Research Brief #5

Financialisation and Development: The South African Case Study
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1. Introduction

This Research Brief #5 for Work Package #6 of the FESSUD project summarising the key findings of the South African case study (Working Paper #142: Isaacs, 2015) on the relationship between financialisation and development. The topic poses a number of challenges as casual relationships, in this case between financialisation and development, are difficult to prove. The case study also spans a vast amount of material exploring the nature of financial liberalisation and development and financialisation, and assessing the impact on growth, patterns of investment and poverty and inequality. The approach adopted is to compare the international evidence regarding the consequences of financialisation generally, with trends observed in the South African context; an imperfect but illuminating exercise.

2. Background

South Africa underwent a process of liberalisation and financialisation beginning at the dawn of democracy (1994) but with roots in preceding policies and transformations. Many trends noted in the paper accelerate between 1994 and 1996, a period during which: the government returned to international capital markets; the financial rand was abandoned; restrictions on foreign bank entry and foreign participation on the Johannesburg Stock Exchange (JSE) were lifted; limits on institutional investors’ financial trading, locally and abroad, were eased; and FDI requirements relaxed. This was followed later by inflation targeting and further market liberalisation. Subsequently, South Africa has been plagued
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by: lacklustre growth; high levels of poverty, inequality and unemployment; and low levels of real investment, all in the context of a marked financialisation of the economy.

3. Financial development and liberalization

Domestic financial development, measured often by the ratio of domestic credit to GDP, has accelerated precipitously, as seen in Figure 1. The paper provides recent international evidence which illustrates that there is a turning point at which further financial development is growth retarding, usually when the credit to GDP ratio reaches between 75% and 100% [with a statistically insignificant impact close to either side of this]. We see in Figure 1 that South Africa has already reached this threshold. There is also ample evidence that financial liberalisation has, contrary to assertions by its proponents, not been growth enhancing. Figure 2 shows us that South Africa has undergone significant financial liberalisation with an economy more open than its middle-income peers.

**Figure 1 Financial Development:**
Credit as a percent of GDP (1966-2014)

**Figure 2 Financial Openness:**
Index
(1970-2011)

Source: SARB, own calculations
Source: Lane and Milesi-Ferretti (2007)
4. Financial liberalisation and capital flows

A number of reasons advanced for the neutral or negative relationship between financial development and liberalisation and growth has to do with the nature of capital flows into and out of emerging markets.

4.1. Volatility

We see in Figure 3 that as the gross stock of foreign assets and liabilities has increased so too has the volatility of capital flows. Volatility is well recognised to have negative economic impacts. We see also that movements in capital flows have been closely associated with the erratic and volatile nature of the South Africa exchange rate, the main means through which crises have occurred in South Africa (Figure 4).

Figure 3 Capital flows and Volatility (shown by standard deviation from a rolling mean) (1970-2014)

[Graph showing capital flows and volatility from 1970 to 2014]

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

Figure 4 Change in Real Effective Exchange Rate and Net Capital Inflows (1993-2015)

[Graph showing change in real effective exchange rate and net capital inflows from 1993 to 2015]

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

South Africa has also suffered from significant capital outflows since liberalisation, depleting funds available for domestic investment. This has occurred in a range of ways. First, capital flight is estimated to have averaged at 12% of GDP between 2001 and 2007, peaking at 23% in 2007. Associated, is the staggering 37% of all reported South African assets held abroad, as of December 2014, sitting in low-tax jurisdiction, up from 24% in December 2001. Second, South Africa, like much of the developing world, has been acquiring large holdings of foreign reserves, particularly from 2000 onwards (Figure 5). The sterilisation process associated with these, as well as the foregone interest on, or investment of, these funds creates vulnerabilities in the domestic economy and depletes domestic resources. Third, as seen in Figure 6, increasing dividend and interest payments have been made to shareholders and creditors abroad.

Figure 5 Reserves as a share of GDP (1964-2014)

![Figure 5](image)

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

Figure 6 Net Interest and Dividend Payments to Rest of World as percentage of GDP (1995-2014)

![Figure 6](image)

Source: Quantec (2015), own calculations

4.3 Patterns of inward investment
The nature of foreign investment within South Africa also poses risks to the economy. A growing share of foreign assets and liabilities, shown in Figure 7, has been of a short-term nature, with a sharp growth in portfolio flows. Such flows are subject to rapid reversals with significant harm to the domestic economy. These flows are necessary to balance South Africa’s current account (in part due to the capital outflows discussed above) and are sustained by high interest rates (relative to other economies) which can dampen domestic investment. The rise in the foreign indebtedness of the South African private sector is also cause for concern.

**Figure 7 Proportional Stocks of Foreign Assets and Liabilities (1956 - 2013)**

![Graphs showing proportional stocks of foreign assets and liabilities from 1956 to 2013.](image)

Source: Quantec (2015), own calculations

5 **Domestic allocation of credit**

The use to which credit is put in the domestic economy is also critical. We witness in South Africa the decline in domestic savings, the rise in domestic indebtedness and the channelling of credit into unproductive activities such as household lending and asset markets. Household indebtedness has risen since 1990 and has sustained consumption expenditure. While mortgages remain the largest share of debt at 53% in 2014, this is down from 63% in 2008 with unsecured lending showing rapid growth. There has also been a substantial rise in unrecorded predatory lending. This has all led to a rise in credit impairment from 38% in 2007 to 48% in 2013.
Credit has also been funneled into asset markets, with the JSE All Share Index, ABSA Housing Price Index and the derivative markets having seen astronomical growth with fluctuations closely related to capital inflows. South Africa’s stock market capitalisation to GDP reached above 250% in 2007/8, 5 times larger than the middle-income country average. Figure 8 summarises these trends showing how foreign inflows, domestic credit, housing prices, stock prices and consumption expenditure all rise from 1990 but how gross fixed capital formation declines.

6 Domestic patterns of investment

Crucial to the process of financialisation are the patterns of domestic investment which have drawn funds away from real fixed investment in the productive sectors of the economy. We witness in South Africa, as in many other countries, the changing nature of corporate finances in line with shareholder value maximisation pressures. This includes the growth in the pay-outs of dividends and interest and in the use of share buybacks by the non-financial corporate sector. This has occurred in tandem with the quadrupling in the
size of assets (as share of GDP) of institutional investors since 1990. In Figure 9 we see a rise in both investment income and dividend pay-outs as a share of operating profits for non-financial corporations, together with a decline in gross fixed capital formation (as a percentage of GDP) and the growth rate of fixed capital stock (the latter shown in Figure 10).

Figure 9 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 10 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: Outliers of government fixed capital stock of < -0.02 have been removed (2 outliers)
7 Poverty and inequality

Finally, we observe a close correlation globally between rising financialisation and increasing inequality, with negative effects on poverty. This is due to general instability and poor growth, the diversion of funds away from employment-generating productive investment and the concomitant transformation of work and the decline in labour’s bargaining power, and the prioritisation of shareholder value maximisation. In South Africa this is observable by the falling wage share (Figure 11) and increasing income inequality (Figure 12). There has also been a very uneven distribution of financial wealth, all compounded by rising unemployment and a fall in the share of employment in the manufacturing sector.

**Figure 11 Wage Share (1990 - 2014)**

*Source: Quantec (2015), own calculations*

**Figure 12 Earnings Inequality (2003 - 2012)**

*Source: Finn (2015)*

8 Conclusion

The South African case study illustrates the robust nature of financialisation in South Africa and how it has accelerated financial development and liberalisation, determining patterns of capital flows and domestic credit allocation, and altered trends in domestic investment and distribution. Together, these have been a toxic mix, with significantly deleterious effects on South African development.
References


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