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Are the trends in the South African economy sustainable?

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by

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Table of contents

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1 Introduction

The South African economy, as measured in standard macro-economic indicators, is relatively stable. Economic growth topped 5% in the second quarter of 2005, being the 23rd quarter of uninterrupted expansion. Relatively low interest rates, an increase in disposable income and rising value of assets such as real-estate continues to support buoyant consumer spending by private households. The moderate depreciation of the rand saw export demand increasing once again benefiting sectors such as manufacturing and mining. It is projected that government revenues will exceed budgeted income, despite a commitment to a more expansionary public expenditure policy.

Despite this continued upsurge in economic activity, unemployment and poverty remains at persistently high levels and many of the country's citizens are not sharing in the benefits of rising economic welfare. Several high-level plans are in development to accelerate economic growth to 6%, widely seen as the level at which the country's unemployment problem can be addressed in a more structural manner. Targeted interventions are implemented or are proposed such as the identification of sectoral focus areas, skills development strategies, expanded public works programmes, small business support, labour market reforms and trade liberalisation. Not only strategies focused on the improvement of income, but also asset development strategies are in process such as land reform and targeted investment in education and health.

Apart from relatively low levels of fixed capital formation and an acute skills mismatch in the labour markets, the South African economy continues to be sensitive to the availability and cost of some natural and environmental resources, most notably oil. In addition, the country is not endowed with an abundance of freshwater resources, the economy is energy intensive and very carbon intensive when compared to similar countries worldwide. With the negative ecological feedbacks of pollution and waste becoming more and more evident world-wide, there are possible medium to longer-term costs and opportunities for the economy.

The success of macroeconomic policy is generally measured on five distinct objectives, namely economic growth, balance of payments stability, price stability, equity and employment. Since the late 1990's the first three objectives have been reasonably achieved (although far from sufficient), but no significant progress was made with regard to the latter two. Macro-resource and environmental trends are not (yet) officially included in the system of national accounts used to measure the state of the economy, but selected environmental indicators can be used to highlight environmentally unsustainable activities.

This document provides a short overview of the South African economy taking a broader than usual view on the indicators measuring its success or failure. The discussion will focus on governmental policies to stimulate the economy, as the document is prepared within a governmental planning process. This approach is needed to expose intersections of unsustainable economic trends and identify mutually reinforcing trends. This analysis will inform response strategies that are currently debated and provide a rationale for effective monitoring and evaluation through processes such as the National Sustainable Development Strategy.

2 Trends in the officially measured macro-economy

The South African economy is experiencing the *longest period of economic expansion in the country's recorded history* (IMF 2005). The average economic growth rate from September 1999 until June 2005 was 3.5%, compared to less than 1.0% in the decade before 1994. Real growth accelerated to 5% in the second quarter of 2005, a record for post 1994 South Africa, but average when compared to other emerging market economies. Treasury expects real growth of 4.2% in 2006, 4.4% in 2007 and 4.8% in 2008.

This growth is largely achieved through increased household spending, but exports also play a pivotal role. Household consumption currently amounts to almost two-thirds of total expenditure in the economy. Domestic consumers are the major driving force behind recent economic growth fueled by low interest rates, increasing disposable income, wealth effects from rising asset prices, most notably property and shares, and the extension of credit by financial intermediaries. As a consequence, private household debt is also on the rise, currently at 62% of disposable income. The financial sector servicing these loans and mortgage advances are still in a financially sustainable position, but are likely to become more cautious on expectations of rising interest rates.

With the moderate depreciation of the rand and the opening up of new export markets in Asian economies, the manufacturing sector provided a broader base to this expansion by showing strong export income in the second quarter of 2005. The value of exports have been growing strong since 2003, but still surpassed by the value of imports on the back of strong domestic demand.

Investment in the economy is still at relatively low levels at around 16 - 17 % of GDP. South Africa has not been successful in attracting a sustained flow of foreign direct investment (FDI), but has outperformed other emerging markets in attracting more short-term portfolio flows, mainly thanks to the depth and liquidity of its financial markets. A possible reason for the low levels of FDI is that South Africa scores lower than countries with similar risk attributes on the levels of economic growth, trade openness, the depth of the telecommunications infrastructure, and labour skills (IMF 2004). The sustained economic growth and targeted government and private investment in infrastructure bottlenecks are expected to create a more favourable investment climate in South Africa.

Government expenditure is currently around 26% of GDP with revenues are exceeding the budgeted income. Government's fiscal deficit is revised down to 1% of GDP, much lower than the 3.1% predicted. This deficit is set to increase again with a policy shift to increased government expenditure on economic services. Public sector capital expenditure is projected to increase from 5.3% of GDP in 2001/02 to 6.7 % of GDP over the next three years.

Although there was a slight downward trend in the value of exports (in constant prices) in the wake of the rand’s appreciation against major currencies, exports since early 2004 have been stimulated by higher international commodity prices and a moderate depreciation of the rand. Imports of durable and semi-durable goods have grown even more strongly and since the last quarter of 2003 the value of imports has exceeded the value of exports, thereby changing a long-term trend of surplus in the current account of the balance of payments. Despite the deficit on the current account, the overall balance of payments has remained positive, largely offset by inflows of (short term) portfolio capital into the country.

International reserves, an important variable in the ability of government to exercise some control in international exchange rate markets and/or pay for imports, have been increasing steadily and is now on 13.5 weeks of import, on par with some other small emerging economies, but still low by international standards.

When analyzing future trends some key aspects need to be highlighted:

- Private household consumption, the current engine of economic growth, is likely to come under pressure in the short to medium term with rising interest rates.
- Domestic demand is on a broader basis as an emerging black middle class continues to be included in the formal economy.
- Government expenditure on services, education and health is hampered by a lack of skills and capacity. It is unlikely that the fiscus will continue to significantly service expenditure before such bottlenecks have been dealt with. Social grants have been growing rapidly, but this growth is also likely to taper of with the government’s focus on infrastructure spending.
- The economy remains vulnerable to short term outflows of portfolio capital. It is expected that government expenditure on infrastructure projects will attract both more direct domestic and foreign capital. The government wants to increase fixed investment from the current 16-17 % to 25% of GDP by 2014, thereby elevating the growth rate in the economy to 6%.
- The volatility in the exchange rate remains a key risk and may deter higher rates of private sector investment.
- Exports are dependent on international demand and prices. The European Union as South Africa’s main trading partner performs at lower levels of economic growth than world averages. There is policy space for South Africa to benefit more from international economic expansion. The integration of South Africa into the rest of the world is supported by several bilateral and multilateral trade agreements as well as a programme of sustained trade liberalization.
- Inflation is at desired levels, but recent data suggest a rising trend, mainly due to high international oil prices and brisk domestic demand. It can be taken for granted that the South African Reserve Bank will exercise its mandate and use the policy instruments at their disposal to keep inflation within the 3-6% target range.

Treasury expects CPIX inflation (consumer inflation less interest costs on mortgages) to average 5.2% in 2006 and 4.7% in 2007.

- Sector policies have been drafted that map out bottle-necks in several primary (e.g. mining, agriculture), secondary (e.g. manufacturing, construction) and tertiary (services) sectors and propose sector interventions (e.g. tourism, business process outsourcing, chemical beneficiation industries, agri-processing industries such as biofuels, and mariculture). There is a developing commitment to R&D support in these sectors, to reduce the volatility of the Rand in as far as what a small, open country can achieve on international financial markets, to deregulate telecommunications and to continue with small business regulatory reforms.

3 Specific trends in the rest of the economy

Macro-economic variables provide information on only one part of the economy. There are at least two other key aspects that deserve attention in an analysis of current development trends in South Africa. One is the desired absorption of the "second economy" and the other is the place of natural resources and environmental sustainability in the country's development path.

Targeted interventions to integrate the second economy
The "second economy" as term came into policy discourse in reaction to the exclusion of a large part of South Africa's poor from the success of the economy. Although the focus on service provision directly targeted this part of the population, it did not set the basis on which participation in the economy was guaranteed. After 1994 the newly elected government started off with a two-pronged approach, first focused on meeting basic needs and building human capital through the Reconstruction and Development Programme and second on attaining economic growth and macroeconomic stability through the Growth, Employment and Redistribution (GEAR) programme.

Disappointing levels of economic growth, persistently high levels of unemployment, increased income inequality, and huge spatial disparities in the effectiveness of basic services on the one side, and gradual decreased levels of government debt and increased government revenues on the other, prompted a policy shift to more direct government involvement. This implies a shift in the emphasis of government spending from social to economic services, although social services will continue to dominate expenditure budgets - declining from the current 60% to 58% of all government expenditure over the next three years. Government wants to achieve the participation of the "second economy" through, amongst others, employment policies on extended public works programmes (EPWP), policies focused on black economic empowerment, public-private partnerships in service delivery and labour market reform. The idea is to create employment opportunities in infrastructure projects, environmental and cultural programs, and social programs such as home-based care and early childhood development. These programmes, however, cost money and can only operate well within a framework of macroeconomic stability. Budgetary trade-offs between such direct intervention and the ability of the economy to finance such programmes will therefore be an essential part of future macro-economic planning. This trade-off is evident as the focus is not only on stimulating the second economy, but also nurturing the first economy to continue to supply the goods.

These shifts are further evident in the changed stance on the restructuring of state assets such as Eskom, Transnet and a portion of Telkom as BEE levers and the various BEE charters negotiated and implemented in the financial and mining sectors. It is also evident in state regulations in the health sector as a mechanism to extent the social safety net. BEE has been criticized for only benefiting a certain segment of the population.

The EPWP main drawbacks are that it is expected to deliver only 200 000 temporary jobs, representing 2 - 4% of the total unemployed workdays per year. It will certainly not be the only solution to the persistently high levels of unemployment and a guaranteed way out of poverty on a macro level.

That these programmes are not having their desired effect yet is evident from estimates on the quality of life of all South Africans. Despite a rise in average economic welfare, this positive trend is not mirrored in a broad-based increase in the quality of life of the average South African. According to the 2005 United Nations Human Development Index, South Africa fell 35 positions to 120th out of 177 countries since 1990, mainly due to the HIV/AIDS crisis negatively affecting a substantial part of the population.

A policy of targeted government spending can only be seen as a start to a longer term solution to the country's unemployment and poverty problems. For this to be successful on a macro scale there is no doubt that private (domestic and/or foreign) knowledge and capital is needed. If private and foreign investment does not materialize, pressure on the social security net will further increase. In the mean time and as a consequence of the limited depth of the EPWP it can be expected that pressure for a more streamlined grant system to reach the poorest of the poor will continue and even intensify, placing more pressure on budgetary trade-offs.

It is therefore unquestionable that other strategies will be sought to reach the desired integration of the second and first economies. One strategy discussed widely is not to only focus on income as a means out of poverty, but to increase the access to and quality of assets. There is a good chance that pro-poor policies focused on subsidised housing, education, property and land will continue to regain its status as a vehicle to poverty alleviation, this time not only packaged as a basic needs issue, but with an increased emphasis on the ability of these assets to generate a livelihood and/or capital to the owner. However, investing in assets is a long term strategy and will not yield immediate returns. Land reform is back on the political agenda as poverty is much more evident in rural areas, but this is far away from being a generally accepted pro-poor strategy.

Another strategy is specifically focused on addressing the skills shortage in the country. In March 2005 the government launched the second National Skills Development Strategy aimed at training initiatives and learnership programs. Although the programme is successful in term of achieving learnership, BEE and equity targets, with almost 80%

of learners previously unemployed, it is too small and focused to count as an macro unemployment or poverty alleviation strategy.

A fundamental trend to monitor is therefore the success at which the second economy is “pulled into” the first economy through these targeted interventions. These interventions can only be seen as a first step, but several risks remain. In parallel, three pathways remain. The first is that the first economy “pushes into” the second economy. A policy of trickle-down will not be sufficient, at least not in the short to medium term. Government is using a mixture of carrots (e.g. tax inventives, small business development incentives) and sticks (e.g. sector charters) to speed up this integration. The second is more expenditure on a social security programme to address absolute poverty, an option government seems unwilling to pursue as social services already takes up most of the fiscal budget and as this effectively crowds-out options for other prioritized interventions. The third is one is to deliberately escape from the rhetoric of first and second economies and built on the multiple forward and backward linkages already existing between the formal and informal economies. This implies one economic policy and not two separate policies, one focused on macroeconomic growth and the other on pro-poor interventions financed by the gains of this economic expansion.

Natural resource use and environmental sustainability

How sustainable are these economic trajectories when the costs of natural resource use and environmental degradation is included? This is a largely over-looked aspect in the growth and development proposals by government at this stage. The last decade has seen a transition in the legislation and management of the country’s natural and environmental resources. Natural resource policies mirror the drive towards a more inclusive allocation of the country’s resources, most notably in the water sector with the recently launched water allocation reform process. Electrification was extended to include the poor and the rural segments of the population. Ecosystems are protected under the umbrella National Environmental Management Act, supported by specific pieces of legislation for several sub-systems. However, these developments have yet to influence economic development planning in a meaningful way.

The traditional approach would be to interpret such legislation as an input risk management strategy. For economic development to happen, one would need natural resources, therefore one would need sound policies governing these inputs. However, a more fundamental question is whether there are any signs whether these changes in political-institutional context have brought with them cleaner, that is less material and energy intensive and less polluting development. With increased pressure on these resources, strategies for effective decoupling for finite and often costly resources and the re-investment of proceeds of exhaustible assets need to be included in economic development proposals. What good will a development strategy be if increasing and/or volatile costs of natural resources, pollution and waste at the heart of it will undermine future delivery? A present-day example is an economy that has tied its development to the abundance of cheap coal and oil. In South Africa, no comprehensive study has been done yet to measure the possible decoupling between resource use, environmental impact and economic development, but selected environmental indicators do shed some light on macro trends. Although data in some instances is a few years dated, on a macro-environmental level South Africa several trends emerge:

- Rapid urbanization (around 60%) and relatively constant rural population density (128 people/sq. km arable land)
- Relatively low nationally protected areas (5.5% of land area)
- Very high percentage of land used for agricultural purposes (82%)
- Persistently high electrical power consumption per capita (3860 KWh)
- Volatile GDP per unit of energy use (3.9 PPP $ per kg of oil equivalent)
- Persistently very high percentage of electricity generated by coal (93.1%)
- Persistently very high CO2 emissions per unit of GDP (0.8 kg per PPP$ of GDP)
- Persistently very high CO2 emissions per capita (7.4 metric tons)
- Very low and rapidly declining freshwater resources per capita (982 m^2)

On a macro level there are as yet no convincing signs of decoupling between economic growth and the natural resource use and pollution intensity of this growth. Given the current energy policy focused on bulk coal-based electricity generation this is also not likely to change in the near future for energy intensity and carbon emissions. There are already clear signs that water prices are rising steeply in South Africa and it can be expected that this trend will continue. This opens up options for alternative water supply options such as waste-water treatment and desalination at coastal cities. The economically viable use of land for other than agricultural purposes, such as enhancing the value of ecosystem goods and services, could be considered as a land development option. Environmental rehabilitation projects also form part of the EPWP. Although there is evidence of initiatives on less material, energy and pollution intensive production and consumption, these have not (yet) influenced macro trends. The high urbanization rate suggests that natural resource use, as well as pollution and waste problems are likely to continue placing pressure on the sustainability of cities. It also suggests that the rural population, most likely to be trapped in the second economy, will be almost solely dependent on social securities supplemented by available natural and environmental goods and services.

4 Qualitative trend analysis

Where are the crucial intersection points in South Africa's economic development trajectories? Will these trends reinforce each other in a positive way or are we likely to witness conflict in future? These are very broad questions and deserve to be studied in much more depth, but a few pointers would have to suffice in this paper.

The macroeconomic stability of the country provides an all-important framework wherein "second economy" interventions can now be carried out. However, the scope of these interventions (EPWPs, skills development strategy, BEE) is not likely to be sufficient to provide a sustainable income to a large part of the poor. It is set to remove bottlenecks in the first economy, and subsequently stimulate growth, but cannot be seen as an all-encompassing strategy to engage the "second economy". The budgetary trade-off between expenditure on social and economic services is likely to remain as acute as in the past decade, and any sign of failure of the EPWPs, BEE and the skills development strategy, or an economy that starts to taper of due to domestic and/or external shocks will place pressure on Treasury to lower expenditure on either economic or social services or both. It is vital that private and foreign investment will be attracted to provide a broader base to this investment-induced development plan and to keep a stable macroeconomic framework wherein this can be carried out.

This systematic opening-up of the South African economy and the domestic policy objective of sustaining and creating jobs will continue to create policy tensions. Trade liberalization and foreign exchange control is likely to keep momentum under macro policy directions raising questions on sectoral winners and losers.

With the expected limited reach of these investment and skills development programmes, and the temporary nature of the resulting income, asset development strategies such as land reform and property entitlement is expected to keep coming back on the agenda. The intensity with which this will happen is to some extent linked to the success of other pro-poor policies. The effectiveness of expenditure on education, health and welfare is an important trend to observe as success or failure in these areas will directly impact on the resilience of especially the poor population. Despite high levels of spending on social services in the last few years, the quality of life decreased significantly mainly due to the devastating HIV/AIDS crisis. It may well be that government is forced to revisit the effectiveness of social services and consider alternatives mid-way through a programme of expenditure on economic services, a hesitation that could have both negative macro-economic implications and may fall short in addressing the quality of life of many South Africans.

There are no easy ways out, and a strategy of cautiously leveraging macroeconomic stability into targeted pro-poor policies is possibly the only sound long-term development option available for government at the moment, but with serious inherent risks that need to be monitored and evaluated very closely for remediating action.

Apart from the intersection of macro-economic and poverty trends, another intersection is the performance of the macro-economy and the use of natural resources and impacts on the environment. The environmental impacts of increased infrastructure development come to mind as an obvious area where sustainability needs to be guaranteed. Spatial and integrated development plans would need to deal with the environmental impacts on third parties and the environment in an economically efficient, socially just and environmental effective way. A relatively small, but reinforcing trend is expenditure on environmental projects as part of the EPWPs.

A further more macro intersection point on economic and environmental development trajectories is the country’s energy and electrification policy and resulting increasing carbon dioxide emissions. In an increasingly globalised world and one where carbon constraints is rapidly becoming a financial cost, global pressure will increase to share this cost among developing countries who contribute a disproportionate amount to emissions.

Current economic development trajectories leave little space for constructive international negotiations and/or a gradual internalization of these costs.

Dwindling freshwater resources will lead to hardship in especially rural communities without access to piped water (a declining percentage), and in all cases increase its costs. Alternative supply options are available and need to be considered as part of an economic growth plan.

5 Key challenges for public policy

Do these trends require any particular public policy and/or stakeholder intervention? With regards to macro-economic stability the answer is probably no. Policy direction has been made clear by various state of the nation addresses, government expenditure priorities, BEE initiatives and sectoral support programmes. With regards to pro-poor policies it can be expected that existing priorities and policies will be tested in the next few years and this policy nexus will remain volatile. With regards to the use of natural resources and environmental pollution, policies are operating distinctly lose from each other and from broader macroeconomic and pro-poor policies. There is an urgent need to measure the relationship between the economy and the environment, and seek integration of economic, industrial and trade policies and environmental policies on the one hand, but also between pro-poor and environmental policies on the other. The polarization between cheap electricity and resultant high carbon dioxide emissions as a pinnacle of development strategies, and the governments' accession to the Kyoto Protocol and lip service to dealing with climate change is obvious. Pro-poor policies further pay scant attention to the sustained flow of ecosystem goods and services that play an important role in the survival of large parts of the rural poor population – a policy nexus not even developed yet.

6 Conclusions

Are the trends in the South African economy sustainable? When looking at macroeconomic indicators of economic growth, price stability and balance-of-payments stability the economy looks fairly healthy. However, unemployment is still persistently high at levels far beyond international norms. A more equitable distribution of benefits has not been achieved. Environmentally sustainability has not officially been measured on macro scale yet, but several selected indicators do point towards a steady deterioration of natural capital.

The government is flexing its muscle by investing directly in the economy. This is expected to lead to higher rates of economic growth and remove bottlenecks in the formal economy, but is not widely seen as a strategy to engage the "second economy". Social security spending will remain an important feature of the South African fiscal budget for quite a long time.

This strategy may prove more sustainable if private and foreign investment is leveraged, if existing pro-poor policies will achieve its intended development of human capital, if asset development strategies such as land reform are well-managed, and if negative environmental feedbacks will not start costing the economy. It is more likely however, that government will have to keep on balancing the budget between intended investments and social services of a population with a deteriorating quality of life, that international demand and exchange rates uncertainty will continue to impact a strategy of export-led growth, and that domestic consumption, the engine of growth in the last 4-5 years, may have less of a party in the short to medium term future. **In the It is It is more likely**

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