South Africa and global economic meltdown

Can South Africa escape most of the damage wreaked by the global recession? **Seeraj Mohamed** explains why he thinks we are in a very vulnerable economic position.

The current global economic meltdown has already claimed millions of jobs.

Initially many economic commentators argued that the crisis would not be global. They thought that the fast growing giants China and India would not be seriously affected by the crisis. Today we know that the crisis is global in reach and workers all over the world, including in South Africa, are paying a high price for the failures of neo-liberal capitalism.

Neo-liberal ideology pushed for less state involvement in economies. As a result of the increased spread of neo-liberal policies since the 1970s, we saw poverty and inequality increase while wages and conditions for workers declined.

We also saw many financial crises. The current global slowdown seems to be a culmination of the contradictions of neo-liberal capitalism. Liberalised financial systems have used their freedom to pursue their greed to the point where they have broken the global financial system and bankrupted much of the real sector.

HOME LOANS NOT THE CAUSE

Many commentators link the financial crisis to the collapse of the subprime home loan market in the US in the middle of 2007. But the global economic meltdown is not a result of an isolated financial crisis. The subprime crisis was a symptom of the crisis of neo-liberal capitalism. It was the next bubble to burst in the unregulated global financial sector.

The widespread deregulation of finance, which was a central tenet of neo-liberalism, allowed people operating in the financial sector to increase their leverage (their levels of debt to the assets they owned). They used their greater leverage to increase speculative activities and risk taking.

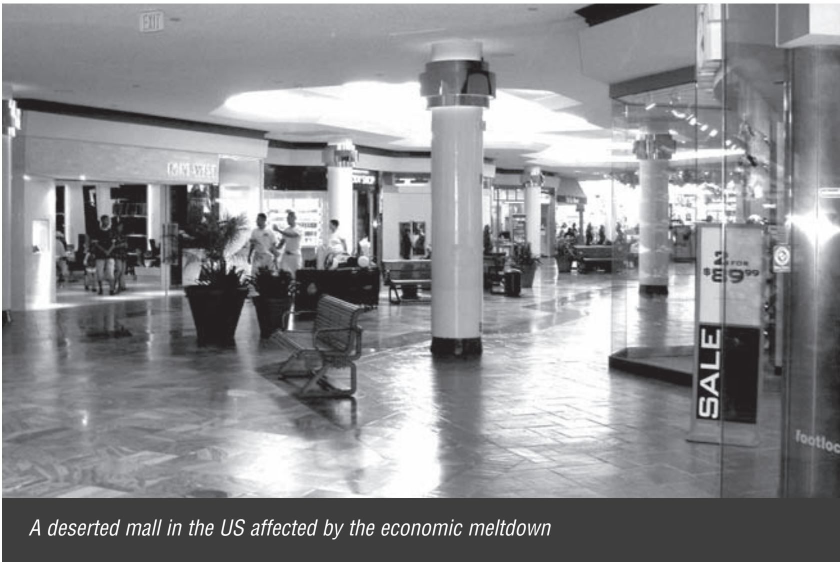
As a result of this liberalisation which began during the 1970s and gained speed during the 1980s and 1990s, the world has suffered many booms and busts and a number of full-blown financial crises. Looking back from the subprime crisis we see the collapse of the Dotcom bubble, the Asian financial crisis, the Mexican peso crisis, the Russian financial collapse, the 1987 Wall Street crash and so on. There were 12 financial crises in developing countries during the 1990s.

CAPITAL FLOWS DESTABILISE

Widespread financial deregulation allowed the uncontrolled movement of capital across international borders and global integration of financial institutions and markets. For example, South Africa liberalised exchange controls and two of South Africa's largest banking groups, Absa and Standard, have foreigners as significant and influential shareholders.

As a result of global financial integration, people in financial markets take bets all over the world and expose their countries' economies to the risk of those bets. Further, financial crises in one country spread through global financial markets. The high level of integration of financial markets means that excessive risk taking in one country creates vulnerability to crisis in many other countries.

The danger of deregulation of cross-border capital flows is not only financial contagion. Liberalising financial flows can create a huge level of macro-economic instability that can easily lead to financial



A deserted mall in the US affected by the economic meltdown

crisis in a country. Citizens and businesses are allowed to take capital out of their country, which can lead to reduced investment, unemployment, lower economic growth and increased speculation and risk-taking in foreign financial markets. Sudden large outflows of capital can lead to panicked capital flight out of the country and result in a collapse in the currency and a financial crisis.

With financial liberalisation, foreigners are allowed to bring in and take out money in an uncontrolled fashion. Most foreign investment is short-term investment into stocks and bonds. The movement of a lot of investment into a country sounds like a good thing but it can be very destabilising to an economy because it can lead to excessive consumption (buying) and speculative bubbles in real estate and stock markets.

The inflow of money creates increased liquidity (assets which can be converted into cash) in a country's financial markets. The banks then start lending more money and often reduce their lending standards. In other words, they take on more risk because they have more money to lend.

South Africa is an example of a country that has received more short-term foreign investment, especially into our stock market since the mid-1990s. This credit was used for increasing consumption and speculation in financial markets and also more recently it is associated with the bubble that developed in house prices.

What is clear is that the short-term foreign capital flows into South Africa are not associated with increases in productive investment. The debt that South Africa incurred was used to increase the consumption of imports, which led to a large increase in South Africa's trade deficit (the amount by which our import expenditure exceeds our export revenue). At a time when the country should be importing machinery and equipment for infrastructure investments and to build our industries we are faced with the problem that we have a trade deficit that is too large. The large trade deficit creates vulnerability to a balance of payments crisis.

NEW FINANCIAL INSTRUMENTS

The increased use of derivatives and the growth of big institutional investors such as hedge funds (means of guarding against financial loss) and private equity (shares) firms that rely on derivatives for their businesses added another level of instability to the global financial architecture. Due to the acceptance of neo-liberal ideas about free markets and limiting state involvement in markets, many countries left derivatives markets and hedge and private equity funds largely unregulated or inadequately regulated.

Derivatives are highly leveraged commercial bets on changes in prices of interest rates, currencies, shares and commodities. They can be used to manage or create risk. Financial speculators have been using derivatives to increase their leverage and risk to earn higher returns.

Many governments and financial authorities were unaware of the level of financial risk in their economies because most derivatives trading occurs outside of formal exchanges. These are referred to as over the counter (OTC) derivatives. At the end of 2007, the amount of outstanding OTC derivative was over $680 trillion. Derivatives allowed corporations to increase their leverage, that is, to increase the amount of their debt relative to their assets. In other words, they allowed bigger bets through the creation of more debt.

Derivatives also allowed businesses to hide risk and misinform shareholders and regulators about their true level of debt and risk-taking. In this way, they allowed financial institutions to ignore regulations and to mislead financial authorities. The hedge and private equity funds have used financial derivatives to become very highly leveraged in order to make bigger bets with fewer assets. Lack of adequate financial regulation allowed financial speculators of one country to speculate in the derivatives of other countries.

The global financial crisis was a result of the huge level of risk taken in all sectors of the US economy but also those of a great many other countries. South Africa is one country where there has been accelerated use of derivatives and rapid growth of hedge and private equity funds over the past few years.

PROBLEMS SPREAD TO REAL ECONOMY

One consequence of financial liberalisation is growth in the power and influence of finance over the rest of the economy. The term 'financialisation' is used to

describe the increasing influence of finance over the rest of the economy during the neo-liberal era.

'Financialisation' does not refer to the rise of finance capital due to increasing industrialisation and the rise of large industrial concerns and monopolies discussed by Lenin in his work *Imperialism*, which drew on the work of the German economist Rudolf Hilferding. Finance capital supports the development of the real sector and industrialisation. 'Financialisation' during the neo-liberal era is different because finance focuses on speculation and not on long-term industrialisation.

The approach of financiers has been to maximise their short-term returns not to build long-term businesses. Through the use of pressure and incentives, such as share options, the financial sector aligned the interests of executives of non-financial corporations with their own interests. As a result, many large non-financial corporations took on a short-term perspective and treated their individual businesses as short-term concerns that are just part of a portfolio of investments to be bought or sold.

At the same time, executives of non-financial corporations focused on short-term profits and often endangered the long-term future of their businesses to keep impatient financiers and shareholders happy. Downsizing their workforce was a common strategy to raise short-term profits even when it weakened firms in the long-term.

Another strategy was to increase a corporation's level of debt unnecessarily to buy back its own shares. These share buybacks were used to push up the short-term share price of a corporation to keep shareholders happy and to increase the value of executive's share options and their bonuses. Many corporations with executives that used this strategy now face severe problems in the current crisis.

In summary, neo-liberal capitalism and the predominance of finance not only led to weaknesses and huge risk in the financial sector but also created unsustainable, weak debt-laden non-financial corporations. The severity of the impact of the financial crisis on the non-financial sectors is due to this weakness that occurred over the past three decades.

IMPACT ON SOUTH AFRICAN ECONOMY

The impact of financial liberalisation of South African corporations is related to the increase in short-term capital flows, debt-driven consumption and speculation in real estate and financial markets.

The investment in the economy over the past few years has been in areas related to speculation and consumption, especially in services such as financial services and wholesale and retail services. Unfortunately, many of these service sector jobs will be lost as a result of the credit squeeze in the domestic and international markets. The bargaining power of unions in these sectors has also significantly declined because of the economic crisis.

The influence of finance over non-financial businesses has promoted a short-term perspective that included reducing labour and outsourcing as many activities as possible. The reduction of labour and outsourcing hurt firms and the economy because it entailed a waste of existing skills and less training of employees. Firms that casualise jobs and outsource do not invest in training. Therefore, in the short-term these businesses may have cut costs and increased profits but in the long-term they make skills shortages worse in the economy.

The impact on labour is severe because workers lose their jobs or becoming casual workers. They have lost their union power. With growth in outsourcing, many workers have lost job security and have to accept lower paying jobs with fewer benefits. The health and safety of their work has also declined.

Today we sit with a depressing situation where there has been a consumption binge by affluent South Africans that leaves the country with more debt and a large trade deficit. There does not seem to be much prospect of the private sector investing in the economy or creating many jobs.

We are left with increased casualisation and outsourcing of jobs. The only significant investment and job creation on the horizon is from the state in infrastructure development and expanded public works programmes. Therefore, given the severity of the current global economic downturn and the level of over-indebtedness in the South African economy there seems little hope of enough employment creation to offset the jobs being lost. The extraordinarily severe unemployment problem in South Africa will get worse.

WAY FORWARD

Government policy choices made the misallocation of capital in the economy worse, promoted financialisation of non-financial corporations, and increased South Africa's vulnerability to the global economic crisis.

Unemployment and poverty will grow as a result of these policy choices. Trade unions have to respond to the depressing situation by challenging neo-liberal economic policies. They should fight for an increased developmental role for the state where the financial sector is tightly regulated and capital is pointed towards long-term, productive, employment creating investments. LB

Seeraj Mohamed is director of the Corporate Strategy and Industrial Development Research Programme (CSID) in the School of Economic and Business Sciences at the University of the Witwatersrand. He is a member of the Congress of South African Trade Unions panel of economists.