

## Trade as a Driver of Structural Transformation for Inclusive Growth in South Africa

Thank you Chair for your kind introduction. Good morning. I am very pleased and honoured to be in your midst.

Despite all the gains that have been made through the pro-poor policies of government since the inception of democracy, poverty in South Africa still remains unacceptably high. Why? This is mainly because of the increasing risk of self-reinforcing poverty conditions in the second economy, which has manifested itself in a widespread gap between the first and second economies in our country.

Inequality has remained high and this has undermined the efficacy of growth in reducing poverty. Until the majority of the poor in the second economy become more productive, South African economic potential cannot rise to the point where poverty and unemployment would finally be eliminated.

To accelerate inclusive economic growth to achieve sustainable poverty reduction therefore requires manufacturing structural change. All countries that remain poor have been unable to diversify their production and export base. Increase in economic growth and employment has to be driven by diversification from traditional production into manufacturing and not by commodity boom, which is highly volatile.

The NDP, together with NGP, the IPAP and SATPSF, acknowledges that sustainable growth and jobs requires manufacturing structural change or industrial development. The pace with which this structural change takes place is the key factor that will determine our success in accelerating and sustaining inclusive growth in South Africa.

But various aspects of structural change in production are linked to changes in trade. Trade plays important role in driving structural transformation.

- ✓ By expanding domestic manufacturing, taking advantage of additional market (export opportunities) provided by international trade (**demand-side effect**).
- ✓ It also has the potential for replacing imports as local producers capture markets initially served by imports, thereby exposing local firms to foreign competition and technology, which may lead to significant productivity gains (**supply-side effect**).

This is not to say that trade opening automatically engender growth. There are several examples of countries in which integration into the world economy was followed by strong growth and poverty reduction, but this is not the case across the globe. Trade liberalisation could actually have significant negative effects when it has not in itself induced the necessary structural change in the economy. The contrasting experiences of East Asia and Latin America provide useful explanations.

The rising role of many Asian countries in international trade reveals high industrial performance and trade-induced structural transformation. In the case of Latin America, this was explained by a greater propensity to export rather than an expansion of domestic manufacturing products.

The relative success that East Asia has achieved in terms of export growth and structural change is a reflection of the greater success in the evolution of its comparative advantage and in the ability of its industries to adjust to trade reforms. In contrast, Latin America specialized according to its static comparative advantages in sectors that offered fewer opportunities for diversification and improvements in product quality. As expected for a region with abundant natural resources, high profitability of their exploitation, requiring little technology hindered the upgrading of its exports.

Numerous studies have shown that one of the major differences between the success stories of East Asia and the experiences of Latin America has been that the East Asian economies have made the transition to knowledge generation, whereas Latin America is lagging behind in this respect. As pointed out by Augusto de la Torre, the World Bank's chief economist for Latin America: "after the Second World War the East Asian economies linked up to Japan, and in the process of getting connected they created the "Asian Factory". It became a virtuous circle. The better they connected to the world, the better they connected to each other." Latin America's post-war experience has been the reverse: "We were connected to the most important growth centre, the United States. But instead of the "Latin American Factory", we got dependency theory, structural adjustment and a lot of disappointment."

For example, of China's top 10 export manufactures in 2011, 6 were high-tech products. Three other were medium-tech engineering products. Mexico and Brazil are the main drivers of the Latin America's exports. But of Mexico's top 10 export products in 2011, only two were high-tech manufactures and five were medium-tech products. Brazil had only one high-tech exports and no medium-tech products among its top 10 exports in 2011. Regional production sharing played a key role in the technological upgrading of exports in East Asia, intra-regional trade in manufacturing goods as a share of total trade increased considerably from 50 per cent to 70 per cent of imports, compared to 10 per cent in Latin America.

In South Africa, export basket is concentrated in primary commodities, resource-intensive manufactures and low-technology-intensive manufactures. The country lost 2 per cent of high-tech and 4 per cent of medium-tech exports to resource-based exports in 2011. Consequently, there are only a limited number of manufactured products that the country can prioritise to increase the pace of transformation.

South Africa is transforming towards the services sector. However, the services sector does not create large numbers of jobs, even when it does these are often high-skilled, in a country in which the unemployed are largely unskilled, an unfortunate mismatch

So what lessons can be drawn from what has worked in terms of accelerating growth and transformation through trade?

- ✓ **We need to build technological capacity:** Technological change and innovation are inherently part of the structural economic transformation process that has been slow. The low level of human capital relevant to industry undermines the country's ability to attain technological progress. If we

were to emulate some of the dynamic growth and diversification of East Asian countries, there would have to be a phenomenal rise in the quality, quantity and completion rates in education relevant for industrialisation. For example, a shortage of skills in design is among the key challenges still facing the South African Textile industry. It takes South African Textile companies 56 days to go through the production process, but 14 days for a company in Mauritius. But, the EU wants it in 10 days.

- ✓ **Better access to input for export production at world prices as well as output markets will increase the competitiveness of domestic firms and hasten structural transformation:** Many African economies are small and have to import most inputs in order to manufacture. They also lack a large domestic market that would provide some form of natural protection for their manufacturers. These challenges are ultimately surmountable through becoming competitive on global export markets. But at the early stages of industrial development they make it more difficult for domestic firms to compete against foreign firms that have the advantages of scale and dense industrial clusters. Harmonised industrial policies through regional integration and suitable institutional arrangements can help countries overcome these challenges and seize opportunities to advance on economic transformation.

This is very critical for South Africa, considering that a large number of its value-added exports are destined exclusively to their neighbours.

Regional value chains can create larger markets for domestic firms and promote inclusive industrialisation as a result of the greater ease through which parts of a product's manufacturing in one African country may be outsourced and located in various countries within the continent. The more we connect to the world the better we should be able to connect to each other and create the "African factory."

Consider the contention that it costs less and takes less time to ship goods from China to many East African markets than from South Africa. Just as national roads and other means of transport is needed to integrate and widen the market within a country, regional roads and other transport systems is also required. Arrangements enabling countries that are well endowed with infrastructure (such as power seaports) to develop them at scale so as to also serve neighbouring countries at lower costs (than those countries could produce for themselves, if at all) could promote faster and inclusive transformation in both countries.

To address the rising input costs and cross-subsidise the resultant growing production costs, some of the firms whose main focus is on the international market, have now established their branches outside the continent (e.g. China) where they can take advantage of low production costs. On the other hand, some of the firms whose focus is on the local market, have now adopted "import strategy" aimed at complementing domestic production with more imported finished products. Should this continue, it would undermine efforts to promote industrialisation and accelerate growth as well as employment?

- ✓ **The broader agriculture-to-agro processing value chain can, if successful, create trading advantages and foster inclusive growth:** The country has an increasing number of comparative advantages in agro-processing products and most of its exports to other African countries are in agro-processing sector. Evidence has also shown that growth in agro-processing output has mostly been followed by employment more than in the manufacturing sector as a whole. This is an indication that the processing of agricultural products can offer a new base for economic growth amid the fall in mineral commodity prices; it can also promote inclusive industrialisation. This suggests that an effective development strategy which addresses both growth and inclusion concerns should pay attention to the agricultural sector.
- ✓ **The country need trade policy space to promote manufacturing structural transformation:** South Africa is a target market for countries producing enormous volumes of value added goods and the extent of government subsidisation and support in some of these countries poses threat to local producers. Hence, there is need to strategically adjust tariffs and explore the water between bound and applied rates in support of manufacturing sectors. As trade policy is informed by industrial policy, tariff support becomes inevitable, but the rate of increase will likely taper off. The question with implications for policy making is how to defend policy space to support industrialisation in South Africa.
- ✓ **Structural transformation is a systematic process:** The comparative experiences of various countries suggest that structural transformation is not an automatic process – history, quality policies, and efficient and effective institutions matter. Different types of industrial policies are necessary at different points in time. It also requires policy certitude and consistency and not only a willingness but a desire to work with the private sector, helping small enterprises grow into medium and large enterprises. It cannot be that the same government which is taking about accelerating the pace of manufacturing structural transformation is providing excessive incentives to the multinationals at the expense of the local producers and procuring from outside the country inputs for infrastructure projects that can be readily made available at home.

In conclusion, Government intervention policies and programmes aimed at addressing poverty and inequality still contribute so little to the transformation of our economy. Going forward, interventions have to be underpinned by the kind of structural transformation that enables the poor become major drivers of the economy.