OECD Economic Surveys: South Africa, July 2010

OVERVIEW

OECD

Summary

A strong macroeconomic policy framework has helped to improve growth performance over the past two decades, but the 2008-09 downturn highlighted the limitations of the domestic-demand-led growth path which has characterised South Africa in recent years. Unemployment, which had remained very high, if declining, throughout the boom years, turned up again in the recession. There is now a need both to ensure a rapid recovery from the downturn and to boost trend growth and thereby create the millions of jobs required to make full use of South Africa's large supply of underutilised human resources.

The global downturn struck South Africa when it had already passed the boom, and the economy slowed sharply, experiencing its first recession in 17 years. The decline in output was moderated by a countercyclical policy response, made possible by past fiscal prudence, and by the resilience of the banking system, which did not experience a crisis. Growth has resumed and is projected to accelerate, but macroeconomic policy stimulus should be removed only gradually, as a self-sustaining recovery, led by the private sector, takes hold.

Evidence suggests several ways to improve South Africa's trend growth performance. Notably, all economies experiencing successful rapid economic development in recent decades have had much higher savings and investment rates and stronger export growth than South Africa, and policy action to increase saving and strengthen export performance are therefore warranted. South Africa should do more to resist waves of real appreciation of the rand associated with surges in private capital inflows, which are largely driven by investor sentiment towards emerging markets in general, and commodity plays in particular. Tighter and more countercyclical fiscal policy, verbal and foreign exchange intervention, and liberalisation of capital outflows all have a role to play. Another key to better trend growth is reform of the regulatory environment. South Africa has low levels of competition and relatively restrictive product market regulation, which hampers more broad based innovation. OECD research suggests that lowering barriers to entrepreneurship could substantially boost South Africa's long-term growth rate.

The macroeconomic framework is strong, but can be improved. South Africa has a good track record of fiscal prudence, but, as in other countries, fiscal discipline was eroded in the cyclical upswing. South Africa would therefore benefit from stronger fiscal institutions to prevent unwarranted fiscal expansion when the economy is strong. The monetary policy framework is sound, but could be refined to bolster the credibility of the inflation targets and to exploit scope for limiting exchange rate fluctuations, to the extent this is compatible with achieving the primary goal of keeping inflation within the target range.

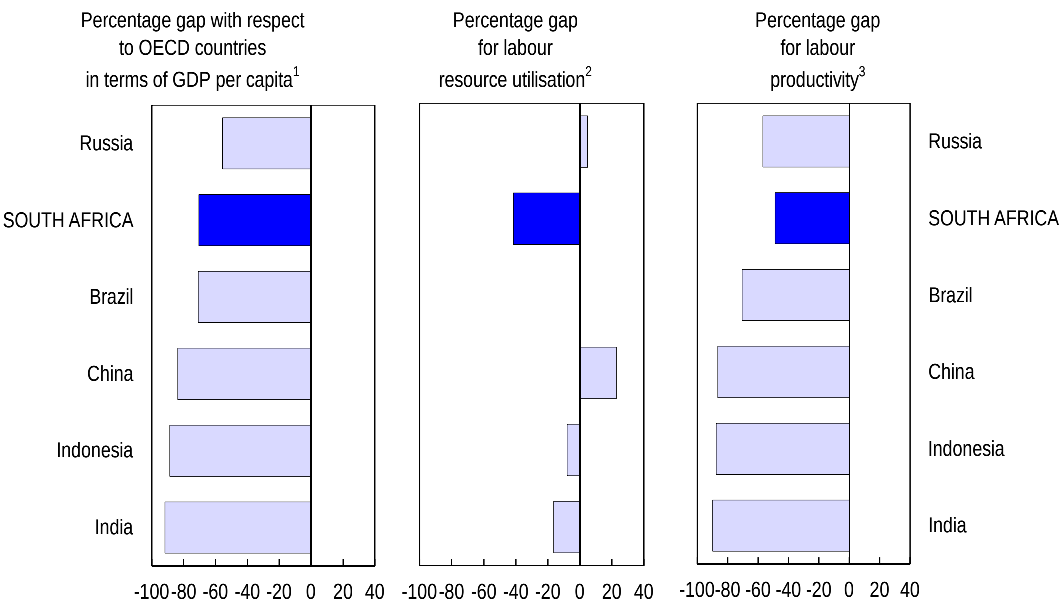
Labour market reforms should complement improved macroeconomic policies to deliver higher employment. A greater level of co-ordination of wage bargaining focusing on wage and price moderation as the ultimate goal, with the government providing a voice for labour market outsiders, could deliver greater wage moderation and increase the credibility of the inflation target. Limiting the legal extension of sectoral bargains would also foster wage moderation and lead to stronger job creation, particularly among smaller and medium sized firms. Other important measures to raise employment over the long term include improved basic education, reduced spatial mismatches between jobseekers and jobs, and better access to credit for small enterprises. Within an overall employment strategy, measures should be targeted at tackling youth unemployment. These could include job search assistance, training-based wage subsidies, age-differentiated minimum wages and extended probationary periods for young workers.

Assessment and recommendations

South Africa needs to boost growth through making better use of its resource endowments

Thanks in part to a better policy framework, growth performance in South Africa has improved over the past two decades. However, this was not sufficient either to offer enough employment opportunities for the young and growing population or to close the aggregate income gap with OECD countries. Despite a strong macroeconomic policy framework, job creation and productivity growth remain too low to underpin sustained rapid GDP *per capita* growth. Better performance on these fronts is needed to broaden access to economic activity and make sustainable the remarkable alleviation in poverty brought about by expanded social transfer programmes by gradually augmenting it by income from economic activity. The overarching challenge for South Africa is to boost its trend growth rate and thereby create jobs. Most successful historical examples of rapid development have been characterised by high savings and investment rates and strong foreign trade growth often kick-started by a period of undervaluation of the currency or at least a reduction in the degree of overvaluation. Despite a favourable endowment of both labour and natural resources, South Africa has in recent years experienced a rather different pattern of economic development, one characterised by strong domestic demand growth, low savings and investment rates, and weak export performance and an overvalued currency. This constellation was

Real income gaps and their composition



1. For 2007, relative to the simple average of OECD countries in terms of GDP per capita, based on revised 2007 purchasing power parities (PPPs) from the World Bank. The sum of the percentage gap in labour resource utilisation and labour productivity do not add up exactly to the GDP per capita gap since the decomposition is multiplicative. See Blöndal and Dougherty (2009) for details.
2. Labour resource utilisation is measured as total employment as a share of total population, based on national labour force and household surveys.
3. Labour productivity is measured as GDP per person employed, including estimated informal employment.

Source: OECD, Going for Growth 2010, figure 7.2 and OECD estimates.

accompanied by high capital inflows from portfolio investors, while net foreign direct investment inflows were relatively modest. The financial crisis has highlighted the need for increasing potential growth through a combination of more counter-cyclical macroeconomic policy frameworks and structural reforms leading to higher employment, more competition on product markets and greater innovation.

Growth objectives should not be limited to a higher increase of GDP *per capita*. Several aspects of welfare are not captured by GDP, and not all are necessarily even correlated with it. In addition, even to the extent that GDP is an adequate proxy for wellbeing in a given period, focussing only on output would ultimately be self-defeating if sustainability were compromised. In particular, environmental conditions affect both current well-being and whether prevailing levels of well-being can be sustained. South Africa tends to score relatively poorly on broad indices of environmental conditions, especially in the area of greenhouse gas (GHG) emissions. Better incentives would make the economy more environmentally sustainable, including by reducing GHG emissions, and could also provide a boost for the development of industries which provide solutions in this respect.

The multi-faceted issues facing the South African economy pose policy challenges for the government on many fronts that need to be addressed simultaneously. The focus of this first *OECD Economic Survey of South Africa* is on increasing the trend growth rate and thereby achieving higher employment, albeit through a broad range of policies. Measures which could help to achieve this goal include support through structural reforms of a shift of resources from either inactivity or serving domestic demand to the export sector, and refinements to South Africa's already strong macroeconomic framework to make policies more growth-friendly overall. To this end the following policy priorities should be considered:

- Increasing the employment rate by reforms to wage determination mechanisms, improved school-to-job transition, reducing general skill/location mismatches in the labour market, developing entrepreneurialism and addressing bottlenecks in the implementation of employment protection regulation.
- Reforming the regulatory environment by reducing entry barriers, increasing the scope for competition in network industries and reducing direct government influence on the economy, which should also widen the scope for productivity-increasing innovation
- Refining the macroeconomic policy framework to build on the successes already achieved in delivering a greater degree of monetary stability coupled with fiscal sustainability while also reducing the real exchange rate relative to a no-policy-action scenario in order to facilitate an export-led growth acceleration.

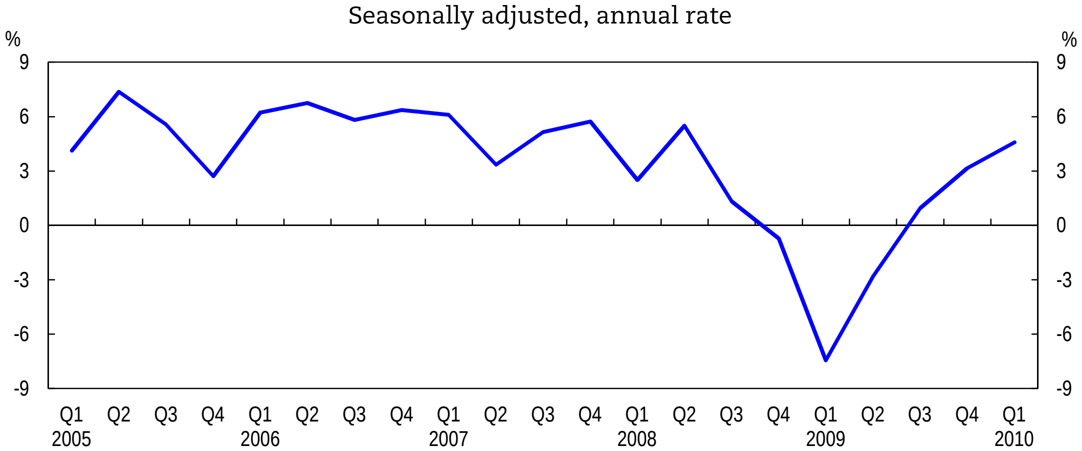
One issue to bear in mind with respect to all policy actions is administrative capacity, which, as recognised in the AsgiSA economic strategy of 2006, is limited. There are other policy areas critical to long-term economic performance which are not addressed in detail in this *Survey* but which will be taken up in greater depth in future Surveys. Notable among these is education, where outcomes continue to be poor on average and extremely variable.

The global crisis accentuated a slowdown already underway…

South Africa was already moving into a cyclical downturn when the international crisis struck, with high interest rates having choked off a prolonged house price boom and halted growth in private consumption. What might have been a moderate growth slowdown in South Africa, as households worked down excessive debt loads *via* higher savings rates, became a recession as global financial conditions deteriorated and world trade collapsed. South Africa's decline was led by manufacturing and mining where the sudden drop in export demand was reflected in a sharp reduction in private investment and subsequently in falling employment. Consequently, South Africa experienced a sharp deceleration of growth from more than 5% in 2007 to a fall of almost 2% in 2009.

GDP growth

Seasonally adjusted, annual rate



Source: Statistics South Africa.

... but the economy was only about averagely affected, in part because there was no banking crisis

Nevertheless, South Africa's downturn was fairly shallow: the peak-to-trough fall in output was smaller than in most OECD countries and emerging market economies. On a sectoral basis, the most important offset to the negative dynamics that took hold in manufacturing and mining was construction, which held up well through the recession. This was primarily a function of public investment, in part linked to the preparations for the 2010 World Cup and associated transport projects. Also, notably, South Africa experienced no bank failures, and a surge in non-performing loan (NPL) rates in 2009 was easily absorbed. There were several reasons for this, including: the banks' strong profitability; the low level of NPLs and comfortable capital cushions going into the downturn; banks' lack of direct exposure to problem assets from the US and Europe; bankruptcy laws that favour creditors in recovering collateral for bad loans; and conservative approaches on the part of both the regulator and the banks themselves.

The crisis response allowed automatic stabilisers to work but was relatively cautious with discretionary stimulus

Macroeconomic policies during the crisis were countercyclical, although to a lesser extent than in many other countries. The consolidated government budget balance worsened by about 6 percentage points of GDP in the 2009/10 fiscal year, due in roughly equal measure to lower revenues and higher expenditure. The latter was less a function of discretionary anti-crisis measures than the maintenance of pre-existing spending plans in the face of the economic slowdown as well as an unexpectedly large public sector wage increase. Ambitious capital expenditure plans in energy and transport by public enterprises that were similarly approved before the crisis and not revised downwards also supported output during the decline. Monetary policy was eased, but not particularly aggressively. In contrast to many OECD countries, where interest rates fell nearly to zero, the South African Reserve Bank's (SARB) repo rate bottomed out at 6.5%, reflecting initial inflation that was well above the SARB's target range and backward-looking inflation expectations. No emergency actions, such as capital support for banks or quantitative easing to support lower interest rates, were needed.

Growth has resumed, and is likely to strengthen this year and next

After three negative quarters, growth turned marginally positive in the third quarter of 2009 and quickened in the fourth quarter, as private consumption resumed growing after five quarters of contraction and the rate of inventory drawdown slowed. Momentum appears to have continued to build in 2010, with house prices picking up and leading indicators signalling growing strength. In addition, external conditions have become more favourable, with a strong recovery of global trade volumes and surging prices for South Africa's main export commodities. The economy will also be boosted by the staging of the World Cup. Output growth is therefore expected to accelerate in 2010 and exceed potential in 2011.

Macroeconomic outcomes and projections 2007-11

	2007	2008	2009	2010	2011
	Percentage changes, volume				
Private consumption	5.5	2.4	-3.1	2.3	5.5
Government consumption	4.7	4.9	4.7	3.6	3.4
Gross fixed investment	14.2	11.7	2.3	3.0	8.9
Final domestic demand	6.9	4.6	-0.6	2.7	5.8
Stockbuilding[1]	-0.4	-1.3	-1.3	1.3	0.1
Total domestic demand	6.4	3.3	-1.8	4.0	5.9
Exports of goods and services	5.9	2.4	-19.5	8.9	6.1
Imports of goods and services	9.0	1.4	-17.4	10.9	9.2
Net exports[1]	-1.2	0.2	0.1	-0.9	-1.1
GDP at market prices	5.5	3.7	-1.8	3.3	5.0
Memorandum items					
Inflation	7.1	11.0	7.1	5.3	5.2
Employment growth	0.4	1.8	-3.6	1.2	2.3
Unemployment rate	22.3	22.9	24.0	24.5	24.0
Current account balance (USD billion)	-20.5	-20.1	-11.2	-17.6	-22.0
Current account balance[2]	-7.2	-7.1	-4.0	-4.9	-5.5
Consolidated government budget[3]	1.7	-1.0	-6.7	-6.1	-4.7
Household disposable income growth	5.5	2.4	-2.8	3.0	4.5
Household net saving ratio	-0.8	-0.8	-0.4	0.0	-0.3

1. Contributions to changes in real GDP
2. As a percentage of GDP.
3. As a percentage of GDP. Data refer to fiscal years starting in April.

Source: *OECD Economic Outlook 87 Database*, Statistics South Africa, *SARB Database* and OECD estimates.

The recovery should be fostered in the near term, although macroeconomic policy will need to tighten as the recovery firms

The output gap is unlikely to be eliminated before 2012, and the key short-term task is to consolidate the emergence from recession and facilitate a rapid catch-up to potential output. The decline in employment since the onset of the recession was much sharper than that of output, amounting to some 7½ per cent between the last quarter of 2008 and the first quarter of 2010. A sluggish recovery would be likely to mean a continued upward creep of structural unemployment, eroding the human capital of displaced workers whose connection to the labour market is weakened. Slow growth would also delay the pickup in investment *via* accelerator effects, increasing the negative impact on potential output and hindering progress on the reduction of poverty and unemployment. The decline in inflation in recent months, combined with the strength of the rand, the negative output gap and the hesitant recovery to date, suggests that the latest downward move in the SARB's policy rate (in March 2010) was well judged. Indeed, scope may yet remain for some further reduction of interest rates, which would be supportive of output growth. As to fiscal policy, public debt levels remain moderate at 32.8% of GDP and the current (2009/10) deficit of 6.7%, although large historically, is not extreme by international standards, so that the modest withdrawal of fiscal stimulus foreseen in the 2010/11 budget achieves about the right balance between supporting demand and preserving fiscal sustainability as long as the economic recovery is in line with government projections. *As the recovery proceeds, or if it is faster than expected this year, there should be further fiscal consolidation, both to safeguard the public balance sheet and to avoid aggravating macroeconomic imbalances. Monetary policy makers will also have to remain vigilant, given that inflation expectations have proved to be backward-looking and downwardly sticky, which has been recently reflected in surprisingly strong wage settlements considering the extent of labour market slack.*

Looking beyond the crisis, South Africa needs to improve its trend growth performance and pay more attention to the environment

Beyond bringing the economy back to potential, many challenges remain. These are broadly interlinked by the need to make better use of South Africa's abundant resources, both physical and human, to accelerate the increase in living standards. Growth performance has been mediocre, with *per capita* GDP increasing by some 1.6% a year from 1994-2009, and by 2.2% over the decade 2000-09, far behind the most dynamic emerging economies. Moreover, although trend growth does appear to have improved somewhat over the past 16 years, South Africa is unusual among emerging economies in having failed to achieve any convergence towards the OECD average of GDP *per capita* over that period. Faster growth is needed to achieve the government's social and economic targets and to meet the aspirations of the people.

South Africa tends to score relatively poorly on broad indices of environmental conditions, especially in the area of greenhouse gas emissions. This is due to its industrial structure and its heavy reliance on coal for electricity generation. The need for progress on tackling climate change has been recognised by the government, but little concrete action has yet been taken to put a price on carbon or stimulate renewables. Moreover, the existence of favourable energy prices for some large industrial users, electricity prices that did not cover capital costs for the development of new capacity, and low coal purchase prices for the dominant electricity generator have all tended both to hinder economic efficiency and aggravate carbon emissions. The urgency of the global problem, South Africa's status as a relatively large emitter, and the slow progress to date all suggest that efforts to mitigate emissions should be accelerated. *One important element would be to move to electricity prices that fully cover long-run costs, with no subsidies for industrial customers. Other measures could include a carbon tax, greater use of other green taxes, and faster development of renewable energy projects and carbon capture and storage.*

… and raising savings rates is likely to help…

Although the relationship between domestic savings and economic growth is theoretically ambiguous, empirically they are strongly correlated. While this correlation does not demonstrate causality, the Commission on Growth and Development (the Spence Commission) noted that there was no case of a sustained high investment path not backed up by high domestic savings, and other recent empirical work finds that growth accelerations are typically preceded by increases in savings rates and an improvement in the current account. The picture for South Africa over the past decade is strikingly different: net private capital inflows were large, the current account deteriorated sharply, and savings and investment rates were low. It therefore appears that efforts to raise the savings rate are warranted. *To that end, public saving over the cycle should be increased. There is little evidence on policy measures that reliably boost private saving, but one which would normally be expected to have such an effect is the implementation of a compulsory pension savings scheme, such as is currently under consideration in South Africa. Even automatic enrolment in a pension plan, with the possibility of opting out, would be likely to have a positive effect on household saving.*

… as are policies to remove obstacles to a better export performance

Export performance in non-industrial countries appears to be strongly related to economic growth. In particular, for such countries, overvaluation of the domestic currency is associated with slower growth, and growth accelerations are generally preceded by reductions in overvaluation or a period of undervaluation. By contrast, the prolonged surge in private capital inflows to South Africa beginning in the early 2000s was associated with a significant increase in the real exchange rate, a very large current account deficit and relatively weak export volume growth. The effect on South Africa was accentuated by the exchange rate policies of some other emerging markets, which meant that they experienced less appreciation and improved their competitive position. All measures to manage real appreciation pressures have risks and costs of their own and are of uncertain effectiveness, but South Africa's circumstances suggest that there could be net benefits from a range of actions designed to ease upward pressure on the real exchange rate:

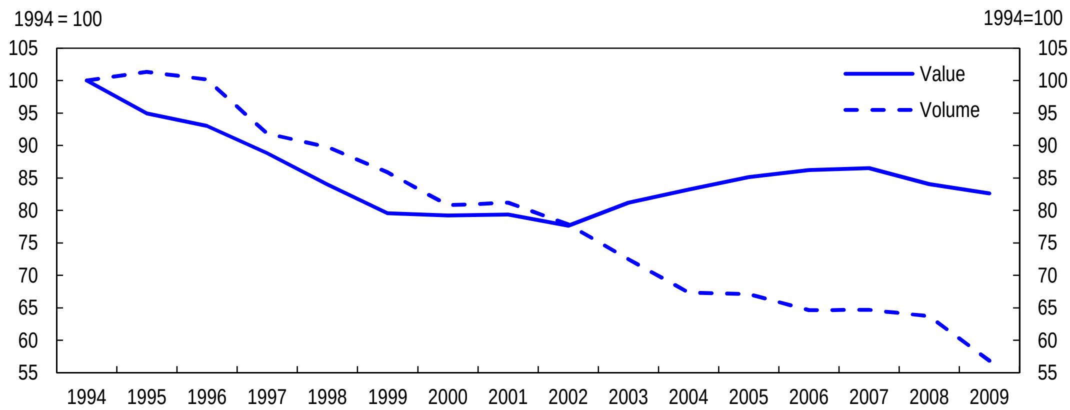
- *Making fiscal policy more rule-based and more countercyclical.* This would, with respect to commodity price cycles, provide a greater degree of offset to private capital inflows, which often surge when commodity prices are rising.

- *Using foreign exchange intervention more actively to resist overvaluation.* The SARB has already tended to accumulate reserves when appreciation pressures have been strongest, while refraining from intervening to resist depreciation. Nonetheless, a somewhat more active intervention policy providing for a more rapid accumulation of reserves when net inflows are strong and allowing depreciation when they ebb, as long as this remains consistent with the primary goal of keeping inflation in the SARB's target range, could do more to avoid or mitigate overvaluation. In any case, South Africa's current level of reserves is low by emerging market standards, leaving some room for an increase on prudential grounds. *Backing up foreign exchange intervention by increased communication efforts to give stronger signals to markets about where the authorities see the exchange rate in relation to its equilibrium level.*

- *Liberalising capital outflows*. Removing the remaining controls on capital outflows and replacing them by prudential rules would provide a one-off easing of pressure for rand appreciation, while also enhancing economic efficiency and easing the administrative burden on residents.

- *Raising savings rates. Given the negative relationship between savings and overvaluation, the options for raising saving also apply in this area.*

South African exports - world market share

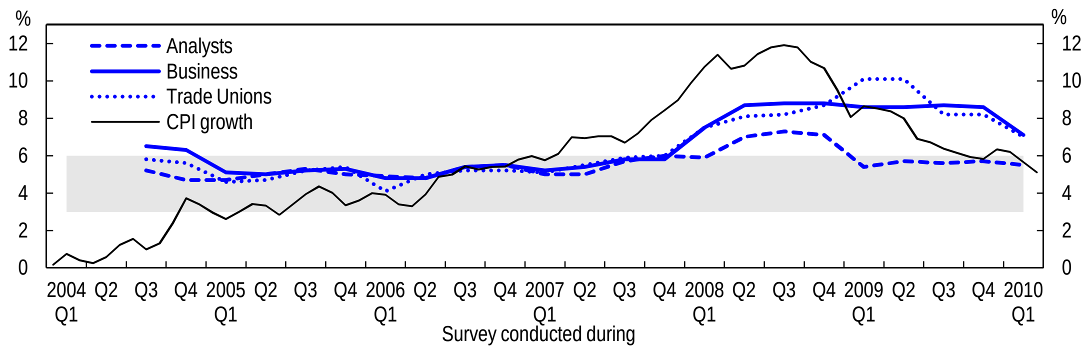


Source: OECD calculations based on SARB database and IMF, International Financial Statistics database.

The inflation targeting framework has proven to be flexible, and should be kept, though some modifications could be made

The inflation targeting regime put in place a decade ago has had notable success. The transparency and predictability of monetary policy have been improved, and inflation and interest rates have been lower on average than in previous years. Like most other inflation-targeting central banks, the SARB has implemented inflation targeting flexibly, taking into account output and employment in the short-run while attempting to ensure that the inflation target is achieved over time. Nonetheless, on the one hand it is criticised for having been too rigid, while on the other hand measures of inflation expectations show that the targets are not seen as fully credible by all economic agents. Additional communication efforts are warranted to bolster the credibility of the inflation target, especially to ensure that the social partners use it as guidance for wage and price setting. The recent outreach initiative of the SARB is a useful step in that direction. *To further increase transparency and signal commitment to price stability over the longer term, the SARB should consider moving in the direction of announcing a policy rate path consistent with the inflation objective. At a first stage, this might involve merely signalling the foreseen direction of policy rates. Ultimately, in line with certain other inflation targeting central banks, the SARB could begin to publish a projected policy rate path in its Monetary Policy Review.* Credibility would only be weakened by a change in the target band, which anyway does not appear to be warranted. The existing band is among the highest internationally. To a large extent this is justified, since in emerging market economies like South Africa relatively rapid productivity growth in the tradables sector is generally transmitted through the economy *via* higher rates of inflation than in advanced countries. The current target range provides ample room for such effects.

Inflation expectations for the coming year[1]



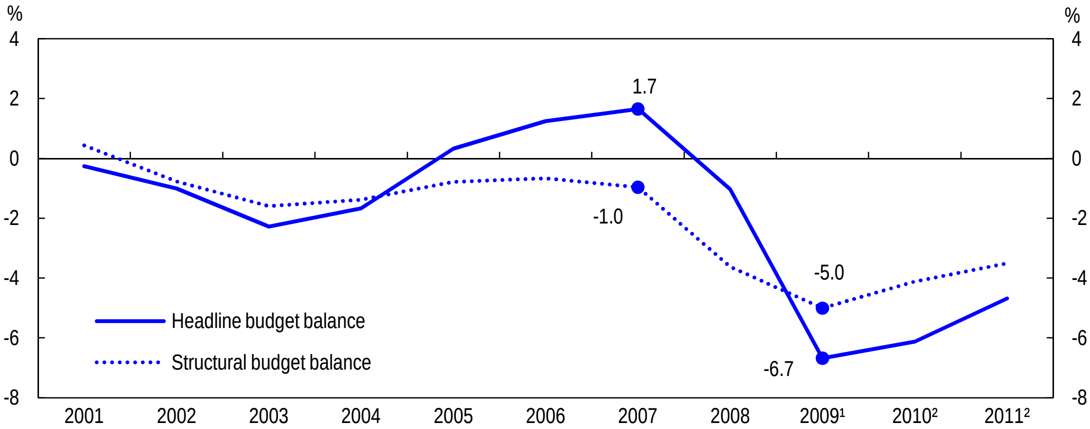
1. CPIX up to the fourth quarter of 2008. Headline CPI (which replaced the CPIX as an inflation target in February 2009) onwards.

Source: Bureau of Economic Research and Statistics South Africa.

Fiscal policy could be strengthened by mechanisms to prevent it becoming pro-cyclical when the economy is strong

The boom in government revenues in the years preceding the crisis eroded the prudent fiscal position and was pro-cyclical, as spending was ratcheted up just as the cycle was peaking. The estimated structural balance, which remained in deficit throughout the boom years, began to deteriorate in FY 2007/08 and worsened substantially in FY 2008/09. In this respect, South Africa behaved similarly to many other countries, which also raised spending as revenues grew rapidly. Although South Africa's public debt burden remains moderate, there has been a sharp shift in the trend, and a difficult medium-term fiscal consolidation lies ahead. While the National Treasury's commitment to prudence remains unquestioned, South Africa *might benefit from additional mechanisms to prevent similar policy errors in future cyclical upswings. This could usefully include a target on the structural balance, buttressed by an expenditure rule.* The technical aspects of administering such rules and public acceptance of the need for fiscal prudence - as has been consistently advocated by the National Treasury - could both be facilitated by using input from a group of independent experts, as is done in a number of OECD countries. International experience suggests that fiscal rules of this sort, if backed by political will, are useful. *The Treasury should in any case continue to develop and draw attention to its work on cyclically adjusted fiscal balances, and existing multi-year expenditure projections could be given greater status, such as by making the expenditure envelope for the out-years legally binding.* This would increase the degree of public and parliamentary scrutiny in the case of proposed deviations from those projections in subsequent budgetary cycles.

Headline and structural budget balances



Note: Consolidated budget, fiscal years (1 April - 31 March).

1. Preliminary estimates.

2. OECD projections.

Source: National Treasury, OECD estimates.

... and it may become worthwhile to separate commodity-related revenue to ensure that windfalls are saved

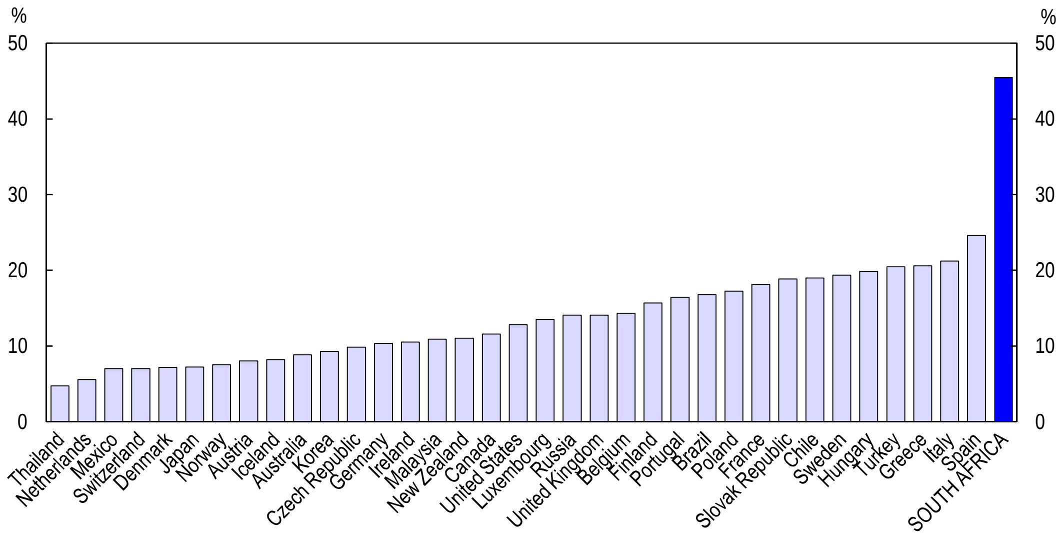
A number of other resource-rich countries have opted to create commodity funds to better insulate their budget and economies from swings in commodity prices. Linking net flows into these funds to commodity prices reduces pressure to spend windfalls when prices are high and provides an extra source of budgetary finance when prices are low. Also, investing in foreign assets can offset some of the pressure for real appreciation of the currency when prices of export commodities are high. South Africa's case is less straightforward than some others, since direct tax revenues from mining are unusually low relative to the size of the sector, and since the revenues come from a number of commodities. Nevertheless, *perhaps in conjunction with a greater effort to identify and tax economic rents from natural resource extraction, a mechanism to ensure that commodity price windfalls are saved should be given further consideration.*

Low employment remains the overriding policy challenge

South Africa has an extreme and persistent low employment problem, which interacts with other economic and social problems such as inadequate education, poor health outcomes and crime. While the unemployment rate fell steadily from 2002 through 2007, helped by the strong cyclical upswing, it never fell below 20% and by the first quarter of 2010 was back above 25%, near the levels of 2004. In addition to high open unemployment, South Africa's very low labour force participation rate in part reflects a large number of discouraged job-seekers, so that on a broader measure, including such individuals, the unemployment rate is above 30%. As in other countries, vulnerable groups are most affected by unemployment, and in South Africa the problem is most extreme for black youth, for whom the unemployment rate exceeds 50%.

Youth unemployment rate, 2008[1]

Persons aged 15-24 years



1. 2007 data for Brazil.

Source: OECD Labour Force statistics database, ILO Laborsta database and Statistics South Africa, Quarterly Labour Force Survey.

Just as the causes are complex, the solution needs to be multi-dimensional

A range of supply- and demand-side factors contributed to the strong rise in unemployment in the decade from the early 1990s and its persistence since then. The end of apartheid was associated with a surge in labour force participation among generally younger, less-skilled and undereducated black Africans, just as the structural balance of the economy was shifting to more skill-intensive sectors. The HIV/AIDS epidemic damaged the employment prospects of millions *via* higher absenteeism and reduced productivity and capacity for job search. And the dysfunctional spatial allocation of the population inherited from the apartheid era has resulted in high reservation wages owing to long, expensive, and sometimes dangerous trips for job search and commuting. A further damaging apartheid legacy was the low level of entrepreneurialism among the black population. There are also signs of a growing dualism in labour markets, with large union wage premia and rising real wages in larger formal sector firms, but broadly stagnant economy-wide real wages. Possibly the single most important factor in the failure to generate faster employment growth, however, has been the mediocre trend growth performance of the economy, combined with the relatively low labour intensity of growth over the economic cycle. In light of the multiple factors underlying the low employment problem, a range of policy responses - on top of the above-mentioned policies to increase trend growth, which are key - will be required if South Africa is to achieve the rapid sustained growth in employment that it needs.

Structural reforms are needed to improve the functioning of labour markets

Thus, on top of an overvalued exchange rate, cost competitiveness has been jeopardized by insider-dominated wage bargaining. *One promising direction to endow outsiders with more voice might be to increase the degree of co-ordination in wage bargaining*. OECD experience suggests that high levels of co-ordination - either through greater centralisation or greater decentralisation - are associated with better employment outcomes by avoiding inflationary wage demands, reducing the real costs of disinflation and increasing the scope for interest rate reductions. Currently South Africa is characterised by an intermediate level of wage co-ordination, which is found elsewhere to be associated with poor employment outcomes. Increased coordination could be achieved by bringing social partners together at the beginning of each annual wage negotiation round and getting agreement on guidelines for increases in that year. Actual bargaining would continue to take place in the same way as it does at present, but against the background of such guidelines. Government involvement in the process could help to make the trade-offs between wages, employment and unemployment clearer to social partners. *Weakening the legal extension of sectoral bargains would likely also help with wage moderation*, since social partners would know that agreed wage levels could be undercut by other firms.

Within an overall employment strategy, measures should be targeted at tackling youth unemployment

In South Africa, as elsewhere, very high youth unemployment rates for the most part reflect high overall unemployment. Youth, being on the margins of the labour market, tend to be the worst affected. A necessary condition for lower youth unemployment rates is therefore likely to be an increase in overall employment. In such a rising tide, however, youth may be the last boats to be lifted, just as they are the first to be stranded in the ebb. Given that the negative externalities of long-term unemployment are likely to be particularly acute for the young, youth-specific measures should be an important part of an employment strategy. Survey evidence suggests that the existing programme of learnerships, subsidised training with preferences for employees hired out of unemployment, has suffered from an excessive administrative burden. *A broadened wage subsidy programme, possibly building on improved learnerships, should bear in mind the priority of keeping administrative demands light. Expanded job search assistance would also be worthwhile, with an upgrading of the public Job Centres and better linkages to other job-seeker databases. Sectoral minimum wages should be differentiated by age to make it easier for the young to break into the job market. Special extended probation periods for employees below a given age could also be considered.*

Less restrictive product market regulation is one clear priority to increase job creation and productivity growth

Liberalising product market regulation is another initiative that would be expected to lead to better labour market outcomes, by reducing the rents available to be shared with labour market insiders at the cost of employment. *The responsiveness of employment to the overall economic climate would also be enhanced by improved access to credit for small enterprises and the development of entrepreneurship in the African population, and further public resources could be devoted to these ends. Initiatives should be rigorously evaluated to avoid waste and ensure focus is placed on successful instruments.*

In the long run, converging on OECD income levels will require a large increase in average productivity, *i.e.* in the economic and technical efficiency of production. Empirically, a strong relationship has been found between robust competition in product markets and the performance of firms in the critical areas of innovation, capital-deepening and corporate management. Competition also removes the allocative distortions caused by monopolistic market structures. However, product market regulation in South Africa is not conducive to robust competition. The OECD's Product Market Regulation indicator puts South Africa among the countries with the most restrictive regulations, and South Africa is found generally to have low levels of product market competition. Econometric work on a range of OECD and emerging economies suggests that lowering excessive South Africa n barriers to entrepreneurship to the OECD average could translate into approximately a ½ per cent higher average annual rate of GDP *per capita* growth over the subsequent decade. *Product market regulation, especially as regards barriers to entrepreneurship, should be made less restrictive in order to spur dynamism*.

Chapter summaries

Chapter 1. Moving beyond the crisis and finding a new sustainable growth path

The global crisis turned what might otherwise have been a mild slowdown in South Africa into a recession. However, thanks to moderately countercyclical macroeconomic policies, and in the absence of a banking crisis, South Africa was only about averagely affected by the global downturn. Given the losses in employment that ensued, pushing up the already very high unemployment rate, the short-term priority is to get the economy growing strongly on a sustainable basis. Once a private-sector-led recovery takes hold, fiscal policy should be tightened and monetary policy will have to protect the credibility of the inflation target in the face of stubbornly high inflation expectations. Beyond the crisis and its aftermath, South Africa needs to improve its trend growth performance to meet the material and social aspirations of its people. Among the areas to focus on to that end, this chapter picks out improving framework conditions for business, higher savings, increasing the contribution of exports to growth and strengthening efforts to tackle climate change.

Chapter 2. Strengthening the macroeconomic policy framework

South Africa's macroeconomic framework has served the economy well, but should be strengthened to make the economy more resilient to external shocks. Enhancing credibility of the inflation target would provide the monetary authorities with more space for flexibility in the face of exogenous shocks. To ease the pressure on the exchange rate emanating from high commodity prices and sentiment-driven surges in capital inflows, the accumulation of foreign exchange reserves by the central bank should be more rapid, and the removal of remaining controls on capital outflows should be accelerated. Fiscal policy has been generally sound, but should be made tighter and more countercyclical during the economic upswings to prevent a structural deterioration of the fiscal balance and to create more room for manoeuvre during downturns. A fiscal rule that institutionally constrains discretionary fiscal policy may facilitate this task and ensure that strong public commitment to address major social challenges, improve access to public services and promote long term growth by investing in physical infrastructure and human capital are met on a sustainable basis. In conjunction with a greater effort to identify and tax economic rents from natural resource extraction, consideration should be given to establishing a mechanism to manage commodity price windfalls.

Chapter 3. Closing the labour utilisation gap

South Africa suffers from extremely low labour utilisation, which interacts with other economic and social problems such as inadequate education, poor health outcomes, and crime. The causes are complex, and a range of policies looks to be required to reduce unemployment decisively. In some areas, OECD experience may point to promising approaches, such as on reducing the restrictiveness of product market regulation, increasing the degree of co-ordination of wage negotiations, weakening legal extension of collective bargaining agreements, and facilitating school-to-work transitions. In other areas the specific context of South Africa may call for additional or different approaches. In particular, rapid employment growth is unlikely to happen without improvement in overall economic growth, and it would help if that growth were more labour-intensive than in recent years. South Africa also needs to make particular efforts to improve basic education, and to continue to redress the spatial misallocation of the population, although these measures will not make a big difference to employment outcomes in the near term.

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