



Trade and Trade Policy in South Africa: Recent Trends and Future Prospects

Frank Flatters

Matthew Stern

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1 Introduction

Since 1994, South Africa has been rapidly reintegrated into the global economy, with the contribution of imports and exports rising strongly as a percentage of GDP. The economy has become more open, more productive and more outward orientated. This adjustment is partially a response to domestic factors and the ending of the country's trade and political isolation, but it is also part of a worldwide process of trade liberalisation and economic integration, commonly termed 'globalisation'.

The gains from globalisation are not equally distributed and whereas some industries and consumers have benefited from higher output or lower prices, others have lost out to more competitive foreign industries or lost their jobs. These trends are likely to continue. Tariffs and other forms of trade protection will come down, exports and imports will rise, and there will be further adjustment costs and benefits.

The purpose of this paper is not to identify the likely winners and losers from trade and trade reform over the next ten years; this would be a spurious and speculative exercise. Instead, the focus here is on the broader trade policy challenges and choices that are faced by South Africa in an increasingly global and competitive world economy. The paper is largely a retrospective synthesis of work done by the authors, but the intention throughout is to gather lessons from South Africa's past in order to describe the main trade issues of the future.

This paper covers three main issues. Firstly, it provides an overview of global trends and explains South Africa's recent trade performance. Secondly, it identifies some of the main determinants of the country's international competitiveness and key constraints to integration and export growth. And thirdly, it reviews the current state of trade policy discussions taking place at the domestic, regional and international levels. From this, a number of possible trade and trade policy scenarios are derived and described in the conclusion.

2 Setting the scene - trade, openness and growth¹

The integration of world markets that characterizes the process of globalization has facilitated, somewhat paradoxically, a fragmentation of global production. Improvements in information technology, transport and logistics, have made it possible to "deconstruct" product value chains and allocate global production tasks for goods and services much more finely and in line with comparative costs of production in different locations. Global production chains have become fragmented and truly global.

Low and middle-income countries that have succeeded in integrating themselves into the global economy through trade and investment have generally grown faster than richer countries. Those that have not succeeded have grown more slowly.² These broad conclusions are not sufficient, of course, to map into a unique set of policy and institutional prescriptions that apply to all countries and all situations. Political reality and differences in economic and institutional circumstances mean that each country must find a path that works best for itself.

For South Africa, endowments of natural resources or basic industries are no longer necessary or sufficient for participation in this new global environment. International trade is a substitute for self-sufficiency at all stages in product value chains and the mere presence of these raw materials domestically, if not managed properly, can be a hindrance rather than a help to downstream

¹ This section is based largely on chapters 2 and 3 in Flatters and Stern (2006), 'Trade and Industrial Policy in South Africa'.

² See Sachs and Warner (1995) and Secretary of State for International Development 2000. While there has been much debate and many (justified) criticisms of the Sachs and Warner work, the general importance of integration with the global economy for growth remains very difficult to challenge.

industries. Instead, improved logistics and trade facilitation are likely to be far more critical to the country's future industrial competitiveness, development and growth.

3 South Africa's recent trade performance³

3.1 Economic restructuring

Liberalization of trade, more general economic deregulation, and the dismantling of international sanctions on trade with South Africa have led to substantial restructuring of the economy. Table 1 shows one set of indicators—the change in export orientation and in import penetration of the economy between 1994 and 2002. 'Export orientation' shows the share of production in each sector that is exported and 'import penetration' shows the share of domestic consumption accounted for by imports.

At broad sector levels it can be seen that the entire economy has become more outward-oriented, with export orientation and import penetration increasing across both primary sectors and manufacturing. The greatest change, however, has been in manufacturing where import penetration has risen by 54 percent and export orientation has almost doubled. Even more remarkable is the uniformity of this experience across all manufacturing sectors; export orientation increased in all except two of the 28 sectors shown in the table, and the same is true of import penetration.

Table 1. Change in Trade Orientation by Sector, 1994-2002

Sector (SIC classification)	Export Orientation			Import Penetration		
	1994	2002	% change	1994	2002	% change
Agriculture, forestry & fishing [1]	16.0	18.6	16.3	5.7	9.1	59.6
Mining [2]	62.6	68.0	8.6	51.5	60.9	18.3
Manufacturing [3]	15.5	29.5	90.3	23.2	35.8	54.3
Food [301-304]	6.7	9.1	35.8	7.6	9.8	28.9
Beverages [305]	6.8	13.2	94.1	3.7	5.9	59.5
Tobacco [306]	3.5	7.3	108.6	1.9	1.0	-47.4
Textiles [311-312]	13.6	19.1	40.4	24.2	31.8	31.4
Wearing apparel [313-315]	9.7	25.1	158.8	8.4	19.7	134.5
Leather & leather products [316]	37.9	39.4	4.0	35.8	38.2	6.7
Footwear [317]	4.6	4.9	6.5	17.9	46.6	160.3
Wood & wood products [321-322]	14.0	22.8	62.9	10.9	15.0	37.6
Paper & paper products [323]	19.9	19.6	-1.5	14.2	9.5	-33.1
Printing & publishing [324-326]	2.3	2.8	21.7	17.9	23.5	31.3
Coke & refined petrol [331-333]	14.1	33.9	140.4	12.6	28.0	122.2
Basic chemicals [334]	40.4	51.7	28.0	45.2	52.1	15.3
Other chemicals [335-336]	5.3	15.3	188.7	22.1	32.3	46.2
Rubber products [337]	9.7	25.4	161.9	21.8	34.8	59.6
Plastic products [338]	4.6	12.2	165.2	9.9	18.8	89.9
Glass & glass products [341]	9.7	15.0	54.6	18.2	26.7	46.7
Non-metallic minerals [342]	7.8	11.6	48.7	10.3	20.7	101.0
Basic iron & steel [351]	45.3	63.6	40.4	11.2	17.6	57.1
Basic non-ferrous metals [352]	44.6	27.6	-38.1	17.5	20.1	14.9
Metal products [353-355]	10.9	17.7	62.4	10.6	18.6	75.5
Machinery & equipment [356-359]	16.8	54.6	225.0	56.3	77.7	38.0
Electrical machinery [361-366]	7.7	15.4	100.0	31.9	38.1	19.4
Communication equip [371-373]	9.6	44.2	360.4	59.4	88.1	48.3
Professional & scientific [374-376]	23.7	62.5	163.7	72.8	91.7	26.0

Source: Based on data in Dunne and Edwards (2006), Table 1.

Note: Export orientation is calculated as the share of exports in domestic production and import penetration as the share of imports in domestic consumption.

³ This section is based largely on chapter 10 in Flatters and Stern (2006), 'Trade and Industrial Policy in South Africa'.

These are all signs of highly successful structural adjustment. Whatever the reasons, and there can be no doubt that economic reform and the dropping of sanctions have played a key role, the South African economy appears to have become much better integrated with the global economy and has rationalized production in ways that respond at least in part to South Africa's relative cost competitiveness. This rationalization appears to have happened not just between sectors, but even within sectors.

3.2 What happened to export led growth?

Despite substantial economic restructuring, South Africa's post-1994 export performance is less than might have been expected or hoped for.

From 1984 to 1994, South Africa's merchandise exports grew at an average rate of 5.7 percent a year (in volume terms), slightly faster than the 5.6 percent growth in world exports. It was anticipated that the end of sanctions and the deregulation of trade and other economic control measures would give a substantial boost to South Africa's relative and absolute export performance. However, while world export growth increased to 6.2 percent a year over the decade since 1994, South Africa's average export growth rate fell marginally to 5.6 percent and the country's share of world exports has fallen from 0.7 to 0.5 percent over this period.

Is this simply due to the unfortunate composition of South Africa's exports? South Africa's exports are highly concentrated in natural-resource-based products, which experienced relatively low growth in world markets over most of this period. Edwards and Alves (2005) compare South Africa's export performance against other developing and resource-based economies. See Table 2 below.

Table 2. Annual Growth Rates (%) by Broad Technology Category, 1988-2002 (US\$)

	World	Developed Countries	Developing Countries	South Africa	Resources Group
Total exports	6.02	4.96	9.58	2.02	6.14
Primary products	3.59	2.79	4.95	-1.14	4.18
Total manufactures	6.32	5.13	10.63	6.91	7.72
Resource-based	4.89	4.09	7.89	4.26	5.63
Pure manufactures	6.59	5.33	11.13	8.57	9.52
Low technology	5.63	4.37	7.94	5.57	8.57
Medium technology	5.67	4.77	11.07	9.67	8.51
High technology	9.10	7.14	15.83	11.53	14.95

Source: Edwards and Alves (2005)

Exports of non-resource-based manufactures have outperformed the world average over this period (8.57 percent versus 6.59 percent), but have underperformed those of other developing countries and other resource-based economies. Within manufacturing, South Africa's strongest relative performance (*vis à vis* the rest of the world) has been in medium and high technology products and it has underperformed both the rest of the world and other developing countries in low technology products. The relatively strong performance of South Africa in 'medium technology' exports is almost fully explained by subsidized auto exports (see section 4. below). All other sub-sectors have performed worse than the basket of resource-based economies (and well below the average performance of other developing countries).

3.3 What happened to employment growth?

A commonly expressed fear about trade liberalization is that it will result in job losses as low cost imports displace domestic products in the local market. This argument ignores the beneficial impact of trade reform on export competitiveness and the resulting job gains in the growth of activities that

can compete domestically and internationally against foreign-produced goods. It also ignores the impact on employment in downstream service industries, especially in the wholesale and retail trades, that grow in response to falling consumer prices and the growing incomes that come from trade reform.

As we have just seen, the past decade has seen a substantial restructuring of the economy and this has resulted in increases in both exports and imports. What has been the overall impact on employment?

The overall picture is not attractive, especially at first glance. Between 1990 and 2002, the tradable goods sectors of the South African economy shed over 700,000 jobs (Dunne and Edwards 2006 Table 2). By 2002 the manufacturing sector had lost almost 11 percent of its 1994 jobs. A closer examination, however, shows that most of the job losses were in primary products sectors—agriculture, mining and resource-based manufacturing. These three sectors accounted for 83 percent of these job losses. Only 17 percent of the job losses over 1994-2002 were in non-resource-based manufacturing (Dunne and Edwards 2006 Table A-1).⁴

What was the ‘contribution’ of trade to this performance? A crude decomposition of the changes occurring in the manufacturing sector over 1990-2002, based on input shares in different subsectors, shows that, as expected, increased import penetration ‘caused’ job losses, while greater export orientation ‘caused’ offsetting employment gains (Dunne and Edwards 2005). The net effect was positive. The overall job gains from export growth exceeded those from increased import competition, and this was true of all factors of production—skilled labour, unskilled and semi-skilled labour, and capital (Dunne and Edwards 2006, Figure 3, lower). However, there are some causes for concern.

- The net effects on employment were small—less than 29,000 new jobs overall, or only 0.2 percent of the total.
- The employment gains appear to have been larger for skilled labour than for unskilled and semi-skilled labour, and the greatest increase in demand arising from South Africa’s changing trade orientation over the past decade was for capital rather than labour.

By far the largest impact on employment according to this exercise, however, has been productivity growth. This has resulted in an average decrease in the demand for labour of 3 percent per year in all tradable goods sectors of the economy and 2.9 percent in manufacturing (Dunne and Edwards 2006, Table 2).

The general pattern of skill-intensive technological change uncovered by this exercise is consistent with global patterns, and it is encouraging that South Africa is not being left behind. The ability to keep up with these changes is essential for successful integration with the global economy. The weak overall impact of intra-sectoral shifts towards more competitive export activities raises some questions, however, as does the apparent capital bias in recent structural changes. Why have exports not grown faster? What explains the capital and skills bias in the evolution of the manufacturing sector since 1994?

Before proceeding to these discussions, it is useful to put this ‘employment accounting’ exercise in perspective. The major source of employment and employment growth in South Africa, as in most other growing economies, has been and will continue to be the service sector. According to household survey data, the South Africa’s service sectors provided over 1.1 million new jobs between 1995 and 2002. This was over 75 percent of recorded employment growth over the period (Bhorat and Oosterhuizen 2004). According to the same data, manufacturing employment grew by only about 200 thousand jobs and in the primary sectors it was negligible.

⁴ A strong word of caution is necessary in interpreting any labour force and employment data in South Africa. Bhorat and Oosterhuizen (2004) describe some of the difficulties with SA’s household survey data. The Dunne and Edwards estimates are based on Quantech (2004) data that is compiled from input-output and national accounts data with interpolation of data between the years in which IO data are supplied and extrapolation of the series for the post-1996, the data of the last manufacturing census (Dunne and Edwards 2006, footnotes 3 and 8). Bhorat and Oosterhuizen’s household survey data show an increase in manufacturing employment of about 200,000 workers over 1994-2002; Dunne and Edwards suggest that manufacturing employment fell by almost 11 percent over the same period.

This suggests that it is incorrect to look at the contribution of trade and employment policies simply through the lens of job creation in tradable goods sectors. The principal contribution of trade and industrial policies to employment is through their impact on overall economic growth. Continued export growth requires ongoing productivity growth. Whether and how much of this results in direct employment growth in manufacturing depends on the net effect of reduced labour requirements per unit of output and of the resulting growth in exports that this makes possible. Sufficient increases in manufacturing competitiveness could well lead to growing overall employment in this sector and this would certainly be a sign of success. But the real test is whether and how much trade and industrial policies contribute to overall economic growth.

4 Trade and tariff policy in South Africa⁵

South Africa began an ambitious set of tariff and trade policy reforms in the mid-1990s. This included substantive multilateral liberalization through the WTO; the elimination of quotas, GEIS and most import surcharges; the replacement of most formula, specific and mixed tariffs with *ad valorem* duties; and new bilateral agreements with the EU and SADC. The tariff structure has also been simplified through a substantial reduction in the number of tariff lines and some reduction in the number of rates levied. Table 3 shows the evolution of the tariff structure from 1990 to 2004.

Of considerable if not most importance of course is the fact that nominal tariff rates have been coming down. The unweighted average nominal tariff (scheduled rates, including surcharges) fell from 22.9 percent in 1994 to 8.2 percent in 2004 (Edwards 2005).⁶ This appears to indicate substantial liberalization of trade.

Table 3. Structure of SACU Tariffs, 1990-2004

	1990	1994	1998	2004 MFN	2004 EU	2004 SADC
No. of tariff lines	12475	11231	7773	6697	6697	6697
Ad valorem	8649	7707	5793	6492	6504	6658
Compound	66	51	6	1	0	0
Specific	499	398	214	135	135	37
Mixed	566	2071	1736	64	53	2
Formula	2695	1004	24	5	5	0
No. of tariff bands						
Ad valorem	38	37	45	38	54	25
Other	695	686	230	62	47	18
Duty free (% tariff lines)	24	26	42	53	56	81
Domestic tariff spikes (% tariff lines)^a	0.7	3.7	4.5	8.9	8.5	14.9
International tariff spikes (% tariff lines)^b	43.7	43.5	39.4	21.2	20.1	5.8
Nuisance rates (% tariff lines)^c	12	11	6	7	6	3

Notes: Calculations based on tariff schedules including *ad valorem* equivalents.

a. Domestic tariff spikes are defined as those exceeding three times the overall simple average applied rate.

b. International tariff spikes are defined as those exceeding 15%.

c. Nuisance rates are those greater than zero, but less than or equal to 5%.

Source: Edwards (2005)

Despite initial appearances, however, trade liberalization has been far less complete than might be thought.⁷

- Despite a commitment at the beginning of the reforms to reduce the number of tariff rate bands to six (0, 5, 10, 15, 20 and 30 percent), the number of MFN bands in 2004 was still 38, exactly

⁵ This section is based largely on chapter 10 in Flatters and Stern (2006), 'Trade and Industrial Policy in South Africa'.

⁶ Cassim and van Seventer 2005 estimate that the unweighted average nominal rate fell from 17.4 percent in 1996 to 8.3 percent in 2004 and the import value weighted average went from 11.0 to 7.5 percent over the same period.

⁷ Edwards (2005) concludes that South Africa has liberalised no faster than other lower-middle-income economies.

the same as in 1990 (see Table 15 above). For imports from the EU the number of bands was 54. In 1998, several years into the reforms, the number of MFN bands had actually increased from 38 to 45. In addition, the complexity of the tariff structure has been increased by the use of special rebates and by detailed differentiation of tariffs within sectors. Special rates for particular sub-sectors have resulted in numerous different rates within 2, 4, and even 6 digit HS tariff headings and sub-headings.

- The proliferation of special sub-chapter rates and rebates reflects a product and sometimes even firm-specific approach to tariff policy. This made-to-measure approach involves deliberations on tariff policy based on the claimed or perceived needs of individual firms and based on judgements about the capacities of local producers of inputs and competing outputs. Rather than setting relatively low and uniform tariffs across all products, as intended at the launch of the reforms, *tariff policy has continued to be negotiable. This is an obvious incentive for rent seeking and a source of uncertainty for investors and producers.*
- The complexity of the tariff structure makes it very difficult to generalize about its impacts on incentives for producers and investors. Aggregate effective protection studies for the economy as a whole or for industry and manufacturing have reached differing conclusions about overall patterns. Some have found that effective protection has gone up on average (Fedderke and Vase 2000) and others that it has gone down (Cassim and van Seventer 1995 and Edwards 2005). The problem with all such studies is that they require analysis at a level of aggregation too high to judge the impact of policy at the level at which it is designed in South Africa. In electronics, for instance, such studies aggregate a wide range of products, some produced in South Africa and some not, some exported and some not, and some with high tariffs and some with low or zero tariffs. Our own examinations at the product level have found that many of the products actually produced in South Africa continue to have very high levels of effective protection and at least some of these have experienced increases in effective protection since 1994. This is a manifestation of the DTI's made-to-measure approach to tariff policy. Edwards (2005) corroborates the view that many manufacturing sectors, including labour-intensive industries, remain heavily protected.
- With the possible exception of India, South Africa has been the developing world's most prolific user of WTO anti-dumping provisions. At the end of 2003 South Africa had 90 different anti-dumping duties in place, placing her fourth in the world, behind the US, India and the EU (Bekker 2005). The trend has continued, and in the first half of 2005, South Africa achieved the distinction of launching more anti-dumping investigations than any other country in the world (Carli Laurens in *Business Day*, 4 November 2005). As in most other countries, the primary targets of such investigations are upstream heavy industries such as steel, chemicals and plastics—i.e. they are a form of disguised protection for 'strategic' industries, and the interests of downstream users and final consumers play an insignificant role in anti-dumping decisions. While certainly of value to highly capital-intensive companies such as Mittal Steel and Sasol, such measures impose further cost penalties on downstream labour-intensive industries and make it more difficult for them to compete domestically and internationally.
- The process of trade reform slowed to a crawl following the first wave in the mid-1990s. Further MFN-based tariff reductions are strongly resisted, in part as a 'weapon' to be used in WTO negotiations. There is even discussion of rolling back previous tariff reductions in cases where applied rates are less than WTO-bound rates. The main focus of tariff reform in recent years has been preferential trade agreements (PTAs).⁸
- South Africa has negotiated bilateral PTAs with the EU and SADC. It is in the process of planning and/or negotiating a variety of other arrangements with countries in many parts of the world. Such agreements contribute little to trade. This is particularly true in the South African case. These agreements add considerable complexity to and hence increase the costs of trade in

⁸ See Cassim and van Seventer 2005, especially the discussion of section 5.

South Africa. Although the number of lines in South Africa's tariff schedule has been reduced from 11,231 to 6,697 between 1994 and 2004, the existence of just the EU and SADC agreements means that the effective number of tariff lines in force now is actually 20,081 (three times 6,697). This is almost twice the number of tariff lines in 1994. Furthermore, implementation of these agreements requires criteria and procedures for determining where goods actually originate—rules of origin. Rules of origin are complex and costly to comply with and to enforce. This is a serious impediment to trade. In addition, rules of origin can and often are designed to restrict preferential trade—to make it difficult if not impossible for importers and exporters to qualify. The EU rules are now widely recognized to be highly restrictive in this regard and to have a significant impact on the ability of South African exporters to take advantage of EU preferences. Even worse, however, is the SADC agreement, in which South Africa insisted on rules of origin in many sectors that could not be met even by South African exporters let alone those in much less developed partner countries.⁹

- Even if they 'work' by promoting trade, PTAs suffer from two serious economic problems—trade diversion and policy diversion. The first of these is certainly well known. Tariff preferences divert imports from low cost non-member sources to higher cost sources in member countries. The risk and cost of trade diversion increases with the gap between preferential and non-preferential tariff rates. The obvious cure for the problem is to lower all MFN tariff rates or better still to make all tariff cuts on a non-discriminatory basis. This approach was followed in a number of heavily protected sectors in Mauritius in conjunction with implementation of preferential tariff reductions in COMESA (see Box 7 of Flatters 2002b). South Africa has been loath to do this. The second problem is less well known but is critical in a policy-making environment with limited policy resources. Negotiating and implementing trade agreements is labour and time intensive. Devoting policy-making resources to this activity reduces resources available to potentially much more useful MFN-based liberalization (unilateral or cooperative) and even more importantly to much more critical domestic constraints to growth.

For all of these reasons, it is apparent that trade reform still has a long way to go in South Africa. This might help to explain why the dividends from trade reform have been less than might have been hoped, especially in most recent years.

4.1 Tariffs and export performance¹⁰

Recent research by Edwards and Lawrence (2007) confirms that there is a very strong relationship between tariffs and export performance. In particular, they attribute the rapid rise in South Africa's non-commodity exports between 1992 and 2000 to the sharp drop in tariff protection over this period.

How can import tariffs affect exports? Protection reduces the demand for imports and hence for foreign exchange, thus driving down the real exchange rate received by exporters. Import liberalization does the opposite. Protection reduces imports and exports. Liberalization increases them.

In addition, import tariffs raise the cost of key inputs (whether imported or not), relative to their cost in the absence of tariffs, further penalizing exporters. It is possible for exporters to receive rebates on tariff duties, but this is administratively costly and is at best only a partial offset of this penalty.

Edwards and Lawrence construct a complex statistical model to demonstrate this simple economic truism in South Africa. They show, unsurprisingly, that lowering tariffs increases the profitability of exporting, and show a clear and strong relationship between tariff liberalization and export growth over the 1990s. They show as well that nominal exchange rate changes have much less of an impact on exports, since any temporary advantage is soon dissipated by compensating changes in domestic prices.

⁹ See Flatters 2002b and Erasmus, Flatters and Kirk 2006.

¹⁰ This section is based largely on Flatters and Stern (2007), 'Geekonomics', Business Day: 5 March 2007.

So why have South African exports stalled? Precisely because the liberalization process that began in the 1990s has also stalled.

4.2 Sensitive sectors

Two specific sectors have attracted priority policy attention over the last decade: clothing and textiles and the motor industry. Both sectors employ large numbers of relatively unskilled workers and are protected by high tariffs and other forms of official support. The next ten years will be critical to the competitiveness and survival of these industries in South Africa and there is likely to be increasing domestic pressure for protection and international pressure for reform. For this reason, they receive special attention in this paper.

4.2.1 Sensitive sector 1: clothing and textiles¹¹

The future of the South African textile and garment sector is apparently under threat. It is claimed that unsupportive Government policies, unrepentant Chinese imports and an unbearably strong rand have dealt a knock-out blow to the local industry and cost South Africa substantial jobs and export income. Manufacturers and workers have called for higher tariffs, stricter customs enforcement, increased safeguards and archaic labelling and retailing restrictions. What are the problems posed by this industry? What should Government do?

Tariff reform in this sector began in the early 1990s as part of an economy-wide program of trade liberalization. The textile and garment industries benefited from a very gradual tariff phase-down as well as a temporary (ten year) export subsidy program. Tariffs in this sector remain high. The 40 percent rate on garments is one of the highest in South Africa's tariff book. The long phase-down was designed to provide time for necessary structural readjustments.

The industry has responded as expected, with rationalization leading to growth of both exports and imports.

At the same time, there have been big job losses in the formal sector. Is trade liberalization the villain? The data suggest otherwise. From 1995 to 2003 exports grew at almost exactly the same rate as imports. The net effect has been a) an increase in sales due to the steadily falling real price of clothing and b) a shift in production towards exports. Trade-induced changes in total output do not explain falling employment.

The cause of job losses must be sought elsewhere and the obvious place to look is productivity growth.

Global restructuring and productivity increases have streamlined the international clothing and textile industries over the past decade. Major adjustments have been the rule everywhere, including China where tens of thousands of jobs have been lost.

On the other hand, trade liberalization and productivity improvements have been of great benefit to clothing consumers worldwide. While the South African CPI has increased by 82.8 percent since 1995, nominal clothing prices have risen by only 5.5 percent. In other words, the real price of clothing has fallen by approximately 75 percent. A significant part of this is due to tariff reductions. Further reductions would have a similar effect.

Another less appreciated effect of trade liberalization has been the booming retail trade, especially in basic garments. This has been good for all consumers, but especially those at the lower end of the income distribution. It has also been good for job creation in this sector.

For the same reasons, the recent appreciation of the rand has been good for consumers and retailers, and bad for garment and textile producers. But the negative impact on competitiveness is an economy-wide problem affecting all producers of tradable goods. It is not an excuse for sector specific remedies of the sort being called for in clothing and textiles.

¹¹ This section is based largely on Flatters and Stern (2006), 'Geekonomics', Business Day: 6 March 2006.

If productivity growth is the “problem”, reversing trade liberalization is certainly not the answer. This would only delay adaptation to the new environment, and discourage the adjustments necessary to boost competitiveness. Further trade liberalization cannot be delayed in the hope of protecting what are ultimately unsustainable jobs.

Adjustment assistance for workers, especially income support and training, might be more appropriate. This will be much more effective and less costly than continuing to prop up non-competitive producers.

At the same time the government needs to think about what can and should be done to ensure a competitive real exchange rate. Further tariff liberalization and a reorientation of industrial policies to encourage labour-intensive rather than capital and resource-intensive industries are essential.

What can be done specifically for the garment industry? Most important is to provide more competitive access to raw materials, especially cloth. Global textile and garment industries are characterized by a complex and highly fragmented division of labour, with fabrics and garments produced at locations all around the world. No country is self-sufficient in any segment. A key to domestic and international competitiveness is to be a successful importer—to source raw material inputs efficiently on a global basis.

South African textile and clothing producers are penalized by high import duties on raw material inputs at every stage of the value chain. This is most serious in the case of garments, where producers face import duties of 20 to 22 percent on imported fabric. The so-called export incentive provided by the Duty Credit Certificate (DCC) program provides a smaller incentive for most producers than a standard duty drawback program, which is itself a costly, inefficient and only partial offset for the effects of high import duties on raw material inputs. The value of the DCC scheme has been further diminished in recent years by uncertainties about its continuation and by pressures from certain domestically oriented producers to restrict their tradability.

Restrictive rules of origin in SADC and in some of South Africa’s most important preferential trading arrangements (AGOA and the SA-EU TDCA) are another serious constraint.

Recent agreements with China to restrict quantities of textile products have reduced choices available for South African producers and consumers, have increased the cost of imported textile products, and have added new and costly layers to customs administration. These all have the effect of decreasing the competitiveness of production in South Africa.

Until South African apparel and textile producers can access the best quality and most affordable fibres, yarn and cloth, they will be unable to compete domestically or abroad.

More trade reform, not less, is the answer, supported by sensible adjustment assistance for those who need it most—workers displaced by the adjustments that will continue to be inevitable in this highly globalised sector.

4.2.2 Sensitive sector 2: motor industry¹²

The Motor Industry Development Programme (MIDP) continues to be touted as one of the major successes of post-apartheid industrial policy. As befits such an important programme, the government has commissioned an independent review to examine its effectiveness and to make recommendations for future policy direction in this sector.

The MIDP was set up in 1995 to assist an industry that was self-sufficient as a result of extremely high import duties and onerous local content requirements. But, for the same reasons, it did so at very high cost, and the industry could not have survived in that form in the face of trade liberalization. The programme provided very generous subsidies to exports and gradually declining import duty rates as a means of encouraging rationalization of production into a smaller number of product lines for export and a greater reliance on imports to provide the variety of vehicles demanded in the local market.

¹² This section is based largely on Flatters and Stern (2006), ‘Geekonomics’, Business Day: 4 September 2006.

Since the export subsidies were directly dependent on the size of the import duties on cars and components, gradually falling rates provided a natural phase-down of government assistance. The programme was initially scheduled to run for five years. It has been extended twice already and is now scheduled to end in 2012.

The aim of the programme was to assist the industry, if possible, to attain some degree of international competitiveness. The costs have been extremely high. We guess that the current level of government support is at least 15 billion Rand per year. It could be more. It is unlikely to be less. Since 1995 the program has almost certainly provided more than R100 billion to the industry. Looked at another way, For every R1 billion invested in the motor industry, the government has handed out an additional amount ranging from R2.6 to 6.8 billion, depending on the characteristics of the particular investments. At best, this 'subsidy' goes towards covering the high-cost of producing motor vehicles in South Africa and the inefficiency of local producers. At worst, it goes into the pockets of a few international vehicle companies.

These costs are borne primarily by South African consumers through high import duties and high car prices that are necessary to subsidize South African exports through the MIDP. They are not shown in any government budget and they are not reported to Parliament.

Have the MIDP subsidies worked? According to all claims and reports from the motor industry, it remains hopelessly uncompetitive and will rely on government support indefinitely.

Has the MIDP been a boon to employment? Less than 15 percent of all the jobs in the motor industry and motor trade are in vehicle production, and the number of these jobs has fallen since the start of MIDP. The vast majority of jobs in the sector are in distribution, sales, service and maintenance. Keeping car prices high reduces vehicle sales and hence the growth of jobs in this important sector. It also draws scarce investment and costly skilled labour into this uncompetitive industry at the expense of other sectors.

5 Other determinants of international competitiveness

5.1 Transport and customs infrastructure¹³

In the era of sanctions and domestic protectionism high transport and logistical costs, inefficient ports and cumbersome Customs procedures were not a problem. Nor was South Africa's relative geographic isolation. In fact they all could be viewed as supportive of the underlying policy regime. This is no longer true. Successful and competitive participation in global production networks now requires efficient ports, smooth logistics and seamless border procedures. South Africa continues to face natural disadvantages due its geographic isolation, and this requires that she strive even harder than others to avoid policy-sensitive impediments to trade.

Unfortunately old legacies are sometimes difficult to overcome. This has been true in the case of seaports.

With approximately 95 percent of her trade volume seaborne, about 85 percent in value terms (Chasomeris, 2005), South Africa is strategically dependant upon the efficiency and effectiveness of her seven commercial ports¹⁴. These ports serve not only a strategic role through trade facilitation, but also help to shape the economic growth and development of the entire Southern African region.

South African ports have been managed traditionally with a high degree of state ownership and intervention and as part of organizations involved in other key transport modes, especially rail.

Ports were generally acknowledged to be poorly managed, to provide poor service and charge uneconomic prices. In recent decades capacity problems increased and service continued to

¹³ This section is based largely on chapter 18 in Flatters and Stern (2006), 'Trade and Industrial Policy in South Africa'.

¹⁴ SA's multipurpose ports include PE, East London – the only river port and Mossel Bay; the hub ports include: Cape Town, a terminal port oriented towards the western sea routes; and Durban which is ideally positioned to serve the eastern routes. The deep water ports of Saldanha and Richard's bay

deteriorate. In 1989 the former SATS was incorporated into Transnet and its operations were commercialised. In 2000, further rationalization included the creation of a separate landlord (NPA) and port operations (SAPO) businesses under Transnet. The latter reorganization included a commitment to a new vision focused on assisting in the development of an export-led economy. Pricing structures and operational systems were improved. Substantial new investments have increased capacity, including the construction of two state of the art car transport terminals to serve exports promoted under the MIDP.

Nevertheless a wide variety of performance and pricing issues remain. Complaints include the following (Chasomeris 2005).

- Congestion and turnaround times remain high.
- Processing of vehicle and other imports is charged at a suspiciously high rate, double that for similar exports.
- Service quality is impeded by inadequate equipment and by low skill levels and high labour turnover.

Organizational and regulatory reforms of the type now underway take time. But the costs of underperformance are high. It might be useful to rethink the state-led model of port service provision and/or seek ways to introduce real competition. This could be achieved through licensing new private operators, maybe as part of ongoing expansion plans, or by encouraging competition through the ports of Maputo and Walvis Bay by working with neighbouring governments to facilitate transit trade within SACU and SADC.

While air transport does not account for a very large share of South Africa's imports or exports, it is also critical for industrial development. Samples and high value shipments can be very important, and reliability of delivery can be critical. A garment producer in a neighbouring SACU country used to ship samples by air to and from Asia via Johannesburg International Airport. Continued pilferage led them to change the routing through Europe so that Johannesburg could be avoided. This added one or two days to shipping time but is apparently worth the extra shipping and time cost. South African-based manufacturers do not have such options available, since all shipments must ultimately come through Johannesburg.

Competitively priced and reliable passenger connections are important for international investors as well as tourists. Lack of competition on key routes to Europe, America and Asia causes high prices and capacity shortages. If buyers, sellers and investors need to delay trips by a week or two because of lack of seat availability, this is bound to have an impact on the amount of business they will want to do in South Africa. Deregulation and increased competition in the airline business can be another important instrument of industrial policy.

Transparency and simplicity of Customs rules and procedures is also important. Complexities of the tariff structure as discussed above are one example. Complex and time-consuming rebate procedures are another. Lack of availability of basic information about tariff rates and other rules increase the difficulty not only of doing business, but also of evaluating trade and industrial policies. The South African government does not make its tariff book or detailed trade data available on the web and it does not provide it in any form of hard copy. This basic tax document must be purchased instead from a private publisher.

The emergence of cottage industries of incentives, customs and trade consultants suggests either a healthy form of specialization of work or a proliferation of excessively costly and non-transparent regulations that increase the costs of trade and serve as barriers to entry for domestic and international competition. While progress has been made in reducing the cost and increasing the transparency of trade in South Africa, more remains to be done.

The World Bank constructs annual indices of the costs of doing business around the world, including engaging in international trade. One indicator is the number of days to undertake all the procedures necessary to clear goods for import into the country. While this is a crude index and includes a

number of quite separate procedures (pre-clearance forms, port clearance, customs clearance and transport to warehouse) it is nevertheless a useful general indicator of ease of importing. The most recent survey (World Bank 2005) reports that it takes 34 days to import goods into South Africa. This is much better than the average for all of Sub-Saharan Africa (61 days). But it is not nearly as good as in successful economies in south and south-east Asia (Singapore 8 days, Malaysia and Philippines 22 days, Thailand 25 days, Sri Lanka 27 days). And it is not as good as other useful comparators such as Egypt (29 days) and Chile (24 days). These are minimal targets to which South Africa should aspire in easing the costs of trade so that South Africa can integrate successfully in the global economy.

5.2 Telecommunications¹⁵

Telecommunications is a service activity that is critical to countries' participation in global production networks. It is of direct importance, of course, to communications intensive activities such as offshore call-centre services. Regardless of the quality and price of domestic labour available to provide such services, they cannot possibly compete without access to low cost and reliable international telecommunications networks. Provision of offshore services to financial institutions requires the same level of telecommunications facilities. Domestic financial services are also highly dependent on telecommunications.

Low-skill and labour-intensive export manufacturing such as garments, footwear and automotive parts, activities that might initially appear to be far from the frontier of high tech telecommunications, have similar needs. Competing in the global garment industry requires constant adjustment and speedy response to small and large changes in customer needs. Designs and other specifications change continuously, and to be able to adapt requires the ability to transfer large amounts of information, including complex designs, across the internet. Local producers also need to be in constant communication with suppliers, often on different continents, in the same way. Changes in cost and pricing information need to be transmitted quickly and reliably.

How does South Africa stack up?

A recent study (Genesis Analytics 2005) assessed the costs of telecoms in South Africa, measuring local pricing against countries that are similar to SA in terms of relevant characteristics including, of course, income levels and general economic development. The comparator countries were also chosen on the basis of representing some degree of 'best practice' performance, a goal to which South Africa must aspire if it is to compete in the global economy. The peer group of 'best practice' developing countries included Brazil, India, Malaysia, Morocco, Philippines and Thailand. In terms of income per capita, SA is richer than all of the peer countries.¹⁶

Some key results of the study are summarized in Table 4.

In almost all the comparisons considered the South African telecommunications sector underperforms and often by huge amounts. This has serious implications for the development of a wide variety of service and manufacturing industries in South Africa and for the benefits they might otherwise provide in terms of employment and income growth.

Government has implemented a set of tailor-made incentives to call centres to offset the high cost of telecommunications in South Africa. This might be of benefit to a narrow set of investors, but it will also deflect attention from the root cause of this problem and do little to benefit the majority of telecoms consumers. Clearly, a much bolder approach to telecommunication regulation and pricing is required to have a broad and beneficial economic impact in South Africa.

¹⁵ This section is based largely on chapter 18 in Flatters and Stern (2006), 'Trade and Industrial Policy in South Africa'.

¹⁶ Based on our own knowledge of some of these countries, it would seem fair to suggest that the 'best practice' standard is not overly strong; in other words, these are *minimal* standards to which South Africa should aspire.

Table 4. How Do South African Telecomms Prices Compare?

Item	SA's Rank	Compared to Average Cost	Compared to Least Cost Country
Business ADSL	Most expensive of the 15 countries sampled	148% higher	9 times as expensive
Domestic leased lines	Most expensive of 12 countries surveyed	102% higher	15 times more expensive
International Leased lines	Almost three times as high as the next most expensive country sampled	399% higher	31 times more expensive
Retail ADSL	Most expensive of 13 countries	139%	8 times more expensive
ISP fees	Most expensive	45% higher	5 times more expensive
Business Voice	5 th cheapest	14% <u>lower</u>	3 times more expensive
Business – local calls	Most expensive	199% higher	11 times more expensive
Business – international calls	5 th most expensive of the 15 countries sampled	14% lower	3 times more expensive
Business – mobile calls	2 nd most expensive out of 15 countries	107% higher	23 times more expensive
Retail – local calls	4 th most expensive	129% higher	8 times more expensive
Retail – mobile calls	5 th most expensive	104% higher	11 times more expensive

Source: Genesis Analytics 2005

5.3 The real exchange rate¹⁷

Changes to the real exchange rate can have a major impact on South Africa's international competitiveness and are an important part of current discussions around trade and industrial policy. For this reason it is important to consider the role of exchange rate policy in supporting economic development and ask what might be done to reduce currency volatility and raise price competitiveness.

Although the exchange rate is not an instrument of industrial policy, it may be influenced by the structure of industrial development and the policies that support it. For example, the dependence of many developing countries on commodity exports is often blamed for their inability to diversify and develop. This is particularly problematic when commodity prices are rising. Unless the rents from commodity exports are somehow sterilised, the exchange rate will adjust to reflect resource flows and non-resource industries will suffer. Such countries are inflicted with the so-called 'Dutch disease.'

Commodity prices have risen strongly over the last few years and South African exporters of precious and base metals have been among the greatest beneficiaries. Rising resource exports have undoubtedly contributed to a stronger rand and the South African currency has outperformed most major currencies since early 2002.

Downstream manufacturers complain that the strong rand has hurt exports and the available evidence suggests that this is true. Has South Africa caught a case of the Dutch disease? And if so, what can policy makers do about it?

¹⁷ This section is based largely on chapter 19 in Flatters and Stern (2006), 'Trade and Industrial Policy in South Africa'.

Determinants of South Africa's Exchange Rate

A recent study (Ricci 2006) produced some quantitative estimates of major influences on South Africa's real effective exchange rate (REER) that are sensible and correspond with previous South African studies.¹⁸ The main findings include the following.

- A 1 percent increase in real commodity prices is associated with an appreciation of the REER of around 0.5 percent.
- A 1 percent increase in openness (trade relative to GDP) is associated with an appreciation of the REER of around 1 percent.
- An improvement of the fiscal balance of 1 percentage point of GDP is associated with a depreciation of the REER of around 2 percent.

Other influences include relative real interest rates (a one percent increase relative to trading partners is associated with a 3 percent REER increase), real GDP per capita (a 1 percent increase relative to trading partners is associated with a REER increase of 0.1 to 0.2 percent) and net foreign assets (an increase of 1 percentage point of GDP is associated with a REER increase of about 1 percent).

Over the last few years, there has been positive movement in almost all of the main determinants of the real value of the rand. But commodity prices have moved particularly strongly over this period and are almost certainly the most important variable in explaining the long-run behaviour of the rand.

Commodity prices have increased by about 50 percent in real terms since January 2003 (Hawthorn et al, 2005). As expected, the REER has appreciated by about 25 percent over this same period. Almost all of this appreciation can be explained by rising prices of South Africa's main commodity exports: platinum, gold, diamonds, coal, steel and aluminium.

Mining versus Manufacturing

The long-term relationship between South Africa's manufactured exports, the REER and commodity prices has been explored in detail. Bell, Farrell and Cassim (2002) provided a particularly good exposition of South Africa's historical trade performance and demonstrated, for instance, how the commodity boom of the 1970s choked off a nascent new pattern of export-oriented industrialisation, with the rise in commodity prices and the associated increase in the real exchange rate making the export of non-commodity manufactures unsustainable.

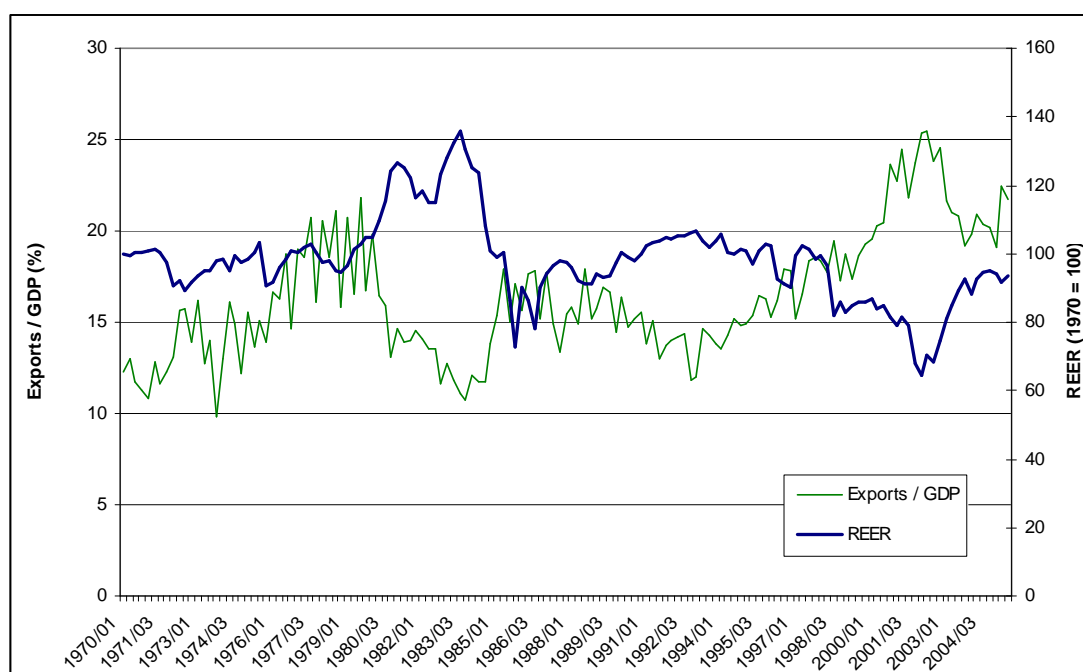
This is clearly evident in Figure 1 below. The sharp appreciation in the real exchange rate over the late 1970s and early 1980s was followed by an equally rapid fall in merchandise exports (excluding gold) as a share of GDP. To some extent the declining contribution of exports to GDP reflects the lower rand value of trade, and not necessarily declining volumes. That said, any decline in the rand value of exports will still have an adverse impact on the economy and the profitability of manufacturing exporters. This pattern repeats itself over the following few decades and the negative correlation between the REER and merchandise exports is remarkably strong.

The real depreciation from the late 1990s to 2002 complemented the post-1994 trade liberalization measures and helped to fuel the beginnings of a merchandise export boom. Export growth was broad-based and included not only MIDP-subsidized vehicles and motor industry components, but also products ranging from electronics to garments, food products and industrial valves.

Starting in late 2002, however, the slowdown in trade liberalization and the commodity-led rand appreciation has had the opposite effect.

¹⁸ The real effective exchange rate is a measure of the domestic exchange rate against a basket of currencies of the country's main trading partners, adjusted for differences between domestic and foreign rates of inflation.

Figure 1. Merchandise Exports (Excluding Gold) and the REER



Source: Based on data from SARB and Quantec Easydata

The impact of real exchange rate has not been even across export sectors. Figure 2 breaks down exports of metals-based manufacturing (we include motor vehicles), other manufacturing, mining and agriculture, all as a share of GDP. The data exclude exports of precious metals (platinum and gold). Exports of metals-based products do not appear to be strongly affected by the REER and have continued to grow over the last few years. Strong international demand for commodities and subsidies to motor vehicles probably explain this intransigence. But exports of ‘other manufacturing’ have fallen dramatically since early 2003, from a high of around 14 percent of GDP to close to 10 percent. This latter category would include most labour intensive and value-added products. Sectors that have been hurt most include clothing, paper and paper products, leather and leather products, textiles and furniture.

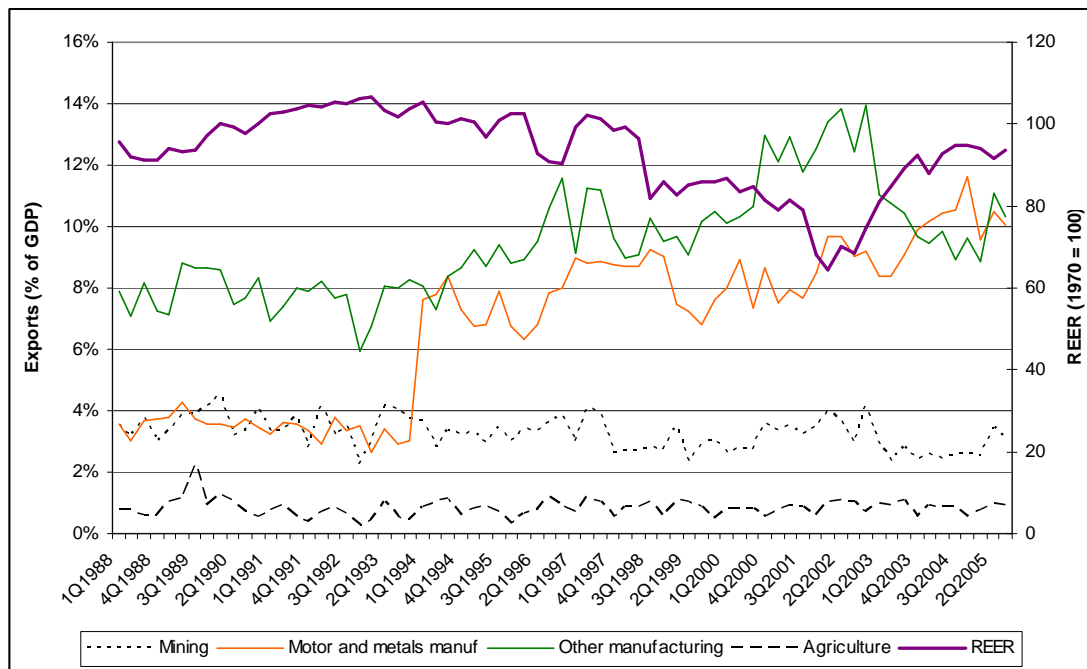
What Can Be Done?

Commodity-led real exchange rate volatility is clearly a problem for South African industrial development. Can the problems be solved or at least ameliorated and if so, how?

One suggestion is for the deployment of more aggressive sector-specific industrial policies, such as the MIDP. The problem with this strategy is that such policies are not sensitive to the resource cycle; they do not respond to the cyclical nature of the real exchange rate effects of resource booms (and busts).

The underlying problem is not sector-specific. Rather, it is a macroeconomic issue related to the smoothing of economy-wide impacts of resource cycles.

Figure 2. Sectoral Breakdown of Export Performance



Source: Based on data from SARB and Quantec Easydata

A sensible macroeconomic policy in the face of resource cycles is to increase national savings during resource booms and reduce them when prices relent. How can this be achieved? One means is through counter cyclical government fiscal actions—increasing fiscal surpluses during booms and decreasing them during downturns. This would be facilitated almost automatically if the government had an effective system for sharing in resource rents through a well-designed royalty system. Not only would this provide a valuable tool for stabilizing the impacts of resource booms, but it would also provide a low cost source of funding for developmental spending on infrastructure, health and above all education and skills development. Well-designed royalties are among the lowest cost form of taxation available to government.

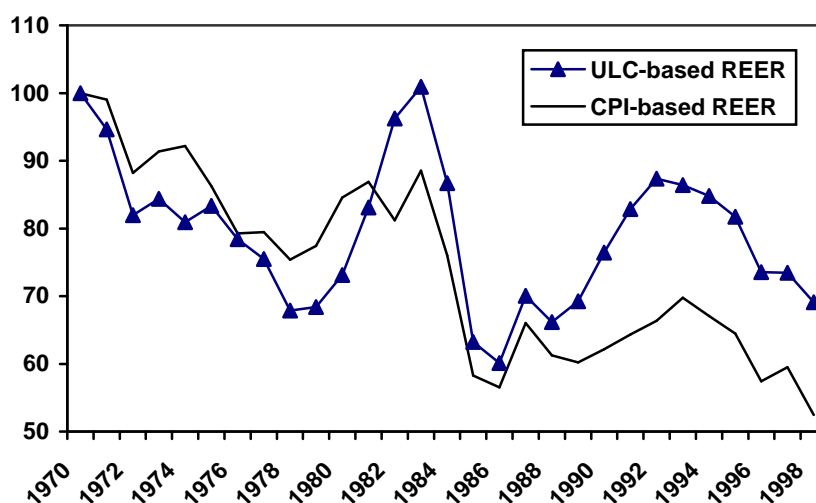
5.4 Unit labour costs¹⁹

The CPI-based REER used by the South African Reserve Bank and described above can be misleading as a measure of international competitiveness, as it includes non-traded goods. One alternative is to use a REER based on unit labour costs (wages adjusted for productivity differences across countries). To the extent that capital and intermediate goods are traded in international markets whereas labour remains largely immobile, unit labour costs (ULC) are likely to diverge much more across countries than other costs of production, and therefore play a disproportionately important role in competitiveness. This is particularly true in emerging countries that are major exporters of manufacturers, such as South Africa.

Figure 3 shows changes in South Africa's price competitiveness over time, relative to the base year 1970, as measured by equally weighted CPI- and ULC-based real effective exchange rates. A downward movement or depreciation of the REER represents an improvement in competitiveness. The fact that the long-term decline in the ULC series is less apparent than that of the CPI-based series, indicates that rising unit labour costs may have dampened the overall improvement in South Africa's international competitiveness. Moreover, it appears that despite a sizeable real depreciation in the 1990's, the ULC-based REER remains well above levels achieved in the mid-1980's.

¹⁹ This section is based largely on Golub, Stephen S., "South Africa's International Cost Competitiveness," Report Prepared for the South African Department of Finance, December 1999.

Figure 3 Comparison of alternative measures of the REER

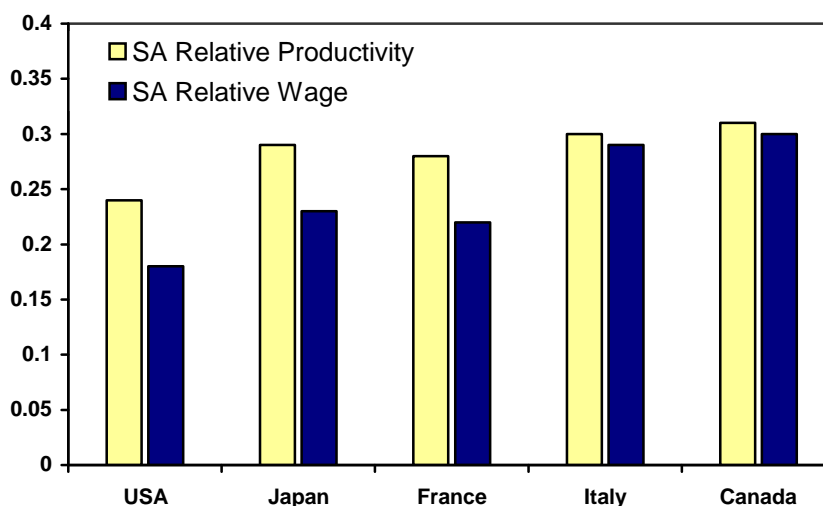


Golub (1999)

The REER indicators presented above show changes in competitiveness over time, and not the level of competitiveness. Thus, for example, while we can determine that competitiveness improved since the early 1990's, we cannot determine whether competitiveness is strong in absolute terms – it may simply be less bad than before. If we compare South Africa's level of labour costs in aggregate manufacturing to other countries on a bilateral basis, a mixed picture of competitiveness emerges.

Figure 4 shows South African wages and productivity relative to a number of major industrial countries. South African productivity is well below that of industrial countries, but in most cases, relative South African wages are even lower. In the case of Canada for example, South African wages and productivity were both around 30% of the Canadian level, meaning that South African unit labour costs were almost equal to those of Canada.

Figure 4 South African relative wages and productivity as a multiple of industrial economies (latest available data)

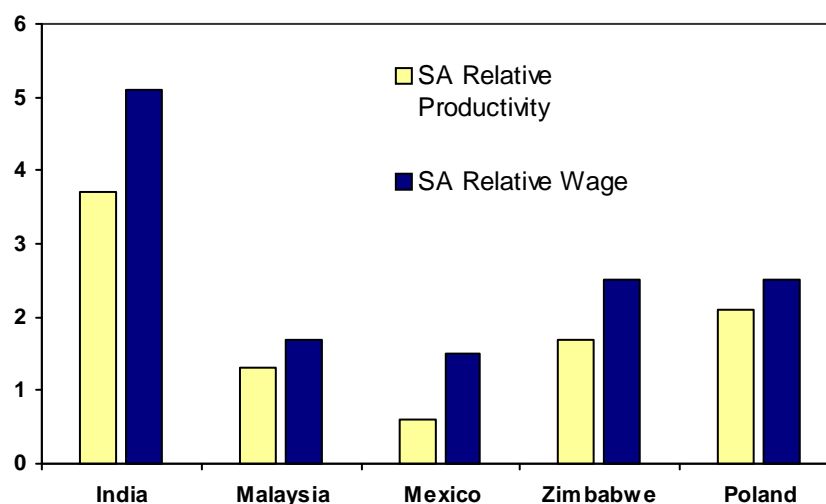


Golub (1999)

It is however more appropriate to compare South Africa to other emerging economies. Figure 5 shows South African wages and productivity relative to a number of developing countries that compete with South Africa for both investment and trade. South African relative wages exceed South

African relative productivity in all cases, implying that South African unit labour costs are high relative to these countries.

Figure 5. South African relative wages and productivity as a multiple of developing economies (latest available data)



Golub (1999)

The same general pattern is reflected across a much wider range of developing and industrial countries. On this basis, South Africa appears to have a serious labour cost problem and wage moderation may be necessary to foster the continued growth of exports and foreign direct investment. It is however important to note that these comparisons ignore other costs of production, such as intermediate goods, non-labour taxes and capital costs

6 Multilateral trade and the WTO

The World Trade Organisation is a forum for setting, monitoring and enforcing the rules of the global trade game. It is the rule-maker and the referee. As the game gets bigger and more complex so too does the role of the WTO. The current impasse in global trade negotiations is in part a reflection of the growing importance of trade across a larger number of sectors and countries and the need for clear rules and a strong referee. The WTO agenda and debate has expanded to include services, environmental issues, government procurement, labour regulations, investment, competition law and trade facilitation. This makes negotiations difficult. But most of the blame for the collapse of the Doha round of negotiations lies with US and EU negotiators and their ongoing squabble over protection and subsidies to their politically-sensitive agricultural sectors.

Multilateral discussions on all of these issues will continue, even if after the next US Presidential elections, and a deal will eventually be struck. South Africa will have little or no influence over the debate and agreement but will have to implement all conditions arising from it. The agreement is likely to include: improved preferences for the world poorest countries; a reduction in agricultural protection and subsidies in the world's richest countries; and further reductions in tariffs and service protection in developing countries, such as South Africa.

What should South Africa do? Continue to “negotiate”? Or get on with badly needed unilateral, MFN-based reform?

South Africa appears to have chosen the former path on the grounds that it does not wish to “give away” any “concessions” unnecessarily. This fails to recognize the basic point that the principal beneficiaries of any trade policy improvements are South Africans, and that these policies have almost no impact on anyone else, and certainly not on the major players in the Doha Round negotiations.

7 Regional integration

As a member of the Southern African Development Community, South Africa has signed-up to an ambitious programme of regional integration, which is supposed to culminate in the launch of a customs union by 2010 and a common monetary area just 6 years later. In addition, South Africa continues to grapple with implementation problems arising from the new SACU Agreement and as a participant in the SADC Economic Partnership Agreement (EPA) block of countries, is also involved in complex bilateral negotiations with the EU. These regional discussions and developments are likely to come to a head over the next ten years and will have a strong bearing on the future of SADC and South Africa's role in it.

7.1 From free trade to a SADC Customs Union

The SADC Regional Indicative Strategic Plan (RISDP) sets out a number of steps which are intended to take the region beyond a free trade area to a Customs Union in 2010, a Common Market in 2015 and a Monetary Union by 2016. This plan was adopted by Heads of State in 2003 and a number of research initiatives are currently underway to help SADC in preparing for and implementing this process. Despite high-level political commitment to this plan the region faces numerous economic and practical challenges which may undermine the achievement of these objectives within the prescribed time period, if not completely. These include:

- The level of intra-SADC trade remains extremely low and is dominated by South Africa. This is unlikely to change under a deeper regional integration initiative, largely because the economic interests of all SADC member states lie beyond the regional market, not within it. The gains from trade from a SADC free trade agreement or customs union are likely to be relatively small. In trade terms, much more could be achieved by lowering the external tariff of individual SADC member countries to the rest of the world.
- The implementation of the SADC Free Trade Agreement is far from complete. Whereas some countries have fully implemented SADC phase-down schedules, progress in other countries has been slow. Moreover, the agreement is hamstrung by excessively restrictive rules of origin in a number of key sectors. Many of the rules were borrowed from the "European Union model" that informed the SA/EU TDCA, and which is based on a notion of development that presumes considerable self-sufficiency in product value chains rather than the efficiency enhancing division of tasks that characterizes global production today. (Erasmus, Flatters and Kirk 2006)
- The overlapping membership between SADC, COMESA and the EAC is both costly and comical. All three regional integration initiatives are committed to the establishment of their own customs unions but member countries remain reluctant to align themselves to a specific and unique configuration. This despite the fact that it is not possible to be a member of two customs' unions. With Tanzania's loyalties drifting towards East Africa; and the DRC, Mauritius, Madagascar; Malawi, Zambia and Zimbabwe locked into COMESA; the SADC Customs Union is likely to be relegated to SACU plus Mozambique and possibly Angola. The fact that Swaziland remains a member of COMESA is farcical.

For these reasons, it is unlikely that SADC will make substantial progress towards the implementation of a new Customs Union by 2010. At best, SACU might expand to include one or two additional countries and be rebranded as a SADC initiative. More importantly, there is no convincing reason why a Customs Union is sufficient or necessary to facilitate deeper and more efficient economic relations between SADC member states; and there is a risk that this initiative will distract from the real and largely domestic constraints to economic growth and development within the region.

7.2 The new SACU²⁰

After eight years of negotiations the new SACU agreement was finalized in late 2002. It was ratified by all members and came into effect the following year, and the revenue sharing formula (RSF) was implemented for the first time in 2005. Immediate “data problems” related to implementation of the RSF have brought to light some more serious issues with the design of the formula and more fundamentally with some of the underlying assumptions and expectations about short and longer term fiscal relationships between South Africa and its smaller and less well developed BLNS partners.

Table 5 shows the current distribution of revenues under the revenue sharing formula, together with some indicators of the importance of these revenues in each of the SACU Member States. The Governments of Swaziland, Lesotho and Namibia are dependent on SACU for an extremely high proportion of total revenue; Botswana is somewhat less dependent. The customs component is by far the largest share of the SACU payment. It is the customs revenue provisions that have become the main source of concern in implementing the new agreement will continue to dominate decisions over trade liberalisation and regional integration among member countries.

Table 5. Receipts from SACU Revenue Pool, 2006

	Excise	Devel'mt	Customs	Total	Total	Total	Total
	R million				% of GDP	% Gov	per
						Rev	Capita
Botswana	586	483	4565	5634	9.0	20.1	3,692
Lesotho	85	560	2191	2836	28.2	53.0	1,398
Namibia	357	523	4584	5463	12.2	41.0	2,695
Swaziland	152	534	3023	3708	24.1	56.9	4,256
South Africa	13512	493	3620	17625	1.0	3.9	666

Source: The World Bank *African Economic Indicators 2004* and budget documentation from the five member states.

It is difficult to believe that the long-term development interests of the BLNS are served by a system that bloats their public sectors,²¹ blunts their inclination to develop sustainable revenue systems and encourages them to resist trade reforms that would assist and promote their integration in the global economy.

While BLNS governments have benefited from this system recently, they must soon realize that it is dangerous to rest long-term development cooperation strategies on the fickleness of changes in the SACU customs revenue pool.

These considerations provide cause for all parties to give serious thought to alternative revenue sharing strategies. Any worthwhile solution would certainly have to remove the perverse trade policy incentives that cloud the future of the current arrangement. It should include a range of other measures to make SACU work better in achieving its primary purpose as a customs union to facilitate trade among its members and with the rest of the world. Among these should be included coordination of border posts, VAT and other tax harmonization, and disciplines on arbitrary trade restrictions.

7.3 The problems posed by EPAs²²

The other ‘new element’ in the equation is the stress to Southern African regionalism posed by the EU’s insistence that the Cotonou trade regime be replaced by a set of reciprocal, regional trade

²⁰ This section is based largely on Flatters and Stern (2006), ‘SACU Revenue Sharing: Issues and Options’.

²¹ The public sectors of the BLNS are about 90 to 100 percent larger on average than for the rest of sub Saharan Africa (excluding RSA and Nigeria). (Source: World Bank *African Development Indicators 2004*.)

²² This section is based largely on Stern et al (2004), ‘Could SACU expand: A review of the obstacles’.

agreements. The membership of these EPAs is as yet undecided, and the formal responsibility is with the ACP to decide which countries will be in which groups.

Of the five SACU states, South Africa was not in line to join any of the EPAs since its trade regime with the EU is set by the TDCA. Until recently, the assumption has been that the other four states would join in an EPA with some or all of the other SADC and, perhaps, COMESA states. But, looking forward, it is easy to see that SACU's neighbours may be uneasy about the implications of joining in an EPA with Botswana, Lesotho, Namibia or Swaziland due to fears of leakage from the TDCA.

Whilst there is no definitive guidance on how the EPAs will be structured, the working hypothesis is that they will follow the TDCA architecture for product coverage. The BLNS and its potential EPA partners therefore face some stark choices:

1. accept the TDCA schedule and timetable; or
2. accept membership of two, separate and different reciprocal trade agreements from the EU; or
3. exclude SACU from the SADC-EPA.

Each of these is problematic. The first is barely conceivable. Under the TDCA the first phase of SACU liberalisation began in 2000 and, by the time the EPAs are due to come into effect (in 2008) only four years will remain before full implementation. Whereas the BLNS might be willing to accept these terms, other members of the SADC EPA team will not. Moreover, the TDCA does not provide for the same degree of preferences in the EU market that the BLNS and other SADC countries currently receive under Cotonou and the EU has stated its unwillingness to extend similar preferences to South Africa. Acceptance of the TDCA could have a substantial and adverse impact on SADC exports of beef and sugar in particular.

The second option would require the retention of robust rules of origin and customs controls between SACU and other SADC EPA members. Without these, imports from the EU could evade any exclusions or delays that were in the EPA but not in the TDCA. The damage being done to SADC integration by the existing rules of origin has been identified by Flatters (2002). The effect of overlapping trade agreements with the EU could be to delay their removal until 2020 or after. If the EPAs commence in 2008 (which is optimistic) and allow a maximum ACP implementation period of 12 years (which may be pessimistic), there would not be free access for non-excluded imports from the EU until 2020.

In a sense, therefore, both options 2 and 3 will put a brake on SACU–SADC trade integration. The third (under which the non-SACU states negotiate an EPA that does not include BLNS) will do so in a sharp, formal way; the second (of overlapping EU agreements) will do so more softly but hardly less forcefully. The stresses created by the EU may provide a strong incentive to 'look outside the box' and consider new ways to cement regional economic integration

8 Future challenges and choices

South Africa has come a long way in integrating itself with the global economy in the decade since democracy. In the context of sub-Saharan Africa, its performance has been well above the average with growth rates of 3.1 percent per year between 1994 and 2004 and direct inward investment of R122 billion over this period (SARB). The initial responses to the end of sanctions, domestic deregulation and trade liberalization were strong and very encouraging. Almost all sectors of the economy became more open and more productive, and experienced simultaneous increases in export orientation and import penetration in response to improved economic incentives.

Nevertheless, South Africa's growth performance has been less than might have been expected and certainly less than necessary to meet the country's ambitious social and economic development goals. Almost all capital inflows have gone into existing assets and the productivity of investment has been disappointing, in terms of its contribution to economic growth, to employment and to the

diversification of the South African economy. Exports have underperformed the world average and that of other resource economies.

Looking forward, South Africa stands at an important juncture in terms of its future trade and industrial policy framework. It can either continue the process of economic reintegration and reform that was begun in the early 1990s; or it can stall and try to stand-up against the tide of globalisation that has transformed the world economy and will continue to do so, with or without South Africa's participation.

There is not uniform agreement on the desired approach and likely outcome. Despite the progress that has been made over the past decade and a half, there are some that feel the need for a strong guiding hand from government in the form of sectoral interventions and strategic restrictions on imports and/or exports to promote the country's long term growth and development prospects.

This view, we would argue, is based in part on a misreading of experience elsewhere, especially in Asia, and in part on an overestimation of government's capabilities to design, evaluate, implement and monitor more interventionist policies in the face of imperfect information and strong rent-seeking interests in key sectors of the economy.

South Africa might continue to dabble with industrial policy and adopt a defensive approach in regional and multilateral trade negotiations, but the gains from such a scenario are likely to be small and this approach short-lived. Global forces and good economics will prevail and in the longer term, tariffs and other forms of protection will come down and the South African economy will become increasingly open to world trade and investment flows.

If one accepts this long-term scenario; then the primary policy focus of the next ten years must be about raising the international competitiveness of the South African economy; and putting in place appropriate support programmes to assist households and individuals that are adversely affected by the resulting adjustment.

Trade policy is just one element of a set of strategies designed to enhance and maximize the opportunities from a country's participation in global trade and investment. South Africa has made enormous strides over the past decade and a half, both in opening domestic markets to opportunities for international trade and investment, and in more general economic deregulation. Nevertheless, much remains to be done on both fronts.

Among the tasks that remain are:

- On the "narrow" trade policy front, further reductions in tariff rates, especially the peaks in a few key sectors, and simplification of the overall structure to a much smaller and narrower range of rate bands;
- In a more broadly defined sense, a more active approach to exploring and exploiting opportunities for greater trade in services; and
- To maximize the effectiveness of all these reforms, far greater attention to a whole range of regulatory constraints to investment and growth that serve little function other than to increase the cost of doing business in South Africa.

These reforms do not require or depend on any kind of international policy negotiations. They should not be viewed as bargaining chips only to be surrendered reluctantly in multilateral or narrower preferential trade agreements. They are in South Africa's own interest and certainly should be pursued in that spirit.

We do not suggest that South Africa should desist from economic policy interventions. To the contrary. This paper reveals numerous areas where better trade, competition and industrial policies are desirable. But the focus should be on economy-wide initiatives and reforms that are likely to have cross cutting effects on all economic sectors and households. This would include continued government investment in infrastructure, education and essential services and further deregulation of telecommunication and transport services.

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