

Enhancing South Africa's Export Performance

Where do we start to change things?

The economic landscape that lies before us (globally and locally) is characterized by falling asset and commodity prices, decreasing GDP worldwide, high unemployment with low interest rates and inflation with major industries and sectors facing huge financial losses and bankruptcies. Nevertheless South Africa must position itself strategically as to exploit any trade opportunities that may arise due to this climate, by pursuing policies that will ensure an increase in exports. This pursuit may seem as an ambitious effort with due cognizance of the current economic climate and South Africa's capabilities of policy formulation in this regard (GEAR, ASGI-SA), (Phiri, 2005). There also exists debates of more trade liberalization (Edwards, 2005) and more protectionism relating to international trade. With all of these conditions existing, this paper will present policies based on unorthodox methods to transcend these conditions in the direction of increasing South Africa's exports.

South Africa's Exports: Structure and Theory

Structure

South Africa's exports are mainly based on resource-based products because of its factor endowment in this regard. It also exports manufacturing goods such as automobile parts, alcoholic beverage, etc. Empirical evidence (Tsikata, 1999) suggests that the structure of South Africa's exports is geared for world markets that are not "growing rapidly relative to other middle-income economies". This indicates that the structure of South Africa's exports lack "export dynamism", which Alvis and Lawrence (2006) define as "the ability to take advantage of high growth products". In Appendix A, Figure 1, 2, 3 illustrates the market positioning (only manufacturing goods) of East Asia and Pacific region, South Africa and Resource Group countries respectively. The dotted line divides the figures into

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four quadrants where the top right hand quadrant indicates “good” market positioning (exporting high growth products) with poor market positioning being the bottom right and top left quadrant.

It is clear from the figures that South Africa has not positioned itself well as to be a “competitive, outward orientated economy” (RSA, 1996).

Theory

Hoggdson (2001) argues that theory must precede empirical results as the former has the ability to simplify reality and provide a framework to conduct investigations but he also argues that sometimes empirical results can precede the theory. In view of the latter, analysis done by Alves and Edwards (2006) finds that South Africa’s manufacturers are on average price takers in the international market and that exports are supply driven. They also found that the ability for SA’s manufacturers to export is not dependent on the “economic prosperity of South Africa’s trading partners”. These results give us the theoretical basis for focusing on policies that will increase export supply rather than demand.

The Lerner symmetry argument, which states that the removal of import protection is symmetrical to an export subsidy, is another result that gives a theoretical basis for increasing exports through trade liberalization. A shortcoming of this result is that it does not show the optimal amount of import removal that will transpire into an export subsidy.

Another result that will be helpful is the Heckscher-Ohlin theory which purports that a difference in the supply of factors will make trade between two countries possible. South Africa is relatively abundant in natural resources compared to many countries which make it possible for it to have mutual beneficial trade.

The Visible Hand

The macroeconomic policy that the South African government followed in the 1990's was a Growth, Employment and Redistribution (GEAR) policy which espoused an export-led growth strategy. The policy failed (Phiri, 2005) in achieving this growth strategy, while other middle-income economies (Taiwan, Mexico, Brazil) like South Africa were being "rising stars" in export-led growth. GEAR made provision for infrastructure upgrades worth about 400 billion rand over a 5 year period but it would seem that the funds were not directed to infrastructure that reduces the cost of production for exporters.

The government needs to minimize the turnaround process (time taken to move from low growth products to high growth products) for exporters by providing an array of infrastructure. This infrastructure upgrade must include transport and communication services, provision of stable electricity as well as clean and functioning water and sanitary services. By providing an infrastructure programme that includes the above items, government will reduce the transaction costs for exporters (Alvis and Lawrence, 2006), provide means for the diversification of export production (Elbadawi, 1999) and also contribute to the development of international production networks (Mayer, 2003). Empirical research (Alvis and Lawrence, 2006) shows that a 1% increase in public-sector infrastructure capital relative to manufacturing GDP increases manufacturing exports by 2.4% in long run. The 787 billion rand that the Minister of Finance set aside for infrastructure upgrade must be directed to an infrastructure programme that is outlined above. An important caveat is that infrastructure upgrade is a necessary but not a sufficient condition for increasing exports. Other measures must be implemented to ensure a dynamic increase in exports.

Other measures that can be introduced are a tax incentive and a research and development centre. The tax incentive will include decreasing the amount of tax

payable by exporters if there is a consistent increase in total exports by industry or by individual exporters depending on the most feasible and viable. Such an incentive will ensure efficiency by all exporters in all industries and also provide signals to the research and development centre. These signals might include lack of necessary infrastructure, a strong exchange rate, etc before there begin to hinder the potential growth of exports. The R&D centre will provide nostrums based on the information given via the signals by exporters to exporters. A R&D centre is an intermediary between the government and exporters. The figure below encapsulates the relationship between exporters, the R&D centre and government.

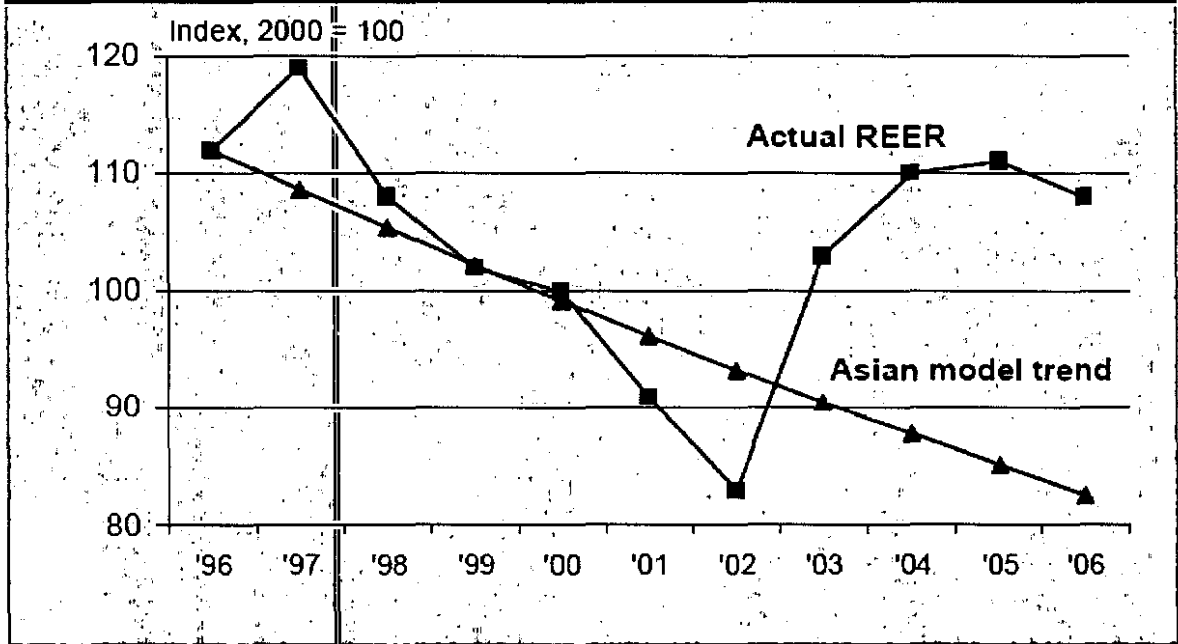


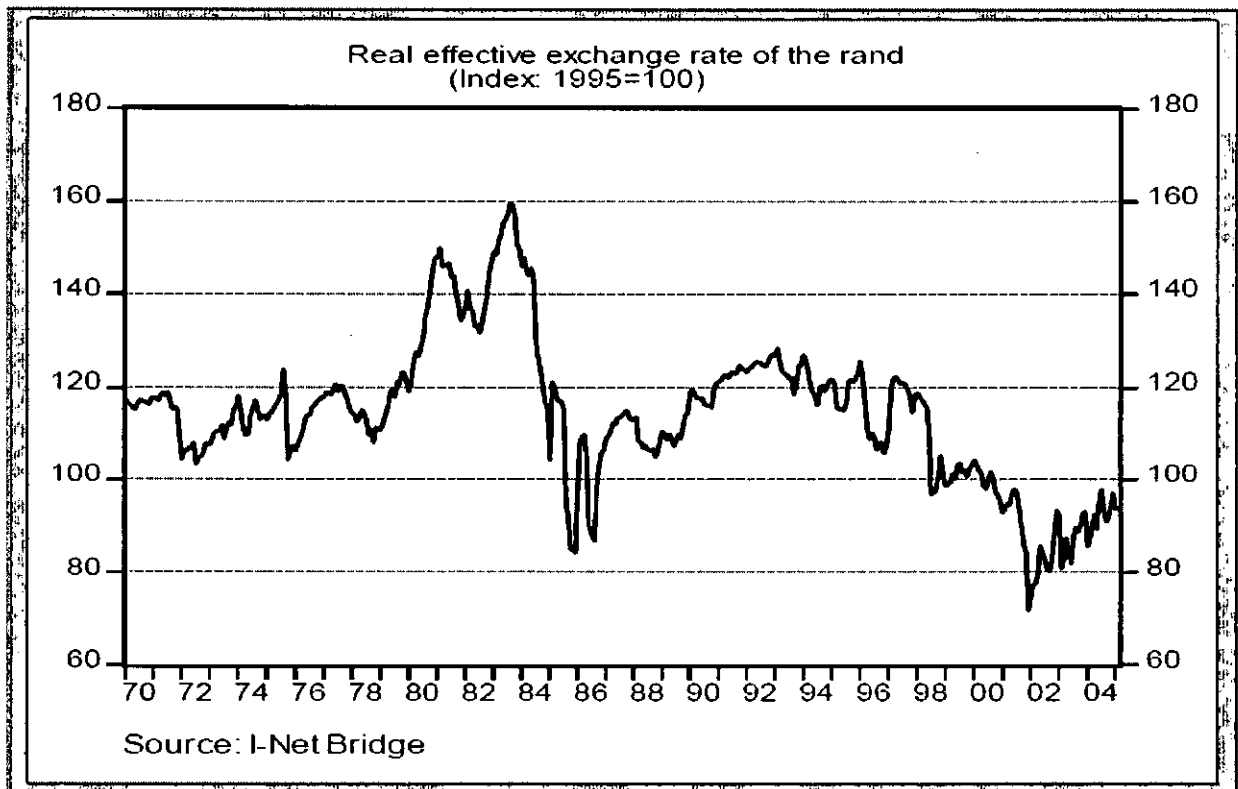
An infrastructure programme combined with a tax incentive and a research and development centre form an integral part to ensuring an environment that is conducive to a stellar performance in exports.

Finding a “Good” real effective exchange rate

Over the past 30 years the real effective exchange rate of Asian tiger economies has been decreasing which has been conducive to an export boom. During the same period South Africa has seen its real effective exchange rate (REER) subject to volatility, thus leading to varying exporting numbers. Looking at the figures below they depict SA’s REER with the Asian model trend and SA’s REER respectively.

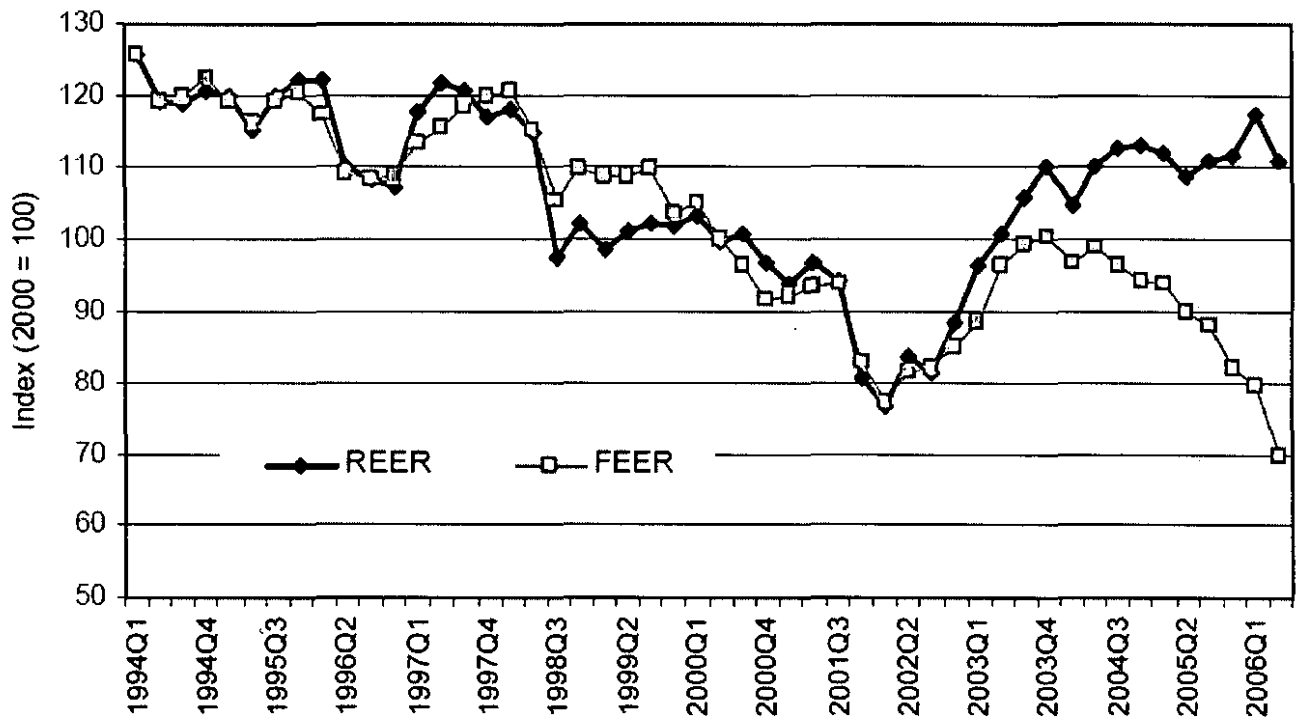
Real effective exchange rate (REER) of the rand & Asian Tiger Model trend





A 'good' real effective exchange rate will differ according to different economic climates, but will always be characterized by the ability to induce exporters to increase exports. Abedian, W de Wet and Pitso (2006) define an optimal (good) currency as the level that establishes internal and external balance in the economy. Using this definition they found a fundamental effective exchange rate that could have produced a zero balance on the current account and gross domestic product at full capacity over the 1994-2006 period (see figure below). By looking at figures it is evident that a decreasing real effective exchange is necessary for export growth.

The FEER consistent with a zero balance on the current account and at GDP full capacity



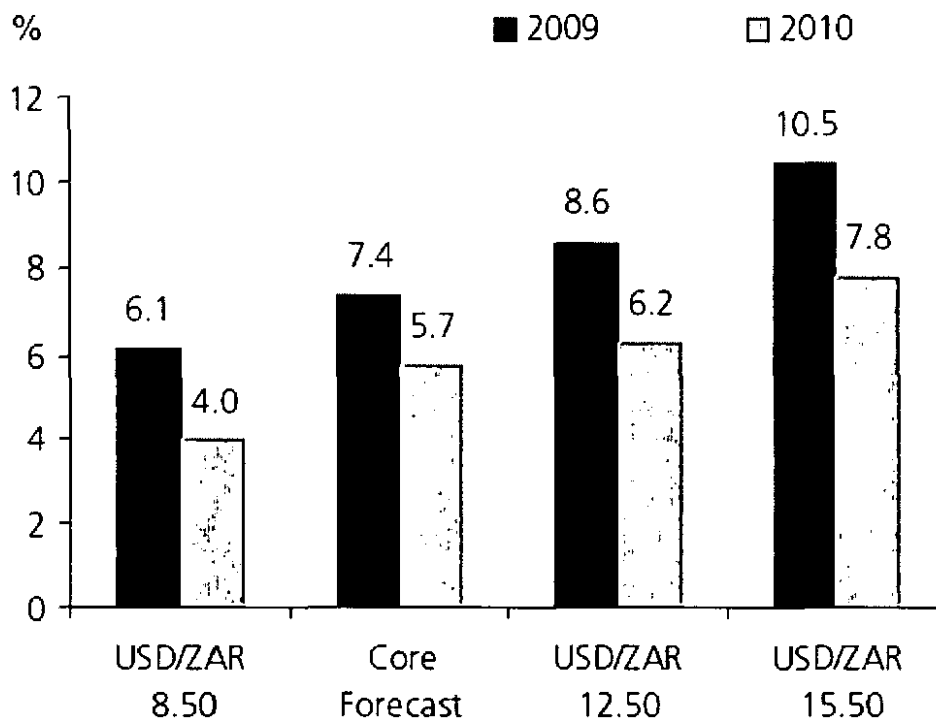
Empirical investigations (Aaron, Elbadawi and Kahn, 2000);(MacDonald and Ricci, 2004) into the determinants of the rand find that its movements are due to the terms of trade, commodity prices, size of fiscal balance, extant of trade openness, country's net foreign assets, long-run capital flows and real interest rate differential in relation to its trading partners. Frankel's (2007) econometric investigation concludes that "high South African interest rates raise international demand for the rand and lead to real appreciation..." and that the rand is a commodity currency. A more precise relationship between the real exchange rate and the economic fundamentals was found by Ricci (2006):

- A 1% increase in real interest rate relative to its trading partner will appreciate the rand by 2-3 percent;
- A 1% increase in commodity prices will result in a 0.5 percent appreciation in the rand

The body of evidence outlined above provides relevant material for a policy formulation to find and ensure a 'good' REER that can persist over the long-run. Currently the South African Reserve Bank uses interest rates adjustments with an approach of inflation targeting to ensure price stability. The Reserve Bank sets its interest rates based on expected inflation rather than on the actual inflation rate. The range of 3%-6% seems to be conducive to higher economic growth and not with a decreasing REER. Since the expected inflation rate is projected to decrease over the next to years with interest rates remaining high relative to our trading partners, it is inevitable that the rand will appreciate in value (Ariovich, Esakov and Marais, 2003). In light of this and other observations it would seem that the inflation targeting range will need to be expanded or be dropped altogether.

A range of about 7%-11% will need to be considered as possible inflation target range. An inflation rate that is between 12%-15% can be brought down in six to eight months to a region of about 9% using only interest rate hikes as a tool. An inflation target range of 7%-11% combined with low interest rates will be able to deliver a decreasing real effective exchange rate in pursuit of an increase in exports. Figure 4 below depicts average inflation rates under different exchange rates. Another option is to drop inflation targeting altogether and consider monetary policy directly to decrease REER. The South African Reserve Bank will need to be aware of our trading partner's real interest rate levels in order to make sure that SA's real interest rate is relatively low compared to theirs. The task of SARB will then be to use interest rates to make SA's real interest lower (relatively) to our trading partners. Such manipulation of the exchange rate will not go unnoticed by speculators and they might desire to make a handsome profit. The addition of some capital controls will play an integral role in ensuring that carry trade activities and speculative attacks do not hinder an optimal real effective exchange rate in the medium to long term. The capital controls are introduced as a means of decreasing variability in the rand by reducing the rand's tradability as a financial asset.

Figure 4: Average annual CPI inflation under various USD/ZAR scenarios



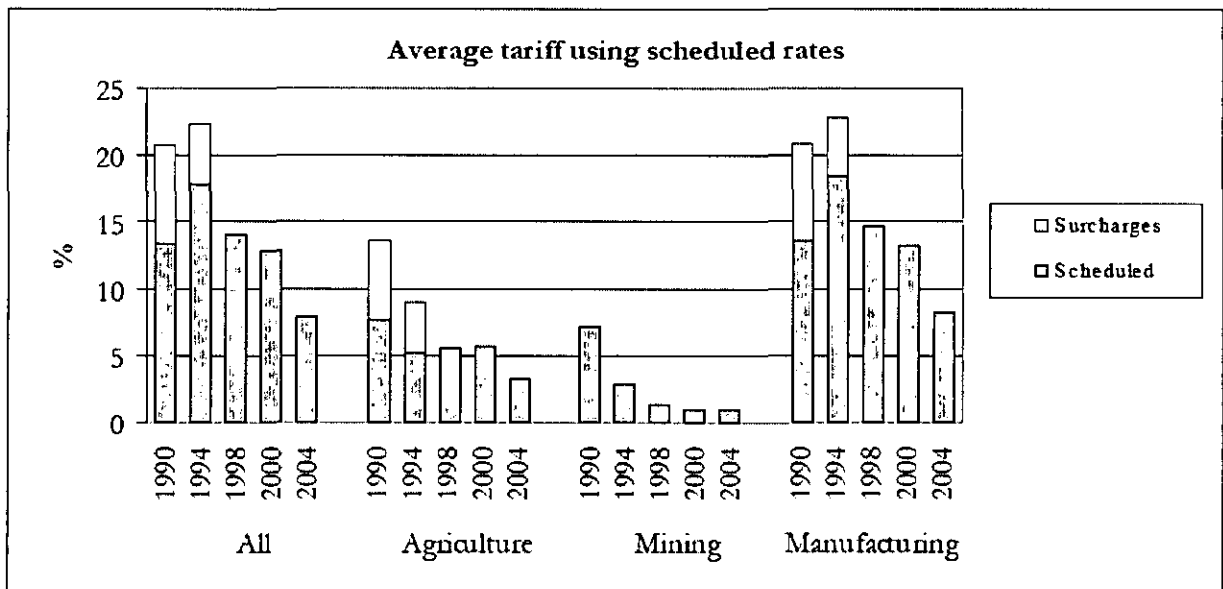
Source: Stats SA, RMB FM Research

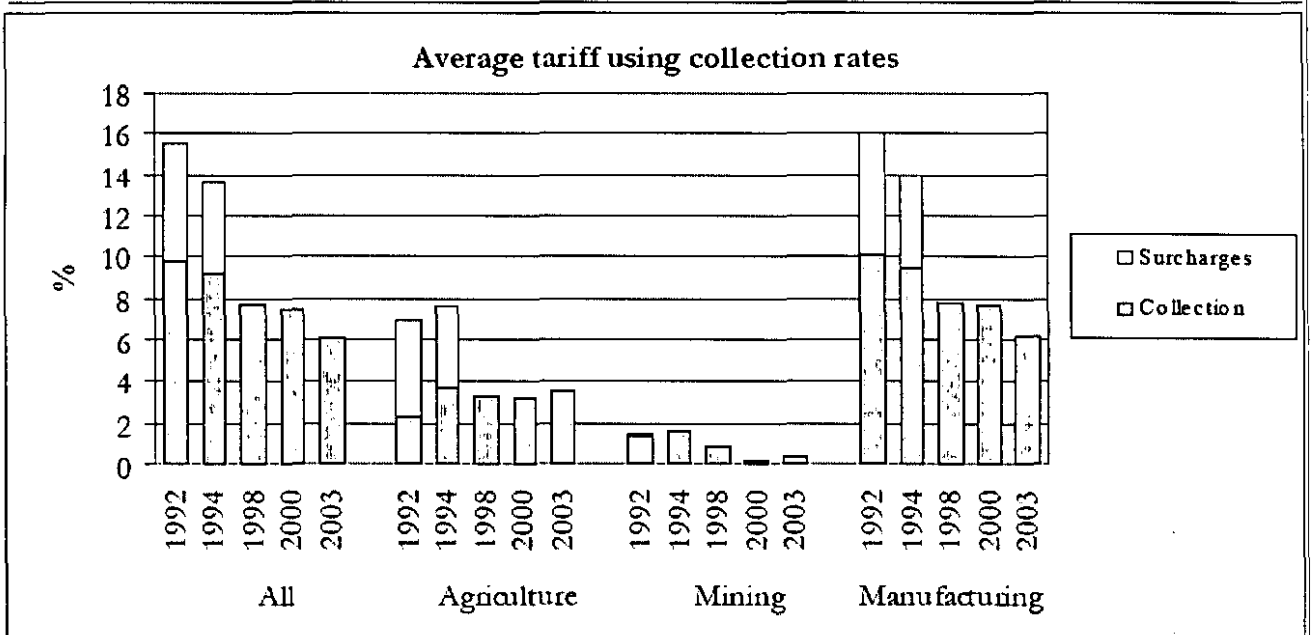
Policies under the visible hand are meant to decrease the cost of production for exporters while policies for a 'good' real effective exchange rate are meant to increase the output price for them. Lower production costs and higher prices are essential ingredients for export growth and also trade agreements.

Protectionism versus Trade Liberalization

One of the most heated debates when it comes to foreign policy is that of more protectionism or more trade liberalization. Both parties present serious and convincing arguments about their stance and none of them is willing to compromise. The graphs below show how protection has decreased by using

scheduled rates and collection rates. Edwards (755, 2005) finds that “although protection has fallen [in South Africa], the decline has been no faster than other middle-income economies.” He also finds that, “significant progress has been made in simplifying the tariff schedules and reducing tariff protection, but further progress can be made in removing tariff peaks, reducing tariff dispersion, and lowering the anti-export bias arising from protection.” Another finding by Ricci (2006) is that a 1% increase in openness leads to a depreciation of the rand.





Free Trade Agreements (FTA) have never been unanimously been accepted by all relevant stakeholders. There is always a question of fairness around them, because free does not necessarily mean fair while fair does seem to imply free. Holden and McMillan (10, 2005) found that the SADC FTA stimulated South Africa's exports to SADC and that the EU-FTA was positive to South Africa's exports also. This gives evidence that bilateral and multilateral Free Trade Agreements can lead to an increase in exports based on fair trade. An important matter to note is that the duty strategies on both Free Trade Agreements are different (Edwards, 762, 2005).

It would serve South Africa best not to pursue trade agreements that are homogenous in nature with different countries. South Africa should design its free trade agreements taking into consideration the industrial competitiveness of its potential trading partners, their exchange rate, degree of openness and its ability to take in South Africa's exports in the long-run. Since the above attributes will differ from one country to another so will the free trade agreements. But all free trade agreements should be characterized by fair trade thus having the potential to increase South Africa's exports.

Conclusion

South Africa is situated at the bottom of Africa while all its major trading partners are situated on the other side of the equator and all are high-income economies. It is also the only African country on the G-20 committee. By achieving such feats South Africa has shown it has the intellectual capacity to produce policies that have great benefits. The world finds itself at the worst of times while South Africa must make it the best of times for export growth. This essay has shown that export growth is possible by letting go of orthodox methods. It also has attempted to add to SA's intellectual capabilities by presenting policies that have great potential in increase South Africa's exports.

Appendix

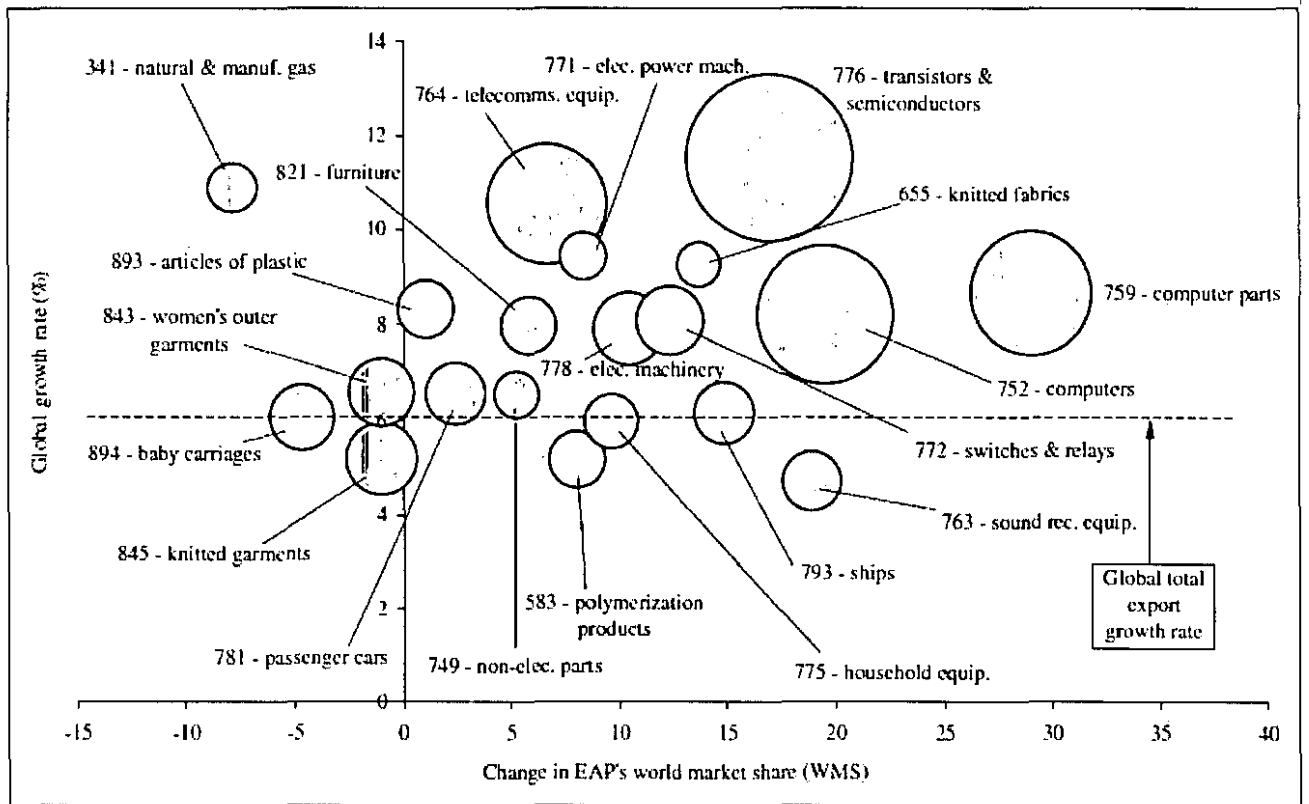


Figure 1. Market positioning and performance of East Asia and Pacific region

Notes: Dotted line is world growth for all products. WMS changes expressed as percentage points. Bubble size denotes export value in 2002.

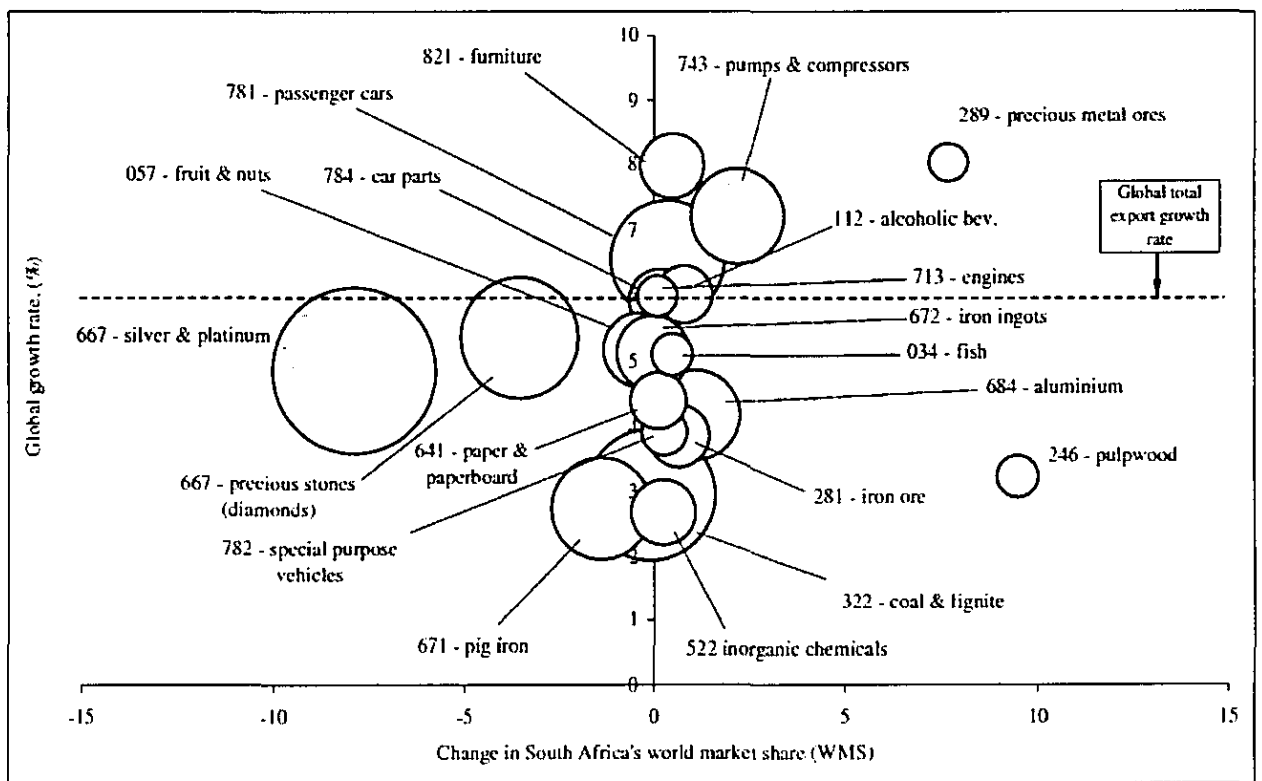


Figure 2. The market positioning of South Africa's top 20 exports

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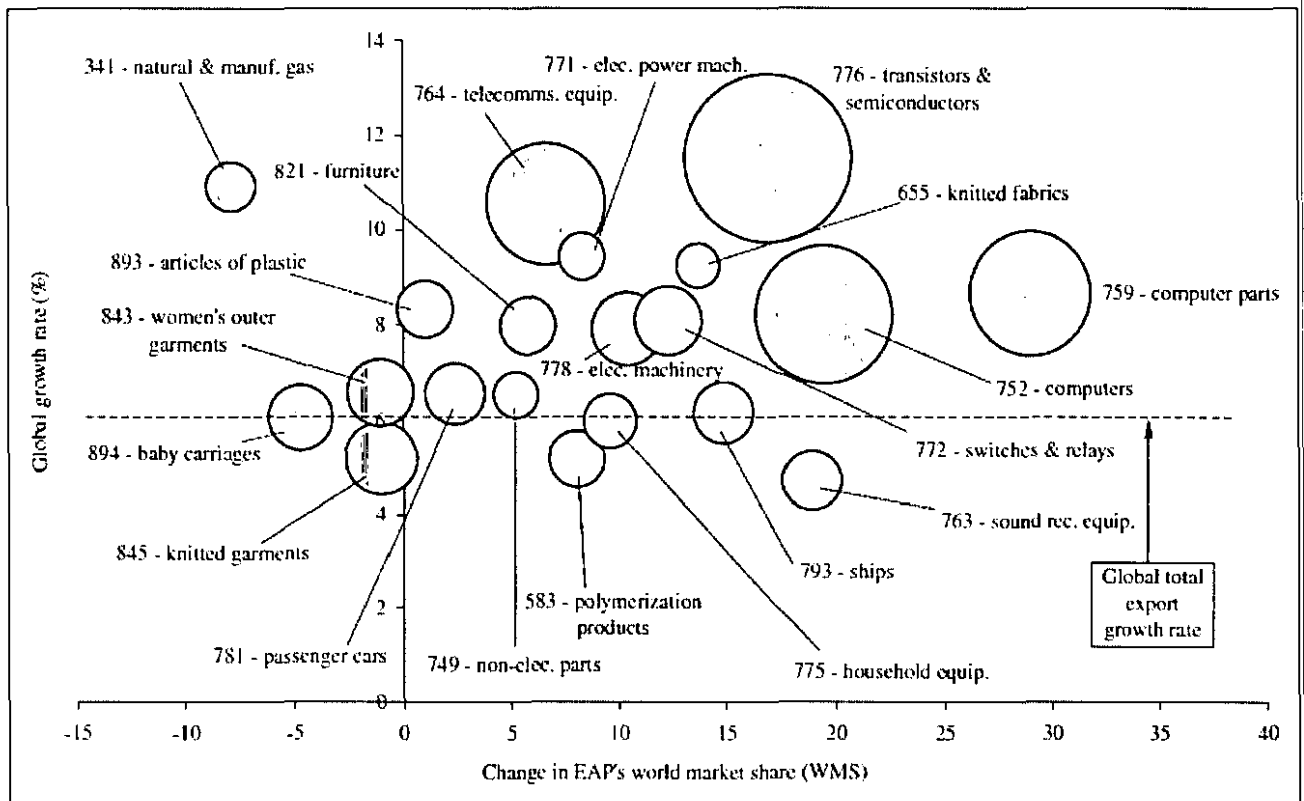


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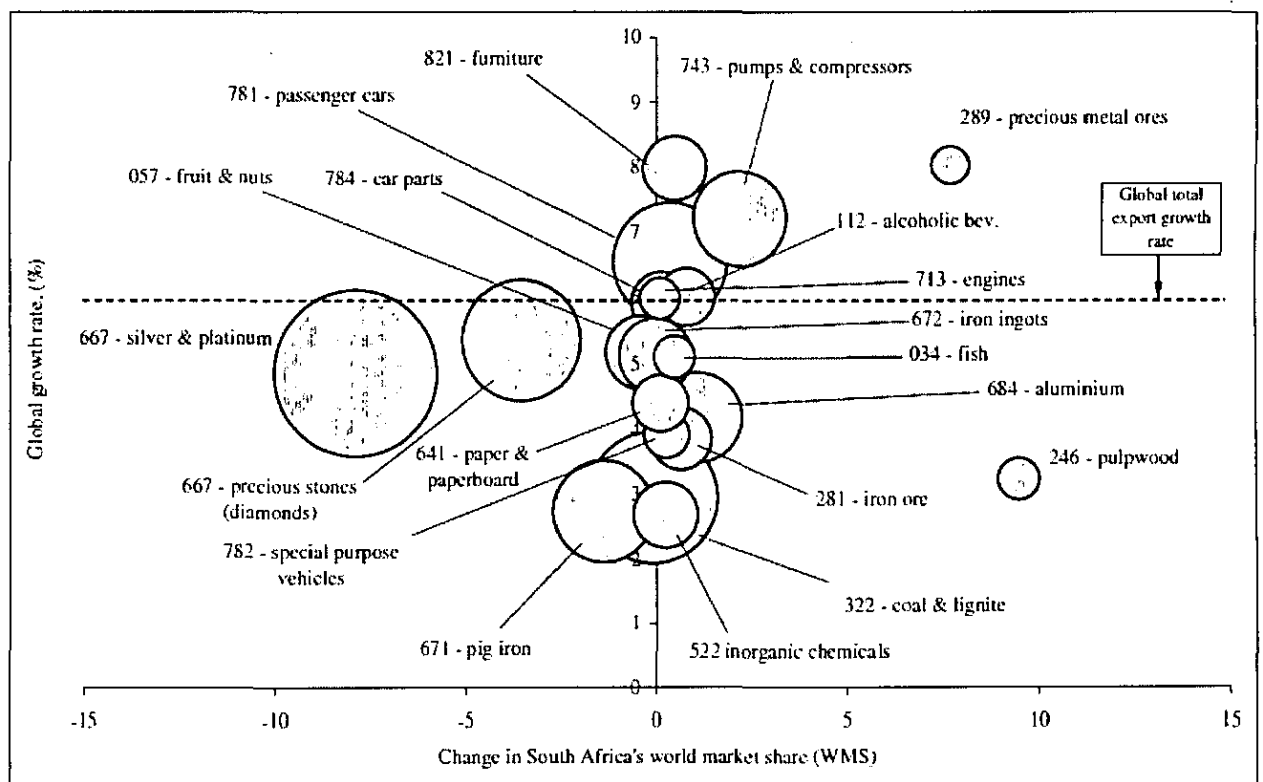


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