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Effects of financial autarky and integration: The case of the South Africa embargo ☆

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The paper interprets the imposition in 1985 and removal in 1993 of the embargo on South Africa as financial autarky and financial integration 'natural experiments', and studies the effects on the economy. The aggregate data indicate a decrease in the levels and growth rates of investment, capital, and output during the embargo period relative to the pre-embargo and post-embargo periods. To further rationalize these findings, we calibrate a neoclassical growth model to the economy. During the transition to steady state, we limit the country's ability to borrow for a period corresponding to the duration of the embargo. The derived dynamics for investment, capital, and output support the findings of a positive (negative) link between financial integration (isolation) and economic growth.

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1. Introduction

Between 1985 and 1993 the world imposed economic sanctions on South Africa to put pressure on its apartheid regime (a political system that granted different rights to citizens based on race). At that time, foreign investors withdrew their capital from the country and stopped making new investments in and loans to South Africa. As a result, net capital inflows declined drastically. In this paper, we exploit the unique reversion toward financial autarky during the embargo period and the reintegration into the world economy in the post-embargo period to study the economic benefits of financial integration for an emerging economy.

☆ The views expressed in the paper are those of the author and do not necessarily reflect those of the Board of Governors or the Federal Reserve System.

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Until recently, it seemed obvious that financial integration yields important economic benefits for emerging economies. The conventional view of financial integration suggests that when countries are integrated, capital flows from capital-abundant to capital-scarce countries to achieve a more efficient allocation of global savings. The inflow of capital speeds up capital formation, and increases economic growth and welfare in the recipient country (see e.g. Obstfeld, 1994; Fischer, 1998; Eichengreen et al., 1998).[1]

The financial crises that devastated the emerging economies of Asia and Latin America in the mid to late 1990s following the liberalization of their capital accounts challenged the conventional view on the economic effect of financial integration, and prompted a renewed research interest in the subject.[2] Since then, several empirical studies have assessed the economic effect of capital account liberalizations with mixed resulting evidence (see Edison et al., 2003 for a survey). Part of the challenge to resolve this issue can be traced to the difficulty in measuring financial integration as noted in Edison et al. (2002).[3]

This study analyzes the effect of financial integration in a novel way that circumvents the challenges of measuring financial integration. The financial isolation is the imposition of the embargo, and the financial integration is the removal of the embargo. A related and often mentioned reservation about some of the previous measures of financial integration is the endogeneity of the integration measure itself. Financial integration, skeptics argue, is a process that does not occur in isolation. It is usually induced by contemporaneous or prospective changes to the economy. In this case, the direction of causality from integration to economic performance is not obvious.

In this study, we posit that the isolation and reintegration due to the imposition and removal of the embargo, can be interpreted as events less subject to the endogeneity encountered in some of the previous studies. The decision by the world to impose an economic embargo on South Africa was not related to the country's economic performance, but to the desire to change its political regime. Similarly, the decision to remove the embargo followed a host of political reforms that dismantled the apartheid regime. The reforms were instituted under a new and more moderate prime minister following the resignation of his predecessor for unexpected health problems.

The study further contributes to the literature by analyzing the benefits of financial integration through the lenses of the adverse effects of financial isolation. A corollary of the view that greater financial integration yields economic benefits is that financial isolation should adversely affect the economy. Since South Africa was integrated prior to the economic embargo and reintegrated into the world financial markets after the embargo period, we can analyze both the negative effects of financial isolation as well as the positive effects of financial integration.

There are, however, potential challenges to using this embargo event study which make it difficult to isolate the effect of the financial isolation. First, the sanctions against South Africa included an embargo on trade, and the effects of the embargo on the economy could have resulted from the trade sanctions, and not necessarily from the financial isolation. Second, domestic policy changes induced by the sanctions, if any, could have been the cause of any distortions to the economy during the embargo period. Third, the embargo took place in an environment of political instability. The risk stemming from the instability could have adversely affected the economy during the embargo period. Last, possible shocks to the global economy during the embargo period could have also affected the South African economy irrespective of the financial isolation. Despite these potential limitations, which we address later in the

[1] Additional references on positive effect of financial integration include Henry (2000a,b), Bekaert et al. (2001), and Summers (2000).

[2] See for example Stiglitz (2000) and Bhagwati (1998) for arguments against the conventional view of a positive effect of financial liberalization.

[3] The literature uses four broad measures. The first measure is IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER). It constructs a binary zero–one indicator for whether the country maintains restrictions on foreign exchanges (see e.g. Rodrick, 1998). The second measure, proposed by Quinn (1997), aims to improve upon the first measure by capturing the intensity of the restrictions. It departs from the binary coding and assigns numerical values based on detailed information in the AREAER. The third set of measures is based on the flow of capital or the stock of foreign liabilities to Gross Domestic Product (GDP) ratios (see e.g. Kraay, 1998). The last measure is based on official dates of stock market liberalizations and considers that the countries are more financially integrated after they open their stock markets to foreign investors (see e.g. Henry, 2003; Bekaert et al., 2001). Edison et al. (2002) provide a detailed survey on various measures.

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