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ECONOMIC POLICY AND SOUTH AFRICA'S GROWTH STRATEGY

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Introduction

Good evening ladies and gentlemen. Thank you for inviting me to address you today to discuss 'new growth paths' in South Africa. Allow me to begin by making two points about 'new growth paths.' The first is simply that our new paths have to be organic shoots growing out of our past. We can never fully escape the myriad of economic events, decisions, and systems that inform our history – they in many cases determine the structure of the economy that we have addressed over the past 12 years and with which we grapple today.

And my second point is that we must use ideas generated here and abroad to develop new paths that reach organically from our past into a future that is determined and shaped by our new democracy. So while the new must come from the old, the direction they take into our common future can and must be consciously influenced by us. I would like to speak with you tonight about some of those paths, where they are going and what I hope they mean for our future.

South Africa's growth path will be the manifestation of a series of underlying dynamics, including a more productive and lower cost set of network inputs to final production, a sustained and rapidly growing array of exports from a more diversified and competitive manufacturing and services industries, and a more proactive, efficient and capable state. Greater levels of employment, both in the short and long term, of a productive workforce needs to be a further critical support to our growth strategy.

Over the medium and long-term, key public infrastructure investments and the renewal of telecommunication and transport networks, and energy production systems will raise investment growth rates, pulling in higher levels of private sector and foreign direct investment, and raising productivity. More rapid economic growth facilitates rising saving and investment as the cost of capital falls. And more rapid growth helps to incentivise firms to finance the skills acquisition and development that is central to sustained increases in labour productivity, rising real wages, and declining poverty.

Macroeconomic stabilisation and the roots of growth

Over the past century, the South African economy has been perhaps the epitome of a mineral-rich economy, exporting its commodities – gold, platinum, diamonds, and coal – to the rest of the world. Agriculture, a variety of manufacturing industries, services, an expansive wholesale and retail distribution networks, and other facets of a more full economic life developed around that basic exporting system.

Apartheid, of course, set strict and ultimately politically untenable limits to the ambit of formal and/or modern economic life. A growing population was excluded from economic life in any meaningful sense, and this was the genesis of many of our skills constraints and labour market problems of today.

These, in turn, represent some of the largest obstacles to a more rapidly growing economy today.

The limits imposed by Apartheid on the accessibility of people to economic activity also resulted in a severely handicapped public sector, incapable of addressing the needs of the majority of South Africans, imbued with a staid bureaucratic culture and outlook, and reliant on outdated tools for implementing public policy. The regulatory and legal structures and industries that give effect to much of our corpus of law were similarly debilitated and simply not ready for the era of democracy and freedom to live an economic life.

By the early 1990s, the attempts of successive apartheid era governments to grow the economy in the face of rising political discontent, an inflexible economy and regulatory system, and the handicaps of minimal foreign trade and capital, had resulted in an inflationary spiral and falling investment.

The key reforms of the first few years of the new government included a series of micro and macro adjustments. The articulation of the Reconstruction and Development Programme helped to set a guide for the compositional shifts in government expenditure that continue through to today to align spending to South Africa's poor majority, even though the spending targets of the RDP were set aside in the initial years. In order to resolve our fiscal and monetary problems of those years, that was the right decision. Along the way, Government's goals and means of achieving them have been sharpened.

From 1996 to 2000, fiscal policy contributed to economic growth by lowering the financial cost of the budget deficit. This is sometimes referred to as a "growth-oriented fiscal contraction," and it seems to me this is an appropriate term. By reducing the level and cost of our public debt, we increased the amount we had available to spend on social policies and permanently lowered the future cost of debt. Since 1998/99, debt service costs as a percentage of GDP declined from 5.6 percent to 3.2 percent in 2006/07, and are expected to decline further to 2.5 percent in 2009. This represents a cumulative saving of about R33 billion which has been available for more productive expenditure.

Alongside the set of fiscal and macroeconomic adjustments made in the early years, the opening up of trade policy played a critical role in providing impetus to investment and growth in productivity. The series of liberalisations of the exchange control environment, beginning with the elimination of the financial rand, have contributed to a robust two-way flow of capital into and out of the economy, demonstrated that South Africa was prepared for longer-term direct investment, and strengthened the flow of knowledge of all sorts into the economy.

A central factor in the strengthening performance of the economy has also been the structural decline in inflation since 1994 and the stabilisation of interest rates. Trade policy and fiscal policy were important underlying contributors to lower inflation over the years. Monetary policy and its conduct was also critical, although as the economy became more exposed to international financial volatility the need to put in place a more appropriate monetary framework also grew.

The inflation targeting framework developed between the National Treasury and the Reserve Bank in 1999 and announced in 2000, provided a more transparent policy with a clearer ordering of policy priorities and greater degrees of freedom to achieve them. A key element of the shift was that the exchange rate would be allowed to float – to adjust to external economic shocks and in doing so to create more stability for domestic interest rates and economic growth.

The economy today and fiscal policy

We live in an economy today that has undergone profound transformation. In real terms, the economy is about 40 per cent larger than it was in 1993. Growth averaged on annual basis 5 per cent during the past three years (2004-2006), up from 3 per cent in the preceding decade (1994-2003) and a mere 1 per cent in the decade 1984-93. The economy is expected to grow by

5,4 per cent by 2009 and average 5,1 per cent in the next three years (2007-2009).

Shortly after the publication of the 2007 Budget, the latest release from Statistics South Africa reported real GDP growth of 5 per cent in calendar year 2006. The final quarter of 2006 was also the 33rd consecutive quarter of growth – the longest economic expansion since 1945. The present economic expansion has its roots in both responsible macroeconomic and fiscal policies and favourable global conditions. Strong employment growth, rising real wages (underpinned by substantial increases in labour productivity) coupled with substantial tax relief and significant increases in social grants in recent years have further increased disposable household income and hence household consumption.

Our investment performance has been especially robust. Real gross fixed capital formation grew by an annual average of 9,4 per cent between 2003 and 2005, rising to about 12 per cent in 2006. Private investment (over 12% in 2006) has been responding to strong domestic demand, reflecting the positive outlook for economic growth and high business confidence.[1]

Construction is currently the strongest-growing sector at an annual average rate of 12,1 per cent over the past three years (2004-2006), compared to only 2,8 per cent in the preceding decade (1994-2003).

The global economy has remained supportive of our growth performance, in response to exceptional growth in China and India, healthy growth in G7 countries and high commodity prices. The commodity price rally has entered its sixth year. Between 1999 and the end of 2006, the gold price rose 121 per cent, the oil price rose 144 per cent, and the prices of both platinum

[1] Investment in manufacturing grew by about 12 per cent between 2004 and the first nine months of 2006, reflecting high rates of capacity utilisation and the need to expand productive capacity.

and coal rose by more than 150 per cent. These price increases have helped to boost the value of South Africa's exports in recent years.[2]

But a greater expansion in the volume and value of exports and export-related employment is needed to lift and sustain the economy's growth rate beyond 6 per cent a year. I will return to this point later.

Our current account deficit has risen to levels close to 6 per cent of GDP last year, and we expect the deficit to continue running at between five and six per cent over the medium term. This is a sign of robust economic growth and other economies are similarly taking advantage of strong exchange rates to increase imported capital goods for domestic investment and capacity expansion.

The 2006 and 2007 budgets – which transitioned from targeting 3% deficits to 1% to a balanced position – were predicated on our understanding of current macroeconomic dynamics and the need to be mindful of the global economy. So, while some observers have argued that our revenue overruns and low budget deficits have created much leeway for government to accelerate spending and slash taxes, we have tended to take a more prudent approach. The fiscal stance reflects the importance of raising government saving as our economy grows rapidly. This indirectly helps to moderate the current account deficit and keep the economy competitive overall.[3] It also ensures that when commodity prices start to fall and the value of our exports weakens, we have the fiscal space available to offset a softer economy with fiscal spending.

The fiscal position also helps to lower interest costs and maintain the investment spending by the private sector and public corporations that is so critical to the long-term strengthening of our potential and realised economic growth rates. Improvements in the fiscal position over the years have been

[2] In the first nine months of 2006, the volume of exports rose 2,2 per cent compared to the same period in 2005 and by an average of 3,9 per cent between 2000 and 2005.

[3] South African FDI amounted to net outflows of 0,1 per cent of GDP during the period from 2004 to the first nine months of 2006 as South African companies raised their acquisition of foreign assets. On the other hand, net foreign portfolio (equity and bond) inflows stood at a healthy 4,1 per cent of GDP in the same period and more than tripled from 2005 to the first nine months of 2006.

self-reinforcing, as stronger growth rates from lower costs of capital in turn push up corporate earnings and government revenue. [4]

Real growth in non-interest government expenditure averaged 9,2 per cent over the past three years. Government will reinforce the fiscal contribution to economic expansion and more balanced growth as real average growth in non-interest expenditure of 7,7 per cent a year is projected over the next three years and growth in capital expenditure increases relative to current expenditure.

Future directions in economic policy and growth

Our efforts to stabilise the macroeconomic environment created a durable platform for the microeconomic reforms also required to further lift South Africa's economic growth rates. A central theme of the growth story is the reinvestment in our network industries to raise their productivity and lower their costs as inputs to final production. Key public infrastructure investments and the renewal of telecommunication and transport networks, and energy production systems will raise investment growth rates, pulling in higher levels of private sector and foreign direct investment, and raising productivity.

Another theme of the growth story is to foster rapid growth in a wide range of exports from a more diversified and competitive manufacturing and services industries. These economic aims need to be achieved by a more proactive, efficient and capable state that cooperates with the private sector to raise production and investment.

A critical input to the growth story must also be much higher levels of employment and a skilled and productive workforce. More rapid economic

[4] For the fiscal year ending in March 2007, our revised estimate for revenue is R29 billion higher than the original budget. Company tax and Value Added Tax receipts have exceeded expectations due to higher profits and strong domestic consumption. The revenue estimate of R545 billion or 28 per cent of GDP. Revenue as a share of GDP is expected to decline to about 27 per cent of GDP by 2009/10.

growth and the need to break through the constraints of capacity will incentivise greater corporate interest in skills development, easing the financing of that process, and leading in the longer run to rising labour productivity, real wages and household living standards. The feedback of that link through to further human capital development is fundamental to our long-run economic future.

As our economic expansion picks up pace, rising income of firms, households and government helps to lower the cost of capital by increasing saving and investment.

South Africa's future growth path is being determined by the series of choices made about the allocation of government spending to create and improve the human and physical capital of the country. It is also being shaped by the ways in which the state regulates and sets the pattern of incentives facing the private sector to invest, produce, employ, and take risks. Both domestic and international policies matter greatly here, including for instance the regulatory structure of the telecommunications sector and its impact on pricing, or the extent to which trade and industrial policy induces firms to sustainably invest and export.

The improved policy frameworks and greater spending on health, education and other social services, alongside the ongoing renewal of economic infrastructure and step up in financing for research and development and higher education, will strengthen economic growth by lowering supply prices and supporting innovation across the economy. Government has placed a special emphasis on improving the regulation of network industries, such as telecommunications and transport, in order to make them efficient providers of key economic services. [5]

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[5] The 2007 Budget allocates R95 million to the *South African Research Network* to look at establishing cost-effective broadband access to global research networks, thus stimulating innovation and the citing of ICT companies in South Africa. Special attention is given to biotechnology and space technologies.

The development of human capital is a central responsibility of the public sector, and a key ingredient to South Africa's current and future prosperity. South Africa spends about 5.6 per cent of its GDP on education overall, considerably higher than in most other middle income economies. Trying to alleviate skills shortages in education and other parts of the social sector has been an important area of focus that is further supported in the 2007 Budget by an allocation of R700 million for the Department of Education to implement a bursary scheme for prospective educators.

Longer-term research and development, knowledge creation and innovation will play an increasingly important role in growth. Considerably stepped up funding for higher education in the last two budgets has been achieved. The 2007 Budget allocates an additional R1,2 billion for an integrated approach to human resource development, knowledge generation, investment in infrastructure and improvements to the strategic management of the public science and technology system. More broadly, government continues to emphasize the importance of skills acquisition and development of the labour force to lower the supply cost of workers, improve productivity and increase employment prospects.

Over the medium-term, key public infrastructure investments and policy reforms will raise investment growth rates, pulling in higher levels of private sector and foreign direct investment, and raising productivity. The efficiency of the state at national, provincial and local levels plays an important role in strengthening those outcomes.

Government has concentrated in recent years on improving the capacity of government at all levels to develop, plan and finance, and roll out infrastructure spending. The partnership called the *infrastructure delivery improvement programme* (IDIP) was established to address underspending of provincial capital infrastructure budgets and target poor planning, lack of delivery, management systems and the general lack of skills. IDIP initially focused on the education sector, and will be expanded to provincial health, public works and transport departments.

The *Siyenza Manje* programme will use R600 million from the DBSA and R741,2 million allocated from government to develop skills in engineering, planning and financial management within municipalities.[6] The new *neighbourhood development partnership grant fund* provides financial assistance to municipalities for partnership-based community and commercial infrastructure in townships and informal settlements.[7]

These sorts of creative policy initiatives will help to improve the use of public resources in the development of public space and public infrastructure at the level of single communities as well as larger municipal and provincial projects.

The scale of government's public infrastructure spending is also an important aspect of the growth story. Because in addition to the many small and local projects being funded, there are also a set of quite large projects that will incentivise even greater investment spending by the private sector. Government plans to boost investment in infrastructure by R416 billion over the medium term, as projected in the latest Budget. This infrastructure programme is a fundamental part of the modernising impetus and will contribute to a steady increase in the gross fixed capital formation ratio.

The infrastructure programme include investment in electricity generation and electrification, roads, commuter rail, housing, bulk infrastructure, research and development, water and sanitation, hospitals and clinics, as well as stadium upgrading and construction and improving public transport networks in preparation for the 2010 FIFA World Cup.

The 2010 World Cup stadiums, for instance, will need extensive redevelopment of urban areas around the stadiums and new transport hubs to service them. The ripple effects of further investments by private sector agents will be felt throughout the relevant municipalities and their communities. The same is true for the development of the Gautrain in Gauteng and the King Shaka airport outside of Durban.

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[6] A total of 144 professionals and 30 interns will be deployed in municipalities as part of this initiative.

[7] To date, technical assistance totalling R50 million has been allocated for redesigning and upgrading of existing and emerging township town centres and main streets.

Another area of extensive investment is the redevelopment and renewal of sectors covered by our public corporations. In the next ten years or so, roughly speaking, South Africa will in effect recreate its rail and road transport network, develop a new telecommunications backbone and link to the rest of the world, and build a new energy production and distribution system.

These developments will drive down the cost of providing the relevant inputs, increase productivity of users of those inputs, and directly strengthen South Africa's potential rate of economic growth. Investment by our public corporations, like our major government infrastructure projects, draws in private sector investment and innovation, and will strengthen overall investment in the economy. The strong private and public investment rates of recent years have begun to reflect those public-private interactions.

Cement, steel, electricity and fuel producers, in particular, are currently operating at or near full capacity. Significant capacity expansion is expected over the next three years in response to rapidly growing demand.

Economic growth over the medium and long-term will also increasingly reflect a better export performance on the back of more competitive manufacturing and services industries, a point made in the past year by government's international panel of economists and specialists.[8]

South Africa initiated an ambitious set of tariff and trade policy reforms in the mid-1990s, including substantial multilateral liberalisation through the World Trade Organisation which moved tariff levels towards the international norm. The number of tariff lines has almost halved from 1990-2004, and about 80 per cent of all tariffs are now duty-free. Other trade policy reforms included the elimination of quotas and most import surcharges; the replacement of most tariffs with ad valorem duties; and new agreements with the EU and SADC.

[8] The international panel is composed of individuals from Harvard University, the University of London, the Massachusetts Institute of Technology, the London School of Economics, and the University of Michigan.

At the same time, however, South Africa's export performance has been erratic over the past ten to fifteen years. Total merchandise exports have fallen from 0,7 to 0,5 per cent as a share of global exports between 1994 and 2004. Although total export volume growth increased to an annual average of 3,9 per cent between 1990 and 2005 from only 1,2 per cent growth in the preceding two decades, this growth was much lower than the average annual growth in world trade of about 6 per cent.

The major step toward a less protective trade regime had large immediate and longer-term benefits. Greater competition via higher levels of import penetration has spurred domestic investment, productivity and higher value added in a range of industries. Partly as a result, export orientation has also increased strongly.[9]

Despite the improvement in manufacturing and services exports, trade policy should be set to enable a sustained improvement and expansion in South Africa's export performance. In particular, the work of the international panel indicates that exports, particularly of manufactured goods, are still constrained by high prices for intermediate inputs and capital goods.

The competitiveness of our exports will be improved in the long term through continued reforms to the regulatory structure of our economy and key policies like trade, improvements to infrastructure and networks, and sustained investment and productivity growth. These sorts of policy reforms are important to influencing private sector behaviour towards greater investment, innovation and employment. And in particular, towards promoting the sustained increases in labour productivity that are needed to allow consistently rising real wages, household incomes and living standards.

Productivity growth is affected by the regulatory framework, the use and management of inputs to production processes, incentives to innovation, new technologies, skills levels and the competitive dynamics of particular markets,

[9] Manufacturing exports increased by an annual average 6,7 per cent between 1990 and 2005, up from 2,9 per cent in the preceding two decades. The export performance of services was even more impressive as export volume growth rose from only 0,4 per cent during 1970-90 to 7,8 per cent during 1990-2005.

including barriers to entry. Over the longer term, a well conceived and implemented industrial policy will stimulate stronger growth and job creation through encouraging businesses to use more labour, inducing continuous growth in productivity and ensuring that new ideas translate into new opportunities.

Industrial policy interventions should provide additional support for new activities and remove regulatory or infrastructure-related obstacles to existing activities. It should also target productivity-enhancing activities instead of individual firms or sectors, and maximise public accountability and transparency, which will help to ensure positive net economic benefits and provide clear mechanisms for discontinuing programmes that do not work.

Industrial policy will be most effective if it is being complemented by a broad range of other policies, including tax and fiscal policy, regulation and price-setting for network industries, competition and trade policy. Government is working on filling in the details of a more proactive approach to industrial policy this year.

Concluding comments

I have presented to you this evening with some of the features of our structural economic legacies. The macroeconomic and microeconomic responses to that legacy have been profound. We have created a more open and accessible economy at the same time as we have modernised our regulatory structures. In our common future lies an economy in which key reforms of the past 12 years reach their fruition and the key reforms of the present and future find traction and deliver a competitive, modern, diversified economy.

A number of the current and future reforms have already taken shape. We know that in our future lies a more comprehensive social security system that provides appropriate levels of income at retirement and short-term adjustment assistance to the economically vulnerable. This complements our approach to skills development, which emphasises the need to take advantage of economic opportunity and to broaden access to the economy.

We also know that our industries and our exports must be competitive and far more diversified. A range of policies, many of which are already underway such as infrastructure development and modernisation of our network industries, have benefited from a more precise articulation of reform and outcomes and will help to increase the potential growth rate of the economy.

The redevelopment of the energy, transport, road, and telecommunications systems will do the same, and also help to boost our investment rates closer to the 25 percent needed for a sustained economic growth rate considerably higher than at present. Trade and industrial policy are also important to our long-term growth prospects, because they help to build a confident, competitive set of industries that can compete on the world stage.

Getting the microeconomics of these policies right is fundamental to much more rapid growth in industrial investment and the resolution of a significant part of our employment problem. Our growth story has to include labour force participation rates much higher than at present, with steady growth in jobs to enable our youth to look forward to an 'economic life,' and with wage rates that reflect a modern and productive economy. A greater proportion of investment spending in the economy and stronger labour force participation will directly help to raise the current economic growth rate in coming years.

Allow me to conclude by noting that our growth story depends on the pragmatic and necessary marriage of a development-oriented and active use of state resources in the service of a long-term public good aligned to the enthusiasm, creativity and investment of our private sector. It is this public-private cooperation that we see reflected in our approach to policy design and reform, that lies behind our current robust economic growth, and which will support and sustain our growth story in coming years.

Thank You.