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GROWTH AND SHARED GAINS

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Thank you for inviting me to address you this morning. The economic mood in South Africa and abroad has become significantly less confident than a year ago, when the last Economist of the Year breakfast took place. At that time economists and policy makers around the world were contemplating the potential effects of the US subprime crisis on the global economy. Although there was a great deal of concern about the outlook and a lot of uncertainty about the scale of bank losses that would be incurred, few could have predicted the rollercoaster ride in financial markets and commodity prices that we experienced in the first half of this year and continue to see. It is safe to say that the extent of financial losses related to the credit crisis have been larger and more broad-based than originally feared, and the macroeconomic impacts have surprised in the form of higher inflation in emerging markets and weaker growth in the G7 and Europe in particular. Commodity prices, having initially increased to record high levels earlier this year, are now deflating in response to expectations of slower economic growth to come.

The credit crisis continues to claim victims in the financial sector, most recently Lehman Brothers and Merrill Lynch. Over the past few months policy makers in the US have committed significant public resources towards containing systemic risk and providing additional liquidity to strained credit markets. It remains to be seen whether actions such as the rescue of Freddie Mac and Fannie Mae will be enough to stabilise the US housing market, but the road ahead continues to look bumpy for now.

South Africa has not been immune to global developments over the past year and there has been a great deal of synchronicity in economic indicators here and abroad, Apart from a deteriorating global backdrop, we have had the added challenge of electricity supply constraints and ongoing infrastructure bottlenecks. In the current environment it understandable that some have become less positive about the future prospects for our economy, but a despondent attitude will serve little purpose if we are serious about achieving our longer term goal of halving unemployment and reducing still high levels of poverty and inequality. As we move through a period of cyclically slower growth driven in large part by external events, it is important to take stock of where we have come from, what we are trying to achieve, and what capacity and productivity enhancements must be delivered to ensure that we can take full advantage of the upswing in the global economic cycle when it eventually occurs.

South Africa has reaped the benefits of successful macro stabilisation in recent years with GDP growth accelerating to an average rate of 5.2 per cent per annum between 2005 and 2007, up from 3.9 per cent in the previous three years. As a policy maker, it would be nice to take all the credit for our recent good fortune, but we must admit that the healthy global environment characterised by the rise of the BRIC economies and strong growth in developed markets, played an important role in supporting our performance via high commodity prices, and strong capital flows to Emerging Markets, which have helped to finance the rapid rise in fixed investment in our country.

Sectors which recorded the highest growth rates, well above 5 per cent in 2007, were construction (18.1 per cent) and finance (8.3 per cent). The transport, communication and trade sectors kept pace with overall GDP growth, but a less positive picture emerged in the primary sector where the mining sector's value added grew on average by only 0.3 per cent between

2005 and 2007 and value added in agriculture contracted by 0.5 per cent. Although this accelerated growth was still not sufficient to address our employment challenges, the myth of “jobless growth” has surely been dispelled, after revised estimates in the new Quarterly Labour Force Survey showed that almost 2 million jobs (1.98 million) were created between the first quarter of 2003 and the first quarter of 2008.

More recently, economic growth has slowed to an average rate of 4.2 per cent in the first half of 2008. Growth was significantly affected by the electricity supply shortage in the first quarter, which slashed output in the mining and manufacturing sectors, but some recovery was seen in the second quarter. Growth in household consumption has also slowed sharply in response to higher debt service costs, reduced household purchasing power in the face of rising inflation and higher food and petrol prices. Wealth effects have also faded as conditions in the property market have deteriorated and the equity market has followed global markets lower. All of these factors have impacted negatively on the retail sector and lowered growth in the previously fast-growing finance and real estate sector. The slowdown in consumer demand, though painful for some, is a necessary adjustment after a prolonged period of rapid growth fuelled by a credit boom that pushed household debt to record high levels. It is encouraging that household debt seems to have peaked at 78.2 per cent of disposable income in the first quarter of this year before declining to 76.7 per cent in the second quarter. Further adjustment will be necessary to reduce imbalances in the economy and to support sustainable growth in future.

The bright spots in our economic performance this year have been agriculture and construction. After a period of depressed growth, the agricultural sector has bounced back strongly in response to high commodity prices and favourable weather conditions (16.7 per cent in 1H08). It is estimated that this year’s maize harvest will be 69 per cent higher than the previous year. We have also been a small net exporter of agricultural products so far this year after requiring net imports in 2007. Strong agricultural production will not only support GDP growth, but also help to reduce pressures on food inflation as time goes by. Double-digit growth in construction (13.7 per cent in 1H08) reflects ongoing strong investment spending by both the public and private sectors. The ratio of investment to GDP rose to 22.4 per cent in the second quarter of 2008, which was the highest level in more than two decades. Infrastructure investment and capacity expansion is a crucial pillar of our growth agenda and will remain a key driver of GDP growth over the medium-term, ultimately contributing to a higher rate of potential economic growth.

Projections for GDP growth in 2008 and 2009 have been revised down for most major economies around the world and also for South Africa. After growing at rates well above potential for the past few years, a period of slower growth is necessary to address imbalances that have developed. These imbalances are clearly shown in the fact that CPIX inflation is now more than double the upper range of the inflation target at 13.0 per cent and the current account deficit has increased further to 8.1 per cent of GDP in the first half of 2008. The electricity supply shortage is also representative of a number of capacity issues that still exist. Ultimately, our aim must be to raise the rate of potential economic growth for South Africa. This can only be achieved if we persist with policies that support macroeconomic stability and push forward with measures that raise domestic savings to support rising investment. Microeconomic reforms are also crucial to ensure that decisions on savings and investment are optimal. For this we need to deliver on skills development and raise the standard of educational outcomes; encourage competition in concentrated markets; improve the performance of network industries and lower costs, promote innovation and productivity improvements; and remove anti-export biases that may exist due to high tariffs and input costs.

Our ultimate aim of halving poverty and unemployment will be hard to achieve in the absence of higher sustainable growth, but our biggest challenge continues to lie in the area of poverty alleviation and distributing the gains from economic growth more equitably. Given the legacy of Apartheid and the structural nature of the challenges we face, it has been necessary for government to take an active role in poverty alleviation over the past decade. A large portion of government expenditure has been aimed at improving access to social services, especially amongst the poorest households, and providing a safety net for vulnerable groups such as children and pensioners. However, we know that participation in economic activity is the most effective means of reducing poverty on a sustained basis and that this requires a higher level of economic growth and job creation. Income support on its own is not a sustainable means to increased prosperity, and it is crucial that our policies create an enabling environment for growth so that we can create opportunities for people to be able to provide for themselves.

Fiscal policy remains oriented towards redistributing the gains from growth towards poor and vulnerable groups in society via spending on social income grants, the provision of free basic services, and increased spending on health and education. Although the budget recorded a surplus of about 1.0 per cent of GDP in the 2007/08 fiscal year, this was mainly due to stronger than expected tax receipts. Indeed, government spending has continued to expand at a healthy rate. Over the past five years, real non-interest spending has averaged about 9 per cent per annum and is projected to rise at an annual rate of 6.1 percent (Budget 2008) over the next three years.

While falling debt service costs have created the scope for increased non-interest spending, we are mindful of the fact that surplus funds should be channelled towards projects that increase the productive capacity of the economy, particularly in the form of investment spending and human capital development. The decision to run a fiscal surplus also reflects a desire to increase government savings as a means to reduce the country’s external vulnerability in the face of a widening current account deficit.

Although there is much to celebrate with regards to the recent performance of the economy, we are also conscious of the fact that policy has a role in ensuring that the benefits of growth are shared throughout the population. There is still much work to be done, but we believe that progress is being made in raising living standards and reducing poverty for the majority of the population.

One of the key positive outcomes of the robust economic expansion has been the creation of 1.9 million jobs in South Africa since March 2003. The official rate of unemployment has declined from a high of 29.3 per cent in 2003 to 23.6 per cent in March 2007, and was 23.1 per cent in the second quarter of 2008. However, gender inequality still remains entrenched, with the unemployment rate for women (26.8 per cent q2 2008) still significantly higher than that of their male counterparts (19.9 per cent q2 2008).

The formal sector has been responsible for the most new job opportunities with the share of formal sector employment rising to 71 per cent last year, up from 61.9 per cent in 2001.[1] While employment growth in general has been strong, some sectors reported job losses in the last year including agriculture, manufacturing, electricity, and trade sectors. The construction sector has seen particularly strong job growth, bringing its share of total employment to 7.6 per cent last year, up from 5.1 per cent in 2001.

It is clear that employment growth has had a significant impact on household incomes, which has supported the consumer boom we have experienced over the past few years. Rising employment has also benefited the fiscus through higher tax collection. Indeed, the number of registered individual tax payers almost doubled to 5.3 million between 2000 and 2007. Strong revenue growth has provided us with the opportunity to use fiscal policy as a powerful redistributive tool to ensure that the benefits of growth reach the most vulnerable groups in society. This redistribution has taken place directly, via social income grants, and indirectly through the provision of free basic services such as electricity, water and sanitation[2], and the provision of low-cost housing. These initiatives have put income back into the pockets of the poor and contributed to reducing poverty.

So far, research confirms that South Africa's social assistance programmes are well targeted and account for a substantial portion of the income of poor

[1] Historical revision to March LFS series

[2] Free basic services include in the electrification of all households and the provision of free basic electricity to poor households (50kWh per household per month) to all households as well as the provision of free basic water (up to 6 kiloliters of water to all households) and sanitation).

households. Child support grants are also associated with improved nutrition and health of children. The number of social grant beneficiaries rose to over 12.6 million people as at August 2008, up from 2.4 million in 1997. The number of children receiving child support grants tripled between 2003 and 2007 and stood at 8.3 million children at the end of last month. Looking at the poorest 20 percent of households, about 40 percent of them relied on pensions and grants as their main source of income in 2005, up from 16.1 percent in 2002. This illustrates the importance of fiscal policy in creating a social safety net for the poor and helping to redistribute the gains from economic growth.

While increased access to grants has played an important role in reducing poverty, it is not sustainable to continue expanding access to income-support at the current rate. For this reason, spending on social assistance is expected to stabilise at about 3.3 percent of GDP over the medium-term, with no immediate plans to expand the scope of the social grant system except for the equalisation of the old age pension to the age of 60 for men and women by 2010. Our medium-term focus will rather be on implementing a comprehensive social security system by 2010, which encourages retirement saving by all workers, including low-wage and part-time employees.

Academic research has shown that non-income forms of support from government have also been very important in improving the lives of poor households. Research shows that government policies around service delivery and housing have been pro-poor over the past decade, although significant backlogs in delivery still remain[3]. The following statistics are worth noting: between 1993 and 2004, the share of the poorest 10 per cent of the households in South Africa with access to piped water increased by 187 per cent; access to sanitation (flush/chemical toilets) increased by 300 per cent; and the provision of electricity for lighting increased by almost 600 per cent. Similarly, there was a 28 per cent increase in the share of low-income households living in a formal dwelling. 70.5 per cent of households were

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[3] Bhorat, H. Naidoo, P. van der Westhuizen, C. 2006. "Shifts in non-income welfare in South Africa: 1993-2004". Development Policy Research Unit, Working Paper 06/108. UCT.

housed in formal dwellings by 2007, up from 64 per cent in 1996. The share of households with access to electricity also increased dramatically from 54.1 per cent in 1995/96 to 72 per cent in 2006/07.

The provision of housing has been a very important part of government policy since 1994 and 2.3 million subsidised houses and serviced stands have been delivered over the past decade. Government is continuing with its drive to provide adequate housing and R35.8 billion has been allocated to the Integrated Housing and Human Settlement Grant over the medium-term expenditure framework. To introduce greater equity in the allocation of national savings, the Financial Services Charter has committed the private sector to make investments of R123 billion in the 12 years leading up to 2014, with R42 billion allocated to housing. The Charter targets the 2.4 million households earning between R1 600 and R8 200 per month.

In the housing market as a whole, research conducted by the Finmark Trust found that 80 per cent of the adult population claimed to own a home in 2007 up from 75 per cent in 2005. This correlates with the South African Advertising Research Foundation (SAARF) Development Index, which shows that homeownership increased to 78 per cent of the population in 2006, up from 73 per cent in 2000 and only 64 per cent in 1994. Homeownership is much higher in rural than in urban areas, but the strongest growth has been in the cities. Indeed, the number of people owning homes in urban areas increased by 33.5 per cent between 2000 and 2006, compared with a 19 per cent increase in the rural population.

The Financial Sector Charter has also been important in ensuring that access to the formal banking system is extended to low-income groups and the previously disadvantaged. According to the Finmark Trust, the percentage of the adult population with access to the formal banking system increased to about 60.3 per cent in 2007 from 46.6 per cent in 2005. Between 2005 and 2007, the number of adults with bank accounts increased by 33 per cent, significantly outpacing the rate of population growth. Bank usage by low income groups increased from 32 per cent in 2005 to 40 per cent in 2007 largely driven by growth in Mzansi accounts, which are now used by 10 per cent of the adult population compared with only 2% in 2005. More than sixty percent of people holding a Mzansi account claim it is their first bank account, which suggests that the initiative has been successful in attracting the previously disadvantaged into the formal banking sector net. This is consistent with results from the Finmark survey, which show that the proportion of the adult population who are financially excluded, with no formal bank account, declined to 30.1 per cent in 2007 from 41.1 per cent in 2006.

Land reform is also an important part of government efforts to reduce inequality in our society. Government targets for land reform include: the redistribution of 30 per cent of white-owned agricultural land by 2014; the provision of security of land tenure for those whose land tenure is insecure; and to complete land restitution by end of 2008. The number of land claims settled by the Commission of Land Restitution by the end of the last financial year increased from 74 417 to 74 747, with 4 949 claims remaining, of which the greater part are rural-based. The majority of urban claimants have opted for financial compensation, amounting to R4.9 billion, while most rural claimants have opted for land restoration.

There is a growing body of evidence, which shows that the incidence of poverty in the economy has declined and that the share of the population classified as “middle-class” has grown substantially, particularly amongst the Black population. The Bureau for Market Research estimates that between 1998 and 2006 the proportion of the population classified as low-income almost halved from 29 per cent to 15 per cent, while the middle-income group grew to 44 per cent from 35 per cent. About 7 per cent of the population was classified as high income in 2006, up from 3 per cent in 1998. These trends are corroborated by the SAARF Living Standards Measure, which has also shown a declining share of the population in the LSM1-3 categories and increased movement towards the middle- and upper income segments.

A recent study by the Unilever Institute at the University of Cape Town has also highlighted the importance of the rising Black middle class, or so-called

“Black Diamonds” in driving consumption patterns in the economy. According to the study, about 2.6 million people, or about 13 per cent of South Africa’s black adult population are considered middle class and the group is expanded by about 30 per cent last year. Black Diamonds currently account for about 28 per cent of total consumer spending power or R180 billion a year, but this share is expected to continue rising into the future.

Conclusion

Our economic performance in recent years has been partly attributable to favourable global economic conditions, but the hard decisions we have made on macroeconomic policy issues have also borne fruit by creating a stable and predictable environment for business, which has stimulated investment and GDP growth. Although not nearly on a large enough scale, higher GDP growth has supported increased job creation and this has been a key element in ensuring that the benefits of growth are distributed more equitably amongst all South Africans. Fiscal policy has also played an important role in channelling resources towards poverty alleviation and this has been necessary given the structural nature of poverty and inequality in the country. However, over the medium- to long-term, a *sustainable* rise in per capita incomes and living standards requires much higher levels of employment across age, race, and educational groups. Rural development programmes are also needed to reduce geographical inequities and to ensure that land reform contributes to the development of skilled and productive farmers who are in a position to benefit from periods of high agricultural prices by raising agricultural output.

We are pleased about the achievements that this country has made in terms of economic growth and we are confident that growth will accelerate again when domestic imbalances have eased and the global economic backdrop improves. The next leg of our development will require a bolder and more determined focus on issues related to competitiveness, productivity growth and the microeconomic reforms that are necessary to raise the growth potential of the economy. Over the medium and long-term, investment growth will be supported by key public infrastructure investments, including the expansion of electricity supply and the renewal of telecommunication and transport networks. Public sector investment should also stimulate higher levels of private sector and foreign direct investment, and contribute to rising productivity. Indeed, more rapid economic growth is a powerful incentive to firms to finance the skills acquisition and development that is central to sustained increases in labour productivity, rising real wages, and declining poverty.

Thank you.