South Africa: Stimulating Economic Growth

South Africa has begun a new phase in its history. Much of its economic future will depend on what happens in the next few years. As part of World Bank's ongoing dialogue with counterparts in South Africa, the study, South Africa - Economic Performance and Policies concentrates on one central question. How can South Africa move on to a much faster growth path through which the poorer majority of its citizens gain the most? To frame a coherent answer, the context in which this growth is sought has to be examined.

The Present Crisis

The recent 1988-1993 recession, the longest in South Africa's history, was due partly to a considerable decline in investment by parastatals in 1985 and a lack of consumer and business confidence. Yet South Africa's economic problems run much deeper. For 30 years, Gross Domestic Product (GDP) growth has been declining; unemployment has increased dramatically; and inequality between blacks and whites (employment, income, education and access to other public services) is dauntingly wide.

Slower Growth

South Africa's real GDP growth has been declining since 1965. With population growing at about 2.6 percent per year, per-capita GDP growth has been negative since 1982. Despite a recovery in 1986-1988, growth has been increasingly influenced by continuing political uncertainty and growing social unrest. Growth in the economy has become increasingly unstable. For the past many years, South Africa's investment of an increasing share of its income in the economy has not been matched by satisfactory economic growth. This was seriously felt in three important sectors of the economy - agriculture, mining, and manufacturing - where growth fell and productivity faltered. Capital intensity and a highly regulated and protected environment for white agriculture resulted in huge investments but low growth in agricultural efficiency. Mining output between 1970 and 1980 declined at 1 percent

a year despite increases in capital stock of about 6.6 percent a year, with a similar trend continuing through the 1980s. Capital productivity in manufacturing, although relatively stable from 1950 to about 1970, has since fallen because of low interest rates, higher wages, and increased investment in heavy intermediate goods. Total factor productivity growth in manufacturing has been low -- 0.5 percent per year -- over the past 20 years, well below the levels achieved in high-performing economies.

**Rising Unemployment**

Employment growth has deteriorated consistently since 1970, with a shift away from agriculture. Labor supply growth, however, has changed little over the past 30 years. Even more striking is the growing imbalance that exists between black labor supply and employment in the formal sector. Less than half of the black labor force hold jobs in the formal sector. Moreover, although subsistence agriculture in the homelands and the informal sector provide an invaluable source of employment for the rest, roughly one quarter of blacks are without work. Unemployment is disproportionately concentrated among females and young people, and only a few new entrants to the labor market can expect to find wage jobs. Black unemployment on such a scale is not only a great waste of resources; it fuels social unrest.

**Extreme Inequality**

Apartheid intensified inequality in South Africa beyond that expected in a country at its level of development. Whites have personal incomes per capita of about 9.5 times those of Africans, 4.5 times those of Coloreds and 3 times those of Asians. Also, while social indicators for whites are in the range for developed countries, those for the African majority are broadly comparable with poorer surrounding countries. In most areas of government expenditure, apartheid worked in favor of whites and further increased the differences in welfare across racial groups. This has resulted in wide disparities in access to public services including water, sanitation, electricity, education and health. For example education, which is compulsory for white children, is not so for black children -- 25 percent of whom are not schooled. For those who are, the quality of basic education is deplorable. This contrast is hardly surprising since public spending per pupil in 1990 was more than 4 times higher for whites than for Africans.

**What Has Been Going Wrong?**

Since 1989, the South African economy has been in a deepening recession which has been made worse by unemployment. Even so, many indicators strongly suggest that this recession is rooted in the demand shock that followed a substantial and sustained fall in parastatal investments after 1985. The recession intensified as private sector confidence declined with growing political uncertainty and social turmoil.

Despite its high investment to GDP ratio, investment in South Africa did not generate more jobs and satisfactory growth for a number of reasons.

- Both investment and growth in the capital stock declined during the 1980s. This was accompanied by a substantial increase in the capital intensity of the economy which further hampered employment growth.

- There was a deterioration in the allocation of capital stock. Investment was increasingly
channeled towards activities with lower-than-average capital productivity such as in the public sector.

- Inadequate acquisition of skills within the workforce. This lowered the returns to investment and slowed productivity growth.

- A probable decline in work input among the unskilled associated with a deteriorating home environment.

- Rising wages and industrial unrest since the early 1980s which further dampened employment growth.

Balance-of-payments problems have greatly constrained the economy in recent years as limited access to international finance has meant that the external current account has had to remain in surplus. In mid-1988, the current account started to slip into deficit following moderate growth in the economy. To protect foreign exchange reserves and dampen inflation following depreciation of the rand, interest rates were raised and new import duties were imposed. This curbed growth and pushed the economy back into recession. At end-September 1993, gross foreign exchange reserves stood at only 1.1 months of imports and this position would rapidly deteriorate under renewed balance-of-payments pressure.

The fiscal deficit was not much of a problem until recently. It grew rapidly over 1991 and 1992 reaching a record 8.6 percent of GDP for FY1992/93. There is no sign of this large deficit leading to higher aggregate demand, as the effect of the increased deficit is being offset by a decline in private investment.

From 1981-1991, South Africa's inflation hovered at 15 percent per year. Only in the past year or so has it fallen. In 1992, it stood at 13.9 percent despite a rapid increase in food prices after the drought. However, inflation in food prices is declining, and was around the 10 percent mark in 1993. This is due mainly to the deepening recession and the mild appreciation of the real effective exchange rate in recent years.

**How Can Things Be Put Right?**

Although the country is in a deep recession, rapid growth is possible in the early years of a new administration. Given the underutilization of resources, GDP could be raised with investment only just sufficient to maintain existing capital stock.

Thanks to substantial public investment in the past, there is underutilization in much of the country's infrastructure and in power-generation. Little new investment will be needed over the coming years in substantial parts of the transport and communication systems or in electricity generation. In addition, South Africa has an unusually low foreign debt-to-GDP ratio. So, if foreign finance can be secured, higher investment could be partly financed by external sources. Also, savings as a percentage of private disposable income is potentially high. Thus, if dissaving by the public sector can be controlled and productivity increased, South Africa could invest more and grow more quickly within a sustainable balance-of-payments position.

Key to a brighter future for South Africa is sustained growth, but that in itself is not enough. Growth without redistribution would almost certainly falter as social tensions rose. Two prime requirements
of redistributive growth are rapid employment creation and narrowing the gap in the provision of public services across racial groups.

For higher growth, South Africa must revive the private sector while it maximizes employment growth and narrows income differentials between blacks and whites. It must also redress massive inequalities in access to public services and facilities, and in land ownership. The analysis used for the study suggests that such a growth path can be achieved if the right policies are in place and other conditions are met.

Sustained growth requires an ongoing improvement in the supply-side of the economy. This can be encouraged by improving export incentives and the skills of the labor force. A revival of demand within the economy can lead to only a limited amount of growth. However, kick-starting the economy through public expenditures could play an important role: well-targeted public investment will help redistribution while assisting economic recovery.

Private investment must increase from its currently depressed level if sustainable growth is to be attained. Higher private investment would stimulate demand, but its more important role is to increase supply. To raise private investment, policies need to be transparent, credible and stable. Excessive fiscal deficits are likely to send the wrong signals.

Redistribution can be achieved through a number of avenues. Public expenditure can be diverted towards investment in activities benefiting the disadvantaged, and a significant proportion of the backlog in social expenditures can be cleared in a few years without breaking important macroeconomic constraints. Unskilled and semi-skilled workers can be upgraded to higher levels, but this must be supported by improved basic education for blacks. A modest program of rural resettlement based on a willing buyer-willing seller exchange should create employment and be affordable. Encouraging the development of small enterprises should also be redistributive and consistent with higher growth. Redistribution through immediate pay increases to lower-paid workers and excessive public expenditure is unsustainable. The results of such policies are likely to include increased inflation and pressure on the balance of payments.

The suggested policy framework outlined in this paper focuses on the medium-to-long run. The main policies arising from the analysis include:

- Encouraging rapid growth in skilled labor, particularly by upgrading semi-skilled and unskilled workers.
- Encouraging a reorientation of manufacturing towards exports.
- Emphasizing job creation in small businesses and in agriculture.
- Restructuring government expenditure by raising investment in infrastructure and public services, targeting the poor and underprivileged, and restricting the growth of recurrent spending to meet budgetary targets.

Maintaining prudent fiscal and monetary policies.

This policy strategy will only be successful if there is a major revival in private investment. If sufficient private investment is available, then sustained per capita growth becomes a reality. Direct
foreign investment should be encouraged, and the regulatory framework should present no obstacles to new ventures. The visible implementation of redistributive policies through greater public investment should improve social stability. But it is equally important that investors should not be discouraged by an opaque and ever-changing policy framework.

Transparency, stability and credibility -- all these matter as much as policies. To stimulate growth, the single most important ingredient is investor confidence. This will only materialize if policymaking is transparent and there are no sudden and unexpected shifts in economic policies. South Africa's new government has a unique window of opportunity to introduce sustainable, consistent, and credible economic policies -- and thus encourage political stability.

Simulating Sustainable Growth

While quick, rough calculations are often useful when looking at short-term effects, an examination of the behavior of key economic variables for the longer term requires a more rigorous approach. With this in mind, a macroeconomic model has been constructed which is capable of simulating future scenarios of the South African economy under different conditions.

The model is based on a set of econometric equations estimated for the years 1960-1992. The aim in constructing this model was to identify the main quantitative relationships that have driven the South African economy over this period, and to then use these to examine the consequences of different policies and changes in exogenous factors that affect the economy. In total, the model comprises around 300 identities and equations of which 45 econometric equations were estimated using time-series data. The treatment of the product market in the model permits an evaluation of both demand-stimulating and supply-raising measures. As such, the model can be used to measure the economic impact of specific measures and policies (a new tax policy, different sizes of public investment programs) or to identify the variables and policies that will be critical if the country is to attain sustainable high growth.

This model has been used to examine the economic effects of launching hypothetical redistributive public investment programs of different sizes over and above recent public investment levels, and to then judge their sustainability and feasibility. The maximum sustainable size of a public investment program was investigated under three scenarios based on the following questions -- How much public investment can South Africa afford? How much of the social backlog of capital expenditures can be eliminated by the maximum affordable public investment program? How much long-term foreign finance would the economy need? In all three, recurrent expenditure growth was assumed below recent levels.

The model has also used on a set of simulations focused on wage issues. While it is tempting to imagine that fast redistribution could be attained by simply encouraging large wage rises for unskilled workers, the evidence suggests otherwise. Excessive wage increases are eventually self-defeating. Inevitably, such a high rise in the money wage would stimulate inflation and raise the fiscal deficit by increasing the cost of employing workers in government service.

Fiscal indiscipline, as represented by excessive government expenditure, could have even worse results, particularly if, as seems likely, this were accompanied by a fall in private investment. Under this scenario, growth in GDP and employment would decline, and the economy would soon face mounting public and foreign debt and faster inflation. Although doubtless motivated by the best of intentions, such excessive expenditures would eventually work to the disadvantage of most of the
The results of the various simulations with the model seem to support the conclusion that a healthy climate for private investment is essential. Without this, sustained growth will not take place. The simulations also seem to support the policy framework outlined -- supply-enhancing policies will have a big impact if the conditions are right. As always, the results are sensitive to the specification of the model and to the assumptions made in the simulations. But it is hoped that these results will assist the debate regarding the policies to be followed.

One thing is clear: South Africa's considerable economic potential can be achieved only if the right policy mix is conceptualized at the very outset of this new era and subsequently operationalized.