A Comment on the South African Reserve Bank’s Commitment to the Liberalisation of Exchange Controls

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Sam Ashman, Ben Fine and Susan Newman

1. Introduction

The South African Reserve Bank (SARB) issued a media statement on the 1 July 2010, stating its intention to implement an ‘Exchange Control Voluntary Disclosure Programme’ (VDP) and amend the Exchange Control Regulations, 1961, in line with announcement by the Minister of Finance in his Budget Speech of 17 February 2010 regarding certain measures relating to Exchange Controls.

SARB ‘quietly’ invited comments from South African individuals and entities on the proposed scheme by the 2nd of August just three months before the scheme was due to be implemented in November 2010. This article is based on comments submitted by the Corporate Strategy and Industrial Development research programme at the University of the Witwatersrand submitted to SARB. CSID’s submission to SARB focuses upon the extent of capital flight from South Africa and the developmental implications of capital flight in terms of domestic investment forgone.

The VDP amounts to a flat charge of ten percent of the market value of the assets for individuals and companies who disclose their illegal expatriation of capital prior to 28th February, 2010. The VDP and Amendment of the Exchange Control Regulations have also been signalled by SARB as part of the gradual liberalisation of exchange controls and so amounts to the ‘regularisation’ of formerly illegal capital outflows prior to their legalisation. This process will allow those who broke the law to retain large amounts of capital offshore to the disadvantage of those who abided by the law as well as the population more generally through the negative impact on the balance of payments. Further, the VDP and Amendment of the Exchange Control Regulations will, as part of a proposed ongoing process of the liberalisation of capital controls, only increase the ongoing expatriation of wealth from South Africa, further contribute to low levels of domestic investment, perpetuating unemployment, inequality and domestic development foregone.

In addition, the VDP and Amendment to the Exchange Control Regulations have been proposed with apparently very little investigation or quantification of capital flight from South Africa by SARB itself. Yet capital flight has plagued South Africa for five decades. Apartheid governments repeatedly turned a blind eye to capital taken out of the country illegally by large conglomerates (Fine and Rustomjee 1996). One exception to this lack of investigation by SARB is Brian Kahn’s 1991 estimate that total capital flight between 1970 and 1985 amounted to 15.38 billion USD (1985 prices). Mohamed and Finnoff (2005) estimated that capital flight as a percentage of GDP increased from an average of 5.4 percent a year between 1980 and 1993 to 9.2 percent of GDP per year between 1994 to 2000. More
recent calculations by Newman (2009) using the same method found that capital flight between 2001 and 2007 was on average 12 percent of GDP per year. This figure increased year on year from 2001 and peaked at 23% of GDP in 2007. In addition, trade misinvoicing remains a significant channel for capital flight by companies.

Capital flight on such a scale has clear implications for South Africa’s economic performance. The notice of just one month for comments on the SARB’s proposals, with very little publicity, is astonishingly hasty given the extent of capital flight, its long history, and its serious implications. The issue requires further research and far greater public debate, not least because the South African government recently discussed the need for a ‘New Growth Path’ to alter the trajectory of South Africa’s economic development, and SARB’s plans, if implemented, will inevitably conflict with other policy measures designed to achieve such a New Growth Path.

We also argue that SARB’s use of the term ‘regularisation’ disguises the extent to which individuals and companies have not only broken the law with regard to exchange controls but they will also have evaded taxation in so doing. The proposed new measures come as other countries adopt measures to reign in capital moved abroad for purposes of tax avoidance and evasion. We fear that this amnesty and further liberalisation of exchange controls in South Africa will not curb capital flight motivated by tax avoidance, nor of capital earned by illegal means.

Critically, however, the expatriation of wealth from South Africa has serious implications in terms of foregone domestic investment. It was recently estimated by Fofack and Ndikumana (2010) that if only a quarter of the stock of its capital flight was repatriated to sub-Saharan Africa, the sub-continent would go from trailing to leading other developing regions in terms of domestic investment. The continued expatriation of resources from South Africa is of particular concern given falling domestic investment in productive activities, declining capital stock across almost all productive sectors, deindustrialisation that has further entrenched the high levels of structural unemployment in the country, and strains on levels of public sector investment.

It is in this context that the proposed VDP and Amendment to the Exchange Control regulation as part of an ongoing process of the liberalisation of exchange controls should be seen. Most methods of measuring capital flight include both legal and illegal capital flows. Whilst liberalisation is likely to reduce illegal capital outflows motivated by the circumvention of current exchange controls, it will do nothing to reduce the extent to which wealth is expatriated. Yet this wealth, if properly utilised domestically, holds the potential for enhancing social and economic outcomes. In this way, the total liberalisation of exchange controls is at odds with the developmental goals of the government’s New Growth Path. To achieve developmental outcomes, a VDP should involve the repatriation of a certain proportion of the wealth taken offshore. This could be part of an alternative process of ‘regularisation’ that leads to the gradual control of capital flows in a manner that is conducive
to domestic investment, the reduction of unemployment and a more equitable economic development path.

To date, much of the capital flight literature has focused on individual motives for the expatriation of capital. Traditionally, capital flight has been seen as a consequence of political or economic instability (Kindleberger 1937). More recently, capital flight has been explained as portfolio choices based on the balance of risks and returns in an increasingly financially integrated global economy (Collier et al 2001). Capital flight is often defined as illegal capital flows either associated with criminal activities, tax avoidance or a desire for the hidden accumulation of wealth (Kar and Cartwright Smith 2008). Rather than focusing on the motives of individuals, our approach emphasises that increases in capital flight or outflows from South Africa need to be understood in the context of broader shifts in the global economy and the historical trajectory of South African economic development that has resulted in an industrial structure that is highly skewed towards mining and related industries. We also suggest that the benefits of further liberalisation of exchange controls will be debated in South Africa as, under the impact of the global economic crisis, even the major neo-liberal international financial institutions such as the IMF are recognising the legitimate role to be played by capital controls in regulating flows of capital.

2. Contextualizing capital flight

The South African Government is committed to the wholesale liberalization of capital flows into as well as out of South Africa. This stance is in line with policy recommendations that have emanated from numerous international panels and commissions charged with providing policy advice to the South African Government, most notably the recent Harvard Panel (2006-2008)\(^1\), the World Bank Commission on Growth and Development (2008), and the OECD (2010). The rationale for liberalizing capital flows comes from the perceived need to narrow the gap between domestic savings and investment through capital inflows. What is notable from their analyses has been the absence of capital flight, either its extent or its implications for domestic investment.

Mainstream economic explanations of capital flight downplay its significance in terms of the outflow of resources that might otherwise be deployed domestically to achieve better social outcomes. Capital flight is explained as a rational market phenomenon in which economic agents exercise portfolio choices based upon the balance of risk and reward. In this way, capital flight is no more than an outcome of the market mechanism acting towards the efficient allocation of resources.

The preoccupation of mainstream economics with rationality, equilibrium and efficiency and its reliance on methodological individualism means that it is inherently unable to deal with the social or historical. Capital flight from South Africa has been significant over the past five decades, its extent as well as its implications cannot be fully understood apart from the

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\(^1\) See debate between Ben Fine and Ricardo Hausmann, the leader of the Harvard Panel (Fine 2009a & b; Hausmann & Andrews 2009)
historical specificities of South Africa and its relationship with the global economy. While capital flight might well be motivated by considerations of risk and uncertainty as part of the portfolio choice of individuals, the extent to, and the modes and channels by, which capital is expatriated is conditioned upon prevailing social, economic and political structures that are specific to the social and historical context of South Africa. Capital flight must be addressed in terms of the evolving political economy of South Africa from which its historical trajectory of economic development can be understood. We argue that this is best located within a political economy framework that emphasizes the notion of a system of accumulation. The latter develops through the historically contingent linkages which develop between different sections of capital – including finance – and their interaction with the state. Corresponding core industries influence the development of other sectors and so induce a specific form of industrial (and broader economic and social) development.

We characterize the system of accumulation in South Africa as a ‘minerals-energy complex’ where accumulation has been and remains dominated by and dependent upon a cluster of industries, heavily promoted by the state, around mining and energy - raw and semi-processed mineral products, gold, diamond, platinum and steel, coal, iron and aluminium. This is not simply in terms of the weight played by the mining and energy sectors but also their determining role throughout the rest of the economy. (Fine and Rustomjee 1996)

The MEC has defined the course of capitalist development in South Africa since its minerals revolution of the 1870s, upon which extraction came to be based on the extreme exploitation of black labour, achieved through a system of migrant labour. The discovery of precious metals and minerals produced a rapid inflow of British capital that quickly established control over the mining industry. The dominance of mining, and its need for large-scale capital investment (due to deep and dispersed gold deposits) rapidly produced concentration in mine ownership in the hands of six finance houses or producer groups which consolidated their stranglehold over production, distribution and marketing through the Chamber of Mines.

The process was facilitated by an uneasy compromise between Afrikaner political power and foreign, “English”, economic control and ownership of mining capital. State corporations, especially for steel and electricity, served the MEC, as did labour control. But policies for diversification of industry out of the core MEC base remained weak. In the 1960s, however, the emergence of an Afrikaner mining house was negotiated (anticipating later black economic empowerment), and dysfunction between large-scale capital and the politics of state intervention was eroded. There was potential for a ‘developmental state’ sort of strategy. But the 1970s witnessed the collapse of the post-war boom raising prices of both gold and energy, thereby consolidating state-conglomerate strategy around MEC core sectors.

This was followed in the 1980s by the gathering crisis of apartheid itself. Yet the effect of sanctions was paradoxical. Exchange restrictions mostly confined financiers to the domestic economy - with the exception of the illegal capital flight that took place - forcing them to invest in established MEC sectors and acquire the foreign subsidiaries made available by
disinvestment. The quantity and range of the conglomerates’ holdings multiplied, while the mining industry remained a staple outlet for ‘trapped’ domestic finance.

Throughout the apartheid period, the state played a major role in fostering capital flight in the way in which it built up the financial system in South Africa. By the 1980s, macroeconomic policy became increasingly geared around supporting the financial sector. This was a financial sector that was controlled by the mining conglomerates and had become increasingly outward orientated since the beginning of the 1970s. The conglomerates were investing off-shore and engaging in capital flight through transfer pricing. (Fine and Rustomjee 1996)

In addition to the historical specificities of the South African economy, capital outflows should be understood in relation to broader shifts in the global economy and how these shifts are played out in the South African context. The neoliberal era of capitalism has been associated with the increasing financialisation of the global economy.² Financialisation as a term is associated loosely with the proliferation of financial markets, institutions and actors that have emerged since the collapse of Bretton Woods. Under this broad term is included the increasing importance of institutional investors; the expanding range of financial activities in the economy; the expansion and proliferation of a range of financial services and instruments and a whole range of financial institutions and markets including the now infamous sub-prime mortgages. It has also witnessed huge rewards to those involved in finance, and widening inequalities against previous trends, together with the penetration of finance into ever more areas of economic and social reproduction.

But financialisation is much more than simply the proliferation of financial markets and assets. Critically, non-financial companies have diversified into and gained an increasing share of profits from their financial activities, a development accompanied by the increasing financing of investment from retained earnings or borrowing on open markets.

The neoliberal period has witnessed the expansion of speculative assets at the expense of real investment and the weakening of labour and the strengthening of capital.

Financialisation can be summarised as (Ashman, Fine and Newman 2010b):

- reducing overall levels and efficacy of real investment as financial instruments and activities expand at the former’s expense even if excessive investment does take place in particular sectors at particular times;
- prioritising shareholder value, or financial worth, over other economic and social values;
- pushing policies towards conservatism and commercialization in all respects

² Finance has been a critical, even definitive, component and mechanism underpinning and perpetuating neoliberalism.
• extending influence, both directly and indirectly, over economic and social policy; and
• placing more aspects of economic and social life at the risk of volatility from financial instability.

As discussed above, economic sanctions in the 1980s acted to consolidate the power of the mining conglomerates. The opening up of the South African economy with the demise of apartheid freed previously ‘trapped’ capital to seek rewards from opportunities opened up by financialisation. Since 1994, major South African corporations have primarily pursued a strategy of corporate globalisation in the form of the increasing internationalisation and financialisation of their operations. This has entailed the export of domestic resources and control, and the relisting of major corporation on the London stock exchange such as Anglo American, De Beers, Old Mutual, South African Breweries, Liberty, Sasol, and Billiton. Such relisting is done so that large amounts of capital in the form of dividends and other payments can be moved out of South Africa legally, unbound by the exchange control restrictions which exist on residents.

This capital flight was in part a consequence of capital’s fear of its loss of political (and, hence, economic) control brought about by the end of apartheid (Mohamed 2009). But it was also because the end of apartheid coincided with important changes in the global economy. South African corporations thus took the opportunity to internationalise their operations and to participate in the mergers and acquisition frenzy of the 1990s which also saw increasing concentration within many domestic sectors despite corporate unbundling (Chabane, Goldstein and Roberts 2006). Corporations have concentrated their operations on core sectors and sold off diversified interests in South Africa but with an increase in levels of corporate concentration within sectors in the South African economy even if overall conglomeration across sectors has declined (Chabane, Goldstein and Roberts 2006). Raising ‘stakeholder value’ has driven the process at the expense of other goals such as employment creation and industrial development. Rather than channel investment into productive activities and the accumulation of capital stock, investment was increasingly channelled into the acquisition of financial assets under the control of, and/or with close links to, the conglomerates with origins in mining.

The financialisation of South African conglomerates and the creation of a new black elite through the positive action of Black Economic Empowerment, with reduced incentives to engage in and promote policies for economic and social investments, have had a major impact on politics and governance and, correspondingly, policy in South Africa since 1994. 1996 saw the adoption of the non-negotiable, neo-liberal Growth, Employment and Redistribution programme (GEAR). GEAR emphasized fiscal austerity, deficit reduction and pegging taxation and expenditure as fixed proportions of GDP. Through GEAR, the government’s stated macroeconomic priorities became the management of inflation, the deregulation of financial markets, tariff reduction and trade liberalization as well as limiting
government expenditure. These policy goals mirror the neoliberal economic policies adopted in much of the global North and the policies of structural adjustment imposed on the South.

By understanding capital flight within the broader context of financialisation and corporate restructuring on a global scale and within South Africa, systemic implications over and above the domestic investment forgone become apparent. Neoliberalism - for which financialisation is a crucial part - has affected the uneven and combined development of capitalism on a world scale. Financialisation and corporate restructuring has consolidated the power of international conglomerates that has led to the reproduction and deepening of North-South inequalities and underdevelopment in the South. Whilst financialisation is associated with slowdown in general over the period since the end of the postwar boom, there have been pockets of development for those who have sheltered themselves from the more dysfunctional forms of finance, used the state to promote (private) real accumulation, controlled wage increases relative to productivity increase, and found both domestic and international markets to serve. China is the most glaring example now, but the East Asian ‘developmental states’ preceded it. With some sectoral exceptions around its core and traditional areas of mining and energy, South Africa provides an example of the precise opposite of this form of capitalist development.

South Africa remains an extreme case of uneven and combined development: an advanced industrial economy and first world lifestyles exist with abject poverty and unequal social relationships and resource distribution of all kinds. The picture of slow growth, declining investment, rising unemployment, rural degradation, and income and wealth inequality that revealed the key features of the economy towards the end of the 1990s remains little changed over a decade later. (Freund and Padayachee 1998) The terms of the post-apartheid settlement, the establishment of liberal democracy and political rights alongside economic inequality and with property ownership intact, have been combined with intensive globalization, financialisation and corporate restructuring of the economy.

ii. Capital Flight and Economic Development

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3 The irony is that while the rationale offered for these policies was to attract foreign direct investment, their actual effect was to increase the outflow of domestic capital – even while the hoped-for long-term inward investment failed to materialise.

4 South Africa is now, ‘officially’, the most unequal society in the world. The poorest 20% of South Africans receive 1.6% of total income while the richest 20% benefit from 70% according to the South African Government’s Development Indicators 2009.
Our empirical discussion of the nature and extent of what we call capital flight from South Africa – as opposed to the more neutral term of outflows - needs to be set in the context of understanding the impact that capital flight has upon the pattern of economic development. Ndikumana and Boyce (2008) estimate that capital flight (defined as the voluntary exit of private residents’ capital for either a ‘safe haven’ or for investment in a foreign currency) for a sample of 40 sub-Saharan African countries amounts to 420 billion in real US dollars over the 30 years from 1970 to 2004. They further estimate that, including interest earnings on past capital flight, the total is $607 billion. Just 25% of the stock of capital flight from the 40 countries surveyed by Ndikumana and Boyce amounts to more than twice the total volume of debt relief these countries received. Widespread capital flight from Africa sits in the context of dramatic increases in the volume of capital flows at the global level, of which sub-Saharan Africa’s share of inflows remains small and of which South Africa takes the lion’s share. Sub-Saharan Africa’s share represents 10% of global net private capital flows to developing countries, with South Africa receiving over 50% of gross market-based capital flows to the region (World Bank 2006).

Africa as a whole has the highest proportion of assets held abroad of any region (Collier et al 2001) and, as a substantial proportion of these assets are held abroad as liquid assets, especially bank deposits, this has been interpreted as a net savings gain for the recipient countries. If only a quarter of the assets estimated to be held abroad were repatriated and used to finance domestic investment in the source countries, sub-Saharan Africa’s ratio of domestic investment to GDP would rise from 18.5 percent to 29.6%, and the liquid nature of many of the assets held abroad means that the transaction costs associated with the repatriation of these assets would be relatively low (Fofack and Ndikumana 2010). Moreover, this would allow the sub-continent to move close to the minimum threshold of investment generally considered necessary to achieve the rates of growth required for the successful achievement of the Millennium Development Goals (UNECA 1999). Much economic literature suggests that deepening financial intermediation to increase savings and raise tax revenue can increase domestic resources and so accelerate growth but this literature neglects the important contribution that repatriating capital flight can make to agendas for resource mobilisation and economic growth.

Capital flight is clearly, therefore, a significant drain on available funds for investment and, in the context of discussion of the active promotion of equitable economic development policies, there is a need for measures not only to reduce capital flight but also for the introduction of capital repatriation schemes to boost domestic investment and growth. Repatriated capital would raise domestic saving, widen the taxable base, raise government revenue which could be used for increased public investment and so contribute to capital formation, the key to long-term growth.

One of the most discussed cases is that of Chile where capital repatriation was brought about using programmes of debt-equity swaps. Nigeria also successfully recovered half a billon dollars of capital from Swiss banks in 2005 (World Bank 2007) – though marginal compared to the US$240 billion stock of capital flight from the country. The UN has been discussing
ways of both preventing illegal capital flight and introducing means to repatriate illegally transferred funds since the passing of UN General Assembly Resolution 55/188 in December 2000. A recent study by Beja (2010) on the relationship between cross-border capital flows, financial depth and governance in ten Asian countries found that well-managed cross-border financial flows are associated with desirable outcomes such as economic expansion along with rising individual incomes and welfare. By contrast, unmanaged flows produced perverse outcomes such as interruptions and/or deterioration in economic performance. The empirical findings in Beja’s paper support the proposition that government should apply capital flow and trade management techniques, together with better governance in administering the domestic economy to reduce unreported flows. Developed or improved capacity enables a country not only to internalise funds more effectively but also convert them more fruitfully into outcomes that lead to progress and development (Beja 2010: 22) South Africa could learn much from a serious study of international experiences of dealing with capital flight and of devising measures to bring about capital repatriation. Measures to curb capital flight and to repatriate wealth taken abroad should be considered an integral part of a developmental agenda.

iii. Calculations for Capital Flight from South Africa

Capital flight has been variously defined in the literature. In its broadest sense it can be defined as all outflows that would yield a higher rate of social return if invested in the domestic economy. A variant of the broad concept is a narrower approach to capital flight as ‘hot money’. These are resident outflows that accrue in the short-term. Narrow definitions of capital flight distinguish it from other capital flows on the basis of: volume (whether or not the capital flow is normal or abnormal given the historical experience of an economy); motive (reflecting individual uncertainty of the investment environment and wider portfolio decisions); legality (with only illegal outflows, usually through trade misinvoicing, defined as capital flight) (Schneider 2004; Epstein 2005). We take a broad definition as we are concerned with the issue of the expatriation of wealth and its implications on domestic investment and economic development. In this way we are concerned with capital flight that, if blocked, would result in an improvement in social outcomes.

Capital flight is typically measured as various unreported components of capital outflows in the Balance of Payments (BOP). Here we employ the World Bank residual method taking account of current account adjustment through trade misinvoicing.
Capital flight is thus measured as the sum of the change in the stock of external debt (DDEBT) and net foreign investment (NFI), minus the current account deficit (CA) and the change in net stock of foreign reserves (DRES) and misinvoicing (MISINVt).

\[
\text{ADJKFt} = \text{DDEBT}t + \text{NFI}t - (\text{CA}t + \text{DRES}t) + \text{MISINVt} \tag{1}
\]

The measure of capital flight shown in equation 1 allows us readily to decompose capital flight in order to study, not only changes in the extent of capital flight but also its character in terms of its different channels that are likely to reflect changes in the policy environment as well as wider developments in the global economy and economic restructuring in South Africa. Figure 1 charts our measure of capital flight as a percentage of GDP for the period 1986-2009. Figure 2 shows adjusted capital flight broken down by its various elements. This is shown in table form in table 1. In addition to the increasing volume of capital flight over the period, the composition of capital flight has also changed.

**Figure 1: Capital flight as a percentage of GDP 1986-2009**

![Graph showing capital flight as a percentage of GDP from 1986 to 2009.]

**Figure 2: Breakdown of capital flight into components of unrecorded capital flows as a percentage of GDP**
Table 1: Breakdown of components of capital flight at percentages of GDP

<table>
<thead>
<tr>
<th></th>
<th>ADJKF</th>
<th>CA</th>
<th>DDEBT</th>
<th>DRES</th>
<th>NFI</th>
<th>MISINV</th>
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<td>5%</td>
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<td>-2%</td>
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<td>0%</td>
<td>-3%</td>
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<td>1990</td>
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<td>1%</td>
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<td>1997</td>
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<td>2002</td>
<td>13%</td>
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<td>0%</td>
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In their 2005 study, Mohamed and Finnoff calculated Adjusted Capital Flight for the period 1980-2000. They found that between 1980 and 1985, capital flight followed the trend in debt conforming to the notion that capital flight was induced by economic uncertainty. Between 1986 and 1993 capital flight was lower than the period of the debt crisis as South Africa was forced to run a trade surplus. This period also saw in increase in the illegal share of capital flight through increased trade misinvoicing. Capital flight as a share of GDP has been increasing since the end of apartheid. Capital flight has shown a positive trend throughout the period shown (1986-2009), peaking at around 20% of GDP in 2007.

Illegal capital flight through systematic trade misinvoicing is likely to be motivated by a desire for tax evasion rather than its being a response to political and economic instability. A closer look at the sectoral patterns of capital flight through systematic trade misinvoicing shows that the vast majority of capital outflows through trade misinvoicing occurs in the ores and metals sectors (see table 2). This pattern of capital flight reflects the continued dominance of the mineral and energy sectors in the economy. Recognising the scale of capital flight which takes place through trade misinvoicing is important. Not only does this flow of capital need to be perceived as damaging to economic development, changes in exchange controls will not curb the capital flight that takes place through trade misinvoicing. Other policy responses are necessary.

<table>
<thead>
<tr>
<th>Year</th>
<th>Capital Flight (as % of GDP)</th>
<th>Capital Flight (as % of GDP)</th>
<th>Capital Flight (as % of GDP)</th>
<th>Capital Flight (as % of GDP)</th>
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<tr>
<td>2003</td>
<td>8%</td>
<td>-1%</td>
<td>3%</td>
<td>0%</td>
<td>0%</td>
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<tr>
<td>2004</td>
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<td>3%</td>
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<tr>
<td>2005</td>
<td>10%</td>
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<td>0%</td>
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<tr>
<td>2006</td>
<td>6%</td>
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<td>4%</td>
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<td>2007</td>
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<tr>
<td>2009</td>
<td>10%</td>
<td>-4%</td>
<td>3%</td>
<td>-1%</td>
<td>1%</td>
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Table 2: Trade misinvoicing by sectors 1995-2006 (USD millions)

<table>
<thead>
<tr>
<th>Year</th>
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Positive value represents an outflow of capital: (Calculations by CSID based on UNCTAD Comtrade database 2009)
Positive value represents an outflow of capital: (Calculations by CSID based on UNCTAD Comtrade database 2009)

Capital Controls, Wealth Repatriation and the Prevailing Policy Framework

The extent to which capital flight is seen as damaging to economic development depends upon the prevailing economic development policy framework. As noted above, there is now a new consensus within government about economic development and the need for a ‘New Growth Path’ to bring about structural change in the economy in order to address high levels of inequality and poverty, persistent unemployment and large unsustainable imbalances in the economy which exist as a result of the legacy of apartheid economic development. The New Growth Path can be seen as one which is employment-led. That is, rather than a residual effect of growth policies, the creation of decent work opportunities through the restructuring of the economy should be placed at the centre of economic and industrial policies.

This shift in thinking has been accompanied by the establishment of new institutions, notably the Economic Development Department and the National Planning Commission, to work collectively with the Treasury and the Department of Trade and Industry in the formulation and implementation of economic and industrial policy. Within this vision of how economic development is to be achieved, there is an important role to be played by capital controls that are designed to minimise the types of capital flight that are detrimental to more equitable social outcomes and that a strong goal of policy should be to restrict the types of capital outflows that hinder development and to redirect these resources in order to maximise social returns.

It is important here that further research and policy formulation designed to implement a New Growth Path identifies the specific types of capital outflows that undermine economic development and which need to be targeted using capital controls and other trade measures. Where capital flight is motivated by tax evasion, the enforcement of restrictions on capital flight either through improved cross border trade controls to reduce misinvoicing or better enforcement of capital controls would improve social outcomes. ‘Odious debt’ is another example of capital flight that is damaging to the domestic economy. This involves external borrowing by governments that is turned into private asset accumulation abroad by domestic residents. It is also important to note that the proper management of cross-border flows will only be translated into positive developmental outcomes in co-ordination with well-designed and well-administered industrial policy.

Such detailed analysis of the nature of capital flight from South Africa will be necessary for the design of future policy measures and should be undertaken by a government commission (or equivalent) set up to investigate all dimensions of wealth expatriation. But the issue of capital flight from South Africa, and its impact on the country’s economic trajectory, must be
situated within broader global developments in order to be fully understood. Financial liberalisation and broader processes of ‘financialisation’ have given rise to an enormous proliferation of financial markets, institutions and actors which has increased the importance of institutional investors, expanded the range of financial activities in the economy including financial services and instruments and a range of institutions and markets. It has produced large rewards to those involved in finance, and widening levels of inequality and household debt, together with the penetration of finance into ever more areas of economic and social life (Ashman, Fine and Newman 2010). Critically, growth in the world economy has been led by speculation and a series of speculative bubbles.

One consequence of these changes has been the extraordinary growth in the value of financial assets which, in the US, grew from four times GDP in 1980 to ten times GDP in 2007 (Crotty 2009). If, as in the Efficient Markets Hypothesis (McKinnon 1973; Shaw 1973), unregulated financial markets operate efficiently, mobilising and allocating funds for investment, the ratio between financial assets and GDP would surely be falling. In addition, non-financial companies have diversified into and gained an increasing share of profits from their financial activities, a development accompanied by the increasing financing of investment from retained earnings or borrowing on open markets. South African conglomerates have participated in this trend since 1994 (Chabane, Goldstein and Roberts 2006), with many choosing offshore listing as a means to internationalise, and financialise, their operations.

Connected to this, and as is well documented, financial liberalisation to reduce financial ‘repression’ became a standard recommendation of international finance institutions and a donor conditionality whilst capital controls became anathema. Finance ministries across the developing world absorbed the idea that liberalisation is necessary to improve the functioning of the financial sector and to attract international capital to the extent that alternative ideas and paths were not even discussed, despite widespread evidence that deregulation has tended to create financial fragility, a greater propensity to crisis, has had negative deflationary and developmental effects and has not attracted higher levels of long term FDI (Ghosh 2005). An increasing connection between financial liberalisation, crisis, and capital flight has also been observed, with the Mexican, Russian and East Asian financial crises of the 1990s as obvious examples before the current global crisis.

One effect of the current crisis has been to bring about an extraordinary about-turn in the thinking of the International Monetary Fund in relation to capital controls. In February 2010, an IMF policy note argued that ‘capital controls are a legitimate part of the toolkit to manage capital inflows in certain circumstances’ (Ostry et al 2010: 15). It recognises that capital controls can be used to prevent inflows of hot money from boosting the value of the home currency and so undermining the competitiveness of exports and that capital controls can reduce vulnerability to sudden changes in financial market ‘sentiment’ which can have ill effects on domestic growth and employment. Dani Rodrik (2010) wrote of this document: ‘In the world of economics and finance, revolutions occur rarely and are often detected only in hindsight. But what happened on February 19 can safely be called the end of an era in global finance.’
At the same time, the IMF also owned that ‘we thought of monetary policy as having one target, inflation, and one instrument, the policy rate’ (Blanchard et al 2010: 3). The IMF even provides evidence that developing economies with capital controls were affected less badly by the sub-prime crisis and its effects than those which did not. But whilst remarkable, the IMF’s ‘mea culpa’ is also severely limited. It provides no explanation for how they got it wrong for so long and its changed thinking has not affected its policy advice and conditionalities in practice. The limited nature of the self-critique can be seen in the brief attention paid to capital outflows where it is argued that liberalising outflows may offset net inflows but, ‘on the other hand, greater assurance that capital can be repatriated may make the country an even more attractive destination for foreign investors’ (Ostry et al 2010: 10).

In the case of South Africa, systematic capital flight needs to be understood through the interaction between the global developments outlined above, the financial liberalisation pursued by the ANC government since 1994, and the inherited structure of the apartheid economy. Paradoxically, economic sanctions against apartheid in the 1980s had the effect of encouraging the development of the private financial sector as exchange restrictions mostly confined financiers to the domestic economy, forcing them to invest in established minerals and energy sectors and to acquire the foreign subsidiaries made available by disinvestment. The quantity and range of the conglomerates’ holdings increased, while the mining industry remained an outlet for ‘trapped’ domestic finance. As a result, the new ANC government in 1994 inherited a highly developed financial system for a middle-income economy.

However, rather than channel investment into productive activities and the accumulation of capital stock, investment has increasingly gone into the acquisition of financial assets. Macroeconomic policy has been oriented towards the management of the smooth export of capital on favourable terms. Liberalised capital account and high interest rate have increased short-term capital inflows through the private financial sector which has systematically misallocated finance towards speculative and short-term projects and away from longer term productive investments. In South Africa, then, financialisation has produced a particular combination of short-term inflows (accompanied by rising consumer debt largely spent on luxury items) and a massive long-term outflow of capital. Capital flight through systematic trade misinvoicing has been concentrated in mining sectors.

Conclusions

We argue in these Draft Comments that SARB’s ‘VDP’ proposal effectively amounts to an amnesty for capital flight. We consider this to be a mistaken policy, the implications of which need to be set in the context of understanding broader processes of financialisation and economic development. We also argue that capital controls can play a part in government economic policy, as is now belatedly recognised by the IMF. If this is not recognised by SARB, the effects of the loss of capital (and foreign exchange) will continue be felt through the ongoing crisis in levels of investment with all the obvious implication this has for record high levels of unemployment, entrenched inequality, and failure to confront the legacy of apartheid. Furthermore, given that the proposed ‘amnesty’ is part of the ongoing process
towards the complete removal of exchange controls, the repatriation of wealth is likely only to increase in the future rather than to fall – in contradiction to theories of capital flow that predict movement from wealthy to poor countries. If we are correct in our calculations, it may be that capital flight has risen to as much as 23% of GDP in 2007, a scale which is clearly going to have a major impact on economic performance. SARB’s proposal for an amnesty for capital flight at 10% as a move towards total freedom of legal capital export can be seen as comparable to a policy to grant an illegal firearm ownership amnesty as a move towards allowing legal ownership without a licence at all! South African conglomerates took the ‘post-apartheid dividend’ abroad illegally and now they look set to be granted a voluntary amnesty for doing so at very little cost, with no incentive to declare, and with the promise of total freedom in the future.

In light of this analysis, we recommend:

1. An extension for comments on proposed changes beyond the 2nd August 2010 and delay of implementation until evidence has been fully and widely considered
2. A thorough and transparent investigation by SARB on the extent of capital flight and assets held abroad from South Africa and the impact of exchange control liberalisation
3. The constitution of a commission to investigate all aspects of wealth expatriation, international experiences and policy options. This will involve both SARB and SARS
4. Discussion by the Parliamentary Finance Committee

We also raise a series of questions to SARB and await a response to these as part of a public debate in which the issues surrounding capital flight are openly discussed with full transparency and accountability. We would like to know:

• Why SARB is offering a capital flight amnesty now?
• Does SARB estimate how much revenue will be generated by its proposal and by what proportion of illegal flows?
• Has SARB estimated the amount of money that has left the country illegally/undeclared? If so what conclusions has it reached and can this important information about South Africa’s economic situation be made public?
• Why if this has been illegal in the past, and there is the promise of its being legal/complete freedom in the future, does SARB consider that there is any incentive to declare?
• What measures are currently in place to investigate illegal capital flight to which the amnesty applies, how many prosecutions or other actions have been undertaken in the past with what effect, and what measures are proposed to discover and deal with those who do not take advantage of the “amnesty”?

Draft – Please do not quote
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### References


Technical Appendix

Capital flight is typically measured as various unreported components of capital outflows in the Balance of Payments (BOP). Here we employ the World Bank residual method taking account of current account adjustment through trade misinvoicing.

Capital flight is thus measured as the sum of the change in the stock of external debt ($DDEBT_t$) and net foreign investment ($NFI_t$), minus the current account deficit ($CA_t$) and the change in net stock of foreign reserves ($DRES_t$)

$$KF_t = DDEBT_t + NFI_t - (CA_t + DRES_t)$$

(i)

The World Bank measure captures all legal financial outflows that are not accounted for in the balance of payments. Given that systematic trade misinvoicing – namely export under invoicing and import over invoicing - is an important channel for illegal capital repatriation, we follow Boyce and Ndikumana (2001) in measuring adjusted capital flight $ADJKF_t$ as the World Bank measure for misinvoicing ($MISINV_t$).

$$ADJKF_t = DDEBT_t + NFI_t - (CA_t + DRES_t) + MISINV_t$$

(ii)

Trade misinvoicing is measured as the sum of under-invoicing of exports ($MISX_t$) and over-invoicing of imports ($MISM_t$).

$$MISINV_t = MISX_t + MISM_t$$

(iii)

Export under-invoicing and import over-invoicing are, respectively, measured as the trade discrepancy for exports ($DX_t$) and imports ($DM_t$) divided by the shares of the major trading partners in South Africa’s total exports ($X_{MT_t}$) and imports ($M_{MT_t}$) as shown in equations 3b and 3c. This adjustment is made because the export ($DX_t$) and import ($DM_t$) discrepancies are obtained as this between South Africa and its major trade partners using data from the IMF’s Direction of Trade Statistics (DOTS) given in equations iiiid and iie.

$$MISX_t = DX_t / X_{MT_t}$$

(iiib)

$$MISX_t = DM_t / M_{MT_t}$$

(iiiic)

$$DX_t = PX_t – CIF_t.X_t$$

(iiid)
\[ DM_t = M_t - CIF_t \cdot PM_t \]  

\( PX_t \) is the value of trading partner’s imports from South Africa as reported by the trade partners and \( PM_t \) is the value of the same trading partner’s exports to the country reported by trade partners; and \( X_t \) and \( M_t \) are South Africa’s recorded exports to and imports from trade partners, respectively, as reported by South Africa. \( CIF_t \) is the adjustment made to account for the cost of freight and insurance computed as the ratio of cif to fob values.