



# Capital Flight from South Africa, 1980 to 2000

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# **Capital Flight from South Africa, 1980 to 2000\***

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## **Abstract**

Capital flight is a serious problem for South Africa, which if not addressed will continue to impede its ability to deal with structural issues such as high unemployment and concentration of wealth. This paper presents an estimate of the wealth that left South Africa in the form of capital flight during the period 1980 to 2000. We find that from 1980 to 2000 average capital flight as a percentage of GDP was 6.6 percent a year. In this paper, we deviate from the existing literature on capital flight from South Africa by suggesting that the motivation of people involved in capital flight before and after the fall of apartheid may have changed. We find that capital flight as a percentage of GDP was higher after the democratic elections in 1994, even though, there was much more political and economic instability during the period investigated before the democratic elections. The increase in capital flight as a percentage of GDP may reflect the discomfort of those involved in capital flight in the post-apartheid democratic process. We also consider how international capital flows and structural weaknesses in the economy have influenced capital flight.

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## I. Introduction

This paper presents an estimate of the wealth that left South Africa in the form of capital flight during the period 1980 to 2000. We adopt the residual method of calculating capital flight used in Boyce and Ndikumana (2001).<sup>1</sup> The residual or the broad measure is an indirect approach to measuring capital flight based on a comparison between sources and uses of foreign exchange<sup>2</sup>. Previous studies of capital flight from South Africa (Smit and Mocke, 1991, Fedderke and Liu, 2002) have by and large ignored the changing political context within which capital flight has occurred. By contrast our analysis suggests that the factors influencing capital flight have changed because South Africa had a successful political transition from white domination under the apartheid system to democratic rule during the period we study.

We suggest that the higher capital flight observed in the relatively more politically and economically stable period 1994 to 2000 (compared to the pre-democracy period 1980 to 1993) is reflective of the attitudes of wealthy white South Africans about the transition to democracy rather than political and economic uncertainty.<sup>3</sup> We also show that changes in liquidity in global financial markets affected capital flight from South Africa. We argue that surges in net capital flows to South Africa are associated with higher levels of capital flight during the apartheid and post-apartheid periods. In addition, we draw on Fine and Rustomjee's (1996) discussion of the political economy of the industrialization process in South Africa to show how structural weaknesses in the economy may contribute to capital flight. Therefore, a closer investigation of capital flight provides us with important insights into the political economy of South Africa during this period.

From 1980 to 2000 on average, capital flight as a percentage of GDP was 6.6 percent a year. During the last 13 years of apartheid, from 1980 to 1993, average capital flight as a percentage of GDP was 5.4 percent a year. Post-apartheid, from 1994 to 2000 capital flight rose to an average of 9.2 percent of GDP per year.

Capital flight of such magnitude will continue to impede South Africa's development. Capital flight negatively impacts the economy in the form of foregone private investment, tax revenue and potential public investment. The extent of accumulated capital flight from 1980 to 2000 was 37 percent of the value of cumulative gross fixed capital formation for the same period.<sup>4</sup> This level of capital flight represents an enormous

sacrifice and missed opportunities for promoting South African growth and poverty alleviation.

A common explanation for capital flight from developing countries is that wealth holders move their wealth out of a country because of political and economic uncertainty. However, in South Africa it seems that wealthy people moved more money out of the country during the relatively more stable post-apartheid period than during the turbulent 1980s when the struggle against apartheid, international pressure and economic sanctions intensified. The four percentage increase in capital flight from the earlier to later period suggests that wealthy South Africans wanted to move their assets outside of South Africa's borders; either in anticipation of coming macroeconomic distress or more likely in order to be safe from the changes brought about by a newly democratically elected government. The wealthy seem to maintain a distrust of the South African government despite the government's efforts to create a business friendly environment and their conservative approach to fiscal policy and monetary policy. This distrust will probably persist as long as the extremely high levels of inequality, unemployment and poverty continue in South Africa (Terreblanche, 2003). In addition, there are a host of complex emotional reasons, such as racial prejudice and feelings of lost power, which might be motivating wealthy South Africans to move their money offshore (ibid.).

Political and economic uncertainties are part of the story but not adequate explanations for capital flight from South Africa. In this paper we wish to provide a more detailed exploration of the political economy of capital flight from South Africa from 1980 to 2000. The structure and institutions of the South African economy are central to this explanatory framework.

The rest of the chapter is structured as follows. The next section will briefly outline the capital flight literature specific to South Africa. Section three will provide a short discussion of our method and data used for calculating capital flight. Section four will contain an in-depth discussion and interpretation of our results aimed at explaining the reasons for capital flight from South Africa. Section five will conclude.

## II. Literature Review

The theoretical debates on capital flight mainly focus on portfolio choice decisions. From this perspective, profit maximizing investors will decide to invest abroad when risk-adjusted returns abroad are higher. Therefore, capital flight is seen as a response to changes to an individual's portfolio bundle arising from factors such as the fear of appropriation of assets, potentially higher taxes or perceived lower returns at home.

Most capital flight literature specific to South Africa utilizes the portfolio choice rubric. Khan (1991), Smit and Mocke (1991), Rustomjee (1991), Wood and Moll (1994), Fine and Rustomjee (1996), and Fedderke and Liu (2002) study various determinants of capital flight. These studies of capital flight are of interest because they attempt to capture different features of capital flight; volume, motive and direction of capital flight unique to the South African experience. These analyses focus on capital flows, macroeconomic instability, fiscal policy, risk and returns to investment, and political instability as the central motivating factors for capital flight. Table 1 outlines these studies and methods used.

### *“Insert Table 1 here”*

Of particular interest to our analysis are the findings of Fine and Rustomjee on the one hand, and Fedderke and Liu on the other. Fine and Rustomjee provide an informative discussion about the combination of factors that contribute to capital flight from South Africa. Their explanation of the causes of capital flight from South Africa include the structure of the economy, the degree of global integration of South Africa's major corporations and the country's failed attempt at financial liberalization in the early 1980s.

Fedderke and Liu, on the other hand ignore the structural and institutional factors affecting capital flight from South Africa and focus on political uncertainty and risk. They consider capital inflows as an unconditional good and capital outflows as bad. However, they do not make the link between surges of capital flows into South Africa and the instability in financial markets and volatility of the currency caused by these surges. Therefore, Fedderke and Liu fail to make the connection, which we show in this paper, between changes in the liquidity in international financial markets, surges in net capital flows into and out of South Africa and capital flight. We attempt to explain capital flight by considering the combination of political instability, structural weaknesses in the economy and changes in net capital flows into the economy.

The South African capital flight literature is helpful in building a better understanding of the volume and flow of capital flight. While Wood and Moll argue that capital flight has been relatively small, evidence from the rest of the literature indicates that by international standards capital flight from South Africa was high. Most authors agree that political instability is a major cause of capital flight. Yet, all of these perspectives, with the notable exceptions of Rustomjee (1991) and Fine and Rustomjee (1996), fail to specifically address the central political fact of the times: the white minority had control over capital and the structural and institutional framework within which choices on the allocation of capital were made.

In this paper, we examine capital flight during a period that includes the apartheid and post-apartheid periods. We argue that the motivation of people involved in capital flight is different before and after the fall of apartheid. We show that during the post-apartheid period, when there was greater political stability and government had enacted economic policies favored by business, capital flight as a percentage of GDP rose to a higher level. We also contribute to the existing literature on capital flight from South Africa by extending the time period to 2000<sup>5</sup>.

### III Method and Data

This study calculated capital flight from South Africa from 1980 to 2000 employing the methodology outlined by Boyce and Ndikumana (2001). We adopted the residual approach and adjust it by adding trade misinvoicing<sup>6</sup>. Capital flight was estimated using the following equation:

$$ADJCF_t = \Delta DEBT_t + NFI_t - (CA_t + \Delta RES_t) + MISINV_t \quad (1)$$

where  $\Delta DEBT$  is the change in South African stock of external debt<sup>7</sup>; NFI is net foreign investment; CA is the current account deficit;  $\Delta RES$  is the change in the net stock of foreign reserves; MISINV is net trade misinvoicing.

Using the above approach we calculated the difference between total capital inflows and recorded foreign exchange outflows. To obtain an estimate for capital flight we added the change in debt from the previous year to net direct and portfolio investment flows and subtracted the current account balance and the change to foreign reserves from the previous year. We then added trade misinvoicing (calculated by comparing South Africa's reported

trade data to their trading partners' data) to capital flight to obtain an adjusted capital flight (ADJKF) estimate.

The data used to calculate the change in stock of external debt is from international financial statistics (IFS). The IFS does not provide a breakdown of long-term debt into the currencies it is held in, thus we were unable to adjust debt for exchange rate changes of currencies that are held against the rand<sup>8</sup>. Net foreign direct investment was calculated using data from the South African Reserve Bank (SARB)<sup>9</sup>. Current account data and change in reserves was obtained from world development indicators (WDI).

The data used to calculate trade misinvoicing was from the IMF's direction of trade statistics (DOTS). Some authors have called into question the quality of trade data from South Africa prior to democratic elections in 1994 (Wood and Moll, 1994). During apartheid a number of goods, including oil, were officially labeled as strategic and it was illegal to report statistics on these goods. It is likely that in an effort to circumvent sanctions a significant portion of international trade with South Africa may not have been reported.

Prior to 1998, trade data for South Africa were included in the trade of the South African Common Customs Area. SACCA includes Botswana, Lesotho, Namibia, South Africa, and Swaziland. Beginning in 1998, SACCA trade data are reported separately as South Africa and SACCA excluding South Africa. In order to make the series consistent we add these two series together for the post 1998 period. South African trade accounts for the majority of SACCA trade.

#### **IV. Discussion of Results**

Our main results indicate that:

- a) Capital flight as a percentage of GDP was high during the period 1980-2000. The annual average capital flight as a percentage during this period was 6.6 percent of GDP.
- b) Average annual capital flight as a percentage of GDP was higher following the transition to democracy in 1994 than it was in the period 1980 to 1993 indicating that the motivation for capital flight during the later period was different. Whereas capital flight during the earlier period may have been caused by political instability, during the later period it seems to have occurred because wealthy South Africans were uncomfortable with the transition to democratic rule.

c) Capital flight as a percentage of GDP peaks during the period 1980-1985 and again during the 1994-2000 period. During the earlier period there was a surge in the volume of short-term bank lending when South Africa became a preferred destination for international lenders after the Latin American debt crisis. During the later period South Africa received large portfolio capital flows as a result of the increased liquidity in international financial markets in the 1990s.

d) The structural weaknesses in the economy may be an important reason explaining why wealthy South Africans choose to take their wealth out of South Africa rather than to invest it within the country.

***“Insert Figure 1 here”***

Figure 1, shows the trends of capital flight<sup>10</sup> (ADJKF). Capital flight exhibits substantial volatility over the twenty year span peaking in 1981-1982, 1984 and again in 1997. The troughs in capital flight occur in 1980, 1986 and 1991. Capital flight remained high during two periods, from 1980 to 1985 at 10.3 percent of GDP and from 1994 to 2000 at 9.2 percent of GDP. The amount of capital that left South Africa during this period would have added up to US \$238 billion dollars if it had been invested in the low yielding (and low risk) 90-day US treasury Bills..

***“Insert Table 2 here”***

**1980 – 1985**

From 1980 to 1985 capital flight from South Africa averaged 10.3 percent of GDP. During this period the vast majority of capital flight occurred with increasing levels of debt. Debt rose during the early 1980’s as the government took on a large share of short-term loans for large projects (Fine and Rustomjee, 1996). Foreign short-term loans to private borrowers also increased significantly as South Africa was perceived favorably by international lenders for a few years after 1982 when some developing countries defaulted on their debt.



***“Insert Figure 2 here”***

Figure 2 graphs changes in debt and capital flight. Debt levels closely followed the trend in capital flight suggesting that at the very least they are codetermined from 1980 to 1985. The real effective exchange rate (REER) seems to have been affected by the increased levels of debt as well. In figure 9 we see that both capital flight as a percentage of GDP and the REER followed a similar trend from 1980 to 1993, which was due the surge in net capital flows, especially short-term debt. From 1984 to 1985 period we see how the collapse of net capital flows led to a sharp decline in the REER and capital flight.

During this early period, misinvoicing also followed capital flight closely. Figure 3, below, graphs this relationship which displays misinvoicing peaking in 1981 – 1982, falling for 1983 and rebounding again in 1985. During this time, misinvoicing is driven by underinvoicing of exports to industrialized countries.

***“Insert Figure 3 here”***

The macroeconomic environment of South Africa was particularly volatile during the 1980s. South Africa had high current account deficits and a growing debt burden from the 1970s (Lowenberg, 1997). The apartheid government, which faced increased international isolation, borrowed heavily to finance a number of large investments. One of these investment projects was Sasol, a project to produce oil from coal.<sup>11</sup> They also spent large amounts on their military and the state-owned arms industry to support their aggression in the Southern African region and within South Africa. These expenses were in addition to the waste and inefficiency associated with maintaining the apartheid system.

The apartheid government attempted liberalization of financial markets in 1980 but was forced to abandon this policy in 1985 when the debt crisis occurred.<sup>12</sup> At the same time South Africa was experiencing economic instability, there was resurgence in the anti-apartheid struggle. There was ongoing mobilization of students from 1980. A resurgence of political trade unionism led to a series of strikes in 1981. In 1983, the United Democratic Front, a national alliance of community organizations (women, youth, cultural and civic organizations) and trade unions was launched. The intensification of the struggle led to the apartheid state declaring a state of emergency in 1985.

The combination of political and economic instability contributed to the development of the debt crisis in 1985 as lenders and other investors became less willing to invest in South Africa. Pressure by anti-apartheid organizations in other countries put pressure on banks to stop lending to South Africa and to disinvest (see figure 4). The success of the disinvestment campaign in developed countries increased during the early 1980s with 47 US companies leaving from 1984 – 1985<sup>13</sup> (see Jenkins, 1990).

*“Insert figure 4”*

It seems that economic problems and the anti-apartheid struggle reinforced one another (see figure 5). On the one hand, the weakening economy and the debt crisis fueled the struggle internally. On the other hand, the intensification of the struggle, which was met by severe repression by the apartheid state, fueled economic problems and provided ammunition for anti-apartheid activists pushing for further economic sanctions and disinvestments.

*“Insert Figure 5 here”*

### **1986 – 1993**

The period after 1985 until 1993 was marked by less volatility in capital flight. The steepest changes in capital flight occurred at the start and end of this period. From 1985 to 1986, capital flight declined by 6 percent of GDP. Conversely, from 1993 to 1994 capital flight increased by 6 percent of GDP.

Capital flight as a percentage of GDP was negative in 1986 and 1987 despite high levels of resistance to apartheid and the continuation of the apartheid government’s state of emergency (see figure 1 and figure 5). From 1986, South Africa was forced to run a trade surplus because of its foreign exchange difficulties as a result of the dearth of capital flowing into the country after the 1985 debt crisis. Repayment of debt, attempts to build up foreign reserves and net outflows of investment also contributed to lower levels of capital flight (see figure 2, figure 4 and figure 6). As in the 1980 to 1985 period, capital flight and

the REER are affected by similar factors. During the 1986 to 1993 period capital flight and the REER seem to respond to the reduction in capital flows leaving the country and the maintenance of a positive trade balance during this period.

*“Insert figure 6 here”*

The negative levels of capital flight did not last long. There was resurgence in capital flight as a percentage of GDP in 1988 and 1989 when misinvoicing as a percentage of GDP increased again (see figure 3). This increase in misinvoicing was affected by the introduction of the General Export Incentive Scheme (GEIS) in 1990.<sup>14</sup> GEIS, which was phased out by the new, democratic government from 1994 to 1997, led to significant overinvoicing of exports from 1990 to 1994.<sup>15</sup> The level of overinvoicing as a result of GEIS is not known.

The overinvoicing due to GEIS would certainly have affected the level of underinvoicing of exports related to capital flight and may have caused the decline in the levels of capital flight as a percentage of GDP from 1989 to 1990. In combination with low levels of net capital flows, export overinvoicing may also have led to the relatively low level of capital flight as a percentage of GDP during 1990 to 1993. The level of underinvoicing of exports increased again with the phasing-out of GEIS. As a result, underinvoicing of exports as a percentage of GDP rose sharply from 1993 to 1994 and again from 1994 to 1995<sup>16</sup>. Underinvoicing of exports increased from less than half a percent of GDP in 1993 to 5 percent of GDP in 2000.

We also find that overinvoicing of imports as a percentage of GDP increased from 1991 through to 1994. We speculate that this rise may have occurred because there was less capital flight due to underinvoicing of exports as a result of GEIS. In other words, people involved in capital flight who wanted the GEIS subsidy may have stopped underinvoicing exports and instead compensated for this decline by overinvoicing imports. Our argument is supported by the fact that the level of import overinvoicing dropped off once underinvoicing of exports recovered. Overinvoicing of imports, as a percentage of GDP, drops from 3.5 percent in 1994 to 2.3 percent in 1995 and stays around that level until 2000 (it is 2.3 percent of GDP again in 2000).

The unbanning of the ANC and other political organizations and the release of political prisoners in 1990, signaled the end of apartheid and hope for more political stability. Negotiations over a new constitution and democratic elections also started in 1990 and picked up pace in 1991. However, by 1992 the ANC publicly referred to the existence of a “third force” that wanted to derail the movement towards democracy. It seemed that certain political parties were using political violence to improve their negotiation position. This violence may also have contributed to the increase in misinvoicing from 1991 to 1992 (see figure 3).

### **1994 – 2000**

Net capital flows from 1991 onwards were positive, reflecting strong growth in international liquidity in the 1990s and possibly the expected political stability after the relatively peaceful first democratic elections.<sup>17</sup> Most of these net capital flows were short-term portfolio investment (Mohamed, 2003). The flows absorbed into the economy led to lower real interest rates and a boom in credit to the private sector. These flows were not utilized for productive purposes as can be seen in figure 7.<sup>18</sup> Mohamed (2003) shows that net capital flows were instead associated with increased consumption, imports of goods and services and capital flight instead of promoting sustainable economic growth. By 2000 net portfolio flows into South Africa reduced significantly.

From 1994 until 1996 business in South Africa were relatively unsure of the ANC government’s economic policies. Business was afraid that the ANC would adopt policies that would hurt them, nationalize private property and expropriate wealth in order to redistribute wealth and to improve the lives of the majority of South Africans. They were also concerned because the economy had been in decline throughout the 1980s. The Nationalist Party had increased debt significantly during the pre-election period as they attempted to buy votes on a large scale. Business feared that the new ANC government would increase debt further in an attempt to improve the lives of the majority of South Africans.

After the democratic elections in 1994, the African National Congress (ANC) government chose to adopt neoliberal economic policies to appease local business interests and to attract foreign investors. They did increase social spending and delivery of basic

services but within the constraints of tight fiscal policy. They also supported development of a black business elite by promoting black ownership of businesses and implementing affirmative action policies. These policies have recently been integrated into a more comprehensive program for black economic empowerment. However, the overall structure of the South African economy, especially the failure to significantly diversify out of the mining and mineral industrial sectors had not significantly changed during the 1994 to 2000 period.

From 1994 the trend between capital flight and the REER are not similar as in the 1980 to 1993 period (see figure 9). The REER does not respond to the surge in net capital flows during from 1993 and continues to decline. This may be due to political instability before the elections and uncertainty about the new government's policies.

*“Insert figure 9 here”*

Adoption of neoliberal economic policies in the GEAR program in 1996 reassured business about the ANC government's economic policies. At the same time, political violence had been brought under control and political stability had been achieved. There is a recovery in the REER from 1996 to 1997 that may be due to improved investor sentiment and also in response to the very large increase in net portfolio flows. However, contagion from the Asian financial crisis and subsequent financial instability in several developing countries seems to have caused a decline in the REER of the rand after 1997.

Despite the achievement of political stability and the adoption of the types of economic policies that business wanted, misinvoicing continued at the same level as in 1994 and 1995. It is interesting to note that misinvoicing is fairly constant from 1994 to 1999 because it indicates that wealthy elites behaved differently in the post-election period. During the pre-election period misinvoicing was volatile and responded to significant events affecting the economy. During the post-election period misinvoicing was relatively high and relatively constant. The behaviour after the elections seemed to indicate a multi-year effort to build up wealth reserves outside of South Africa rather than a knee-jerk response to larger problems as in previous years. A possible reason for this is that a large proportion of the business community in South Africa continued to have a number of fears and insecurities about the new democratically elected government. They feared that:<sup>19</sup>

- they would be punished for their support or at least their failure to oppose apartheid;
- nationalization of their assets would be seen as just because they benefited from apartheid;
- the need to redistribute wealth may have led to sequestration of their assets;
- measures to ensure black economic empowerment would have a negative effect on their businesses;
- the new government would force them to invest in low-return investments aimed at redistributing wealth or improving the lives of the majority of South Africans;
- the need to invest in social and economic infrastructure and programmes would lead to unmanageable fiscal deficits and macroeconomic instability that would damage their businesses;
- tax rates would sky-rocket to pay for improving access to health, education and basic needs; and
- the new government would not have been able to control people who have been oppressed and exploited for so long and that there would be persistent instability in South Africa.

***“Insert Figure 7 here”***

However, uncertainty and insecurity about a new government’s policies is not enough to explain the behaviour of South African elites. The poor performance of the South African economy is an important motivating factor for capital flight. In figure 7 one can see that wealthy elites reduced their level of investment from 1981 onwards. At the same time business and household savings declined. Average business saving as a percentage of GDP was 6 percent during the turbulent 1980-93 period and declined to 5 percent during the period 1994-2000<sup>20</sup>. Household average savings as a percentage of GDP was 3 percent for the 1980-1993 period and dropped to 0.8 percent for the 1994-2000 period. We also see in figure 7 that exports as a percentage of GDP remain low for the entire period after it declined in value in the early-1980s. The poor performance of the South African economy may have reinforced wealthy South Africans decisions to build up upshore assets. At the same time, capital flight contributed to the poor performance of the economy by removing resources necessary for investment in future growth.

### **Capital flows and financial instability**

South Africa's reintegration into the global economy at the end of apartheid increased the vulnerability of the economy to financial crises. This reintegration provided an opportunity for more capital flight. The increased vulnerability provided another reason for capital flight.

There were two occasions during the last two decades when there were crises in the South African financial system: the debt crisis in 1985 and the currency crisis in 2001. Both crises were caused by inadequate capital controls. Both crises were preceded by surges in net, short-term capital flows and sudden sharp declines in these flows.

There were surges in net capital flows to South Africa during the early 1980s and from 1994 (see figure 5) that contributed to the growth in capital flight in both periods. The peaks in capital flight in 1982 and 1997 were clearly the result of the peaks in net capital flows into South Africa in those years (see figure 5). The reason for the surge of net capital flows into South Africa in the early 1980s was because South Africa became a preferred destination for short-term bank lending after several Latin American countries had defaulted. The reasons for the surge in net capital flows after the 1994 elections were because of the growth in international liquidity in the 1990s, the growth of investment in emerging economies by institutional investors of industrialized countries and possibly the expected political stability after the relatively peaceful first democratic elections.<sup>21</sup> The net capital flows after 1994 were in the form of short-term portfolio investment.

The flows absorbed into the economy after 1994 led to lower real interest rates and a boom in credit to the private sector. However, as can be seen in figure 7 and figure 9, these flows were not utilized for productive purposes. Mohamed (2003) shows that the surge in net capital flows were associated with increased consumption, imports of goods and services and capital flight and were not associated with productive investment in the economy.<sup>22</sup> The surge in net capital flows could not last and it collapsed in 2000. This collapse in capital flows probably contributed to the increase in misinvoicing from 5 percent of GDP in 1999 to 7.5 percent of GDP in 2000.

Wealthy South Africans may have engaged in capital flight in order to hold their assets in developed economies that are less vulnerable than South Africa to financial crises

and contagion. This same reason has been used by companies that have moved their primary listing from the Johannesburg Stock Exchange to the London Stock Exchange.<sup>23</sup> They claimed that they wanted to reduce currency and other risks associated with being listed in South Africa, which is classified as an emerging market

The ANC government believed that foreign investment was important for further industrialization of the South African economy. They seemed to pay very little attention to whether foreign investment was short-term or long-term. They adopted neoliberal economic policies, which included little control over capital movements by non-residents, to attract foreign investment. The result of these policies was wasteful use of the surge in portfolio flows by private borrowers, a currency crisis in 2001 and more capital flight.

The policy conclusion one can draw from this discussion is that capital controls are necessary in South Africa because they may reduce capital flight by addressing the country's vulnerability to financial crises and contagion. Unfortunately, the same companies that listed offshore push for open capital markets.

### **Attitudes of the elite contributing to capital flight**

Another important reason for capital flight by wealthy South Africans has been mentioned above: the lack of faith of South African elites in the South African economy. These views are reinforced by social problems associated with poverty, like high levels of crime and corruption. This doubt about the future of the economy seems to contribute to weakening the economy further. It may also be exacerbated by racist views about the "black" government's ability to govern the country and to manage economic policy. Many racists may have further doubts about the future because of the greater role played by black people in senior management positions in all spheres of the economy. These types of issues are continually raised in the South African media. White South African tourists, business people and emigrants are often accused of "badmouthing" South Africa abroad and providing a negative picture of the country to foreign investors. In most cases, tensions that arise between government and white business are not usually overtly about race but issues of race more often than not lurk just below the surface.<sup>24</sup>



### **Structural weaknesses contributing to capital flight**

There are serious structural weaknesses in the economy that affect accumulation and contribute to capital flight. It is worthwhile to explore these structural weaknesses in the South African economy further to understand some of the reasons there may be capital flight rather than productive investment. The roots of these weaknesses lay in the type of industrialization that occurred within the context of South Africa's racist economic policies.

Fine and Rustomjee (1996) provide a very good framework for understanding the structural weaknesses of the South African economy. They organize their ideas around the existence of a minerals and energy complex (MEC) at the core of the South African economy. Fine and Rustomjee argue that the MEC includes the mining and energy sectors and a number of associated subsectors of manufacturing.<sup>25</sup> They make the point that most economic analyses of South Africa present a decline in the mining sector and a greater role for manufacturing and services after World War II. However, the type of manufacturing and services that have developed, are closely associated with, and often dependent on, the mining and energy sectors. Viewed from this perspective the role of mining and energy in the economy has increased not decreased.

The strength of Fine and Rustomjee's analyses is their description of the MEC as a system of accumulation, where they show a close relationship between ownership and control of the few conglomerates. These conglomerates include industrial and financial interests that control most of the South African economy. They discuss the history of industrialization in South Africa and the role played by key corporations and the state in developing the MEC and how the influence of the key corporations in the MEC extends into the financial sector<sup>26</sup>. They argue that through control of the core sectors and finance these conglomerates were able to extend their control to other sectors<sup>27</sup>.

The high level of concentration in the South African along with the domination of the MEC imposed serious limitations on the success of industrial policies aiming to diversify industry<sup>28</sup>. Concentration in the economy limits the ability of firms not within the dominant conglomerates to expand. The conglomerates also limit competition in the economy by suppressing competitors and buying up new entrants. Physical and other forms of infrastructure in the economy are geared towards the requirements of the MEC and may increase the costs associated with non-MEC activities.

Fine and Rustomjee note that a major weakness of the MEC as a system of accumulation was failure to diversify out of the MEC into downstream manufacturing. They say:

“The evolution of the MEC has left the economy with both strengths and weaknesses. The strengths arise out of the productive and infrastructural capacities that have been built up around its core sectors. The weaknesses arise from the failure of this to be vertically integrated forward into the rest of the economy. ...the result has been an internationally uncompetitive consumer goods industry and limited capacity across a range of intermediate and capital goods. In addition, the scope of infrastructural provision, broadly interpreted to include the full range of what are normally public utilities as well as housing, health, education and welfare, is extremely limited as a consequence of apartheid.” (Fine and Rustomjee, 1996, p 252)

The implication of the failure of the conglomerates that control most of South Africa's economy to diversify out of the MEC is that there has been relative stagnation in the economy with declining investment in new activities and limited replacement of old capital stock. These problems could lead to capital flight but are also reinforced by capital flight. Figure 8 shows capital flight as percentages of gross fixed capital formation. Average capital flight is 34 percent of GFCF per year for the entire period. During the early period, 1980-1985, capital flight as a percentage of GFCF averages 39 percent, dropping to 9 percent from 1986-1993. During the latter period, 1994-2000 capital flight as a percentage of GFCF averages a high of 58 percent. On the whole, it is clear that a very large amount of investment has been foregone in South Africa as a result of the magnitude of capital flight.

Fine and Rustomjee estimate that average capital flight from South Africa between 1970 and 1988 was 7 percent of GDP per year. They say that the high level of capital flight ‘... indicates the global nature of South Africa's major corporations and their longstanding failure to promote diversification out of indigenous strengths in and around the MEC core’ (p.247). They add, ‘The lack of industrial investment and diversification has its counterpart in the over-bloated financial system and corporate capacity to transfer funds abroad whether through transfer pricing, false invoicing of trade or other methods’ (ibid). They succinctly summarize how the limitations of the structure of the South African economy contribute towards capital flight.

In addition to these structural reasons, an important explanation for large capital flows from South Africa is the deep integration of South African capital with capital in industrialized countries<sup>29</sup>. This level of integration means that moving wealth and assets offshore is relatively easy for many wealthy South Africans. Our calculations indicate that the lowest level of misinvoicing was 1.9 percent of GDP for the period investigated. Therefore, it seems to us that capital flight may be standard operating procedure for many of the large South African importing and exporting firms.

Alejandro's (1994) discussion of capital flight from Latin America is relevant to South Africa as well. Those engaged in capital flight escape the burden of contributing (by paying taxes) to investments that develop the country. The burden is shifted to people who keep their wealth in the country. In addition, capital flight from South Africa entrenches MEC and the structural weaknesses in the economy. The holders of capital choose not to invest in diversifying the South African economy or to further develop the economy. They stifle development by shifting the cost of development to the rest of society. At the same time, they pressure government to adopt neoliberal policies that limit state spending and stifle demand.

## **V. Conclusion**

Our interpretation of the data and South African economic history leads us to believe that capital flight has been rampant from the South African economy. We show that it was affected by the ebb and flow of capital flows into and out of the economy. Capital flight peaks in periods when there are peaks in net capital flows in South Africa. We also show that misinvoicing, even when using a conservative estimate, is an important source of capital flight that has been consistently high. We believe that tracking misinvoicing provides important insights into how wealthy South Africans engaging in capital flight behaved before and after the 1994 democratic elections.

Despite the relative political stability and the adoption of neoliberal policies that wealthy South Africans favor, they made a concerted effort to build up wealth outside South Africa. We believe that racism, fear and a sense of loss of power were important explanations of capital flight.

In addition, the structural weaknesses of the South African economy that limited diversification and stifled investment are central to our explanation of capital flight. The control by a few white-owned and controlled conglomerates that have power over the major financial institutions in the country and also have deep ties with capital in advanced industrial countries provides an important reason for capital flight.

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**Databases:**

Direction of Trade Statistics (DOTS) CD-ROM 2003

Global Development Financial (GDF) CD-ROM 2002

International Financial Statistics (IFS) (Online), <http://ifs.apdi.net/imf/logon.aspx>

South African Reserve Bank, Balance of Payments data (Online), [www.resbank.co.za](http://www.resbank.co.za)

World Development Indicators (WDI) CD-ROM 2003

**Table 1 Alternative measures and determinants of capital flight from South Africa**

Author(s)	Methodology	Sample Period	Macro Instability	Risk & Returns To Investment	Political Instability	Main Finding
Khan (1991)	Balance of Payments, trade misinvoicing	1970-1985				Calculates capital flight from 1970-1985 as US\$15,380 millions (1985 prices). Finds misinvoicing is a major channel for capital flight.
Smit and Mocke (1991)	Balance of Payments, Indirect, Direct and Derived	1970-1988	Average real growth rate over last 3 yrs, balance on current account and budget deficit, and changes in gross foreign debt.	Real exchange rate, real exchange rate minus PPP of real exchange rate, real domestic interest rates (0), difference between domestic and foreign short-term interest rates (0).	Number of emigrants, number of european tourists.	Calculates capital flight using derived measure from 1980-88 as US\$6,099 billion.
Rustomjee (1991) and Fine and Rustomjee (1996)	Balance of Payments plus errors and omissions and trade misinvoicing	1970-1988	Failed financial liberalization and debt default.			Calculates capital flight from 1977-1988 as US \$55 billion. Calculate capital flight from 1970-1988 as 7% of GDP. Explanation of capital flight includes structure of economy and global integration of South Africa's major corporations.
Wood and Moll (1994)*	Trade misinvoicing	1970-1985				Calculates capital flight from 1970-1985 between US \$2 and 5 billion. Misinvoicing has been exaggerated by Khan (1991) and Rustomjee (1991).
Fedderke and Liu (2002)	Balance of Payments, Indirect and Derived.	1960-1995	Growth	Exchange rate adjusted interest differential, overvaluation of exchange rate in terms of PPP.	Political rights index, political instability index (Fedderke et al, 2001)	Calculates capital flight from 1980-89, using derived method, as US \$628 million and from 1985-95 as US \$462 million.

*No statistically significant effect (0)*

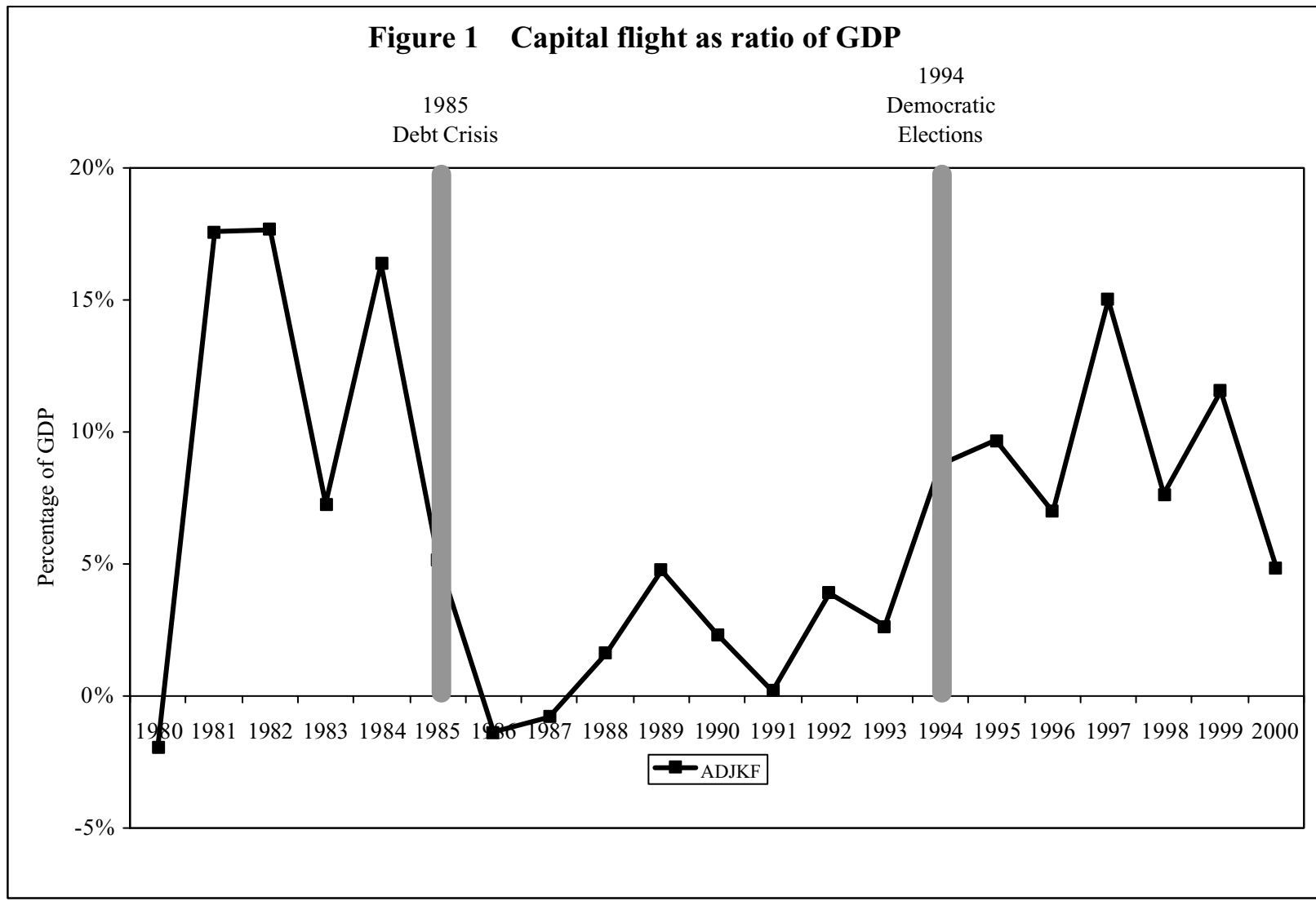
\* Wood and Moll do not provide reasons for capital flight but seem to suggest that people have a predisposition to evade exchange controls. They write, ' In countries where people are nervous about the long-run safety of their assets, capital drain will never be stopped...' (pp.41).

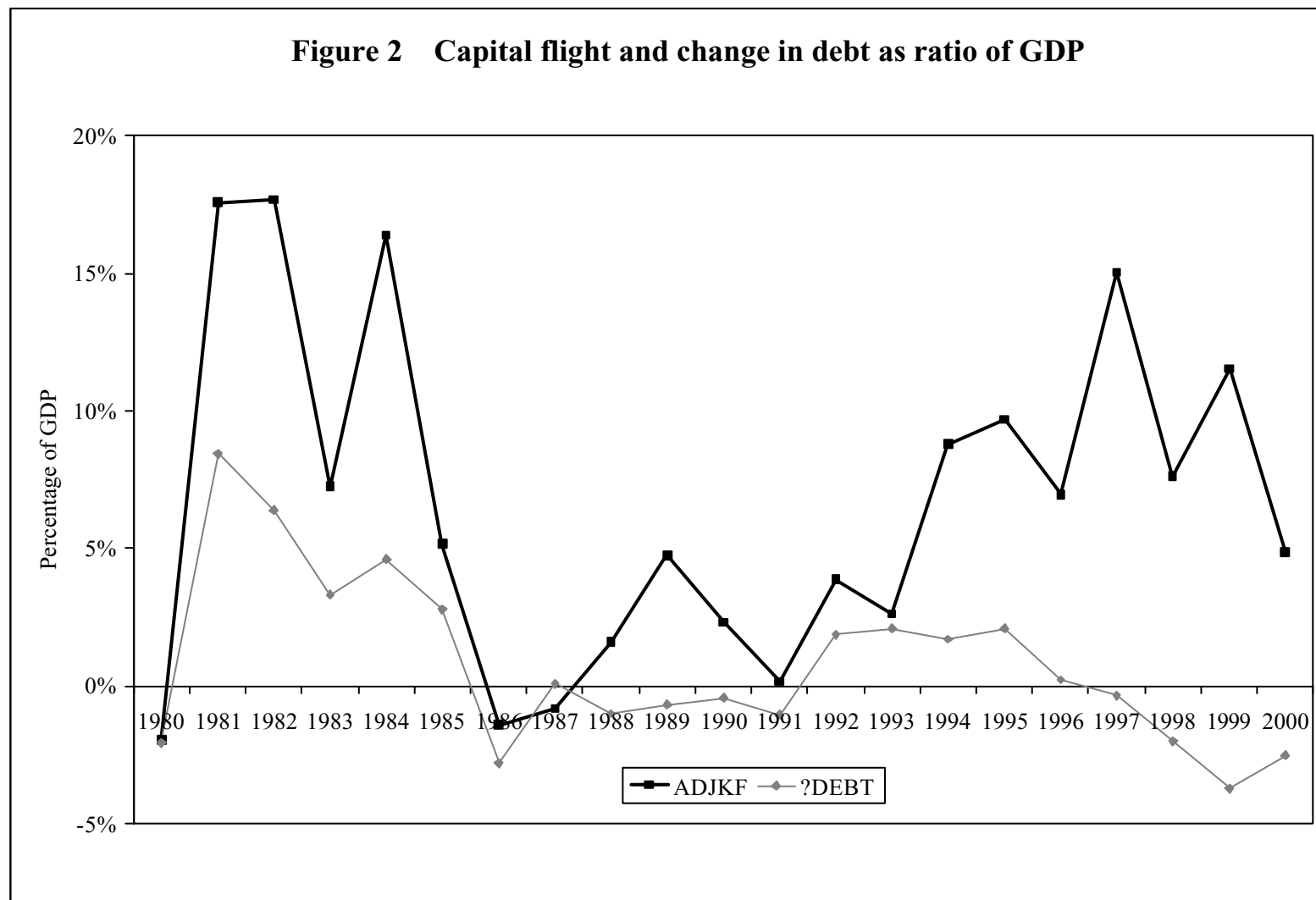


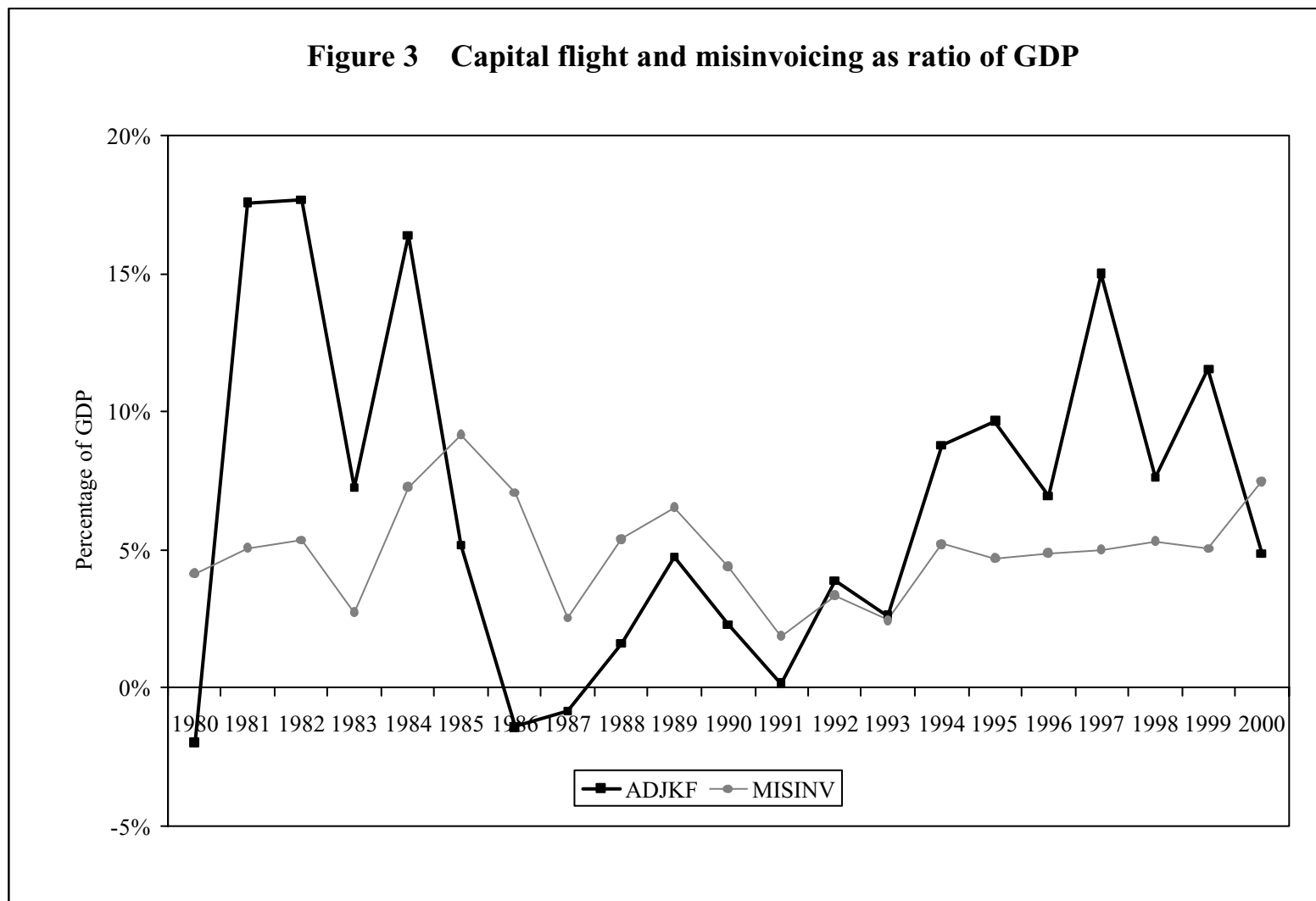
**Table 2 Capital flight calculations (in US\$ millions)**

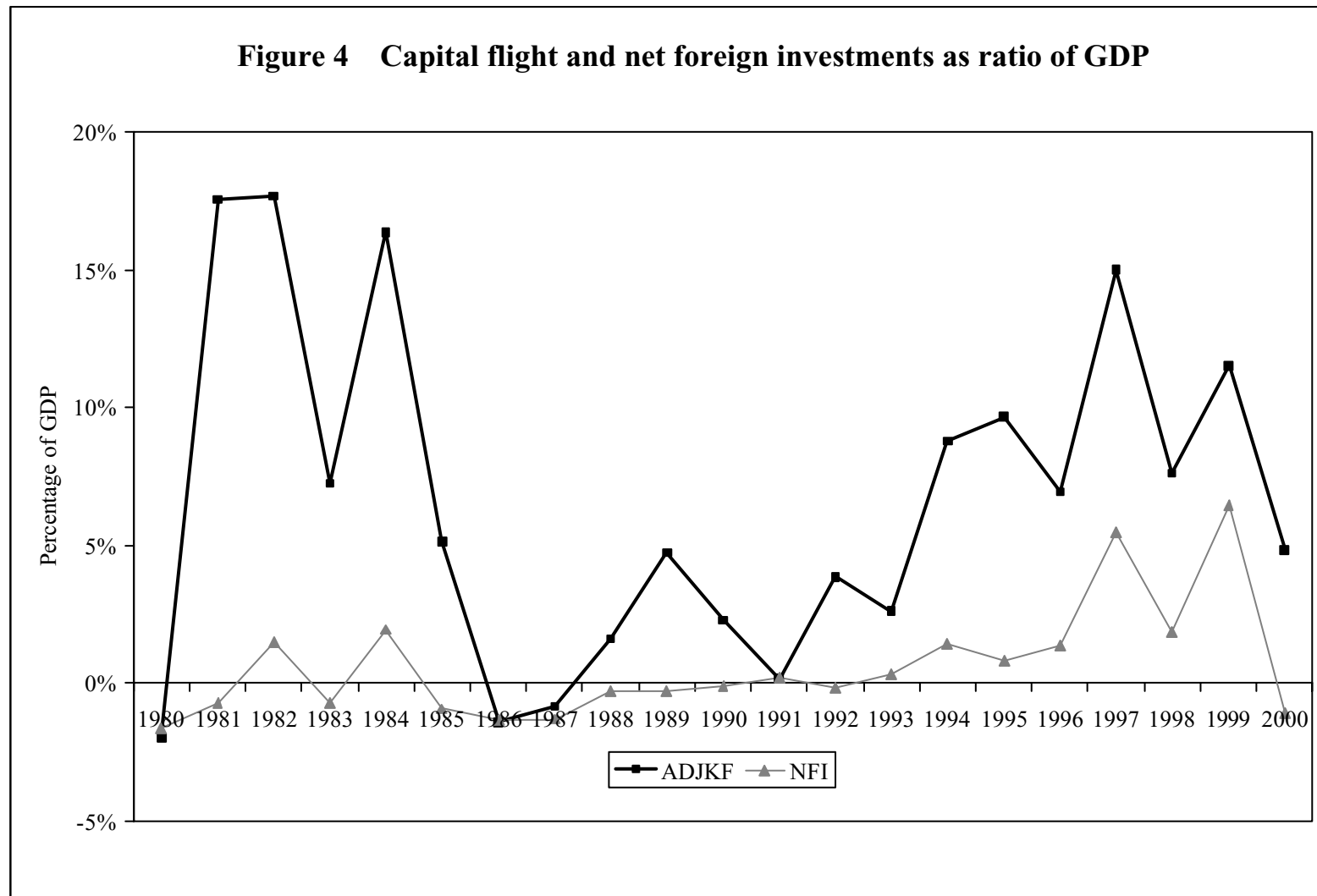
Year	Change in Debt	Net Foreign Investment	Current Account	Change in Reserves	Capital Flight	Misinvoicing	Adjusted Capital Flight	Real Adjusted Capital Flight
1980	-1656	-1307	3161	-1201	-4923	3334	-1589	-12130
1981	6241	-513	-4621	1101	9248	3757	13005	86702
1982	4766	1129	-3390	100	9186	3994	13180	77527
1983	2484	-534	-300	-1129	3379	2061	5440	28938
1984	2498	1060	-1802	428	4932	3937	8869	43475
1985	1383	-458	2317	606	-1997	4568	2571	10942
1986	-1921	-914	2828	146	-5808	4840	-968	-3470
1987	63	-1167	3347	-1407	-3045	2299	-746	-2323
1988	-886	-227	1504	715	-3332	4750	1418	3885
1989	-671	-293	1343	-528	-1780	6477	4697	11184
1990	-495	-101	2134	-355	-2375	4975	2600	5509
1991	-1265	284	2256	-1147	-2091	2289	199	376
1992	2284	-185	1967	-503	635	4094	4729	8196
1993	2614	434	1503	1341	204	3072	3276	5318
1994	2313	1968	112	-683	4852	7101	11953	17920
1995	3133	1223	-2205	-907	7468	7053	14520	19891
1996	292	1839	-1880	1272	2740	6451	9191	11768
1997	-487	7667	-2273	-4595	14049	7028	21076	25211
1998	-2520	2327	-2157	-920	2884	6671	9555	11033
1999	-4863	8434	-640	-4261	8472	6578	15050	16430
2000	-2942	-1262	-575	-544	-3085	8776	5691	5691

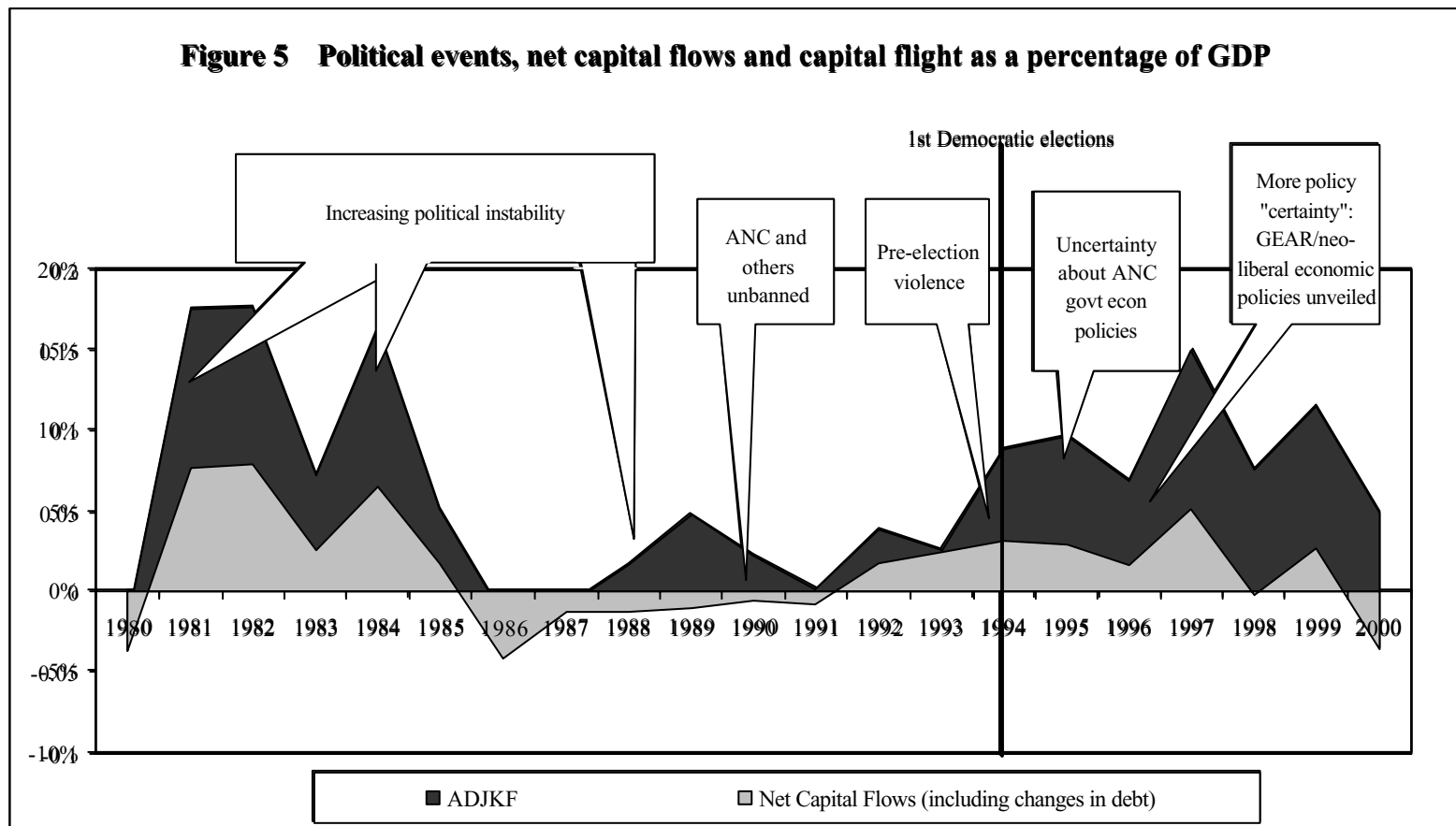
*Source:* Authors computations using SARB data for net foreign investment, IFS data for change in debt, WDI for current account and change in reserves and IMF-DOTS data for misinvoicing. Real figures are calculated using the South African producer price index (2000=100).



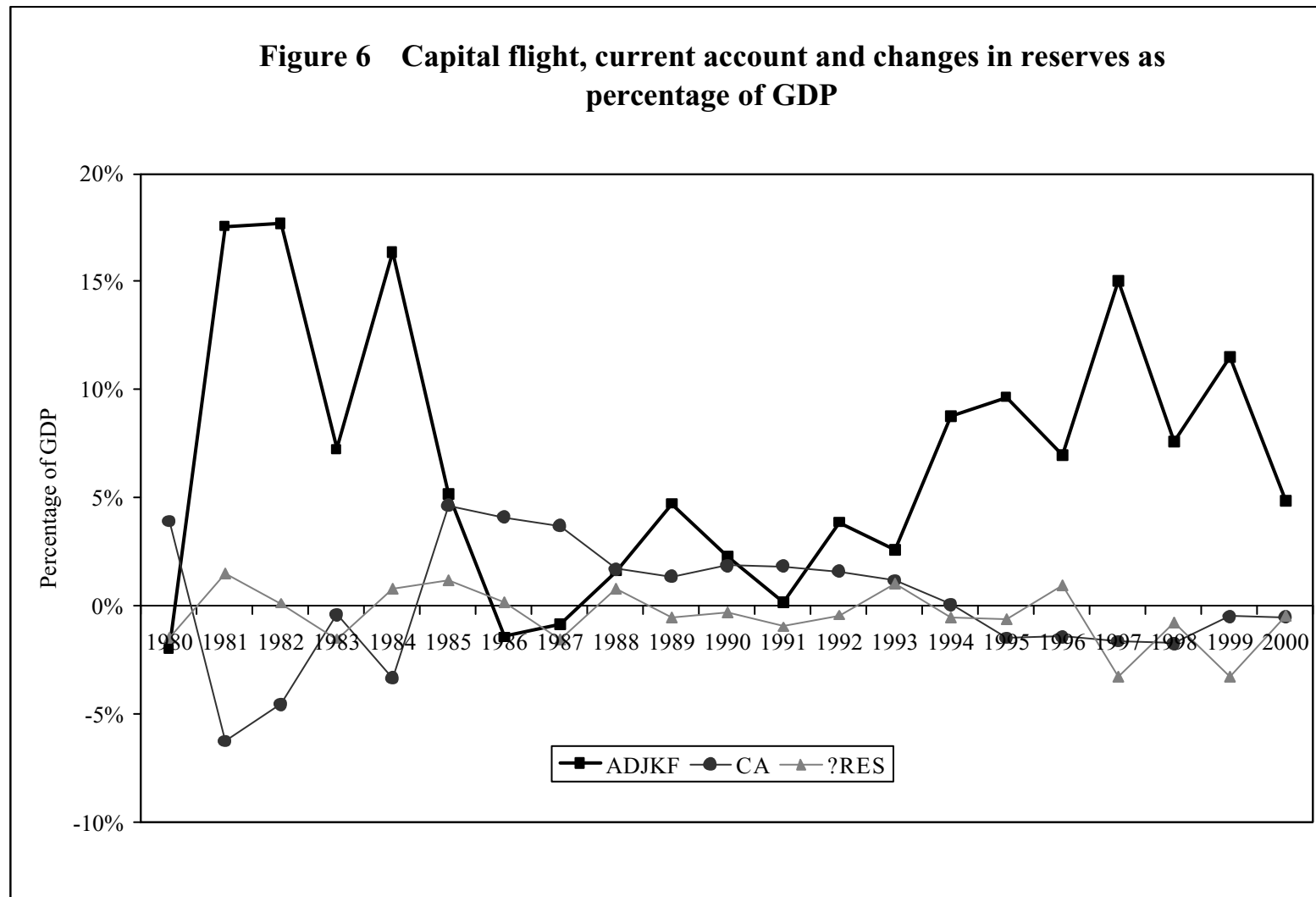


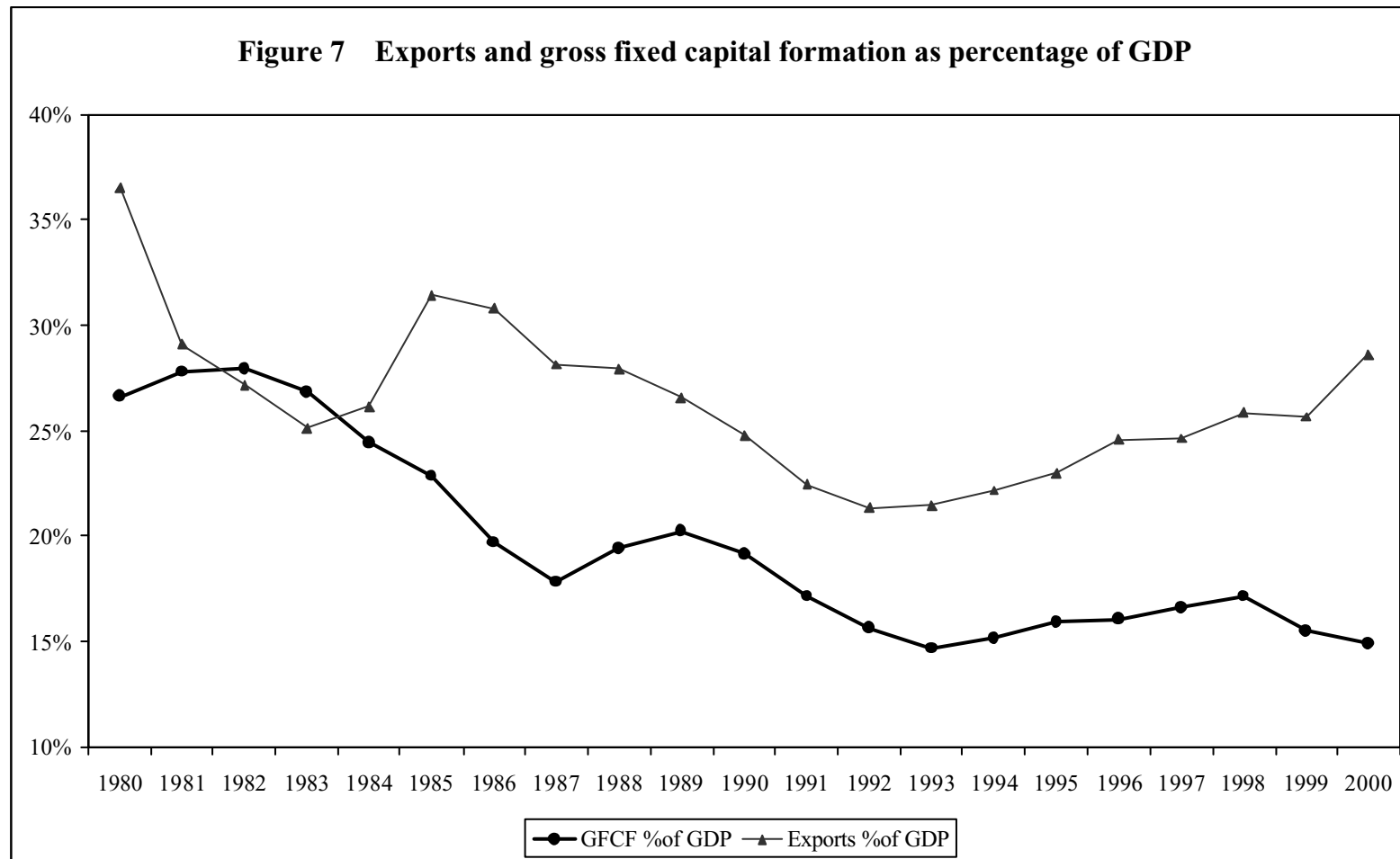




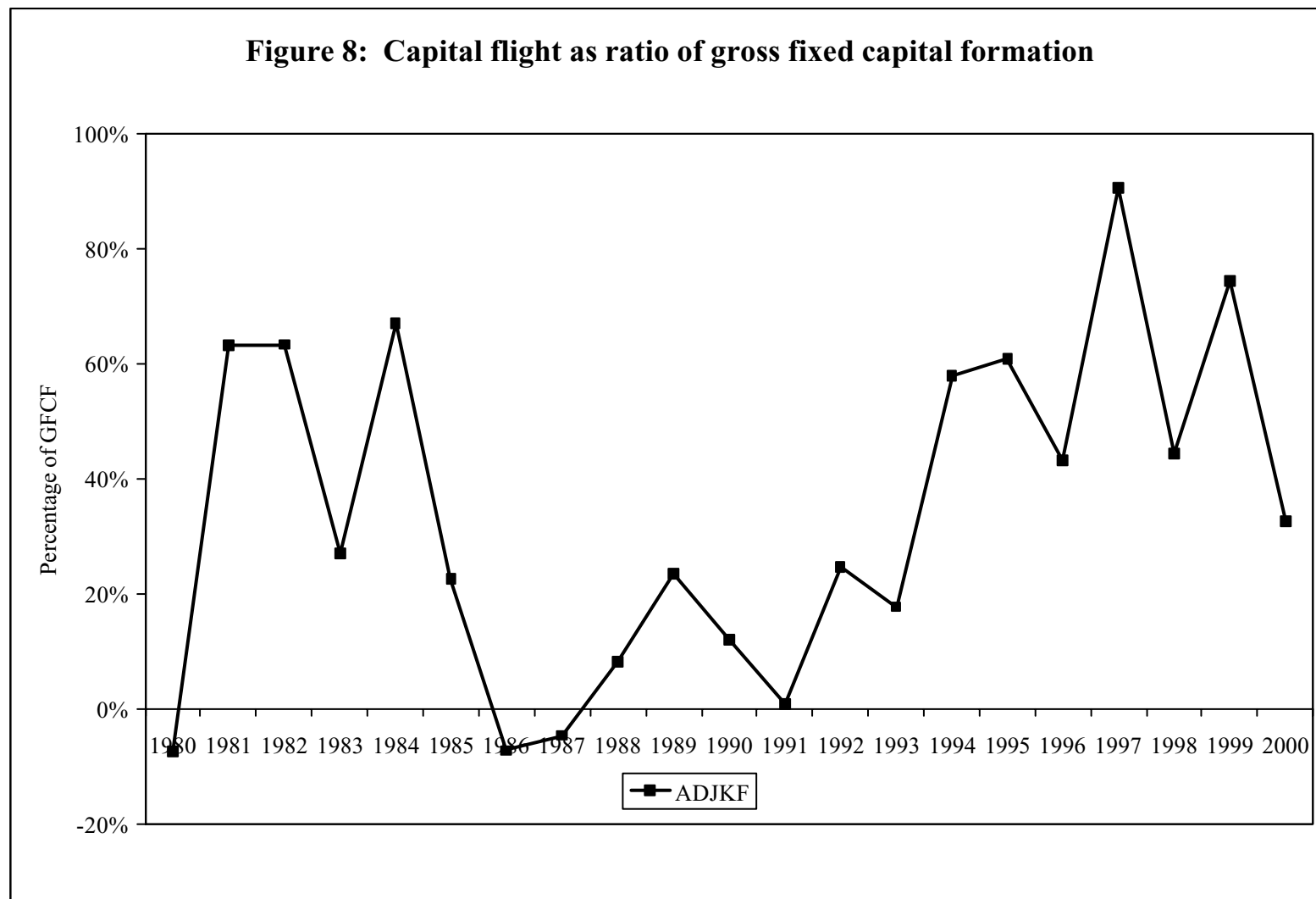


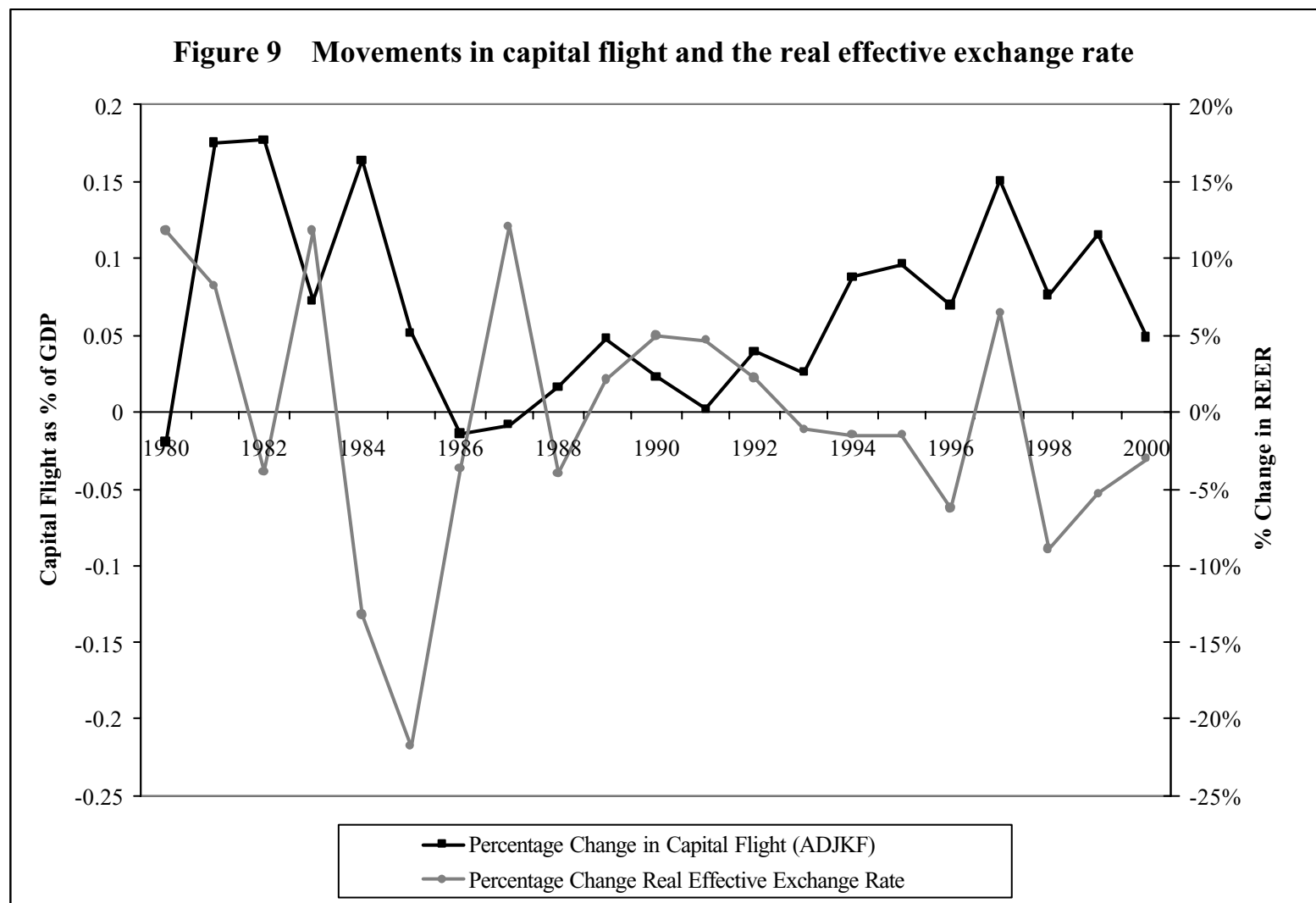
**Figure 6 Capital flight, current account and changes in reserves as percentage of GDP**











## Notes

<sup>1</sup> See Beja, Chapter 1, this volume.

<sup>2</sup> Operationally, we compute capital flight as the sum of change in external debt, foreign investment inflows, current account surplus and change in international reserves.

<sup>3</sup> See Terreblanche (2003) for a discussion of white attitudes during the post-apartheid period.

<sup>4</sup> Cumulative totals for capital flight (including misinvoicing) and gross fixed capital formation are obtained by simply adding the nominal values for each year from 1980 to 2000 respectively. We do not consider potential rates of return on domestic capital or capital held overseas.

<sup>5</sup> The latest period investigated in the South African capital flight literature ends at 1995 (see Fedderke and Liu, 2002).

<sup>6</sup> We modify Boyce and Ndikumana's (2001) calculation to obtain a more conservative estimate for trade misinvoicing. Boyce and Ndikumana's calculation assumes that the levels of trade misinvoicing for the African countries they examine are the same in developed and developing countries. In order to provide a conservative estimate of capital flight from South Africa, we assume that there is no misinvoicing of trade to and from developing countries.

<sup>7</sup> Boyce and Ndikumana (2001) use an adjusted change in external debt variable to revalue foreign debt taking into account cross currency exchange rate fluctuations. South African debt data decomposed by different currencies was not available for the time period we were investigating.

<sup>8</sup> Global development finance (GDF) has available decomposed debt data from 1994.

<sup>9</sup> IFS only has data for South Africa from 1985.

<sup>10</sup> Capital flight in our discussion of results refers to adjusted capital flight (ADJKF), which includes misinvoicing.

<sup>11</sup> The apartheid government built Sasol 1, Sasol 2 and Sasol 3 at great expense to ensure that they had enough oil in a situation when sanctions was escalating.

<sup>12</sup> The apartheid government was forced to call a four-month moratorium on \$14 billion short-term loan repayments in August 1985. This moratorium was later extended to March 1986. The debt crisis was a direct result of the surge in liquidity when South African borrowers were piled with short-term loans after the Latin American debt crisis.

<sup>13</sup> According to Jenkins (1990, p.279), seven US companies left South Africa in 1984, 40 left in 1985, 49 left in 1986, 58 left during 1987 and almost 80 left in 1988. By 1987, 20% of British firms in South Africa had left.

<sup>14</sup> GEIS was a subsidy to promote manufactured exports. The levels of subsidy were higher for goods with higher levels of value-added. The introduction of GEIS as a 'general' incentive was indicative of the apartheid state choosing a more market-oriented approach to industrial policy and their rejection of alternate views that called for a more targeted approach to industrial policy (for more on this debate see Black, 1993).

<sup>15</sup> This information was obtained in private communication with people who had administered GEIS in the South African Government's Department of Trade and Industry. They mentioned a number of drawn out court cases as a result of charging exporters with fraud for claiming GEIS subsidies when they had overinvoiced exports. Wood and Moll, (1994) also refer to overinvoicing due to GEIS.

<sup>16</sup> Authors calculations.

<sup>17</sup> See Palma (2000) for a discussion of the massive rise in liquidity in global financial markets in the 1990s.

<sup>18</sup> Gross fixed capital formation as a percentage of GDP does increase by 2% from 1993 to 1998, possibly in response to the increased access to debt as a result of the increase in net capital flows. However, after 1997 when net portfolio flows peak, GFCF decline back to 15% of GDP -- the lowest level for the period 1980-2000.

<sup>19</sup> See Terreblanche (2003), for a discussion of South African white business attitudes and fears.

<sup>20</sup> Calculated using SARB annual data on corporate and household savings.

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<sup>21</sup> International investor sentiment towards South Africa improved once the government had adopted GEAR and may have contributed to further growth in short-term capital flows after 1996. It is ironic that these capital flows spurred by improved investor sentiment contributed to capital flight.

<sup>22</sup> Mohamed (2003) says that from 1999 to 2000 net portfolio flows into South Africa reduced significantly and in 2001 these flows were negative. He argues that this sudden drop in portfolio flows may be an important reason there was a currency crisis in South Africa in 2001 when the rand depreciated by 35 percent relative to the US dollar.

<sup>23</sup> ABSA (1999) says that international investors demand risk premiums on funds invested in emerging markets. When local companies list off-shore they are seen to attract "...keener interest by foreigners" (p.6).

<sup>24</sup> Thabo Mbeki's column called "letter from the president" has an article called "Empowerment good for the economy and the nation" in the 5-11 December 2003 issue of the ANC's newsletter "ANC Today". This article provides an interesting insight into the tension between business and the ANC government about policies like empowerment and continued white domination of the economy.

<sup>25</sup> They use input-output table to establish the linkages between the core MEC sectors and associated sectors. They allocate a number within the MEC that have traditionally been allocated to manufacturing because they are directly attached to mining and energy. They provide the example of metal fabrication that is allocated to manufacturing in traditional classification systems but which in reality is directly attached to mining because it follows on from the ore making process.

<sup>26</sup> During the post-World War II period, the development of Afrikaner nationalism; the apartheid state's support for Afrikaner business; and the conflict-cooperation relationship between the apartheid state and English capital, which dominated the economy, is important for understanding the specific form of industrialization that occurred in South Africa. During the interwar period, the Afrikaner nationalist movement chose to build Afrikaner political and economic influence by supporting the development of large corporations.<sup>26</sup> After the Nationalist Party took power in 1948, English capital was forced to accommodate Afrikaner capital because of their political power. The apartheid state invested directly in the mining and energy sectors and developed financial institutions in order to foster the development of a powerful Afrikaner corporate sector. This process carried on through most of the post-War period and locked South Africa into a form of industrialization that was centered on the mining and energy sectors. It led to increased interpenetration of English and Afrikaner capital from the 1960s, which intensified with the disinvestments by foreign capital. This industrialization was based on large scale, capital and energy intensive investments. This type of large-scale capital and energy intensive investment still dominates the South African economy today despite a change in government and unemployment of close to 40 percent.

<sup>27</sup> Innes (1984) also provides a detailed account of the concentration of South African industry through his vivid history of the Anglo American Corporation.

<sup>28</sup> Inadequate diversification out of core MEC sectors and low GFCF was accompanied by increased financial market activity. During the 1980s financial institutions played an exaggerated role in the economy that supported further concentration in the economy. South African capitalists were influenced by trends of hostile takeovers and merger and acquisitions in many industrialized economies and the earlier trends towards diversified conglomeration in the 1960s and early 1970s. This trend towards further concentration was fueled by the increasing number of disinvestments by US and British companies from the South African economy during the 1980s. This further entrenched the inability of the economy to diversify out of the MEC.

<sup>29</sup> There have always been strong links between the families that own the holding companies that control the largest most powerful companies in South Africa and powerful businesses in developed countries. Reasons for this are colonialism and imperialism. Wealthy South Africans have maintained or built strong ties with European and US businesses over a long period of time. Large finance houses like Citibank and Barclays Bank have historical and long-term interests in South African businesses. They have financed South African mining houses since the discovery of diamonds in the 1830s and have had and continue to have representatives on the boards of the major South African conglomerates or their subsidiaries.