POST-APARTHEID SOUTH AFRICA

The First Ten Years

Edited by Michael Nowak and Luca Antonio Ricci

International Monetary Fund

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This book is dedicated to the memory of
our friends and colleagues
Gunnar Jonsson and Matthias Vocke

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The following symbols have been used throughout this volume:

. . . to indicate that data are not available;

— to indicate that the figure is zero or less than half the final digit shown, or that the item does not exist;

– between years or months (e.g., 2003–04 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

/ between years (e.g., 2003/04) to indicate a fiscal (financial) year.

"n.a." means not applicable.

"Billion" means a thousand million.

Minor discrepancies between constituent figures and totals are due to rounding.

The term "country," as used in this volume, does not in all cases refer to a territorial entity that is a state as understood by international law and practice; the term also covers some territorial entities that are not states, but for which statistical data are maintained and provided internationally on a separate and independent basis.

Foreword

Ten years after the end of apartheid in South Africa, this book takes stock of how the economy has been managed to address the consequences of apartheid and lay the basis for a durable and broad-based improvement in living standards. It recognizes the many achievements in economic policymaking during this period, while also emphasizing the substantial challenges that remain ahead. The studies in this book provide a perspective of what the authors consider to be the central policy and analytical issues facing the country.

The pace of economic growth has doubled since the end of apartheid and inflation has been brought down to low and predictable levels. The studies here suggest that these favorable trends reflect disciplined macroeconomic policies, diversification of the economy's productive base, and an opening up of the economy to foreign trade. In the process, the delivery of basic social services has been greatly improved and important gains in welfare have been achieved. Concerted action has also been undertaken to address the incidence of HIV/AIDS, which has taken such a heavy social and economic toll. High growth, however, has yet to be accompanied by a significant expansion in job opportunities; policymakers need to continue to focus on upgrading job skills and reducing labor costs if substantive inroads are to be made in lowering unemployment and alleviating poverty.

The South African authorities deserve much credit for the progress realized over the past ten years. They have rightly recognized that sustaining the process of economic reform requires social cohesion and stability and that policies, such as the Black Economic Empowerment program, are integral to this effort. The achievements are not confined to South Africa. The government has played a pivotal role in establishing the New Partnership for Africa's Development (NEPAD) and in implementing NEPAD's shared vision for the continent.

The book was prepared by a team led by Michael Nowak that included Faisal Ahmed, Vivek Arora, Athanasios Arvanitis, Ashok Jayantilal Bhundia, Thomas Harjes, Mark Horton, Ketil Hviding, and Luca Antonio

Ricci. The insights contained here will prove invaluable to the IMF's future work, not only on South Africa, but on emerging market countries more generally.

ABDOULAYE BIO-TCHANÉ
Director
African Department

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1

The First Ten Years After Apartheid: An Overview of the South African Economy

MICHAEL NOWAK

In successfully navigating the transition from apartheid to democracy, the government of South Africa has made impressive gains in stabilizing the economy and laying a firm foundation for higher economic growth and a broad-based improvement in living standards. The public finances have been strengthened significantly, interest rates have been lowered, and inflation has been brought firmly under control. The economy has also undergone a major structural transformation. Industrial efficiency has been raised by greater exposure to competition from overseas and the economy has become much more diversified and less vulnerable to commodity price swings. In the process, the rate of economic growth has more than doubled on average since the end of apartheid in 1994. There have been corresponding improvements in many areas of social welfare, although persistently high unemployment and the severity of the HIV/AIDS epidemic continue to impose a drag on poverty reduction.

The government that came to power in South Africa in 1994 inherited the economic and social legacies of apartheid. It was faced with a large pool of unskilled and unemployed labor, acute and widespread poverty, and poor access to education, health, and other basic public amenities for a large majority of the population. A battery of capital controls imposed from within and the impact of economic sanctions and political isolation from overseas had essentially cut the economy off from the rest of the world. The economy was suffering from falling investment and growth, persistently high inflation and interest rates, and weak public finances. The new government faced a difficult political future, and considerable doubt prevailed at the time about whether economic performance could be successfully turned around.

In the event, South Africa has made major strides in raising economic growth and the living standards of its population. Between 1995 and 2003, real GDP grew at an average of nearly 3 percent, which was about double the growth rate recorded between 1980 and 1994. The key to this performance was essentially twofold. At an early stage, the government sought to strengthen the public finances, thereby paving the way for a more stable and predictable financial environment. In addition, as explained in Chapter 2, the economy experienced a sharp turnaround in productivity performance. This shift largely reflected the impact of greater integration with the rest of the world following the removal of trade sanctions in the early 1990s and the implementation of extensive trade reforms. At the same time, the incidence of poverty has fallen, and significantly more South Africans have access to improved housing and basic health, sanitation, and utility services (Chapter 6). Education standards have also improved and literacy rates have risen. On the other hand, the incidence of HIV/AIDS has seriously strained the health system and has led to an increase in infant mortality and decline in life expectancy (Chapter 7).

There remain, nonetheless, significant impediments to achieving higher growth. Fixed investment has been relatively weak, failing to rise above 15–17 percent of GDP for the last ten years or so. The pace of job creation, moreover, has been insufficient to make an appreciable dent in unemployment, which has remained high. Much of this book examines the obstacles that remain to stimulating investment and job creation and delivering durable and broad-based growth and poverty reduction.

* * *

South Africa has enjoyed considerable success in stabilizing its economy over the past ten years. After hovering at around 10–15 percent in the early 1990s, inflation (consumer price index) was progressively lowered to about 3 percent by mid-2005. Confidence in economic management has contributed to a reduction in sovereign risk spreads on South African debt to unprecedented lows, and domestic interest rates have fallen accordingly. Throughout, the financial system has remained strong and healthy, weathering several episodes of currency depreciation without apparent difficulty. The economy's resilience to shocks from overseas has been further strengthened in the past several years by a marked improvement in the country's international reserve position.

Heightened fiscal discipline has been integral to the stabilization effort. The government has sought to maintain a competitive tax regime, increase social spending at a measured and sustainable pace, and introduce greater transparency and accountability into the budget process at all levels of government. It has successfully resisted pressure to use the budget as an instrument for quickly redistributing income. By 2002/03 (April–March), the public sector borrowing requirement had been lowered to around 1 percent of GDP, from a peak of around 9 percent in 1993/94. This effort involved major improvements in the efficiency of tax collection facilitated by the creation of an independent revenue authority—the South African Revenue Service (SARS). SARS has been highly successful in broadening the tax base, and revenue targets have been consistently exceeded. This strong performance has allowed cuts to be made in both personal and company income tax rates. The fiscal strategy also rested on initiatives, such as the Public Finance Management Act (1999), that were designed to better monitor and control spending and to provide safeguards against waste in government. In the process, important changes took place in the composition of government spending. A lower debt-service burden and large cuts in defense spending freed up resources that were reallocated to enhancing the delivery of social services and upgrading the country's economic infrastructure.

South Africa now enjoys relatively low inflation. The success of the fight against inflation is attributable to a number of factors. First, fiscal policy has been highly supportive of the anti-inflation effort. Not only has the budget deficit been reduced but deficit-financing operations have been financed without recourse to borrowing from the central bank. Second, the strong fiscal performance has contributed to lower real interest rates, which together with productivity gains, have helped ease increases in business costs. Third, the improved international reserve position has contributed to lower currency volatility and thereby dampened a major potential source of inflationary pressure.[1] And fourth, the South African Reserve Bank (SARB) has sharpened the effectiveness of its monetary policy strategy, moving in February 2000 to the adoption of a formal inflation targeting regime (Chapter 12).

Inflation targeting has bolstered the credibility of monetary policy and anchor inflation expectations. This has helped reduce potential output

[1]Episodes of renewed inflationary pressure in South Africa have generally been associated with periods of currency weakness. For example, inflation jumped by 5 percentage points in one year to a peak of over 11 percent in October 2002, following a large currency depreciation in the second half of 2001.

losses normally associated with efforts to lower inflation. Under the inflation-targeting framework, the South African government establishes an inflation target, after consultation between the National Treasury and the SARB; this target is presently set in the form of a band of 3 percent to 6 percent. The SARB influences liquidity conditions through the rates at which it repurchases short-term funds from the commercial banks (the "repo" rate). Since its inception, a number of adjustments have been made to the framework that have improved its operational effectiveness. In November 2003, the inflation objective was changed from an annual average target to a rolling monthly target. At the same time, an "explanation clause" was introduced, whereby the SARB was required to explain deviations from the inflation target and indicate how it intended to bring inflation back on track. In addition, the frequency of the SARB's Monetary Policy Committee meetings, which is the vehicle for deciding on changes in interest rates, was increased to six a year. These innovations made it easier for the public to understand the inflation-targeting process and subjected the SARB to more continuous and stringent accountability.

For much of the 1990s South Africa's susceptibility to external and domestic shocks was heightened by an extremely weak international reserve position. This position reflected not only the outcome of many years of economic isolation but also the result of repeated attempts by the SARB, such as in 1996 and again in 1998, to counter strong exchange rate pressures through heavy market intervention. This intervention was financed predominantly by engaging in forward swaps (in effect, short-term borrowing) that left the SARB with foreign currency obligations far in excess of its reserve holdings. Exchange rate policy shifted abruptly after 1998 when the SARB ceased intervening in the foreign exchange market to influence the value of the rand. It confined its foreign exchange purchases solely for the purpose of winding down its open forward position and, once this was achieved, rebuilding its international reserves. As a result, international reserves, as a ratio of short-term debt (including forward market obligations), rose from a perilously low trough of 25 percent at the end of 1998 to much more comfortable levels of around 180 percent by mid-2005. The SARB's open exposure in the forward market was finally closed in 2004. Subsequent chapters in this book present a body of empirical evidence suggesting a number of benefits associated with the accumulation of reserves. These include lower spreads on long-term debt (Chapter 13) and reduced currency volatility (Chapter 11). The absence of intervention, moreover, has enabled South Africa to better weather the potentially adverse effects of periodic bouts of currency pressures (Chapter 10), although the currency depreciation of 2001 made it clear that the currency could still "overshoot"

(Chapter 9). The replenishment of international reserves has paved the way for a progressive easing in capital controls (Chapter 8).

The strength of South Africa's financial sector has contributed to the stability of the macroeconomic environment. An in-depth examination of the financial sector, undertaken by the IMF during 2000–01, concluded that the banking system was healthy, robust, and resilient to potentially large exchange rate and interest rate shocks. At the end of March 2005, all of South Africa's 36 operating banks were adequately capitalized and nonperforming loans amounted to less than 2 percent of total loans and advances. A series of bank failures in 2002 threatened the stability of the financial system, but the problem was quickly addressed by the SARB and the National Treasury primarily through a combination of closures and sales.[2] Much of South Africa's black population, however, remains without access to banking services and the challenge facing the authorities will be to reach out to the "unbanked," while ensuring that the banking system remains efficient and sound.

The progress that South Africa has achieved in stabilizing the economy and reducing its susceptibility to adverse shocks begs an important question. Why did investment and job growth not pick up significantly in response? The answer to this question can help provide important insights into the heart of the economic challenges confronting South Africa's policymakers.

Since 1994, investment, or capital accumulation, has contributed only a little over ½ percent a year to economic growth. Although the pace of investment has risen over the past several years, largely in response to reduced government budget deficits and lower borrowing costs, funding for domestic investment remains constrained by relatively low levels of saving, particularly by the household sector (Chapter 4). Moreover, foreign investment has failed to materialize in substantial amounts. Chapter 5 identifies a number of reasons why South Africa has not attracted foreign direct investment on the same scale as some of its emerging market counterparts. It notes that investors have been deterred by a chronic shortage of skilled labor and by labor market rigidities, such as difficult dismissal procedures, which have kept the costs of unskilled and semiskilled labor artificially high. The cost of doing business in South Africa has also been affected by the prevalence of the HIV/AIDS pandemic and by the perceived incidence of crime. Infrastructure weaknesses, such as congestion at ports and on the railways, have further discouraged investment. Finally, notwithstanding the liberalization that has already taken place, the tariff regime

[2]The banks involved were relatively small and experienced difficulties as a result of involvement, either direct or indirect, in microfinancing operations.

continues to penalize most export activities and afford high levels of protection to certain import-competing sectors.

The persistence of chronically high unemployment is arguably the single most important impediment to poverty reduction in South Africa.[3] The acute unemployment problem is the result of a variety of factors, most notably serious skill deficiencies resulting largely from poor infrastructure and standards in education during apartheid, and institutional rigidities that have weakened the ability of the labor market to create new jobs (Chapter 3). In response to the problem, the government set a target in 2003 of halving the unemployment rate by 2014. This is an ambitious goal that will require, in addition to initiatives already taken, further measures to upgrade job skills and create new jobs.

The government's strategy for dealing with unemployment is multifaceted. It includes skills development, improvements in matriculation standards, and the streamlining of workplace conciliation and arbitration procedures. In addition, the 2004/05 budget launched a labor-intensive public works program aimed at raising employment and providing basic job skills. Labor market rigidities, however, remain an impediment to job growth in the form, for example, of minimum wages, while the expense of dismissal procedures continue to inhibit the incentive to recruit new workers.

Between 1995 and 1998, the government introduced a raft of labor legislation intended to address many of the abuses of apartheid labor laws. The legislation sought to promote and facilitate collective bargaining at the sectoral level, provide protection for workers, and introduce affirmative action measures and safeguards against discrimination. Concern over the possible unintended consequences of this legislation, and a desire to enhance employment opportunities, prompted passage of a range of amendments in August 2002. Many of the changes helped introduce greater flexibility to workplace practices and lower labor costs through streamlining arbitration and conciliation procedures. Other provisions offered added protection to retrenched workers. On balance, the amendments represented an important step in the right direction, but they did not tackle the issue of minimum wages (see below). Dismissal and retrenchment expenses, moreover, continue to constitute a substantial portion of total labor costs.

To address the problem of skill deficiencies, legislation was passed in 1998 to pave the way for the National Skills Development Strategy (NSDS). The program became operational in 2000 with the introduction of a pay-

[3]As of March 2005, the official unemployment rate, which excludes people not actively seeking work ("discouraged workers"), was 26.5 percent. When discouraged workers are included, the unemployment rate was 39.5 percent.

roll levy to fund skills enhancement. The levy is presently set at 1 percent and applies to all, but the smallest, of businesses. The program established a number of performance indicators, such as the number of enterprises that provide training, and implementation of the NSDS has been reasonably good, with many of the goals set having been met. There are, nonetheless, ways in which the strategy could probably be improved. In particular, the NSDS focuses primarily on training workers who already have jobs. Because these workers typically encounter less difficulty in finding jobs than the unemployed, a shift in focus that devotes proportionately more of the available resources to training those without jobs could have a more substantive impact on unemployment. Moreover, the NSDS relies for its funding on a payroll levy, which directly raises the cost of labor; tapping alternative less distortionary sources of funding from the government budget would help support the objective of job creation.[4]

The South African economy is highly unionized.[5] There is little evidence that the existence of trade unions, per se, has contributed to unemployment (see Chapter 3). However, workplace relations in most of the major sectors of the South African economy are governed by centralized collective bargaining agreements. Under these agreements, minimum wage rates are negotiated between trade unions and the largest employers, and they are then extended by law to nonparticipating parties, which are typically small and medium-sized enterprises. As a consequence, these enterprises have little autonomy in setting wages to reflect productivity differences.[6] A relaxation of the "extension principle" would help reduce labor costs, enable small businesses to operate on a more competitive basis, and create new jobs.[7] In several sectors not covered by collective bargaining agreements (agriculture,

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[4]In principle, up to 80 percent of the payroll levy is refundable, but, in practice, only a fraction of this has been returned to employers.

[5]About 35 percent of workers belong to a union. The rate of unionization, however, varies significantly by sectors, with membership rates in mining and manufacturing running at about 80 percent and 55 percent, respectively.

[6]Moll has argued that, because businesses participating in collective bargaining agreements tend to be the largest and most capital-intensive in the sector, these agreements result in wage rates that are higher than the smaller nonparticipating nonlabor-intensive businesses can afford to pay. See Peter Moll, "Compulsory Centralization of Collective Bargaining in South Africa," *American Economic Review, Papers and Proceedings,* Vol. 86 (May 1996), pp. 326–29.

[7]Employers can, in principle, seek exemption from the terms of collective bargaining agreements from the Minister of Labour, but the number of applications has generally been limited. Instead, there appears to be extensive evasion of minimum wage requirements by both small and large firms. This evasion, and the costs associated with it, underscore the need for more flexibility in this area.

retail, and domestic services), statutory minimum wages, or "sectoral determinations," are set by the Minister of Labour. These wages have been increased in the last several years at rates well above prevailing inflation. Consequently, while they may have helped protect the living standards of those in employment, they have likely weakened labor demand, particularly in rural areas, where the unemployment problem is most acute.

Total factor productivity (TFP) growth has accounted for about one-half of the economic growth recorded since 1994.[8] Virtually all of South Africa's factor productivity growth since 1994 appears to have emanated from the greater openness of the economy and increased integration with overseas markets. The process of trade liberalization is described in Chapter 8. Between 1988 and 2004, the average (unweighted) tariff on imports into South Africa was cut from 22 percent to around 11 percent and virtually all quantitative restrictions were removed. Increased trade integration has also contributed to greater diversification of the economy. In 2000, manufacturing represented about 33 percent of total merchandise exports, up sharply from 19 percent in 1993; and there has been a corresponding decline in the share of mining exports. This diversification has helped cushion the economy against volatile and adverse commodity price shocks.

There remains considerable scope for further trade liberalization. The tariff structure remains highly complex and a number of sectors, such as textiles and footwear, continue to be highly protected. Further liberalization and streamlining of the tariff regime would help provide a further boost to productivity growth. It would also reduce the "anti-export bias" that arises when imported inputs for exports are taxed, but exports are afforded no protection, unlike production for the domestic market.[9] It would, nonetheless, be important that liberalization be accompanied by labor market reform so that the potential benefits translate into employment as well as output gains.

In addition to trade integration, there have been other, albeit less important, sources of productivity growth. South Africa's public enterprise sector is not particularly large, accounting for less than 2 percent of total employment in 2003 and about 6 percent of GDP, but it operates in strategically

[8]TFP growth is essentially the increase in output arising from gains in the efficiency of inputs, such as capital and labor, into the production process.

[9]There is no import duty drawback scheme in South Africa. In the automobile industry, however, the government offers import duty credits based on the value of local content of exports. In terms of export performance, this program has been highly successful, but it is a highly complex arrangement that appears to involve a combination of export subsidies and heightened protection for domestic production.

important parts of the economy, such as utilities, transport, and communications. The public enterprises underwent an extensive restructuring exercise during the 1990s that has helped improve productivity and competitiveness and keep costs down. The restructuring, nevertheless, also led to significant labor redundancies.[10] Comparatively few public enterprises have been privatized, although the sale in 2002 of shares in Telkom, the state telecommunications company, was a major exception. Disappointment with the market value of this transaction, however, has taken some of the steam out of the privatization effort. The current strategy focuses on significant new investment for the larger enterprises and the sale of smaller noncore assets.

The HIV/AIDS pandemic is exacting an increasingly heavy social and economic toll. Data compiled by Statistics South Africa indicate that approximately 15 percent of the adult population are HIV positive and that prevalence rates are rising (Chapter 7). Demographic projections suggest that, in the absence of corrective action, around 20 percent of the current population may be lost over the next decade. Estimates indicate that the disease could reduce output growth by between 0.5 and 2.5 percentage points a year.

In response to the severity of the problem, the government made a landmark decision in August 2003 to provide anti-retroviral (ARV) drugs through the National Health System. The provision of these drugs offers the prospect of mitigating the worst impact of HIV/AIDS. The treatment regime is, however, complicated and the program is unprecedented in scope internationally. But effective implementation will require a major upgrade of personnel, facilities, and management.

South Africa inherited acute income and wealth disparities from the apartheid era. These disparities are a potential source of social strain. Since 1994 the government has embarked on two major initiatives—land reform and the Black Economic Empowerment program—that have sought to address the issue. The IMF has expressed support for these initiatives since they have the potential to achieve greater social cohesion, contribute to poverty reduction, and help sustain the process of macroeconomic stabilization and structural reform.

South Africa's land reform program is motivated by both social and economic considerations. By encouraging the subdivision of large-scale farms, the program represents a viable means of raising agricultural productivity and tackling rural unemployment and poverty. The government has been

[10]Between 1994 and 2001, employment in the largest public enterprises fell by nearly 30 percent.

careful to emphasize the voluntary nature of the land reform program and to distance itself from the approach to land redistribution adopted in neighboring Zimbabwe. Expropriation is provided for, but is subject to judicial appeal procedures. A target has been established for 30 percent of agricultural land to be transferred by 2015. The pace of land redistribution has picked up in the past several years with improvements in the administration of the program and the provision of additional funding from the budget. Nonetheless, by 2004 less than 5 percent of land had been redistributed.

The Black Economic Empowerment program, which was launched in 2003, seeks to encourage the transfer of assets and promotion of black participation in business management and operations. A target has been set to achieve 25 percent black ownership of South African companies by 2014. The approach is voluntary. Charters so far have been drawn up for several sectors, including mining and finance. As the empowerment process moves forward, the success of the program in strengthening the country's social fabric will require that the benefits be distributed as broadly as possible across the black population.