The impact of the global economic crisis on the South African economy

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Introduction

This paper will discuss the impact of the current global economic crisis on the South African economy. The aim of the paper is to show that the worst impact of the crisis on the South African economy is associated with structural industrial weaknesses and recent areas of growth, particularly in the services sectors. The more recent growth is associated with behaviour of the South African financial sector which emulated that of the US. The financial sector enabled increased liquidity and leverage in the economy. Increased private sector credit was allocated not towards productive investment but towards speculation and debt driven consumption by affluent South Africans.

The South African economy had an unemployment crisis and poor industrial performance before the crisis. These economic problems are a legacy of past economic and industrial development and are related to the industrial structural weaknesses of the economy. These problems have been exacerbated by recent debt-driven and consumption led economic growth and have intensified as a result of the global financial crisis. Further, uncertainty about continued levels capital flows to developing countries as during the crisis increases the fragility of the financial sector and the risk that the South African economy will have balance of payments problems because of the recent growth of its trade deficit.

The analysis presented in this paper draws on the work of Fine and Rustomjee (1996) who argue that the development of the South African economy was dominated by a minerals and energy complex (MEC). They argue that the manufaxturing sector of the economy has not adequately diversified. I build on Fine and Rustomjee's work by examining changes in the South African economy since the early-1990s. An important influence on this analysis of the period since the early-1990s is the recent literature on financialisation. Epstein (2005) defines financialisation as "… the increasing role of financial motives, financial markets, financial actors and financial institutions in the operation of the domestic and international economies (p.3)." The collapse of investment and economic growth during the 1980s was followed by a period where financial motives and financial institutions dominated the economy. There was a massive restructuring of the South African corporate sector during the 1990s. The reasons for this restructuring were the democratic political changes and the process of financialisation of the economy. Large, powerful corporations withdrew capital from the South African economy, became increasingly internationalised and restructured under the influence of the shareholder value movement (Mohamed, 2009). At the same time, there were increased short-term capital inflows to the economy. These short-term capital inflows led to increased levels of private sector debt. This increased private debt was not allocated towards increased long-term, productive investments but were used for increased consumption and financial market speculation (Mohamed, 2006).

Recent economic growth in South Africa has been unsustainable because it was in large part driven by liquidity growth induced financial speculation, debt-driven consumption and investment in their associated services sectors, such as finance and wholesale and retails services. Construction and the automobiles and components manufacturing sector also benefited from increased private access to credit. The increased demand and rising prices for minerals commodities played a lesser role in increasing investment and contributed towards economic growth. The onset of the global financial crisis led to tighter global and domestic credit markets. In South Africa there was concern about rising debt to asset leverage levels before the financial crisis but the banks significantly reduced debt after the collapse of the subprime market in the United States (US). Tighter credit markets led to rapid declines in private sector access to credit, which in turn led to rapid declines in the services sectors associated with increased debt-driven consumption, construction and automobiles and components. There has been a large increase in automobile repossessions, house foreclosures and business bankruptcies. Hundreds of thousands of jobs have been lost. Manufacturing output has declined by close to 25% over the past year. The impact of the financial crisis on the real sector led to declining global demand for mining and minerals products causing job losses and increasing capacity in those sectors. The impact of the crisis on South Africa has been negative economic growth and lower levels of investment and employment.

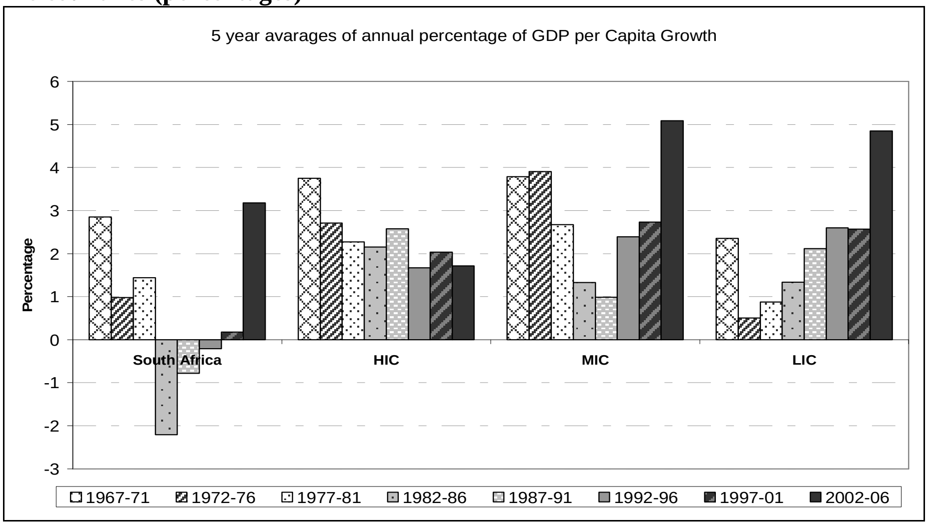
The potential longer-term impact on the economy is related to the fact that finance was not allocated towards industrial investment and redressing the industrial structural weaknesses of the economy. It seems that the economy may become even more dependent on the mining and capital intensive minerals sectors of the economy as a result of the global economic crisis. Further, the growth in short-term capital inflows provided increased liquidity in the South African economy that contributed to the debt-driven consumption led economic growth, which in turn contributed to increased imports and a large trade deficit. The South African economy has become dependent on maintaining short-term capital inflows to finance the trade deficit. This dependence is a huge risk given the impact of the financial crisis and increased uncertainty about global levels of liquidity and capital flows to developing countries. It increases uncertainty in the economy and also requires high interest rates to keep attracting capital – both work against long-term productive investment that would support employment creation and restructuring and diversifying industry.

Industrial structural weaknesses

South African economic development occurred around the mining and minerals sectors or a minerals and energy complex (Fine and Rustomjee, 1996). The state and mining industry supported growth of manufacturing sectors with strong linkages to the MEC. According to Fine and Rustomjee, the formation of the MEC was a result of the political compromise between large English mining interests and the Afrikaner large business and political establishment. It was also shaped by the politics of oppression of black South Africans and the strict control over black workers.

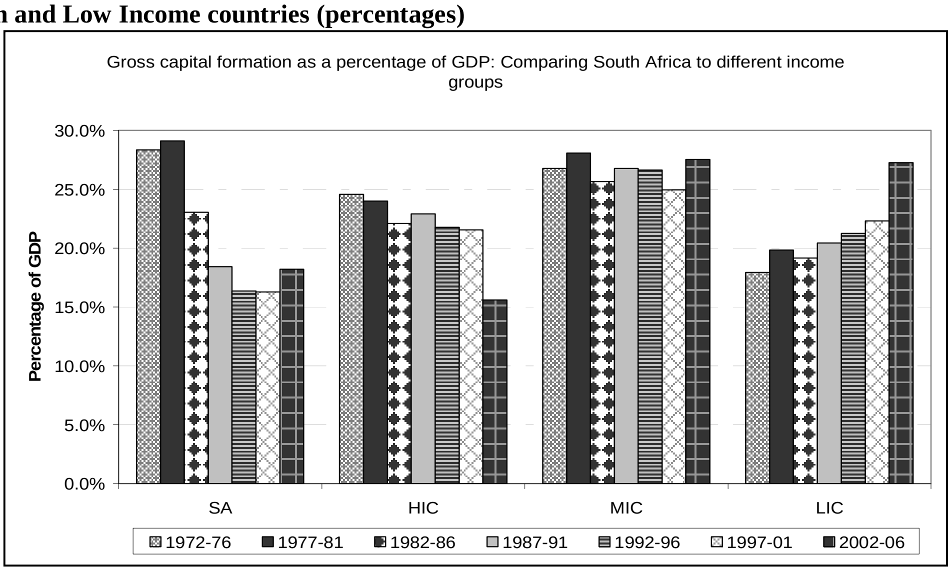
Most manufacturing sectors with weaker linkages to the MEC have remained weak and have not received strong state support and adequate investment from the large mining finance houses that dominated the South African economy until the 1980s. With the exception of a few sectors, such as automobiles and components, manufacturing remains dominated by sectors with strong links to the MEC. These sectors with the exception of engineering and capital equipment are capital and energy intensive process industries, such as electricity generation, minerals beneficiation (iron and steel, aluminum) and the Sasol oil from coal process and its chemicals byproducts. Downstream, value added manufacturing sectors have not been adequately developed and manufacturing remains relatively undiversified.

Figure 1: GDP per capital growth, 5 year annual averages for South Africa and High, Medium and Low income countries (percentages)



Source: World Development Indicators

Figure 2: Gross capital formation as percentages of GDP, 5 year averages for South Africa and High, Medium and Low Income countries (percentages)



Source: World Development Indicators

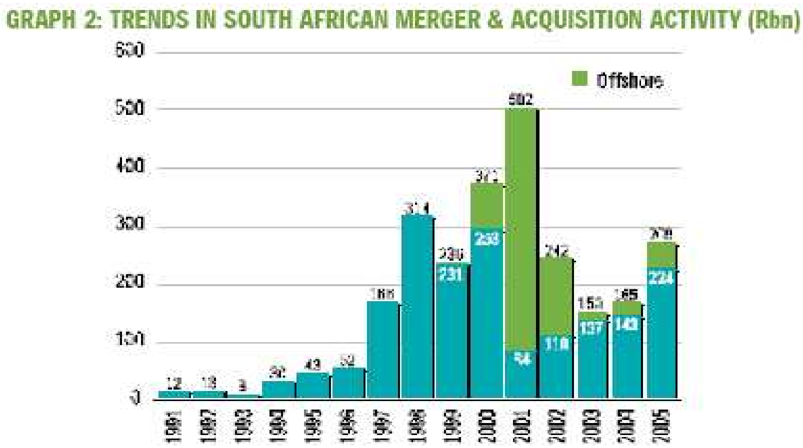
Fine and Rustomjee explain the inadequate diversification in South African industry. They argue that "… there was no structural or institutional basis laid down to diversify into non-MEC sectors… (p. 174)." They say that performance and investment in the economy during the 1980s was affected by the decline of new investments in the MEC sectors (mines, minerals beneficitiation and new power plants). They acknowledge exceptions to the decline during the 1980s but say that these were "… some subsectors driven by military and mega-project expenditure, whose buoyancy was prolonged until the late 1980s (ibid)." On the whole, South African economic performance declined during the 1980s when there was large decline in investment by the state and private sector into MEC projects. Figure 1 shows the decline in economic growth during the 1980s. South Africa's average economic growth rates dropped much lower than the averages for all income groups (i.e., high, medium and low income countries).

Figure 2 shows the decline in investment (gross fixed capital formation) as a percentage of GDP in South Africa. South Africa's 5-year average level of investment collapsed from 28% of GDP for the period 1977-81 to under 20% of GDP for the periods from 1987 to 2006. Investment levels increased to over 20 percent of GDP in 2007 and 2008 as a result of increased investment in sectors associated with debt driven consumption and increased state investment in large infrastructure projects.

The low levels of investment from the mid-1980s and 1990s were not only as a result of declining investment in mining and minerals sectors. South Africa faced increasing international isolation as a result of apartheid. The anti-apartheid movements in developed countries succeeded in getting many large corporations to disinvest from South Africa. At the same time, labour reform under apartheid during the early-1980s, including recognition of black trade unions, led to an assertion of worker rights by black workers that broke down the racist apartheid control and discipline in South African workplaces (Omar and Webster, 2003 and Von Holdt, 2003). The militancy in the workplace was also a reflection of escalating political militancy in the community struggles against apartheid.

During the 1980s big business had a very close relationship to the apartheid state. According to Terreblanche (2002), they were represented on apartheid state security structures. Therefore, one would expect that their response to a more assertive black population and organized black working class would be to consolidate and maintain their businesses and to look at ways to move capital abroad. Mohamed and Finnoff (2005), using the World Bank's residual method of calculating capital flight, estimate that capital flight from South Africa increased during the period after the 1994 democratic elections. They calculate that that the annual average capital flight as a percentage of GDP was 5.4% a year from 1980 to 1993 and that it grew to 9.2% a year from 1994 to 2000.

Figure 3: Mergers and Acquisitions in South Africa, 1991-2005 (Rbillions)



Source: Ernst and Young

During the 1990s the response of big business to progressive labour market and democratic political change was massive corporate restructuring. A number of the largest South African corporations (including Anglo American which controlled over 50% of the capitalization of the Johannesburg Stock Exchange during the 1980s) moved their primary listing abroad to become de facto foreign investors in South Africa. Much of this corporate restructuring is reflected in the huge growth in merger and acquisition activity shown in figure 3. This growth in merger and acquisitions also reflected an unprecedented growth in global mergers and acquisitions activity. According to data from Ernst and Young (2006), the value of global mergers activity grew from over US$150 billion in 1992 to peak at over $3.4 trillion in 2000.

Nolan (2003) argues that the massive restructuring in global business occurred because of the revolution in information technology and large-scale privatizations in former socialist countries and in Latin America and Africa. Nolan also sees the growth in influence of the shareholder value movement as driving consolidation and concentration in the global economy as an important factor in explaining large-scale, global corporate restructuring and the surge in mergers and acquisitions during the 1990s. He says that the powerful shareholder value movement demanded simpler corporate structures and focus on core businesses. He says that global corporate restructuring occurred in large part to meet these demands. Nolan shows that there has been tighter control of global value chains by lead firms. He also says that the result of these changes is a more concentrated global economy where a few firms dominate a large share of global markets for many goods and services.

The political change in South Africa that caused many large South African corporations to restructure and move their assets abroad, occurred during the period when there was economic globalization and increased global integration of trade and financial markets. It was also a time of massive global corporate restructuring and concentration, in part, driven by the process of global financialisation and the rise of the shareholder value movement. Global markets were opening up and being reapportioned. The largest South African corporations that restructured and internationalised attempted to take advantage of the new openness. However, when they moved into global markets and listed on stock markets of developed countries these corporations had to accede to the demands of the shareholder value movement. Their restructuring occurred not only to consolidate their South African holdings and to move assets abroad but also to simplify their corporate structures and to focus on core business. Today, most of the top 20 South African corporations by market capitalization are transnational corporations with multiple stock exchange listings. A quick perusal of the senior management statements in annual reports of these corporations over the past decade will show their continued stated concern with increasing shareholder value through focusing on core business and simplifying corporate structure. As a result, most of the pyramid structures, which were at the center of the MEC as a system of accumulation and were used by the powerful families to control most of the South African economy during the 1980s, were restructured and disentangled.

The offshore listings have allowed South African business leaders that live and work in both the global North and South Africa to change their power relationship with the new South African state. They are able to control the South African assets that they wish to retain but also have more control over the global movement of their capital. The democratic South African state had become less willing to interfere in these companies because they fear that they will lose credibility with other potential investors and financiers. The changes also meant that the shareholder value movement in the North (including, flighty institutional investors) has had more influence over the major corporations operating in South Africa and also in the future direction of the economy. At the same time, the South African Government has become hesitant about implementing economic policies, such as increasing government's budget deficit, that could address unemployment and poverty for fear that these policies would drive down share prices and create a negative view of South African policies in international financial markets and business media.

Goldstein's (2000) study of South African corporate restructuring supports the argument that South African corporate restructuring has occurred for politically expedient reasons and to simplify corporate structure. He says, "Of the twenty largest South African deals reported in 1992-98, 75% corresponds to the simplification of the corporate structure; 10% to consolidation in the financial industry; 10% to foreign acquisitions; and only one deal – TransNatal's acquisition of Rand Coal to form Ingwe Coal in 1994 – is a "genuine" South African merger.(p.17)." By "genuine" Goldstein means a merger that would increase the production efficiency of the merged businesses. Further, he makes the important point that it is remarkable that South African conglomerates had practically not made any large acquisitions in their own country during the 1992-98 period he studied.

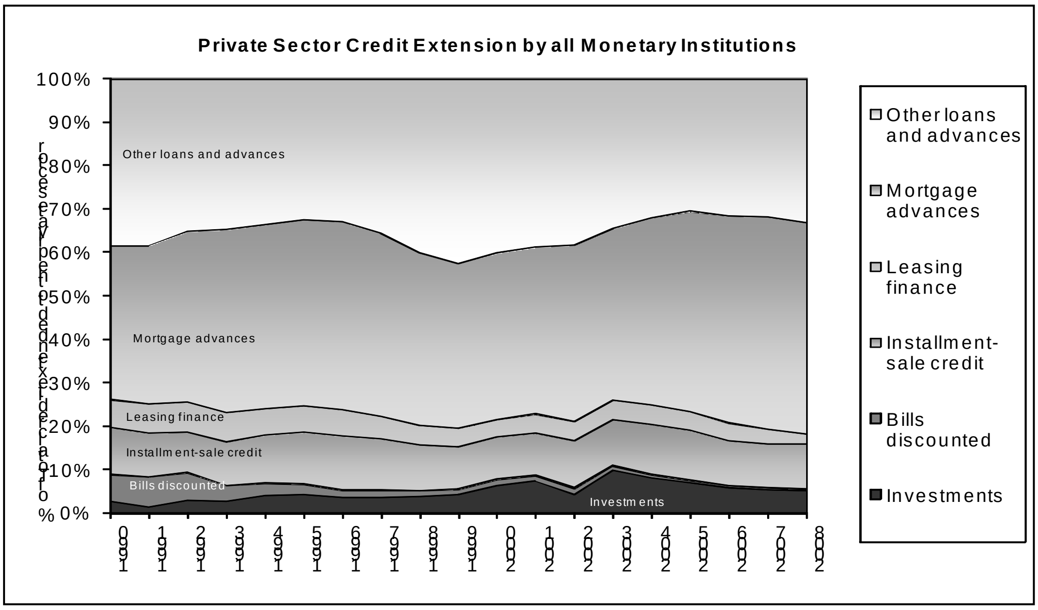
Roberts (2005) shows that, even though, there have been large changes in South African corporate structure there has not been much change in South Africa's industrial structure since 1994. Industry remains largely undiversified and dominated by concerns with strong linkages to the mining and minerals processing sectors. Roberts says, “Essentially, liberalisation in South Africa has meant trade performance that reflects existing capabilities and, as such, the previous patterns of intervention. There is little to suggest that liberalisation realises the development of diversified industrial capabilities (p. 16).”

Post-apartheid economic policies, including trade and financial liberalization, have not adequately addressed the industrial structural weaknesses of the economy. The economy remained dependent on the production and exports of mining and minerals products during the post-1994 period. Since the transition to democracy in 1994, most economic value added and investment growth occurred in services sectors, particularly financial services, which increased their contribution to GDP relative to mining and manufacturing. In short, post-apartheid South Africa seems to be characterized by an economy with industrial structural weaknesses due to its development around the mining and minerals sector. The impact of financialisation of the global and domestic economies occurred on top of that industrial structural weaknesses that already existed in the economy at the time of the democratic elections.

Financialisation of the South African economy

The South African financial system had developed along similar lines to that of the English and US systems and can be described as market-based rather than bank-based (Roux, 1991). In other words, South African businesses that require finance for long-term investment would use retained earnings or seek finance in securities markets. The state owned Industrial Development Corporation does provide some industrial finance but on the whole its lending is a very small share of total lending in the country and its main customers have been large, capital intensive projects in the mining and minerals sectors (Roberts, 2007). The banks and other monetary institutions largely provided business with short-term operating capital and serviced the credit card, home mortgage, vehicle lease and finance and other short-term lending for consumption.

Figure 4: Private sector credit extension by all monetary institutions by type (percentages of total)

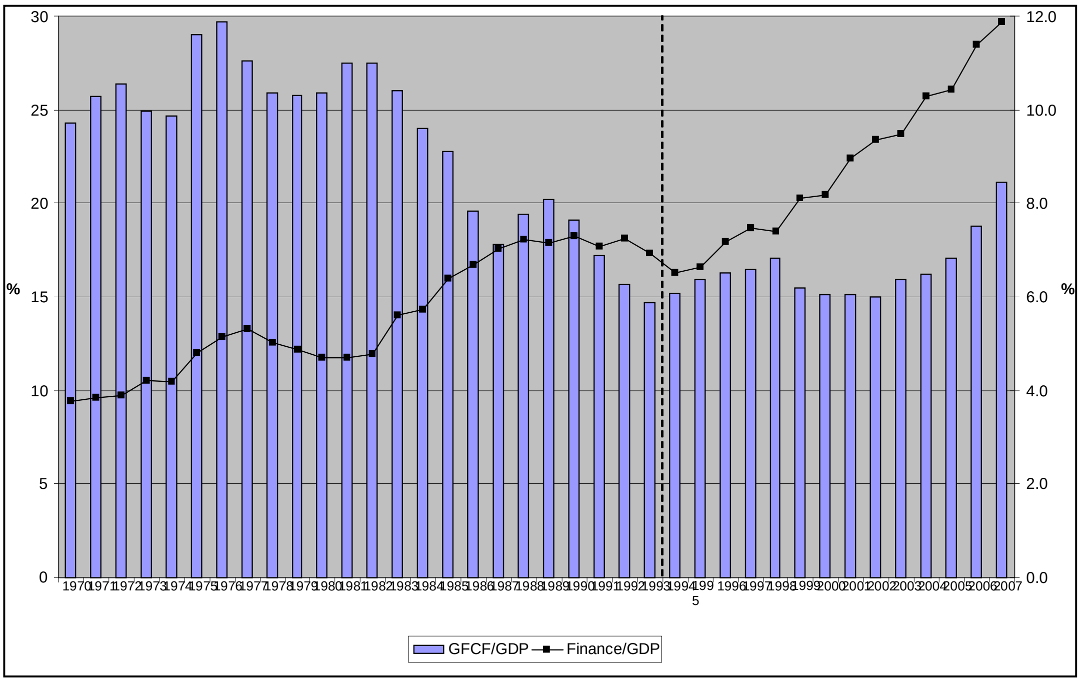


Source: calculated using SARB data

Figure 4 shows that during the period 1990 to 2008 this form of credit allocation continued in the economy. One can see the growth in mortgage advances from 2003 to 2008, which supported the growth of a housing price bubble in the relatively more affluent real estate market in South Africa. South Africa has had average house price increases larger than the US during the period 2003 to 2007. For the period 1990 to 2008 we see that investment was a relatively very small share of total private sector credit extension.

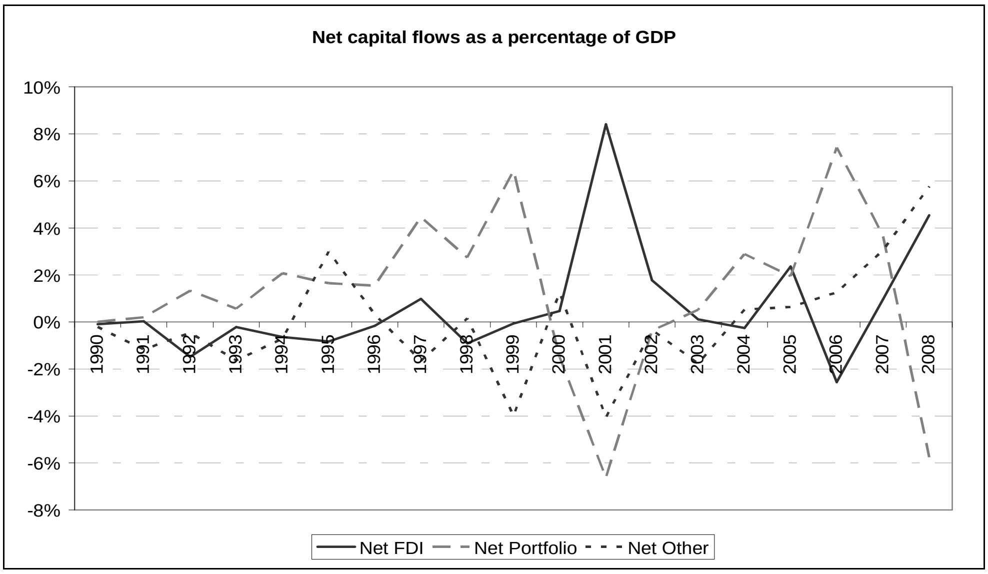
An important phenomenon in the global economy and South Africa is financialisation as the size and influence of the financial sector grew from the 1980s when financial markets and cross-border capital flows were liberalized. The market-based banking system and banking deregulation by the apartheid state during the 1980s seemed to have supported growth of the South African financial sector. Further, the political changes, the decline in MEC investments and trade liberalization led to greater private sector interest in financial assets from the mid-1990s. Figure 5 shows that value added of the finance and insurance services sector increased rapidly during the 1980s when economic growth and investment as a percentage of GDP declined significantly. The finance and insurances sectors contribution to GDP grew even more rapidly from 1994 to 2007 while overall investment levels remained relatively low. There was an improvement in investment levels from 2003 which included the impact of government's infrastructure investments from 2006, increased services sector investment linked to financial sector growth, increased household consumption and more household construction and purchase of automobiles. In short, one sees that the growth of the financial sector and its increased share of GDP were not associated with higher levels of investment.

Figure 5: Gross fixed capital formation and Finance and Insurance sector value added as percentages of GDP



Source: N. Zalk of Department of Trade and Industry who used SARB and Quantec data

Figure 6: Net capital flows to South Africa as percentages of GDP

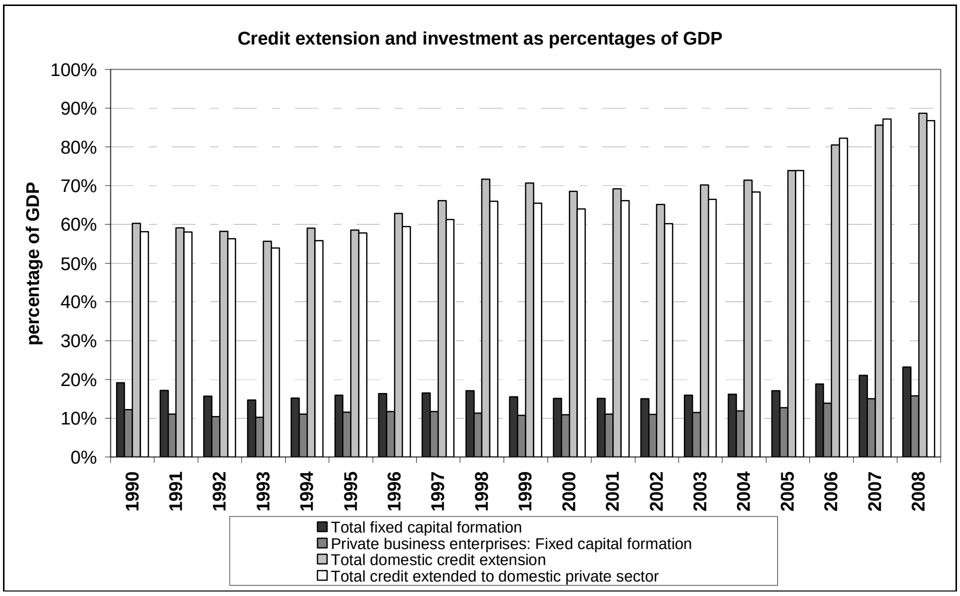


Source: SARB

An important aspect of the financialisation of the South African economy during the post-apartheid period was increased capital inflows, particularly short-term portfolio flows from developed countries. These short-term flows signaled not only the end of apartheid financial isolation but more importantly global financiers' change in sentiment about South Africa after ignoring South Africa after its 1985 debt crisis. The slow liberalization of exchange controls by the South African government from 1996 may also have affected this sentiment. The more important reason for the increased flows to South Africa was the huge increase in global liquidity that was accompanied by large movements of short-term portfolio flows into certain developing countries in Asia, Latin America and South Africa in Africa.

Mohamed (2006) argues that the surge in net short-term capital flows to South Africa increased macroeconomic instability with more volatility in exchange rates, interest rates and inflation associated with changes in capital inflows. A stark illustration of this volatility and instability was the sharp drop in the rand to dollar exchange rate of 35% in 2001, which could be defined as a currency crisis. The 2001 currency crisis was caused by a rapid decline in net portfolio flows in 2000 which turned sharply negative in 2001 (see figure 6). During this period inflation increased sharply as a result of the weaker rand. The South African Reserve Bank, which follows an inflation targeting policy, increased interest rates by 4%. Net portfolio capital flows began recovering in 2002 and turned positive in 2003. They grew over the next few years to peak at nearly 8% of GDP. This recovery in portfolio flows was accompanied by rapid reductions in interest rates that seemed to contribute to the house price and financial asset bubble during 2003 to 2007.

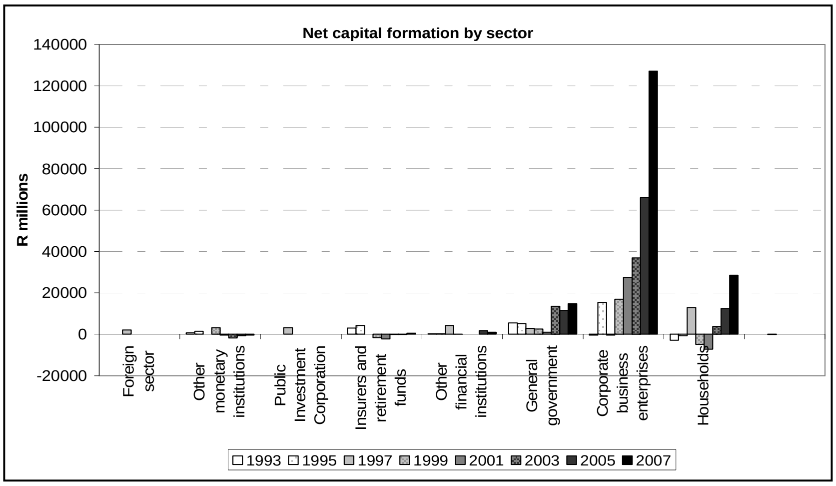
Figure 7: Credit extension and investment as percentages of GDP



Source: calculated using SARB data

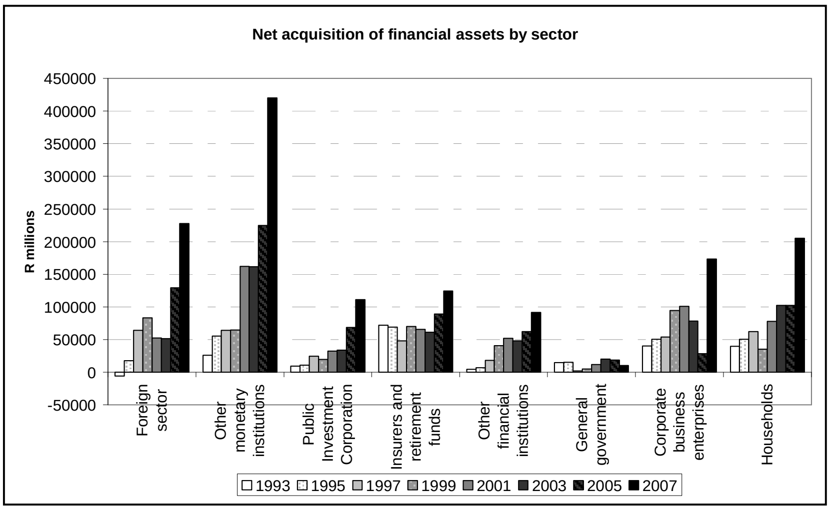
Mohamed (2006), in an examination of the period up to 2002, argues that the surge in portfolio capital flows to South Africa and the related increased extension of credit to the private sector during the 1990s was not associated with increased levels of fixed investment but with increased household consumption, financial speculation and capital flight. Figure 7 compares the trends of total fixed capital formation, private business fixed capital formation, total domestic credit extension and total credit extended to the private sector all as percentages of GDP for South Africa for the period 1990 to 2007. Figure 7 shows that credit extension to the private sector increased about 22% from 2000 to 2008 but that private business investment increased by only 5% during that period. What can also be inferred from figure 7 is that a part of the increase in capital formation from 2006 may not be due to private business capital formation but due to state investment in infrastructure. The increase in private capital formation during from 2003 to 2008 is due to investments spurred on by increased financial speculation and debt driven consumption not investment in long-term productive investment that may help redress the structural industrial weaknesses of the South African economy. I begin explaining the process I would describe as misallocation of finance below.

Figure 8: Capital allocated to capital formation by sector, Rbillions



Source: calculated from SARB flow of funds data

Figure 9: Capital allocated to financial assets, Rbillions



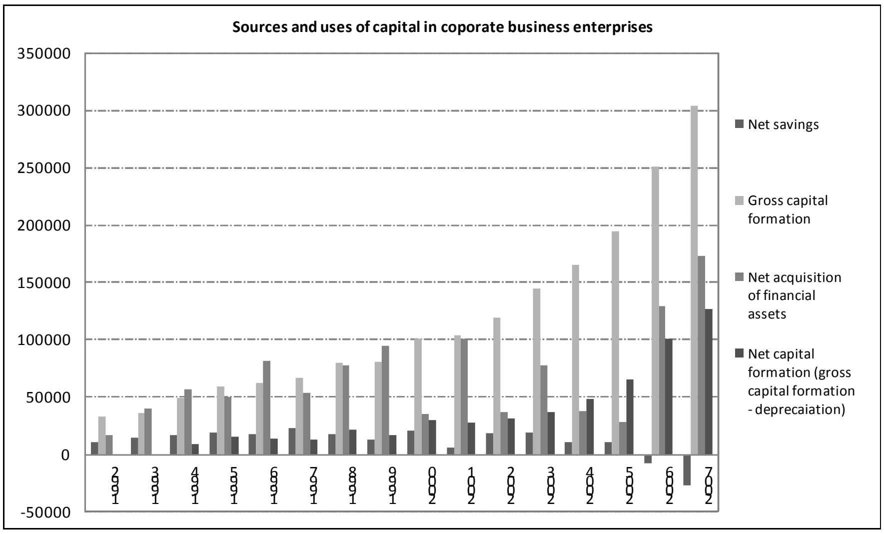
Source: calculated from SARB flow of funds data

Figure 8 draws on data from the SARB's flow of funds data to provide a trend of capital formation after depreciation by sector. We see that the foreign sector has very low levels of net fixed investment. The South African financial institutions (the banks and insurers) net investment in fixed capital formation turns negative from 2003. Figure 9 shows that there has been a huge increase in corporate business enterprise net investment from about R30 billion in 1999 to almost R130 billion in 2007. There has also been large growth in government and household net capital formation over that period.

Figure 9 shows calculations for trends of net acquisitions of financial assets by sector calculated from the SARB flow of funds data. The first stark difference between figure 8 and figure 9 is the scale of the scale of the different charts. The Y-axis on figure 8 goes up to R140 billion and that of figure 9 to R450 billion. The next stark difference is that every sector in figure 9, except for general government had large and increasing net acquisition of financial assets whereas in figure 8 we noted that it was only government, household and corporate business enterprises that had large increases in net capital stock.

There was rapid growth in acquisition of financial assets in all the financial categories. The other monetary institutions category, which includes the commercial banks, had huge growth in acquisition of financial assets, which nearly tripled from just over R150 billion in 2003 to nearly R430 billion in 2007. Household net capital formation in 2007 at around R30 billion was a fraction of their net acquisitions of financial assets, which more or less doubled to R200 billion in 2007 from about R100 billion in 2005. The trend in acquisition of financial assets by corporate business enterprises increased up to the financial crisis (and the dotcom crisis) in 2001 and then declined until 2005. However, it had a sudden surge and by 2007 had grown from the 2001 peak of about R100 billion to over R170 billion in 2007.

Figure 10: The main sources and uses of capital in corporate business enterprises, R millions



Source: calculated from SARB flow of funds data

Figure 10 highlights an important fact about corporate business net acquisition of financial asset relative to net fixed capital formation for the period that we have SARB flow of funds (1993 to 2007). Corporate business enterprise net capital formation (i.e., gross capital formation less depreciation) was lower than net capital formation for all years between 1994 and 2007, except for 2004 and 2005. Corporate savings was low for the period and turned negative in 2006-7. Many of the studies of financialisation in the US economy focus on the increasing financialisation of non-financial corporations (NFCs). One aspect of this financialisation is the increased share of income and profits of NFCs from involvement in financial markets and investment in financial assets. The flow of funds data on use of capital by corporate business enterprises in South Africa seems to support the notion that there has been financialisation of NFCs in South Africa.

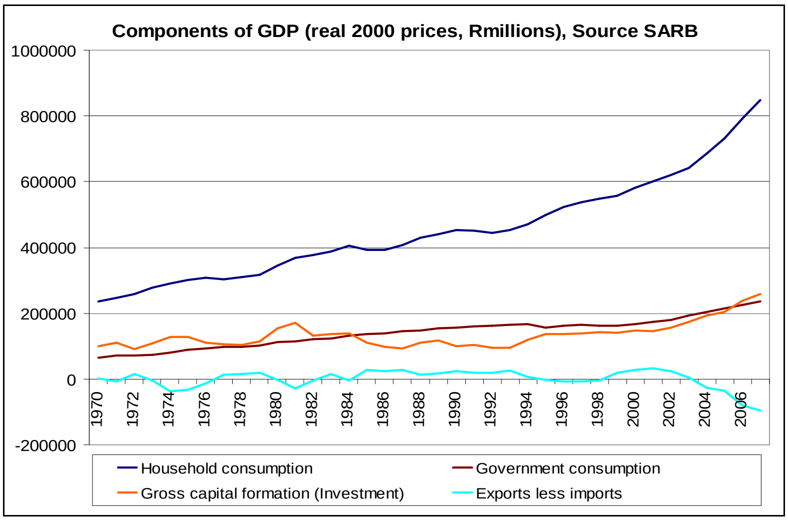
A number of recent studies show that financialization of nonfinancial corporations was associated with lower levels of investment by nonfinancial corporations. This literature focuses on developed countries, particularly the US. Aglietta and Breton (2001) argue that the greater influence of financial markets on nonfinancial corporations and their demands for higher returns influenced executives of nonfinancial corporations to increase their dividend payments and to use share buybacks to raise share prices. They were left with less capital for investment. Crotty (2002) explained that nonfinancial corporations have increased the sizes of their financial subsidiaries and gotten involved in more financial speculation. Dumenil and Levy (2004) showed that interest and dividend payments from nonfinancial corporations to financial markets increased. They argue that nonfinancial corporations, therefore, had less capital to invest in their own activities. Stockhammer (2004) uses regression analysis to show that financialization is associated with lower levels of capital accumulation. Froud et al (2000) show the extent to which executives of nonfinancial corporations have become focused on the concerns of the financial markets for short-term high returns. They show through case studies of global corporations how this sensitivity to financial markets has created dysfunctional behaviour in large corporations. They argue that the narrative provided by CEOs of large corporations to financial markets is not supported by examination of the financial statements of those companies. Orhangazi (2007) uses firm level data in the US to show a negative relationship between real investment and financialization. He argues that financialization of nonfinancial corporations may have caused a change in the incentives of management that caused them to direct capital towards financial investments.

Much more research is required to understand the impact of financialisation of NFCs on the South African economy and developing countries in general. Given the available evidence I argue that the largest South African corporations have become more sensitive to the demands of the financial sector, particularly the shareholder value movement. Recent corporate restructuring and the content of annual reports of these giant corporations are indications of this sensitivity. Lazonick and O'Sullivan (2000) argue that the predominance of the shareholder value approach to corporate governance has been accompanied by a shift from patient to impatient capital. In other words, the increased influence of financiers and the shareholder value movement over corporate executives has caused a shift in management behaviour where investors and management are less concerned with building and nurturing businesses over a long period of time but have become focused on short-term returns. This behaviour would be even more merked where big business had been making an effort to move capital out of South Africa and increasing their efforts to internationalise. Crotty (2002) says that this shift to impatient capital has led to management treating their subsidiaries not as long-term investments but as part of portfolios of assets. We have seen formerly South African giant corporations unload a huge number of South African businesses that they have decided are not part of their core businesses and increasing their investments abroad. Froud et al (2007) argue that this increased focus on short-term financial returns in NFCs is bad for labour because decreasing employment is good for increasing profits in the short-run even if losing experienced workers may be detrimental to these NFCs in the long-run. South Africa requires capital that will make a long-term commitment to employment and building the skills of their workforces. Financialisation increases short-term motives where firms are less likely to invest in long-term skills development.

The impact of financialisation on the South African economy

The process of financialisation occurred on top of an industrial structure dominated by the MEC where the manufacturing sector was inadequately developed and diversified. The infrastructure and institutions of the economy had developed to support the MEC and were not geared towards supporting diversified industrial development. Economic policy choices did not support investments in industry but supported a preference for liquid, financial investments. The inflows of short-term capital to the economy from the mid-1990s led to increased private sector access to credit but this increase in private sector access to credit was associated with increased debt-driven consumption by households and speculation in real estate and financial asset markets.

Figure 11: trends in household consumption, government consumption, investment and trade, 1970 2007 (Real 2000, Rmillions)

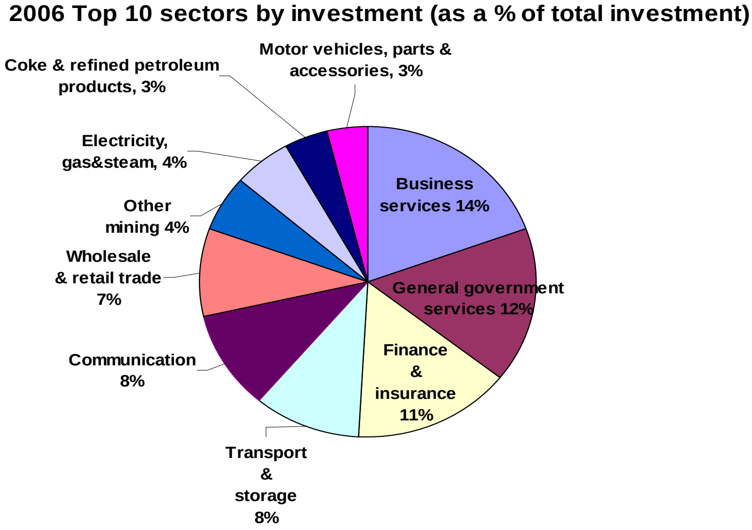


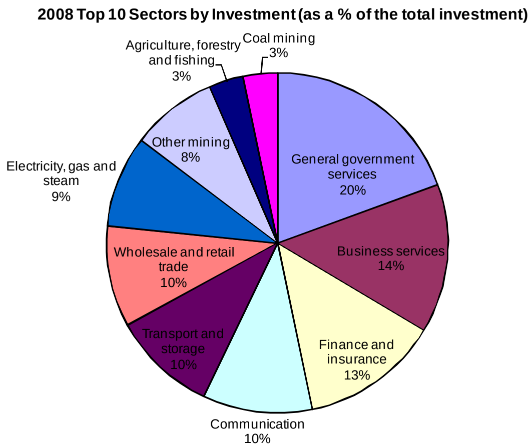
Source: SARB

Figure 11 shows acceleration in household consumption from the mid-1990s that speeded up even more from 2003. The impact of increased short-term capital flows and increased access to private debt seems to be an important influence on household consumption. Obviously, the trade deficit is negative for years when net flows are positive but we also see a large increase in the trade deficit from 2005. It grows to over 7.5% of GDP in 2008. Household debt to disposable income grew from about 60% in the mid-1990s to close to 80% in 2008. Household savings turned negative in 2005 and remained negative through 2008. It is worth noting that a large proportion of South Africans do not have access to credit. Therefore, the average debt to disposable income numbers reported by the SARB may well underestimate the level of indebtedness of more affluent South Africans. Since late-2007 house foreclosures has grown to over R300 million per month and banks report over 6000 car repossessions per month.

The impact of growth in net acquisition of financial assets and the increased level of household debt-drive consumption is shown with the next few charts. Investment and capital formation has been concentrated in the financial services sector and services sectors that benefit from increased consumption.

Figure 12: Top 10 investment sectors for 2006 and 2008

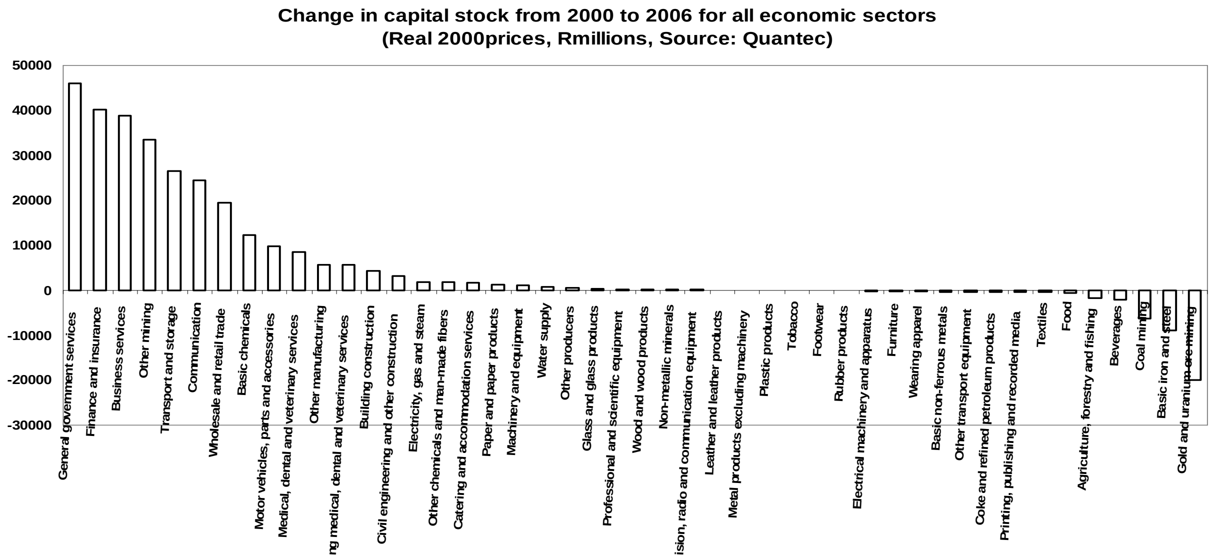




Source: Quantec

Figure 12 shows the top 10 sectors by size of investments for 2006 to 2008. 2006 was an important year for increased debt-driven consumption, increasing minerals commodity prices and the growing house and financial asset price bubbles. During 2006 services sectors dominate investment. The other mining sector, which is largely platinum mining, makes it into the top 10. Two manufacturing sectors, automobiles and components and coke and refined products (investments into Sasol the company that produces oil from coal) make into the top 10 investment sectors. Automobiles and components is supported by increased private sector credit that led to a large growth in car sales. The manufacturing sectors do not make it into the top 10 investment sectors in 2008 as a result of the declining investment in manufacturing due to the impact of the global economic crisis.

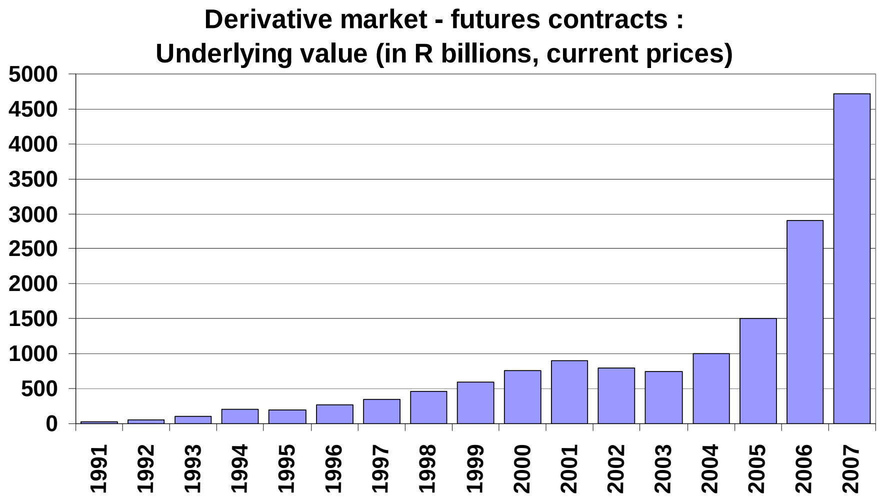
Figure 13: Change in capital sock from 2000 to 2006 for all economic sectors (Real 200 prices, Rmillions)



Source: Quantec

Figure 13 shows changes in capital stock from 2000 to 2006 for all sectors of the South African economy. The change in capital stock is important to consider because there was an increased level of depreciation write downs during the period (see figure 10). The period from 2000 to 2006 was chosen because it would show the impact of the 2001 currency crisis and the recovery from 2003 until 2006. 2007 is excluded because investment performance was affected by the start of the financial crisis. Figure 13 shows that the sectors that benefited from investment and that had growth in capital stock were services sectors. The largest capital stock growth after general government services was finance and insurance services. Almost all manufacturing sectors had relatively low growth in capital stock or negative capital stock growth. Motor vehicles, parts and accessories sector was the only manufacturing sector that had relatively large growth in capital stock. This growth in capital stock occurred because automobiles and components was the only manufacturing sector where government had implemented an industrial policy. It was also supported by the increased access to private credit.

Figure 14: Derivative market futures contracts (Rbillions, current prices)



Source: SARB

The South African economy has not only emulated the increased levels of debt, house prices and household consumption in the US economy. Our financial sector has also copied the behaviour of their US counterparts. They have increased debt and increased securitization of debt. Figure 14 shows the rapid growth of derivatives market (futures contracts) in South Africa from 2003. There was also huge growth in US and global derivatives markets during this period. Even though, the South African financial sector has not had significant direct losses related to the collapse of the subprime market in the US, one sees that the South African financial sector could well have been headed to creating the conditions for a domestic financial collapse.

Conclusion

Over the past two decades, the large increases in global liquidity led to increased flows of short-term capital to certain developing countries. Mohamed (2006) shows that since the end of apartheid South Africa was one of the developing countries that received increased short-term capital flows. The increase in short-term capital inflows to South Africa are associated with an increased contribution to GDP of services, particularly financial services and services sectors related to increased debt driven consumption. The short-term capital (mostly portfolio investment) inflows had the impact of increasing private sector access to credit and strengthening the exchange rate. Capital was misallocated to increased speculation in real estate and financial assets and to increased consumption by the affluent (a large proportion of South African society, particularly poor black people, remain unbanked and without access to formal credit markets). The increased capital flows strengthened the rand, which meant that growth in consumption was also associated with growth in imports and the high trade deficit. Further, there has been rapid growth in areas of the financial sector now associated with the US financial meltdown, such as derivatives trading. South African financial institutions seemed to have followed the trends in the US financial sector until the subprime collapse. The South African financial sector has not been seriously affected by the collapse in markets for subprime and other toxic assets but the financial sector has created weaknesses in the economy because they behaved like their US counterparts. They increased their leverage and increased liquidity into South African financial markets since 1994. They allocated debt to short-term consumption, mortgages (which they repackaged and sold) and towards increased speculation and consumption.

Economic growth in South from 2003 to 2008 has been due to debt-driven consumption that supported growth of the services sectors. Allocation of finance was skewed away from long-term industrial investment towards services sectors associated with financial speculation and consumption. Much of the recent economic growth is not sustainable. The impact of the current global economic crisis highlights the unsustainable nature of recent economic growth and it may well leave the economy more dependent on the mining and minerals sectors (even though global demand for these commodities is much lower and their prices have declined). Therefore, the outlook for long-term productive investment, increased industrial diversification and job creation is pessimistic. The financialisation of the South African economy seems to make the outlook even more pessimistic. The financial crisis has highlighted the need for industrial diversity. It also shows that there will have to be a significant reorientation of the financial system towards supporting long-term productive investment.

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