential maturity mismatches – as we shall discuss below – given the short-term nature of their debt.

Figure 21 Holders of stocks of foreign debt by sector (1956 - 2013)



Source: Quantec (2015), own calculations

Figure 22 Composition of stocks of foreign bank debt of domestic banks (1956 - 2013)



Source: Quantec (2015), own calculations

Fourth, and finally, a disconnect has emerged between “real economic fundamentals” and the drivers of (short-term) capital flows. Ananchotikul and

Zhang (2014) show that the short-run dynamics of portfolio flows have come to be driven mostly by conditions at the capitalist core (particularly in the US) and by global “push” factors. Primary among these are asset returns in advance economies, swings in global risk aversion, and expansionary monetary policies. Capital flow reversals in emerging economies reflect this with net inflows turning to net outflows at the peak of the Eurozone crisis in 2011/12 as a result of a spike in global risk aversion. Similarly, the reversals in May 2013 and January 2014 can be attributed to both growth concerns in these economies and expectations of an exit from quantitative easing by the U.S. Federal Reserve.

According to an IMF report, global “push” factors are ‘much more important contributors’ to volatility than ‘domestic factors’ but domestic factors drive long-term trends (Ananchotikul and Zhang 2014, pp. 9–10).²⁶ Financial openness (particularly in the case of stock market volatility), macroeconomic stability, inflation and the current account balance (particularly in the case of bond market volatility), foreign bank penetration, and the length of bond/debt maturities all mediate the extent to which global factors impact on the volatility of flows (Beck 2000, Ananchotikul and Zhang 2014). However, in general emerging market flows appear highly synchronised, especially in the wake of the recent global financial crisis (Ananchotikul and Zhang 2014).

Crucially, the rise of massive institutional investors has meant that foreign investment abroad is more about portfolio management than anything else (Bonizzi 2013b), driven by concerns over returns, liquidity, and arbitrage opportunities.²⁷ This confirms that the volatility of flows, through the sometimes rapid buying and selling of assets, is about rebalancing portfolios; it may therefore be “rational” for investors to react to news and market rumours despite unchanged fundamentals (Demir 2006).²⁸

This relates to the differentiated positions that countries occupy in the international financial system, a topic explored with regards to financialisation in discussion on “currency hierarchies” (see Kaltenbrunner 2015). Essentially, a limited number of currencies – predominately the US dollar – occupy a privileged position as the universal means of payment. Other currencies, including those of developing countries, occupy subordinate positions. This has crucial implications for monetary policy autonomy, external vulnerability and financial structure. It also means that the cost of inflationary adjustment from monetary expansion at the core (to the extent that monetary expansion actually leads to inflation) is displaced to the periphery (Vasudevan 2009, 2010) with ‘the notorious carry trade is not an aberration from perfectly working markets, but a structural feature of the international monetary system’ (Kaltenbrunner and Paineira forthcoming, p. 6).

There is little doubt that such dynamics exist for South Africa. As we have seen already in Figure 10 the rand exchange rate is heavily influenced by capital flows. We have also noted that relatively high interest rates have been maintained in order to continue to attract capital. This vulnerability to the vagaries of capital flows – opposed to traditional vulnerabilities to external debt – are also felt in how they impose conservative macroeconomic policy within South Africa (see Isaacs 2014). Overall, the subordinate position of the South African economy (and rand) within the international financial system means that financial integration involves risks that simply cannot be ameliorated on the country level within the framework of open capital markets.

4.4 The domestic allocation of credit

Of equal importance, and related to the forms which flows have taken, is the use to which credit expansion in the domestic economy has been put – whether for productive, consumption or speculative purposes – which markets it enters

– for example stock or real estate markets – and to whom it is lent – businesses, banks, households or the state.

A significant body of literature is emerging which illustrates that non-productive credit, of which household credit is a large component, is ultimately growth retarding. Dos Santos (2011) demonstrates that the “maximal” rate of growth of a capitalist economy is negatively impacted by the growth of consumption credit whereas Basu (2011) shows that where the *share* of consumption credit expands, all else being equal, this will have an adverse impact on the steady (state) rate of growth. Productive credit is spent on both material input and workers’ wages whereas consumption credit only finances the purchases of goods. Further, productive credit generates the conditions for its own repayment (via expanded production and realisation) whereas consumption credit does not, often ultimately indebting households beyond their means and with the possibility of producing instability and crisis.²⁹

Despite the positive consumption effects of financial and housing wealth,³⁰ against which households can borrow to consume – with a propensity to consume of between 0.7% and 7% depending on the study and country group (see Hein and Dodig 2014, pp. 24–25) – Hein and Dodig (2014, pp. 25–26) note that such consumption expenditure is associated with increasing gross indebtedness.³¹

“An increase in household debt initially stimulates aggregate demand transferring purchasing power from lending high-income households with a low marginal propensity to consume to borrowing low-income households with a high propensity to consume. But interest payments on debt subsequently become a burden on aggregate demand, because purchasing power is redistributed in the opposite direction.”

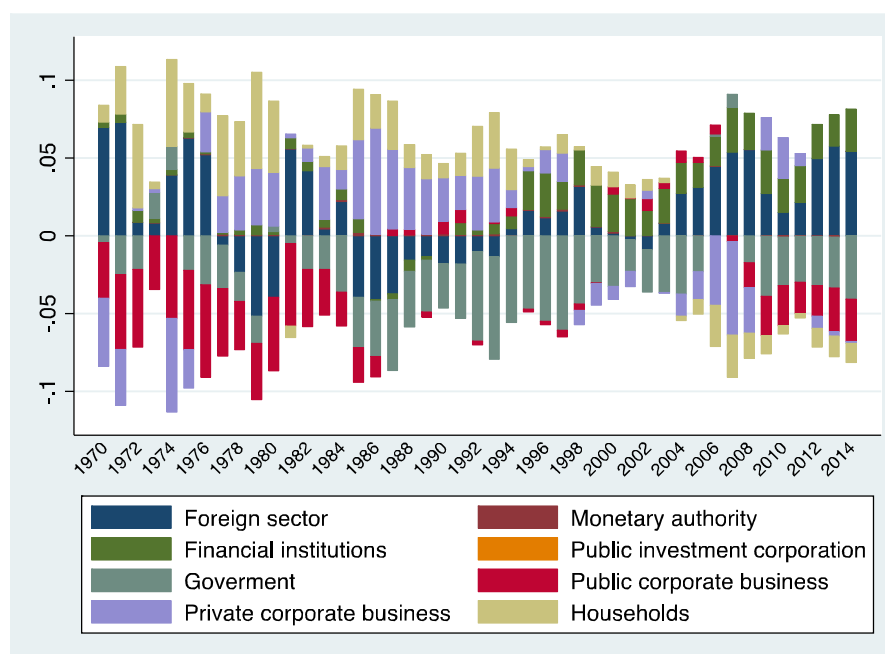
“[Meaning that] the expansive effects of consumer borrowing may be overwhelmed in the medium run by rising interest obligations, which reduce households’ creditworthiness and eventually require higher saving. A debt-led consumption boom will then turn into a debt-burdened recession.”

The other insight from circuit of capital models is that the time lags between points in the circuit open the possibility for both dysfunction and crisis. Stocks of value can accumulate in three different forms – unused inputs, unsold inventories and idle money – corresponding to the three flows – production, realisation and investment – within the circuit. It is both the presence of these lags as well as the attempts made to mitigate them that can ultimately lead to dysfunction and crisis, even if they are functional in the short-term; this is a classic example of an “internal contradiction” of capitalism. Unsold inventories can lead to business failure but the consumption credit extended to allow for realisation can result in credit crises (as seen in the sub-prime crisis of 2007/8). Households are not the only vulnerable sector, such funds have to be channelled through the financial sector and this creates room for speculation and the allocation of resources to the financial, and not the productive, sector. This has a ‘net negative effect on sustainable, productive and long-term growth and development’ (Garcia-Arias 2015, p. 27). On the other hand, over investment via productive credit can lead to over-capacity and excess supply. Finally, a hoarding of funds by enterprises – “over capitalisation” – can lead to underinvestment in the economy at large and stagnation. The extent and nature of international capital flows has a profound influence on domestic credit allocation with short-term non-FDI flows promoting such patterns.

Many of the patterns above can be observed in South Africa. Figure 23 shows the extension of credit in the South African economy. We see that households who are the largest net savers in the 1970s become net debtors by the 2000s.

The government's net acquisition of debt in the late 1980s and 1990s reverses in the early 2000s and then grows following the 2007/8 financial crisis as does the debt of public corporations. We see that debt expansion from 2002 onwards is supported predominately by the foreign sector and that this is particularly true of the consumption led boom of 2002/3 to 2006/7. Net debt and credit expansion is, unsurprisingly, strongest during 2007. Finally, between 2009 and 2011 the private corporate sector is a net supplier of credit with net credit/debt supply/acquisition close to zero in subsequent years, speaking to the over-capitalisation of NFCs and their reserves of cash savings.

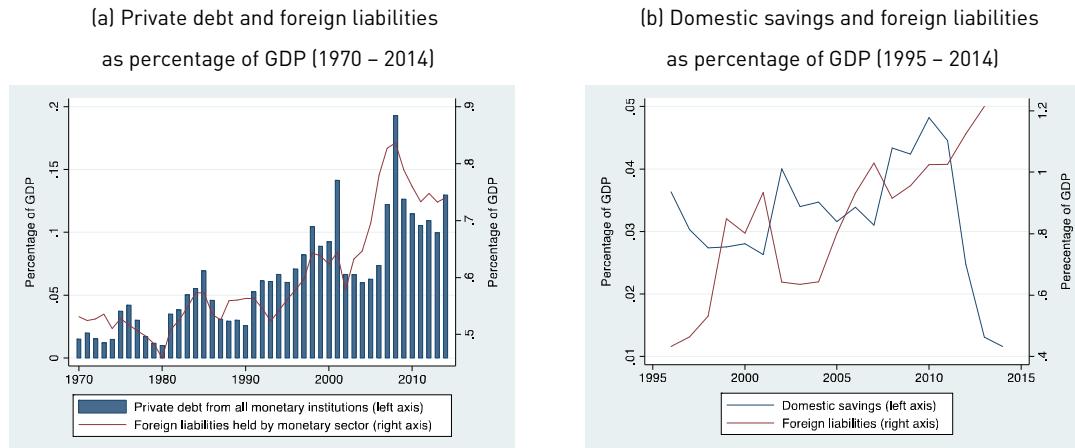
Figure 23 Borrowing and lending by sector as a proportion of total borrowing (-) / lending (+) (1970 - 2014)



Source: SARB (2015b) Flow of Funds, own calculations

The relationship between domestic debt and savings is further unpacked in Figure 24. In Figure 24(a) we see, in the monetary sector, a very strong correlation between foreign inflows and domestic credit expansion. In Figure 24(b) it is clear that domestic savings have declined as foreign inflows have risen. These indicate how the foreign sector has fuelled credit expansion and how that has decreased savings in the domestic economy.

Figure 24 Foreign and domestic sectors: debt, savings and credit



Source: Quantec (2015), own calculations

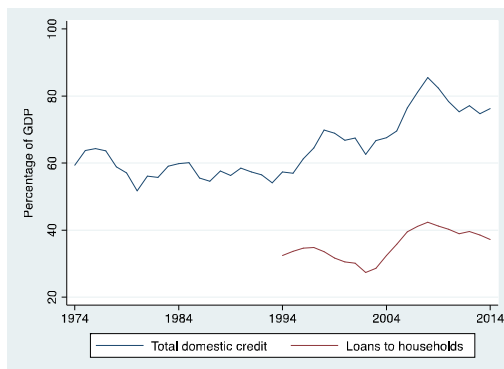
Taking a closer look at households we see that household debt has played an important role in driving overall levels of indebtedness in the economy which has increased from below 60% of GDP in 1994 to over 85% in 2008 (Figure 25(a)). Figure 25(b) shows that household debt and consumption rose in tandem with the sharp rise of household debt to disposable income, shooting up in the late 2000s as increases in disposable household income flag; not shown is that debt service costs as a share of disposable income peak at over 14% of disposable income in 2008. During the consumption-led boom of the early and mid 2000s, household credit as a share of total credit rose from 44% in 2002 to 52% in 2006 and has remained between 48% and 52% since.

The majority of this debt was for mortgages, with mortgages averaging at 53% of overall household liabilities between 1994 and 2014 compared with 47% in the 1980s (SARB 2015a).³² Mortgages therefore played a crucial role in overall levels of credit in the economy, as shown in Figure 26 reaching almost 55% of total credit (up from under 35% in 1985) and 35% of bank credit by 2010. Other forms of consumption credit have also risen particularly for low-income

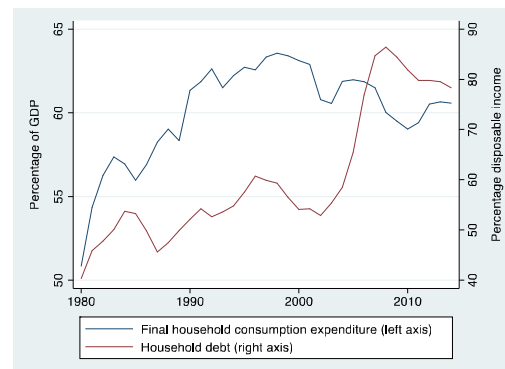
households. In particular credit card debt (also shown Figure 26), store cards and unsecured lending have risen steeply, as has the number of impaired loans indicating the unsustainability of lending (Table 2) (FinMark Trust 2012, NCR 2014). These figures do not fully capture the scope of informal lending often taken on by the poor at exorbitant interest rates (see NCR and Devnomics 2012).

Figure 25 Total credit, household debt and household consumption

(a) Total domestic credit and loans from monetary institutions to households as percentage of GDP (1974 - 2014)



(b) Household debt and consumption expenditure (1980 - 2014)



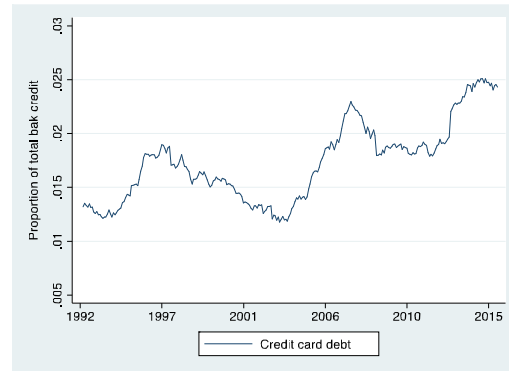
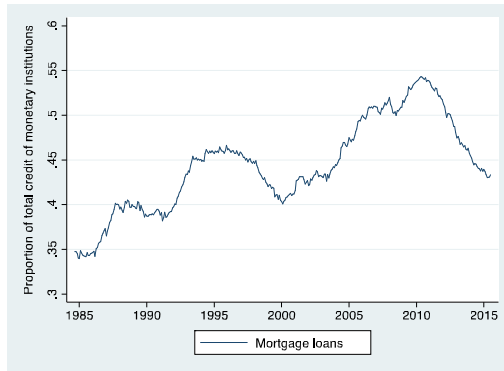
Source: SARB (2015a), macroeconomic time series data, own calculations

Figure 26 Mortgage and credit card debt as a proportion of total credit

(a) Mortgage loans by all monetary institutions (1985 - 2015)

(b) Credit card debt from banks (1992 -

(1985 - 2015)



Source: Quantec (2015), own calculations

**Table 2 Credit types, credit active consumers and impairments for individual creditors
(2007 – 2014)**

Gross Debtor Book				
	2008Q1	2010Q1	2012Q1	2014Q1
Mortgage	63%	65%	60%	53%
Secured Credit	21%	18%	19%	21%
Credit Facility	12%	11%	11%	12%
Un-Secured	4%	5%	9%	11%
Developmental	0%	0%	0%	2%
Short Term	0%	0%	0%	0%

Credit Granted				
	2008Q1	2010Q1	2012Q1	2014Q1
Mortgage	50%	34%	26%	29%
Secured Credit	32%	36%	33%	33%
Credit Facility	9%	12%	16%	15%
Un-Secured	8%	16%	23%	18%
Developmental	0%	0%	0%	3%
Short Term	1%	2%	2%	1%

Credit Granted				
	2007Q4	2009Q4	2011Q4	2013Q4
Credit active consumers	51%	52%	54%	55%
Impairments	38%	45%	46%	48%

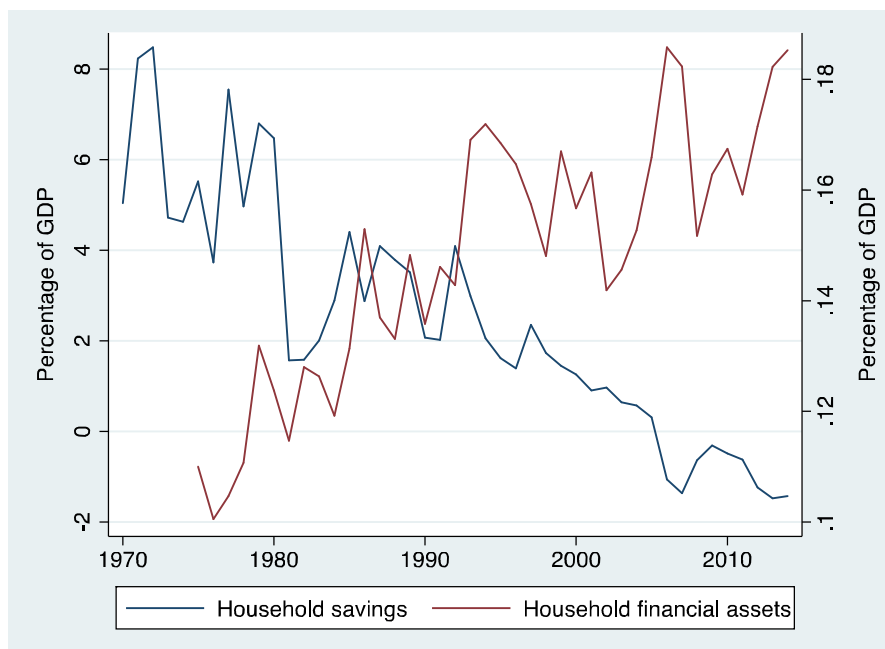
Source: (NCR 2014, SARB 2014)

All of this illustrates the reliance on consumption credit in the economy. While pundits of “financial inclusion” may view this as a positive development it is clear that over indebtedness, from both formal and informal lenders, has become a major problem. Official data on debt impairment, as seen in Table 2, shows a rise from 38% of loans in the last quarter of 2007 to 48% in the last quarter of 2013. While South Africa has not had a spectacular credit bubble

burst like in the United States, over-indebtedness is a slow-boil crisis, particularly amongst the poor. This all speaks to the potentially retarding nature of non-productive, opposed to productive, credit extension.

This increase in the net occurrence of liabilities by household has manifested despite the rapid increase in the acquisition of household financial assets as shown in Figure 27. The rise in household financial assets is related to large institutional investors; the share of household assets with pensions funds and long-term insurers has grown from 29% in 1975 to 54% in 2014 (SARB 2015a). As discussed in Section 4.6, these are highly unequally distributed. A key source of the increase to household wealth has been skyrocketing real estate values with The Economist (2009) recording South Africa, between 1997 and 2008, as having the highest percentage increase in house prices in the world (albeit perhaps off a lower base)!

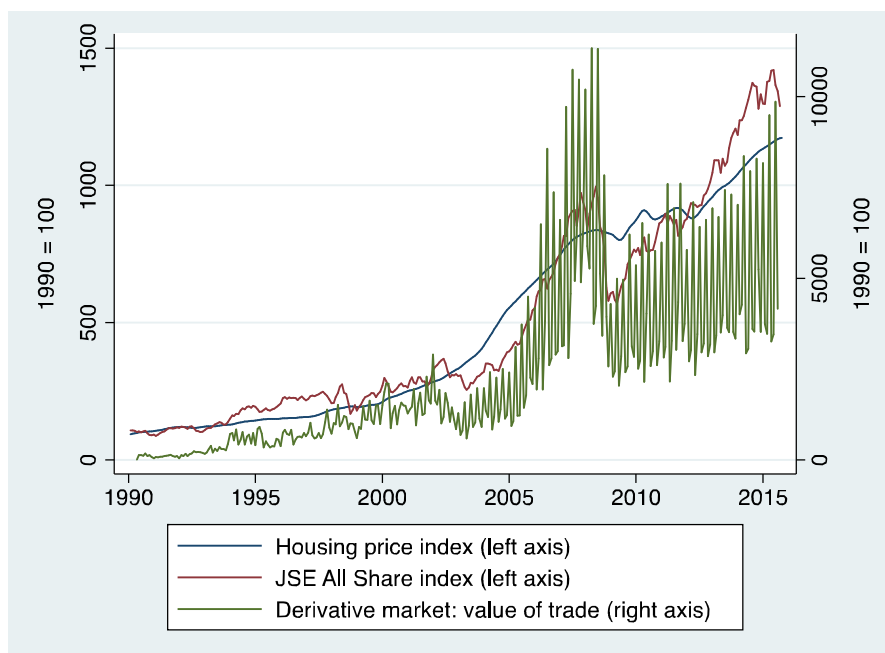
Figure 27 Housing savings and financial assets as a percentage of GDP (1970 - 2014)



Source: SARB (2015a), macroeconomic time series data, own calculations

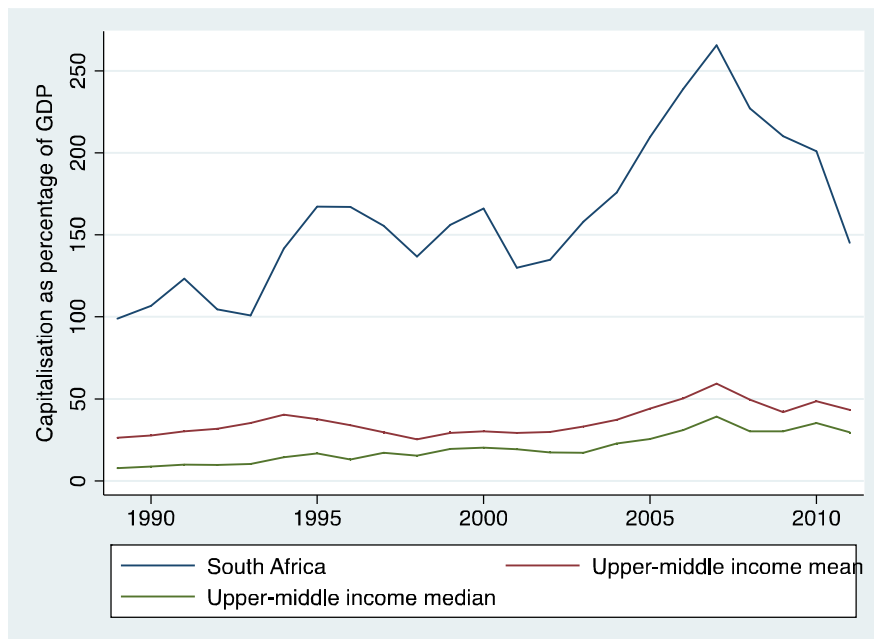
This speaks to how credit expansion, and capital inflows in particular, have clearly led to an appreciation in asset prices. Figure 28 shows the increase in housing prices and the expansion of the JSE All Share index and derivative markets, well out of proportion with the actual expansion of the economy and with middle-income country trends (Figure 29). Figure 30 shows the correlation between capital inflows and changes in these market indexes from the previous quarter. Besides for fuelling asset bubbles, these inflows and onward lending can result in maturity mismatches with short-term foreign inflows converted into longer-term mortgage debt. All of these create domestic market risks and channel funds into asset markets and away from productive real investment with the attendant developmentally harmful consequences discussed above.

Figure 28 House price, JSE All Share and derivative market indices (1990 - 2015)



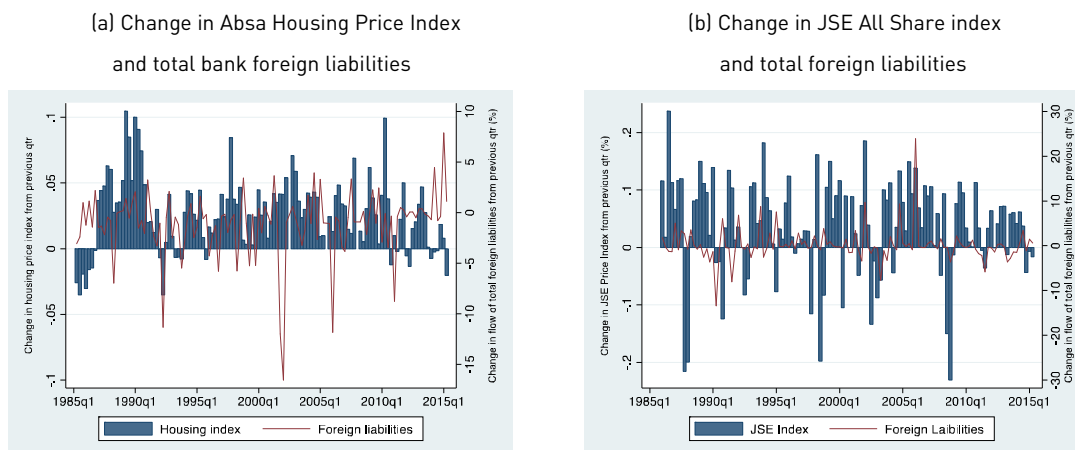
Source: Absa (2015) and Quantec (2015), own calculations

Figure 29 Stock market capitalisation as percentage of GDP for South Africa and Upper-middle income countries (1989 - 2011)



Source: Demirguc-Kunt et al. (2013), own calculations

Figure 30 Change in housing and JSE price index and foreign inflows (1985 - 2015)³³



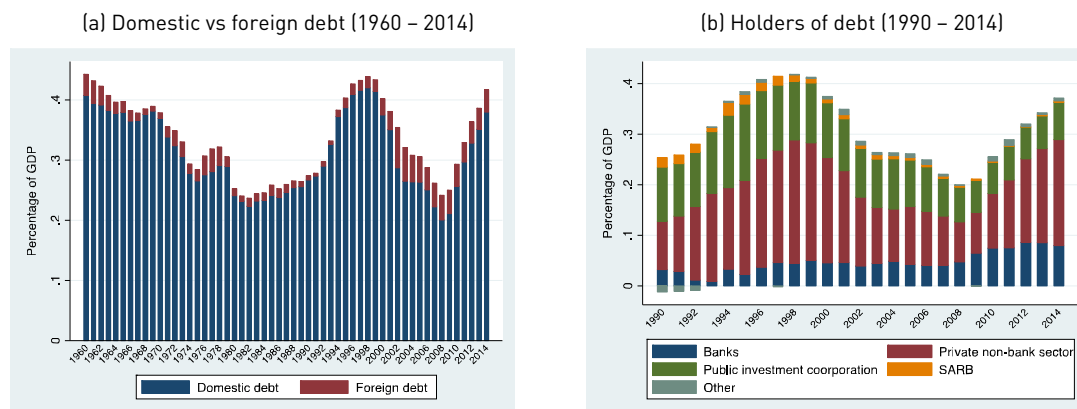
Source: Absa (2015) and Quantec (2015), own calculations

Note: In (a) outliers of > 20% and <-20% of change in bank liabilities have been excluded (3 outliers)

There is little remarkable about government borrowing which unlike private borrowing declined in the 2000s after having peaked in 1998, as shown in Figure 31. It began to rise again from 2009 onwards with foreign debt playing a larger role although South African government debt is overwhelmingly domestic and

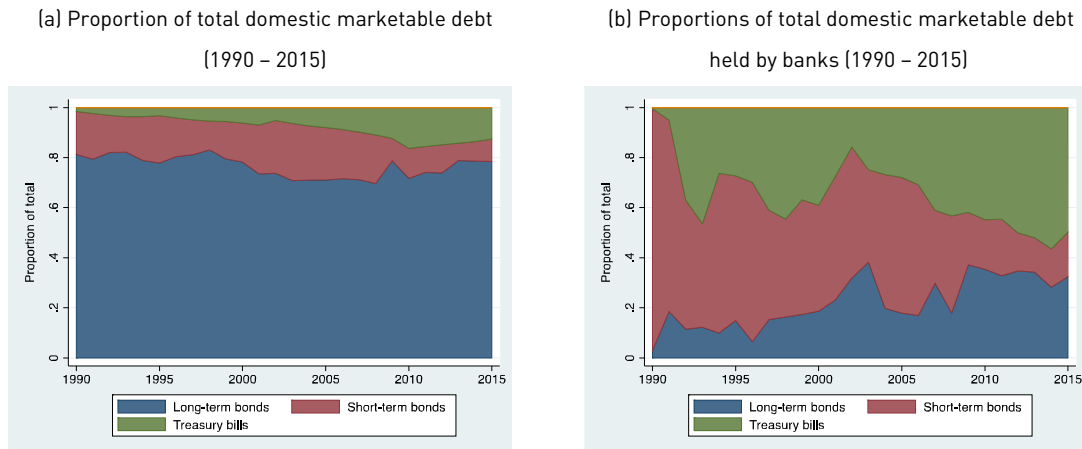
local currency denominated. The majority of this debt is held by the private non-bank sector, with the holdings of banks increasing from 2009. It is also overwhelmingly long term in nature although a large proportion of bank holdings are short-term, seen in Figure 32. There is also little remarkable with regard to South African inventories, which have fallen as a share of GDP over the past two decades and while the utilisation of productive capacity in manufacturing peaked in 2006 at 88%, it has remained consistently from 1970 to 2014 at between 75% and 88%.

Figure 31 Breakdown of South African government debt



Source: Quantec (2015), own calculations

Figure 32 Proportion of South African government debt by term (1990 - 2015)



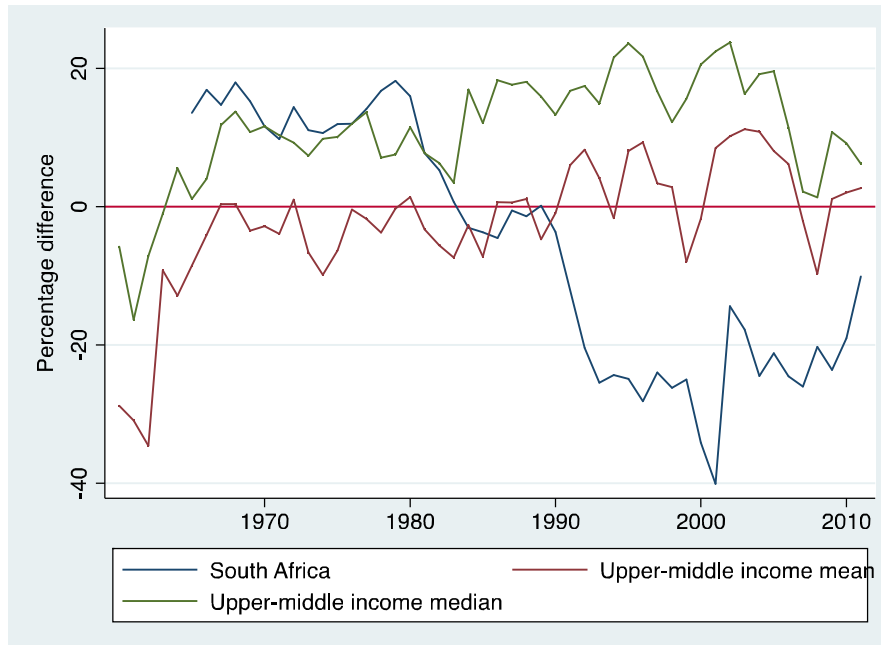
Source: Quantec (2015), own calculations

Together with the foreign sector financial institutions are the largest net lenders. There is no consistent long-term data available disaggregating bank lending between sectors. In Figure 34 we cut the SARB BA900 and DI900 data series³⁴ (the data that banks must report monthly) into three internally consistent pieces (1993 to 2000, 2001 to 2007 and 2008 to 2015). We observe a decline in bank assets held as loans or other advances to non-financial corporations as a share of overall assets between mid 1996 and 2001, between 2001 and mid 2006 and again between mid 2008 and mid 2011. There are periods of increase (1993 – mid 1996, mid-2006 – 2008 and 2013 onwards) but the overall trend is downwards. This should be read with extreme caution but may indicate a reduction in bank lending to NFCs. The aggregated data of the series is consistent and through this we can observe, in Figure 35 an increase in the financial investment of banks, which includes portfolio assets, securitisation etc. with a predictable slump during the global financial crisis

Figure 33 shows that there is a large negative relationship between bank deposits and bank credit indicating that South African banks are financing a considerable part of their lending with borrowed funds. Recall also that we saw in Figure 21 that the bank sector is the largest holder of foreign liabilities.

These facts expose South African banks to some risk although thus far banking crises over the last twenty years have been rare.

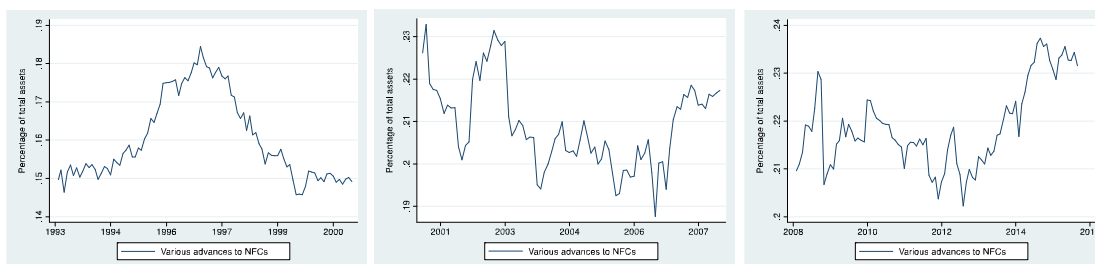
Figure 33 Percentage difference between bank deposits and bank credit (1970 - 2011)



Source: Demirguc-Kunt et al. (2013), own calculations

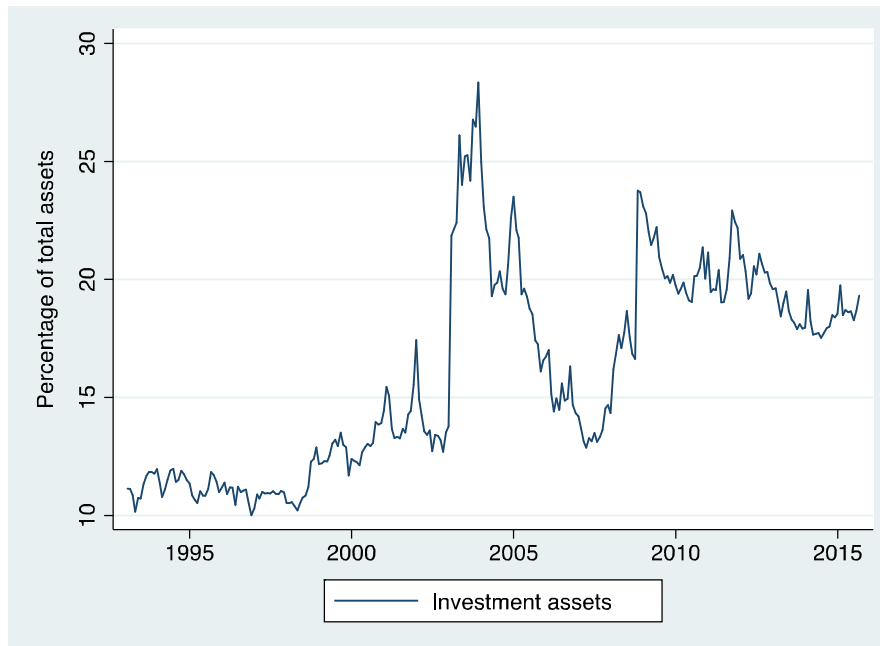
The corporate private sector has also become a net borrower in recent years, as seen in Figure 36, despite large build-ups of cash on their balance sheets (Karwowski 2012). In fact the key question of the next section is just how the non-financial sector has been allocating its investment.

Figure 34 Bank assets attributable to non-financial corporate sector (1993 - 2015)



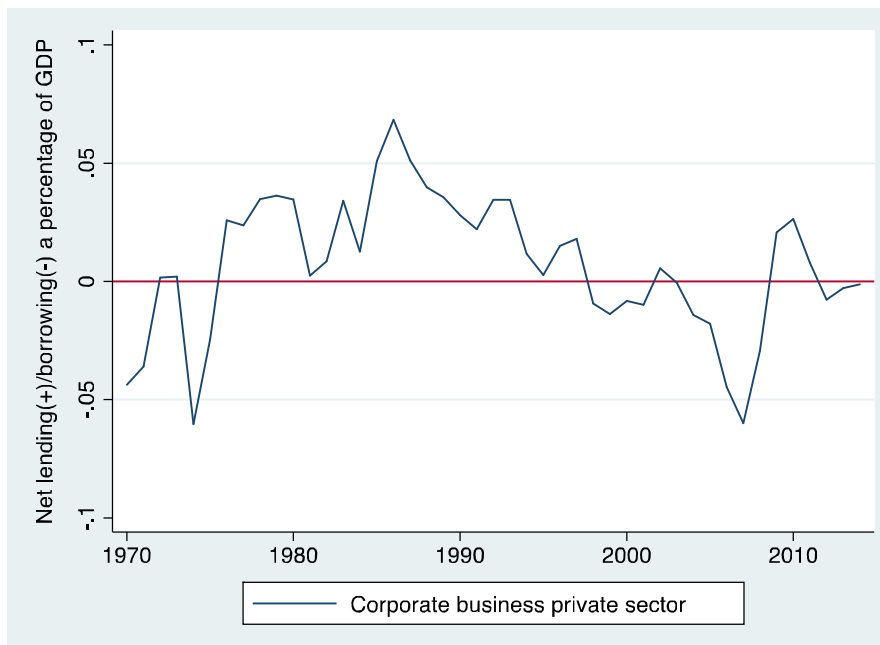
Source: SARB (2015c) BA900 banking data series via Quantec

Figure 35 Investment assets of banks as share of total assets (1993 - 2015)



Source: SARB (2015c) BA900 banking data series via Quantec

Figure 36 Corporate business sector net borrowing / lending as a percentage of GDP (1970 - 2014)

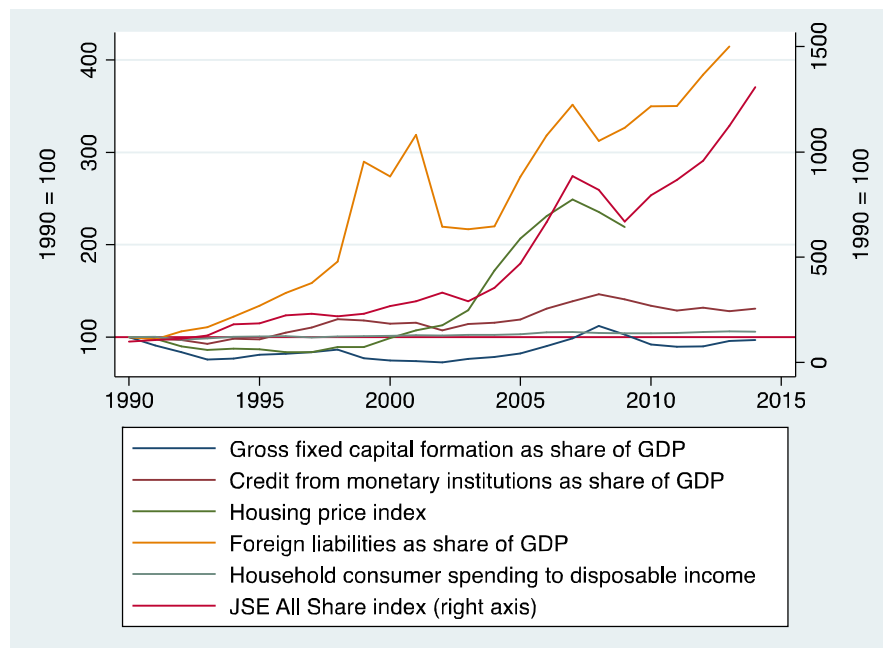


Source: SARB (2015b) Flow of Funds, own calculations

The findings of this section are neatly summed up in Figure 37 which shows a range of indices where 1990 is equal to 100. We see that credit from monetary

institutions, housing prices, consumer spending, foreign liabilities, and the JSE All Share index all increase over time. The only index to consistently remain below the base year (in all but two of the 25 years) is gross fixed capital formation as a share of GDP. What we have witnessed in South Africa is a surge in unproductive credit, directed towards consumption and asset markets, with a strong focus on lending to households and asset price appreciation. Through the diversion of funds away from productive investment, the unsustainable nature of debt-financed consumption-led growth, and the vulnerabilities which come with asset bubbles, these patterns of credit allocation have surely been developmentally retarding.

Figure 37 Select indices compared with gross fixed capital formation (1990 -2015)



Source: Quantec (2015), own calculations

4.5 Patterns of domestic real investment

Financial liberalisation and deregulation and financialisation more broadly have also had a profound impact on the patterns of investment in local non-financial corporate sectors. Changes in business behaviour from the 1970s onwards was noted by Lazonick and O'Sullivan (2000) who argued that firms had moved from a "retain and invest" to a "downsize and distribute" strategy. This was accompanied by the increased importance of takeovers and mergers and acquisitions (Holmström and Kaplan 2001). NFCs have also increased their investment in financial assets, part of a broader trend towards focusing on short-term profitability. This short-termism is spurred by the increasing prioritisation of shareholder value maximisation which also arose in the last three to four decades as a consequence of the rise of powerful institutional investors, generic investment matrices against which investment decisions are made, and the alignment of shareholder and executive priorities. It is also accompanied by an increase in the payments of dividends and interest, both of which flow into the financial sector.

Stockhammer (2004), van Treeck (2008), Orhangazi (2008a, 2008b) and Onaran et al. (2011) all show the negative effects of financial motives, profits or payouts of non-financial corporate investment either on the aggregate level or with firm level data. Stockhammer (2004) finds evidence that the "rentier share" and "rentier payments" (the share of dividends and interest as income and payments, respectively, over the value added of NFCs) is negatively associated with real investment in the UK, US and France but not in Germany. Tran et al. (n.d.) makes a similar finding for the US between 1960 and 2007. Stockhammer (2009) also shows that the ratio of private gross fixed capital formation as a share of operating surplus has decreased on aggregate in the EU, US and Japan between the 1970s and 2000s and that residential investment has not increased. Looking at interest and dividend payments, each in relation to the

capital stock, van Treeck (2008) finds that an increase in dividend payments – indicative of pressures for short-term financial gain by shareholders – illustrates rising shareholder value maximisation pressures. In the case of the NFC sector in the US (1965-2004) this has a statistically significant negative effect on capital accumulation. Interest payments do not necessarily have this effect because debt holders are more likely, he argues, to take a longer-term view of the corporation.

Onaran et al. (2011) in a time series study of the US (1962-2007) find that increases in the “rentier profit share” (net dividends and net interest payments of domestic industry as a share of nominal GDP) dampens real gross domestic investment, while the opposite is true of the “non-rentier profit share”. Given the rapid increase in debt, contributing to more than half of the growth of the financial sector in the US, this is congruent with the claim that financialisation has seen a transfer of income from the real economy to the financial sector (Tomaskovic-Devey *et al.* 2015).

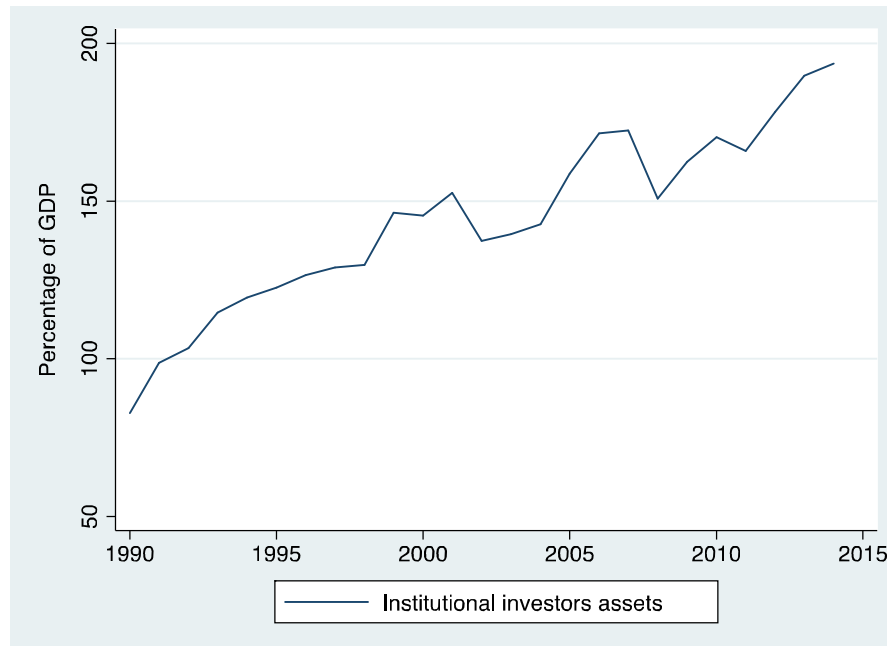
Similar findings of the negative effect on real NFC fixed investment of total financial payments and the share of profits from financial components are present in Korea (Shin 2012) as is their negative effect on R&D investment (Seo *et al.* 2012). Milberg and Shapiro (Milberg and Shapiro 2013) also point to the negative role of financialisation on innovation.

Emphasis is placed on financial payments because the rate of capital accumulation has been shown to closely match the rate of retained profits and financial payments reduce the latter (Tran *et al.* n.d., Stockhammer 2004, Orhangazi 2008a).³⁵ However, this is not the only means through which financialisation can reduce physical accumulation. Clevenot (2010) shows that in the case of France *net* financial payments/receipts have not risen for NFCs. Instead, it is through the ‘short-term concern for financial profitability’ that

capital accumulation has suffered. Efforts to achieve financial returns can increase the cost of capital and lead to high levels of financial leverage, the risk of over-indebtedness, greater volatility, and subsequent crises. These short-term planning horizons are also a consequence of shareholder value orientation, particularly the attempt to achieve a certain return on equity or other financial indicators. This places priority on core competencies, growth through mergers and acquisitions rather than investment, and quarterly performance indicators over long-run growth (Tran *et al.* n.d., Clevenot *et al.* 2010). Clevenot (2010, p. 699) shows that 'maintaining such high levels of financial profitability ultimately came to represent a significant (and in the end unsustainable) effort for firms'.

Figure 38 shows the increase in the size of assets held by institutional investors as a share of GDP. In addition, their share of market ownership was approximately double in the 2000s than what it was in 1990. These statistical measures tell a useful story but the real weight of institutional investors is felt in the manner in which they exercise influence over corporate decision-making. In this regard it is clear that South Africa has become subject to the same shareholder value maximisation pressure as elsewhere in the world (for an example of the platinum sector see Bowman and Isaacs 2014).

Figure 38 Size of institutional investors' assets as share of GDP (1990 - 2014)



Source: Quantec (2015), own calculations

In

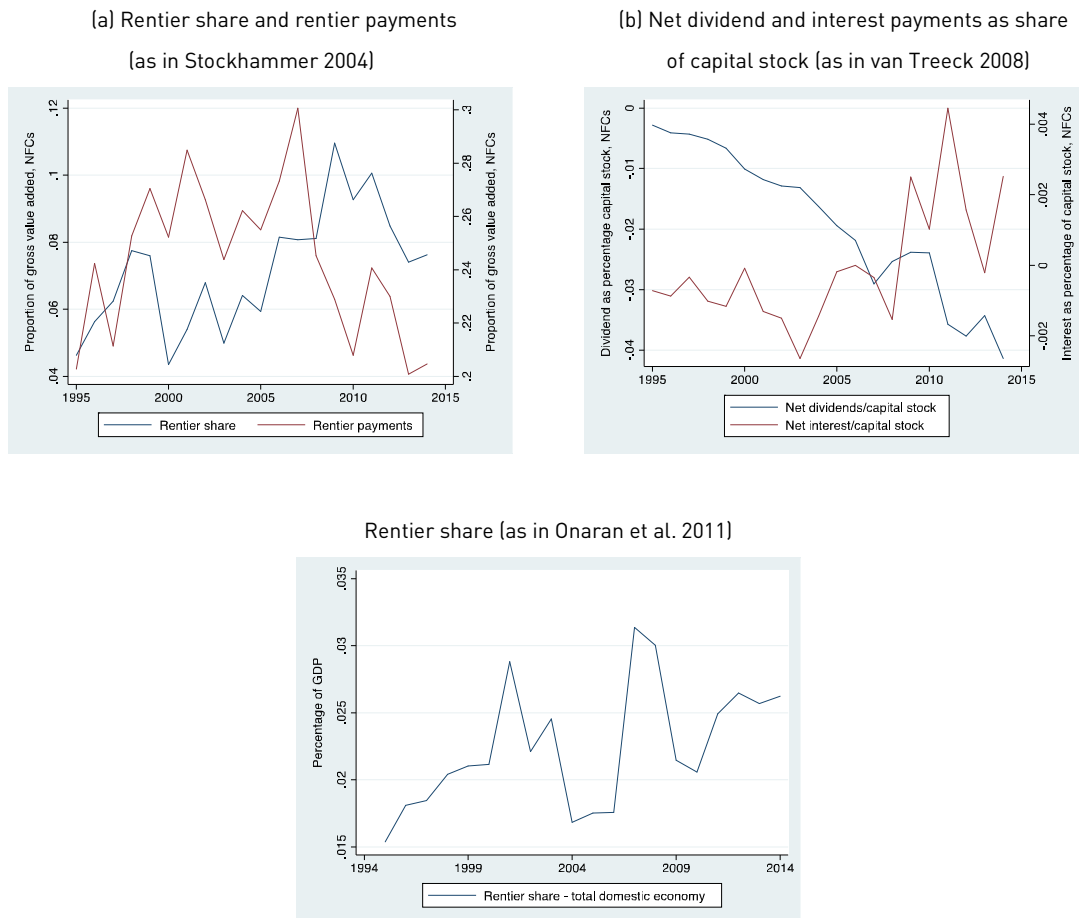
Figure 39 we apply the measures described above to the South African context.³⁶ We see in

Figure 39(a) that both Stockhammer's (2004) rentier share and rentier payments increase significantly albeit with the latter declining in the wake of the global financial crisis. As predicted by van Treeck (2008),

Figure 39 (b) shows that dividend payments have increased when compared against capital stock – an indication of shareholder value pressures – whereas interest payments have moved in the opposite direction. We see also, that the “rentier profit share” as per Onaran et al. (2011), which has been shown to depress real gross domestic investment, has risen in South Africa (

Figure 39(c)).

Figure 39 Measures of financialisation of NFCs (national accounts data)
(1995 – 2014)



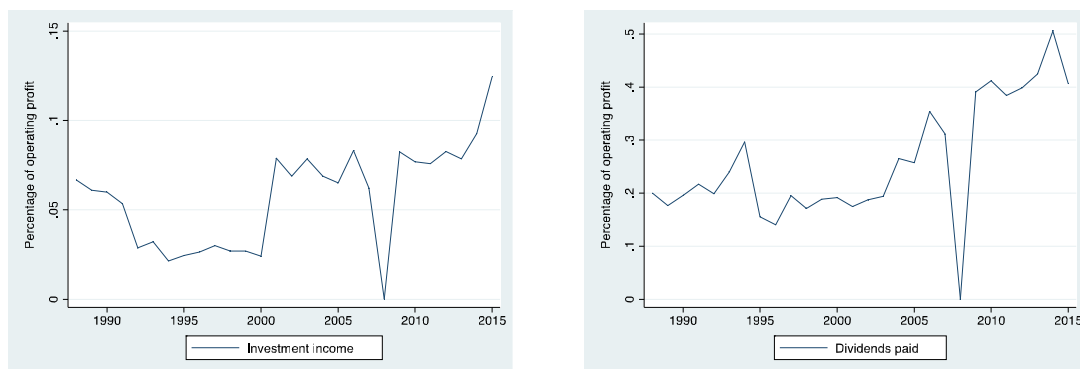
Source: Quantec (2015), own calculations

Orhangazi (2008a, 2008b) using firm-level data of NFCs in the US (1972-2003) finds that a shift in favour of short-term financial profits (the sum of interest and equity income in net earnings) has a negative impact on real investment for large firms but a positive one on small firms (relieving financing constraints) and that financial payments (interest expenses, cash dividends, and purchasing of firms' own stocks) have a negative impact across the board. The share buybacks that Orhangazi includes in his analysis have led the stock market to make an overall negative contribution to the financial position of non-financial businesses (Schaberg 1999). This has meant NFCs increasingly rely on internal finance for investment projects. Similarly, Davis (2013, 2014), focusing on firm investment in fixed assets, finds that, for large NFCs, lower

levels of investment in direct production are associated with industry level stock buybacks and increased debt-based financing.

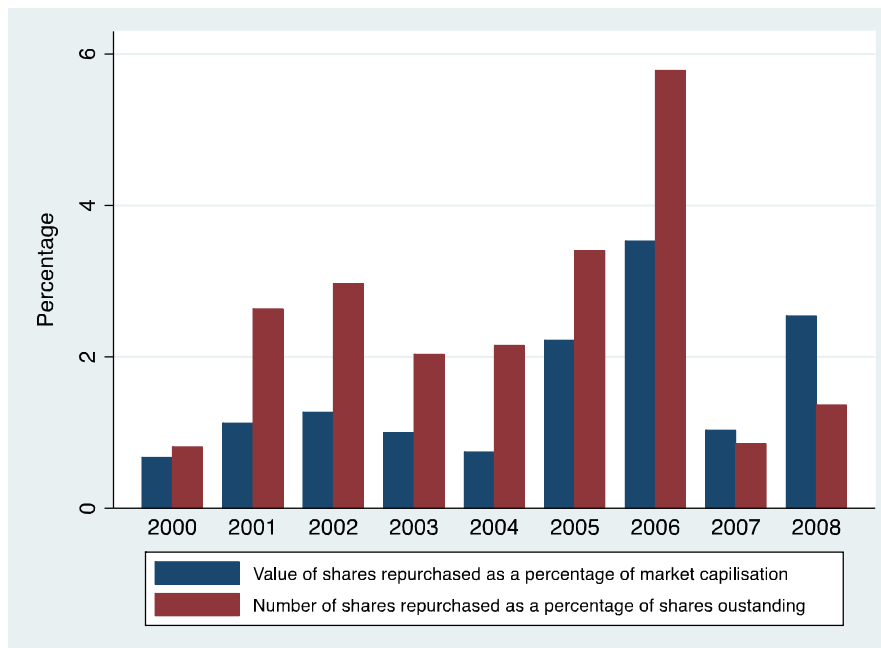
Firm level data from South Africa shows similar trends with both investment income and dividend payments growing as a share of operating profit, as shown in Figure 40. Share buybacks, another means through which corporate income is returned to shareholders have only been permitted in South Africa since 1999, and reporting of these remains fragmented. Between 2000 and 2007, in a sample 132 industrial companies Bester et al. (2008) find that 52% of companies engaged in at least one round of share repurchases with an upwards trend between 1999 and 2005 (see Figure 41).

Figure 40 Investment income and dividend payments income as a share of operating profit for listed companies in all non-financial sectors (1988 - 2015)



Source: INet BFA (2015), aggregate data, own calculations

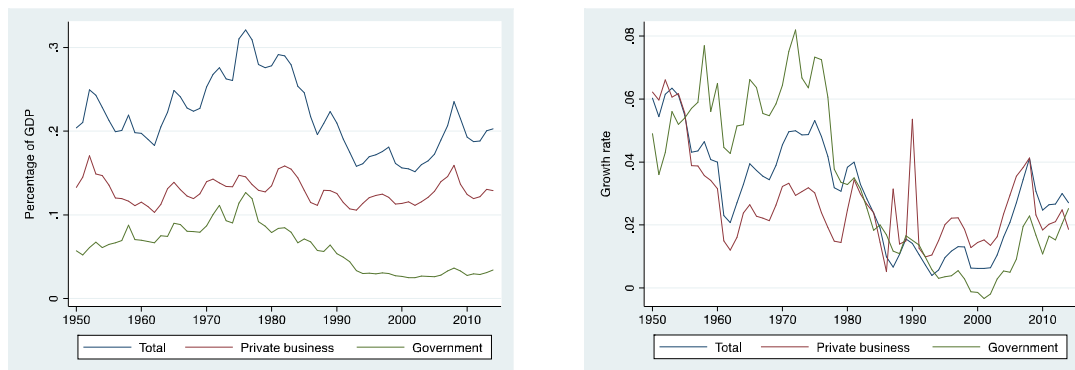
Figure 41 Share repurchases (2000 - 2008)



Source: Bester et al. (2008) as in Isaacs (2012)

In contrast to the emphasis placed on shareholder value maximisation, it is possible that the increased financial investment strategies by NFCs are simply attempts to avoid rent extraction by increasingly powerful financial firms or attempts to profit from those same rent-seeking activities by entering financial markets (Tomaskovic-Devey *et al.* 2015). The evidence however is clear, these trends have been associated with patterns of investment that have been harmful to the real economy. We see these deleterious effects in the South African case in the decline of gross fixed capital formation as a share of GDP which continues until the mid 2000s, when it was boosted by large infrastructure projects, and in the declining growth rate of capital stock, both shown in Figure 42.

Figure 42 Gross fixed capital formation as a share of GDP and the growth rate of fixed capital stock (1950 – 2014)



Source: Quantec (2015), own calculations

Note: In (b) outliers of government fixed capital stock of < -0.02 have been removed (2 outliers)

This microeconomic analysis of how shareholder value orientation has altered firm's behaviour must be completed by understanding how financialisation has altered the macroeconomic environment within which they operate. This environment is characterised by volatility on financial markets and hence a high degree of uncertainty making large physical investments less attractive. Greenwood and Scharfstein (2013) have shown that the main sources of growth in finance – asset management and the provision of household credit, the latter which has fuelled “shadow banking” – has increased instability in the financial system. Further, the volatility of exchange rates seems to have dampened manufacturing investment although the existing evidence is not conclusive enough. Despite rising share prices, there is little empirical evidence that share prices have a significant effect on investment (Stockhammer 2008). South Africa, as shown earlier, has been subject to all these developments.

Demir (2007, 2009a, 2009b) pulls these micro and macro threads together by showing how capital market liberalisation – which has increased uncertainty, raised real interest rates, and exacerbated exchange rate and capital flow volatility – together with a lack of availability of long-term credit, increased

competition in goods markets and the presence of high returns in financial markets has precipitated altered investment decisions by NFCs. In Turkey financial investment has helped cushion NFCs from the impact of these negative financial shocks but at the same time the rise in liquid short-term assets has reduced spending in long-term fixed investment projects and shifted firms away from manufacturing (Demir 2009a). In Argentina and Mexico increases in short-term capital flows, increase the financial assets to fixed assets ratio (not in the case of Turkey) as do FDI in all three countries, the latter calling into question the assumed positive impact on real investment by FDI flows (Demir 2007). Demir (2007) also found that in all three cases, increases in short-term capital inflows increased financial profits more than operational ones. Finally, in Argentina and Mexico a negative relationship is found between financial profits and private investment, whereas in Turkey the relationship is positive but financial profits have an almost fifteen times smaller economic effect on fixed investment than operational profits (Demir 2007). Research into the exact dynamics in South Africa is still needed.

Van Treeck (2009, p. 909) notes that:

'When firms in the aggregate reduce investment (the accumulation rate), perhaps as a result of shareholder value orientation, an increase in profits (the profit rate) is only possible if some other component of aggregate demand more than compensates for the decrease in investment (the accumulation rate). More precisely, macroeconomic profits are by definition equal to the sum of investment spending, consumption expenditure out of profits, the government deficit and the external surplus, less saving out of wage income (Cordonnier, 2006; Kalecki, 1942).'

This pulls together the various elements we have discussed thus far. The imperatives of financialisation reduce aggregate fixed investment but this must be compensated for in order to maintain aggregate demand and profitability. Credit-fuelled spending is a crucial response, supported by asset bubbles against which funds can be borrowed. In the short-run, profitability can also be maintained by financial market speculation which becomes tied up with the expansion of credit in a dizzying array of financial assets further and further removed from the productive capacity of the economy. These trends are apparent in South Africa albeit with its unique features, one of which is the exclusion of the poorest from financial markets as discussed below. In South Africa the system has not come crashing down, in part because South African banks have not engaged in a similar scope of speculative investment as in the US. But a slow-burn crisis is still underway with a real-investment strike by businesses, as we have seen in this section, at its heart. We turn to a final consideration, the impact on distribution.

4.6 Distribution: poverty and inequality

Inequality has been on the rise worldwide over the past three decades. The functional distribution of income – the share of wealth going to capital and labour – has become more unequally shared, together with rising inequality within the income distribution and in the holding of other forms of wealth.

There is once again tension within the relatively thin mainstream econometric literature on the relationship between finance and inequality. Regarding domestic financial development, in cross country studies Beck et al. (2007) and Clark et al. (2006) find that financial development disproportionately benefits the poor and improves income inequality; Johansson and Wang (2014) find that financial repression increases inequality. By contrast Rodríguez-Pose and Tselios (2009), Gimet and Lagoarde-Segot (2011) and Roine et al. (2007) find the

opposite. Even within the same region the findings are contradictory (for example Batuo *et al.* 2011, and Fowowe and Abidoye 2013 on Africa).

The individual country studies in the main argue that financial development reduces inequality but this is not unanimous³⁷ and is also differentiated within countries, for example by regions (for example between rural and urban areas, see Arora 2012). Some studies emphasise the need for threshold levels of financial development (Kim and Lin 2011) or institutional quality (Law *et al.* 2014) before a positive impact is felt.

Mainstream econometric evidence on the relationship between inequality and financial liberalisation between countries is far more unanimous than, that greater financial openness exacerbates inequality. Cornia (2003) shows this specifically for developing and transitional economies where domestic deregulation and external liberalisation increase inequality and Bumann and Lensink (2012) show the same in a cross-country analysis (Azzimonti *et al.* 2012, see also Larrain 2012, 2014, Furceri and Loungani 2013, Kunieda *et al.* 2014). Even IMF (Jaumotte *et al.* 2013) and OECD (Jomo 2001) working papers find a positive relationship between increased financial globalisation and inequality.³⁸

In some instances certain aspects of financial development and liberalisation show one thing, and other aspects another. For instance, Kai and Hamori (2009) argue that globalisation increases inequality but financial development improves it, similarly Shahbaz and Islam (2011) show that financial development reduces income inequality while financial instability aggravates it. The difficulty here is that, as our previous analysis illustrates, these phenomena are inseparable: globalisation and financialisation go hand in hand and financial development and liberalisation lead to instability. Together, these findings indicate some of the limitations of the econometrics literature. They

also show how the interconnectedness of these phenomena makes it more difficult to tease out the role of financial developments from broader globalisation and neoliberal restructuring. Given all this, to truly understand the relationship between finance and inequality, and why finance has had significantly harmful effects, we need to turn to a political economy analysis.

The financialisation literature is both clear and convincing in the mechanisms through which financialisation has increased inequality. Importantly, financialisation has affected both the functional distribution of income – through a compression in the wage share – and income distribution itself. This has occurred because of shifts in patterns of investment, the organisation of work and levels of employment, compensation trends, and household integration into financial markets.

There is a substantial body of literature which highlights the relationship between declining wage shares and financialisation. A critical channel through which this has occurred has been through the reallocation of funds towards financial investment and pay-outs, associated with shareholder value pressures. First, this has shifted investment away from jobs in the productive sector, which has occurred in tandem with the downsizing of large corporations and the offshoring of certain jobs to low-wage locales. This has decoupled the generation of surplus from production, which together with liberalisation and globalisation, has weakened labour's bargaining power. Second, large pay-outs have altered the distribution of value-added at the firm level with shareholders receiving a larger slice of the pie. Third, changes in distribution have not only occurred between capital and labour but also within capital's share between retained earnings and financial pay-outs; with declines in retained earnings undermining long-term investment.

Lin and Tomaskovic-Devey (2013) argue that such factors could account for more than half of the decline in the labour share, 9.6% of the growth in senior staff compensation, and 10.2% of the growth in earnings inequality in the US between 1970 and 2008 (see also Tomaskovic-Devey and Lin 2014). Dünhaupt (2012) makes similar findings for the US and Germany, Alvarez (2015) in France and Dünhaupt (2013, 2014) for 13 OECD countries (for other similar findings see Zalewski and Whalen 2010, Charpe 2011). In an ILO paper covering 28 advanced and 43 developing countries, Stockhammer (2013, p. viii) finds that 'financialisation has been the main cause of the decline in the wage share'. Welfare state retrenchments and globalisation have also had a negative impact. Tomaskovic-Devey et al. (2015) find that overall value added of the non-financial sector declined in the US between 1970 and 2008 and that this decline was disproportionately born by labour and the state while increasing value was channelled to corporate debt and equity holders. Giovannoni (2014) cites a 2013 ILO paper which argues that 46% of the decline in wage share can be attributed to financialisation alone, 25% to institutional factors, and 10% to technical change. All of these run counter to the usual claim that it is technical change driving shifts in the functional distribution of income.

Hein (2011), using a Kaleckian theoretical framework, analyses factors which contribute towards an increase in the profit share. He shows that shareholder value orientation; rising dividend payments; increasing interest rates and payments; increases in top management salaries; rising financial investment at the expense of fixed investment; mergers and acquisitions; and financial globalisation and liberalisation, all contribute towards changes in: price competition in goods markets; the bargaining power of labour; overhead costs and profit targets; the price of imported goods; and the sectoral composition of the domestic economy. These, in different ways predominately raise the profit share.

Financial crises have also contributed to declining wage shares with Diwan (2001) estimating that the cumulative effect of crises between 1970 and 2000 has been a fall in the labour share of 4.1% of GDP (see also Lübker 2007). In sum:

‘Regardless of the variable or combination of variables chosen, the empirical literature overwhelmingly finds that the primary force behind the decline in the wage share has been financialization, even after controlling for changing institutions and increased international trade’ (Giovannoni *et al.* 2014, p. 36)

In South Africa, as shown in Figure 43, we see a significant decline in the wage share in the post-apartheid period. Between 1950 and 1990 compensation for employees averages at 55% of gross value added compared with an average of 51% since 1994. In 2007 and 2008 it reaches a low of close to 48% after which it rises, probably driven by a squeeze on profitability in the wake of the crisis, and perhaps rising real wages in a few sectors, such as mining. In addition, South Africa’s wage share is estimated to be approximately 5% below its developing country peers (Strauss Forthcoming). Finally, Burger (2015) shows that productivity growth has outstripped real wage growth, with an increasing gap between the two.

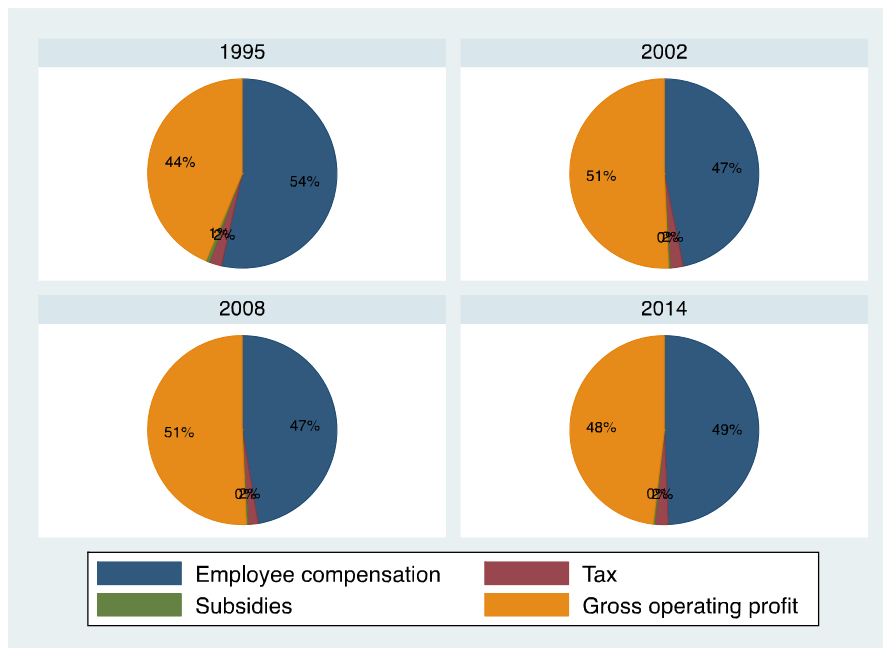
Figure 43 Wage share (1990 - 2014)



Source: Quantec (2015), own calculations

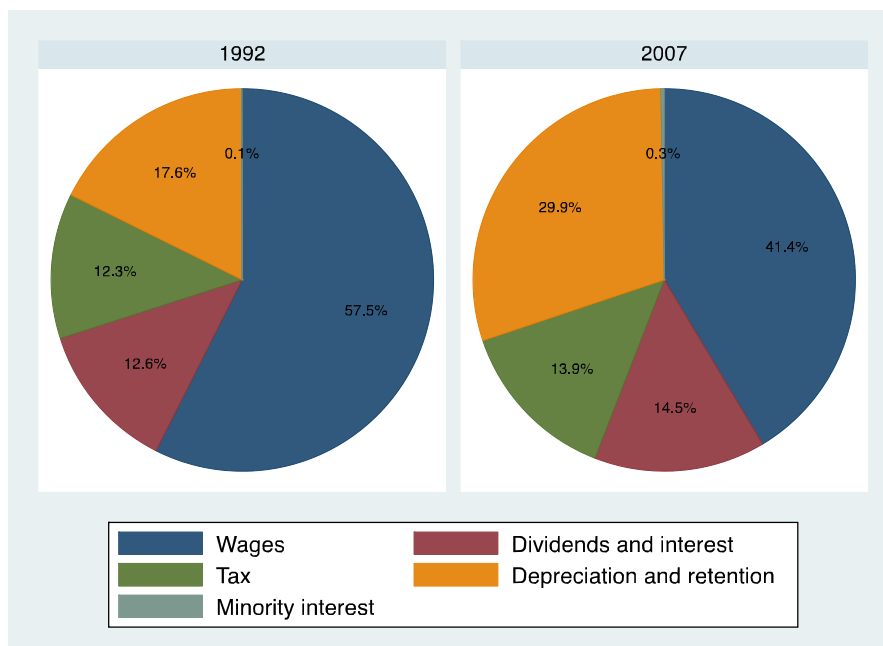
We see the declining wage share represented strongly in the distribution of value added within the non-financial sector. In both Figure 44 (national accounts data) and Figure 45 (company data) the wage share declines significantly between the early 1990s and 2007/2008 after which it begins to rise. In Figure 44 it overtakes the share allocated towards gross operating profit in 2013. Recall that in Figure 40 we have already shown that dividend pay-outs increase as a share of gross operating profits during this period, meaning less retained earnings within the profit share.

Figure 44 Allocation of value added within non-financial sector from national accounts (1995 - 2014)



Source: Quantec (2015), own calculations

Figure 45 Allocation of value added within listed non-financial corporations from company accounts (1992 and 2007)



Source: INet BFA (2015), aggregate data, own calculations

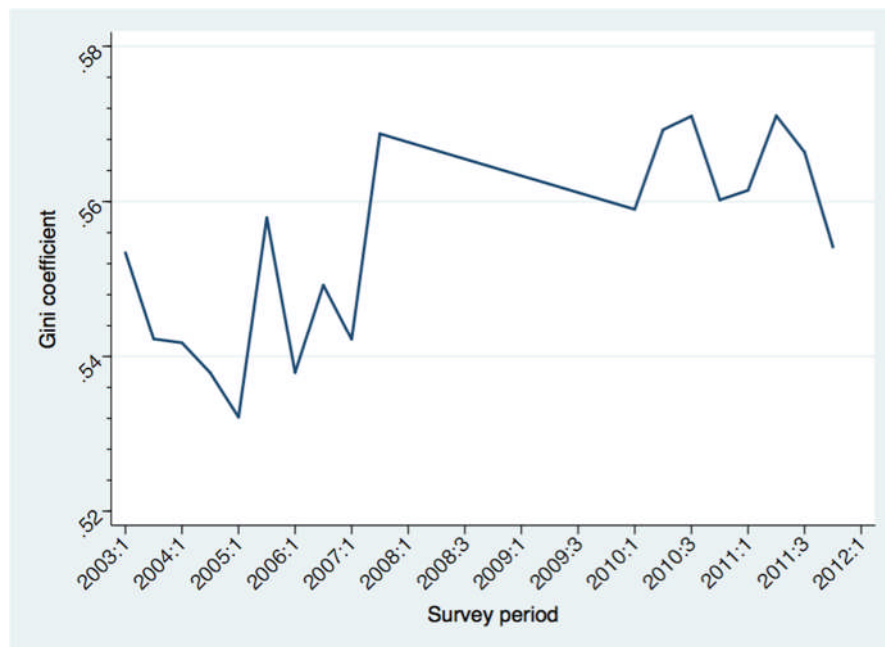
Rising income inequality is another critical facet of overall increases in inequality. Here financialisation has also played a significant role. First, financialisation has contributed to the broader restructuring of work under neoliberalism. This includes the shifts in investment discussed above, which have undermined jobs in the productive sectors (Demir 2006) and also supported increasing casualisation and outsourcing. Simultaneously, liberalisation has been shown to increase the demand for skilled workers (Larrain 2014). These shareholder value maximisation pressures have been facilitated by the rise in executive pay, including via stock bonuses, and the enormous increases in top salaries. Third, compensation in the financial sector itself has increased with financial sector employees disproportionately represented amongst top earners (Bakija *et al.* 2012). In France, between 1996 and 2007, finance (which is 3% of private sector employment) has been responsible for half of the rise in inequality at the top end of wage distribution (Godechot 2012).

As executive pay forms a component part in the wage share, the wage share's decline is even more startling. Internationally we have witnessed a stagnation in real wages for a sizeable share of the labour force despite rising productivity. Financialisation has played a crucial role, Kus (2012), for example, shows that there is a strong correlation between financialisation and income inequality in 20 OECD countries, which remains robust after controlling for traditional drivers of inequality.

In addition to wages, wealth inequality has also increased through the differentiated holding of capital, including financial assets and capital gains accrued therefrom. Nau (2011, p. ii) argues that in the US 'financial income, which is the returns to wealth, has come to account for the majority of overall income inequality in the last decade'.

Income inequality in South Africa is severe with a Gini coefficient of 0.66 in 2012 (Finn 2015), higher than at the end of apartheid. The driving force behind this, despite high levels of unemployment and hence zero-earners, is wage inequality within the labour force (Leibbrandt *et al.* 2010). We see, in Figure 46, the Gini coefficient for wage earnings between 2003 and 2012 (the period for which we have the most consistent household survey data) remains stubbornly high.

Figure 46 Earnings inequality (2003 - 2012)



Source: Finn (2015)

Table 3 shows earners by percentile, in 2014, according to different earning groups. We see very clearly the large gap between the mean (average) and median (p50) earnings. This is a strong indicator of inequality. Average earnings have grown more substantially over time than median earnings indicating stronger wage growth at the top of the distribution than at the bottom. We see the large differentials between earnings through different ratios in Table 4 with the 90th percentile earning 26 times the 10th percentile for all earners in the economy.

Table 3 Earnings by percentile for different groups (2014 in 2015 rands)

	Average	p10	p25	p50	p75	p90
All earners	9 503	728	1 623	3 328	8 321	18 722
Formal sector earners	9 514	936	2 184	4 160	10 401	19 762
All employees	8 167	804	1 664	3 224	8 321	17 682

Source: Stats SA (2015), Labour Market Dynamics in South Africa 2014, data treated as per Finn (2015)

Notes: earners refer to the employed and self-employed, employees refer to the employed only

Table 4 Ratios of earnings showing inequality (2014 in 2015 rands)

	p90/p10	p75/p25	p50/p10
All earners	26	5	5
Formal sector earners	21	5	4
All employees	22	5	4

Source: Stats SA (2015), Labour Market Dynamics in South Africa 2014, data treated as per Finn (2015)

Notes: earners refer to the employed and self-employed, employees refer to the employed only

A full accounting of the drivers of these trends is well beyond the scope of this paper. However, many of the trends observed above associated with financialisation, globalisation and neoliberalism can be observed in South Africa. Table 5 shows the decline in union density in the post-apartheid period, in the private sector – declining from 36% in 1997 to 24% in 2013 – and overall – declining from 40% to 34% over the same time period. Casualisation has also been marked, growing from 23% of the workforce in 2001 to 28% in 2006. Over the same period permanent employment grew by a paltry 4%, whereas casualised employment grew by 38%. It is also possible that these statistics underestimate casualisation as they may mask ‘subcontracted workers,

independent contractors and home based workers as there is no reliable data provided' (Bodibe 2006, p. 56).

Tregenna (2010) shows congruent findings for outsourcing between 2001 and 2007, with a focus on domestic work and security guards. In Table 6 we observe negative growth in the employment of cleaners in manufacturing and security guards in the public sector compared with large projected positive growth should outsourcing not have occurred. Table 7 shows that 58.5% of the growth in cleaners and 28.1% of the growth in security guards in the service sector can be estimated to have been due to outsourcing in other sectors. There is no reason to believe this trend has not remained steady or accelerated.

Table 5 Union density (1997 - 2013)

Year	Private sector Number of union members	Union members as % of workers	Public sector Number of union members	Union members as % of workers	All workers considered	Union members as % of all workers considered
1997	1 813 217	36%	835 795	55%	6 607 428	40%
2001	1 748 807	31%	1 070 248	70%	7 241 800	39%
2005	1 925 248	30%	1 087 772	68%	7 986 483	38%
2010	1 888 293	26%	1 324 964	75%	8 955 912	36%
2013	1 868 711	24%	1 393 189	69%	9 671 931	34%

Source: Borat et al. (2014), last two columns are own calculations based on previous columns

Table 6 Percentage growth in employment of cleaners and security guards with and without outsourcing (2000 - 2007)

	Actual growth	Projected growth without outsourcing
--	---------------	---

Cleaners in manufacturing	-4.14%	2.34%
Security guards in public services	-7.86%	8.12%

Source: Tregenna (2010)

Table 7 Percentage growth in private service sector employment of cleaners and security guards due to outsourcing from other sectors (2000 - 2007)

	Percentage of growth
Cleaners	58.5%
Security guards	28.1%

Source: Tregenna (2010)

Executive compensation, a tool through which management priorities are aligned with shareholders', has ballooned in South Africa. In Table 8 we can see that between 2004 and 2008 total nominal annual compensation for executive directors grew by 126% with gains on shares skyrocketing by 247%! Interestingly, executives in the financial sector do not earn higher income in total guaranteed pay (that is, excluding variable pay and incentives) than in other sectors (PwC 2012, 2013). However, the earnings for the upper-end of the financial sector (for wage earning employees) are higher than in most other sectors: second highest at the 95th, 90th and 75th percentiles, and third highest at the 99th percentile and the median. Huge gaps exist between the upper, middle and lower end of the distribution in this sector (Finn 2015, Stats SA 2015).

Table 8 Percentage yearly increases in executive directors' remuneration (2004 - 2008)

	2004 - 2005	2005 - 2006	2006 - 2007	2007 - 2008	2004 - 2008
Base pay	-1%	32%	16%	34%	103%
Benefits	-32%	41%	21%	31%	52%
Performance bonuses	56%	16%	37%	-5%	137%
Total annual compensation	16%	34%	25%	16%	126%
Gains on shares	120%	154%	-22%	-21%	247%

Source: PwC (2009), as appeared in Isaacs (2012)

Wealth inequality is also a severe problem with assets highly unevenly distributed. Table 9 shows that the Gini coefficient for total assets, net worth and financial assets are considerably higher than for income. Daniels et al. (2012) also note that the vast majority of assets, 84%, are held by the top decile, and that 79% accrue to the top 5%.

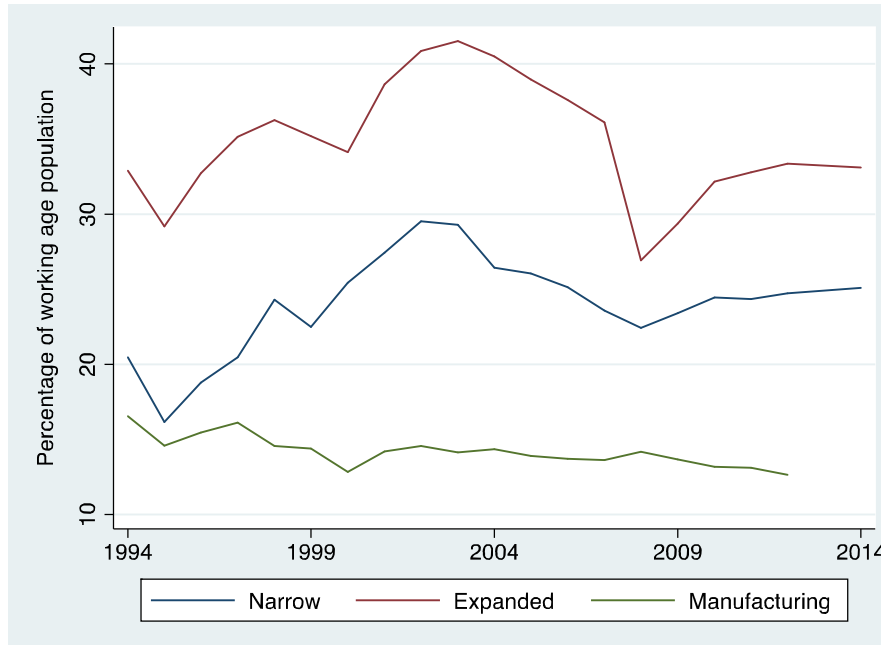
Table 9 Gini coefficients (2011)

Income	0.699
Total assets	0.839
Net worth	0.830
Financial assets	0.951

Source: Daniels et al. (2012). Note: outliers removed for total assets and net worth

Finally, unemployment has, of course, played a significant role in sustaining both inequality and poverty. Disturbingly, unemployment has risen significantly over the last two decades and in 2014 sat at approximately 25% for the narrow definition and 33% for the expanded definition. We see also in Figure x that unsurprisingly, manufacturing as a share of employment has fallen, illustrating the undermining of the productive sector as an engine of employment growth.

Figure 47 Unemployment rate and percentage of manufacturing employment as share of total employment (1994 - 2014)



Source: Kerr et al. (2013) and Stats SA (2015), own calculations

The global financial crisis and on-going financial turmoil, with financialisation as their underlying cause, and the responses to these developments have also exacerbated inequality. Even in non-crisis times financial markets have had a “disciplining” effect on macroeconomic policy which reduces public expenditure, advances privatisation and supports less progressive taxation. We have also observed a sort of pro-cyclical “boom-bust” cycle regarding sovereign borrowing. The resultant fiscal adjustment can fall disproportionately on public investment via the postponement of promised investment programmes. It could also lead to reducing consumption expenditure, particularly public sector employment, depending on the political feasibility of retrenching public sector employees and/or dismantling public programmes.

In this crisis in particular the bailouts have resulted in a massive fiscal cost which has been born by the public. The resultant rising levels of government debt have served as an excuse for welfare state retrenchments and put downward pressure on public expenditure. The crisis saw millions of jobs lost and the aftermath has witnessed a “jobless recovery” which has seen only slow gains in employment. Many workers have turned to often predatory lending in an attempt to get by. All of these consequences exacerbate poverty and inequality (see Kaltenbrunner *et al.* 2015).

The crisis has not resulted in bailouts in South Africa but the effect on foreign trade, particularly with the EU, and on borrowing costs has had negative economic impacts. After an initial increase in public debt in the wake of the crisis the government has now adopted austerity measures, albeit partially obscured. The annual rate by which real government expenditure rises has dropped significantly, growth in real per capita spending has turned negative, and social grants have increased at below inflation.

Given all this it should come as no surprise that financial development and liberalisation can have deleterious effects on poverty. Proponents would argue that positive effects arise from increasing the possibilities for accessing credit, reducing the costs of financial services and releasing resources to finance services such as education and health care. Often, expanding “financial inclusion” is advanced with microfinance being a leading means through which this is to be achieved, despite the popularity of the assertion that these are poverty alleviating, the evidence for this is thin (see for example Cull *et al.* 2008, Demirgüç-Kunt *et al.* 2008). Microfinance often funds consumption expenditure and is another means through which households can become over indebted. Although greater access to investment finance for SMEs may be beneficial. Many studies also show that the negative effect of economic and financial crises, which accompany financialisation, far outweigh the possible benefits in

terms of the impact on poverty (see Garcia-Arias 2015). Poverty in South Africa remains extreme for both households with and without wage earners.

5 Conclusion

This paper has explored the relationship between financialisation and development in South Africa. It has used international evidence pertaining to the nature of this relationship to draw conclusions from South African data. The topics covered have been extensive. We have illustrated that South Africa has reached a level of financial development that may very well be growth retarding, and that South Africa has a high level of de facto financial openness which poses substantial risks. One of these risks is the susceptibility to capital flow volatility and we have observed that rising volatility is indeed the reality for South Africa, with a close relationship between capital flows and exchange rate fluctuations.

We then turned to examine the nature of international capital flows and observed high levels of capital flight and possible tax avoidance. We also noted large outflows in the forms of reserve accumulation and dividend and interest payments, both costly to the domestic economy. Capital flows have become increasingly short term and volatile, which makes South Africa vulnerable to sudden reversals and results in relatively high real interest rates to continue to attract capital. We also explored the patterns of domestic credit allocation which are heavily influenced by these capital inflows. Here we observed a significant rise in unproductive lending, with increasing household indebtedness and large amounts of money flowing into asset markets. These create unsustainable levels of indebtedness and asset bubbles, while diverting funds away from real investment in productive sectors.

Patterns of domestic investment are equally important and here we also observe non-financial corporate incomes channelled into financial markets in the form of dividend payouts and share buybacks due to shareholder value maximisation pressures. These altered patterns of domestic investment have lead to a fall in gross fixed capital formation and a decline in the growth of fixed capital stock. Finally, we have traced how financialisation has exacerbated inequality through both a reduced wage share, as income is diverted to shareholders, and to rising income inequality as casualised employment, lower union density, decreased employment in productive sectors and increased executive remuneration all stretch the wage distribution.

Together this paints a rather bleak picture. The objective has been to provide an overview of the relationship between financialisation and development and not to exhaustively deal with each of these topics; more detailed research is needed in each instance. However, what emerges clearly is that the *nature* of the financial expansion in South Africa, and the *nature* of South Africa's global financial integration is developmentally retarding.

6 Bibliography

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¹ For a lengthier theoretical discussion see Bonizzi's (2013a) literature review of *The changing impact of finance on development* prepared as the first paper for this work package of the Fessud project.

² More fully, endogenous growth theory stressed the role financial institutions play in "mobilizing savings, allocating resources to the most productive investments, reducing information, transaction and monitoring costs, diversifying risks, and facilitating the exchange of goods and services. This results in a more efficient allocation of resources, more rapid accumulation of physical and human capital, and faster technological progress" (Samargandi *et al.* 2015, p. 67).

³ "Financially excluded" refers to "[i]ndividuals who use no financial products – neither "formal" nor "informal" – to manage their financial lives" (FinMark Trust 2012, p. 63).

⁴ King and Levine's (1993a) work was heavily critiqued on methodological grounds by Arestis and Demetriades (1997, 1999).

⁵ Deidda and Fattouh (2002) and Rioja and Valev (2004a, 2004b) find positive casual relations in richer countries, but insignificant relationships in developing or low-income countries whereas Huang and Lin (2009) found the positive effect to be more pronounced in low-income countries.

⁶ Prior to this new wave of literature only two studies Deidda and Fattouh (2002) and Rioja and Valev (2004a) considered a non-monotone relationship (Arcand *et al.* 2012, p. 5). Detailed critiques of earlier methodologies have been offered. The seminal work of King and Levine (1993a, 1993b) as well as Goldsmith (1969), Levine and Zervos (1998) and many other use OLS estimation on cross-sectional data. A number of authors have argued that in this approach results are sensitive to the sample of countries chosen, time-series variation in the data is not taken advantage of, and causality cannot be established (see Samargandi *et al.* 2015, p. 68). The use of panel data, particularly using autoregressive distributed lag (ARDL) models, has emerged as the gold standard.

⁷ Some studies, for instance Ferreira and Laux (2009), show that openness is, in general, positive for growth.

⁸ The scatterplot in Rodrik (1998) illustrates nicely the flat relationship between financial liberalisation and growth.

⁹ These purportedly include: increasing the efficiency of the domestic financial system through exposure to the international financial market; generating efficiency gains for domestic firms through foreign competition; and lessening the autonomy of developing countries whilst simultaneously ensuring better corporate and state governance, accountability and oversight.

¹⁰ Some studies have shown capital flow liberalisation to reduce volatility, for example Bekaert *et al.* (2004b) shows a reduction in consumption volatility; these positive findings are overwhelmed by the negative ones.

¹¹ Beck (2000) shows that foreign bank entry increases volatility.

¹² The argument that capital account liberalisation is beneficial due to stock returns and the cost of equity capital is also questionable (Demetriades and Andrianova 2003).

¹³ Often net capital flows are presented. This, however, can obscure the extent and volatility of flows. The calculation here is made by aggregating the absolute values of various types of flows

in a given quarter and then dividing that by GDP for that quarter. The SARB Flow of Funds data has 24 categories of assets/liabilities.

¹⁴ For yearly flows (1970 – 2014) the rolling mean is taken over a five-year period and for quarterly flows (1992Q1 – 2015Q1) the rolling mean taken over nine quarterly periods.

¹⁵ Unfortunately, appropriate data for measuring output volatility was not located (besides for GDP growth, a very crude measure).

¹⁶ The insight that capitalist economies without credit mechanisms will be plagued by the problem of insufficient aggregate demand is usually attributed to Keynes but Marx noted something similar and this is also a logical conclusion from the circuit of capital model (see Basu 2011, p. 18).

¹⁷ The accumulation of reserves by emerging markets has recently slowed (IFF 2015)

¹⁸ The decrease in net interest payments abroad up until 2007 is probably due to decreased government debt.

¹⁹ There is no universally accepted list of “tax havens”. This amount is calculated using widely accepted low-tax jurisdictions in which South African businesses, households and government institutions hold assets, this includes: Bahamas, Kingdom of Bahrain, Bermuda, Cayman Islands, China, P.R.: Hong Kong, Guernsey, Ireland, Isle of Man, Jersey, Luxembourg, Maldives, Malta, Monaco, Switzerland, British Virgin Islands. There are other such jurisdictions but no South African assets are held there.

²⁰ Interestingly, some research suggests that FDI’s positive growth impact (when it occurs) takes place predominately through increases in efficiency (the “efficiency effect”) and not due to an increased volume of capital available for investment (the “investment effect”) (Choong 2012).

²¹ Such characteristics include: initial level of development (Blomstrom *et al.* 1992); trade policy and human capital development (Balasubramanyam *et al.* 1996, Borensztein *et al.* 1998); and third country effects (Baltagi *et al.* 2007a, 2007b). In addition great stress has been placed on the absorptive capacity vis-à-vis the level of financial development in the recipient country (Hermes and Lensink 2000, 2003, Alfaro *et al.* 2004, 2010, Durham 2004, Eller *et al.* 2006, Azman-Saini *et al.* 2010, Adeniyi *et al.* 2012, Sun and He 2014). The somewhat arbitrary definition of FDI – as more than a 10% investment stake in a foreign company – may also explain differing effects, that is, some FDI is simply large-scale portfolio investment and may differ markedly from greenfield investment.

²² There is some evidence to suggest that FDI flows are as volatile and unpredictable as short-term flows (see Claessens *et al.* 1995). Lensink and Morrissey (2006) show, in a panel of 87 countries, that FDI volatility has a significantly negative effect on economic growth.

²³ Levchenko and Mauro (2007) show that portfolio debt experiences a reversal, though it recovers quickly, whereas other flows, including bank loans and trade credit, demonstrate the most severe drops and often remain depressed for a few years. Sula and Willett (2006) show that private loans are as reversible as portfolio flows. Ananchotikul and Zhang (2014) show that bond and equity flows (particularly high-frequency flows) respond differently to different events, in general extreme surges and reversals appear more frequent for equity than bond flows. Bosworth (1999) argues the negative impact on the current account can be attributed to loans not portfolio flows, similarly Joyce (2011) argues that it is a build up of debt liabilities that is correlated with crises

²⁴ Ananchotikul and Zhang (2014, p. 16) show that in non-crisis times, across all emerging market regions, a 0.1% GDP increase of flows leads to a 0.4% to 0.8% exchange rate appreciation. Such effects are magnified during crisis times, by three times for emerging Asia (driven by India and Indonesia) and five times in Latin American (driven by Argentina, Brazil and Mexico). Over the long term, Asian currencies show less volatility probably reflecting the more managed exchange rate regimes in many countries of the region. Furceri *et al.* (2011) show the significant impact of capital inflows on domestic credit expansion.

²⁵ Both the bank and nonbank sector may have debt denominated in foreign currency but the banking sector faces an extra risk due to the prevalence of interest arbitrage where financial

institutions borrow at lower rates abroad and lend at higher rates domestically (Stockhammer 2008).

²⁶ The mainstream empirical evidence provides ample support for the fact that 'following financial liberalisation external factors started accounting for most of the volatility in real exchange rates, reserve movements, stock prices and the direction of capital flows in developing countries (Calvo et al., 1993; Grabel, 1995)' (Demir 2006, p. 9).

²⁷ See Bonizzi (2013b) for how this challenges mainstream theoretical conceptualisation of capital flows.

²⁸ Fitzgerald (1997, p. 6) notes: 'The volatility of portfolio flows thus cannot be attributed to investor irrationality or even to 'speculation' except in the technical sense of international or intertemporal arbitrage (Hirschliefer and Riley, 1992). Rather it is the scale of these flows in relation to the size of the domestic capital market - in terms of both the proportion of the domestic capital stock that is effectively 'on the market' and the size of the local market in relation to the international market in which the non-resident investors operate - and the high covariance between asset prices within a given developing economy or even region, which renders them problematic. In sum, although capital movements towards 'emerging markets' should depend upon 'fundamental valuation efficiency' on the part of international portfolio managers in assessing future income streams; because this is very difficult in practice and relies to a great extent on observing the behaviour of other investors, so that in practice misallocation is widespread and sudden corrections are frequent (Tobin, 1984).'

²⁹ "Excessive" consumption credit has also been associated with rising inequality, this is dealt with in Section 4.6.

³⁰ Financialisation has seen greater access to consumption and housing credit, and the appreciation of housing prices which have in turn facilitated further credit expansion,

³¹ Hein and Dodig do show that there is a possible scenario in which debt-led consumption could be expansionary but that 'the conditions for such expansionary and stable effects are highly restrictive. And even if they exist, they tend to be undermined by financialisation itself, through redistribution at the expense of the labour income share, which has a depressing effect on income growth in a wage-led economy and may turn a debt-led economy debt-burdened, through lending too much to deficit households and through depressing animal spirit, which may each turn a stable workers' debt-capital ratio unstable.' (Hein and Dodig 2014, pp. 35-36)

³² The National Credit Regulator data (NCR 2014) shows mortgages as higher percentage between 55% and 65% of total credit.

³³ Note, excluded changes in bank flows < -20 and > 20 - 3 observations

³⁴ The BA900 is the current data format that banks must report, it replaced the DI900 in 2008. The DI900 data has been converted into BA900 format but some levels of disaggregation that exist in the BA900 data do not exist in the DI900 data.

³⁵ The rate of retained profit is different to the overall rate of profit which may be measured prior to financial payments. A divergence therefore may be observed between the rate of accumulation and the rate of profit.

³⁶ Theoretically the notion of financialisation as driven by "rentier" interests is problematic (see Isaacs 2013). We have not seen the rise of a small parasitic financial class but rather all actors in the economy, to varying degrees and in different ways, being subjected to the dictates, priorities and logic of financial markets. Nevertheless these measures offer us a useful gauge of the financialisation of NFCs.

³⁷ On Brazil see Bittencourt (2010), Vietnam see Hoi and Hoi (2013), China see Liang (2006) and Jalil and Feridun (2011), Iran see Muhammad et al. (2012) and India see Sehrawat and Giri (Sehrawat and Giri 2015). For the inequality enhancing impact of financial development in the United State see Jerzmanowski and Nabar (2013) and for Thailand Motonishi (2006).

³⁸ There are some exceptions, for example Mandel (2010) Sun et al. (2012) but even some of these are qualified with need for appropriate institutions.

Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number: 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?

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1 (Coordinator)	University of Leeds	UK
2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
7	Tallin University of Technology	Estonia
8	Berlin School of Economics and Law	Germany
9	Centre for Social Studies, University of Coimbra	Portugal
10	University of Pannonia, Veszprem	Hungary
11	National and Kapodistrian University of Athens	Greece
12	Middle East Technical University, Ankara	Turkey
13	Lund University	Sweden
14	University of Witwatersrand	South Africa
15	University of the Basque Country, Bilbao	Spain

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Published in Leeds, U.K. on behalf of the FESSUD project.



This project has received funding from the European Union's Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

