

# EATING THE CAKE WE HAVE: SOUTH AFRICA'S EXPORT POTENTIAL

15 May 2009

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## Abstract

This report investigates the potential of export growth in South Africa, and its ramifications for economic growth. We show that South Africa has suffered poor export growth in the recent past, and explain why export growth is the most viable and sustainable method of financing ASGI-SA's investment-led growth strategy. Slow structural transformation, in particular dependence on natural resources, is shown to be a major constraint, and appropriate methods to remedy this are suggested. Policies to facilitate strong exports, focusing on currency devaluation, tariff liberalization and improved infrastructure, are also discussed. All figures referred to may be found in the appendix.

Word count<sup>1</sup>: 1995

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# 1 Introduction

This report investigates the potential of export growth in South Africa. First, we discuss why South Africa needs to grow its exports; we then explore how this export growth can be achieved. The structure of the paper is as follows:

Section 2 establishes that South Africa's export performance over the past 40 years has been poor, and investigates whether export growth would be beneficial, or possibly even unconditionally necessary, in a South African context. Section 3 addresses the question of how to improve export performance, looking first at what exports South Africa should concentrate on, and then discussing a number of macro and microeconomic tools. The analyses of these tools are conducted with their use/misuse in the past in mind, to shine light on how they should be used in the future.

## 2 Past performance, and the view from here

### 2.1 South Africa's export performance

While many countries have enjoyed the benefits of export growth over the past 40 years, South Africa's performance in the export market has been lacklustre, with real exports per capita only marginally higher than 40 years ago.

In a sample of 56 comparable countries<sup>2</sup>, Hausmann and Klinger (2008) find South Africa ranked 50th in terms of growth of exports per capita over this period. Edwards and Alves (2006) compare South Africa to other middle-income countries, and conclude too that South Africa's export growth has been mediocre. Furthermore, Edwards (2009) shows that South Africa's export performance has been weak in comparison to other developing countries.

This weak export growth is often attributed to South Africa's being a natural resource exporter, but South Africa's export growth is low even amongst other natural resource exporters. Figure 1 (Hausmann and Klinger, 2008) compares the evolution of real exports per capita over time for Argentina, Australia, Canada, and Malaysia with that of South Africa. Each of the countries in Figure 1 was a natural resource exporter in 1965, and all have subsequently outperformed South Africa in export growth. No matter how one looks at it, South Africa's trade performance in the recent past has been dismal.

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<sup>2</sup>Countries with a population of more than 4 million, and a GDP per capita of at least 25% of South Africa's.

## 2.2 The need for export growth

South Africa's current account deficit this year will stand at around 6.3% of GDP, and is expected to increase to 6.9% for both 2010 and 2011 (Budget Review, 2009). South Africa is consuming more than it is producing: we are net importers. The Accelerated and Shared Growth Initiative of South Africa (ASGI-SA), launched in 2006, focuses on investment-led growth, which Edwards and Lawrence (2008), as well as Edwards, Rankin and Schöer (2008), show to be very import-intensive. Furthermore, any growth resulting from this import-heavy initiative will raise aggregate demand, and therefore import demand too, intensifying pressure on the current account.

Promoting investment is certainly good, but the 'borrowing' associated with import growth needs to be financed using foreign currency, through the running down of foreign reserves, foreign direct investment, or exports. Insufficient foreign currency therefore would choke growth: if we are to promote economic growth based on import-intensive policies, then we also need to increase our holdings of foreign currency.

A policy making extensive use of foreign reserves would clearly not be sustainable. Instead, South Africa has recently relied primarily on foreign direct investment to finance the deficit, a strategy made possible by the recent boom in our economy. However, this boom has been succeeded by a severe economic downturn, and the FDI on which South Africa has been reliant is no longer reliable. Indeed, FDI in developing countries is expected to shrink by around 30% in 2009 (World Bank, 2009). It is fast becoming clear that exports are the most viable and sustainable method of financing imports (Edwards and Lawrence, 2008).

These thoughts are echoed by Hausmann (2008), who contends that if South Africa is to achieve the desired 6% growth, exports need to rise considerably. It is perhaps surprising then that ASGI-SA does not emphasize trade per sé as a major constraint to growth (ASGI-SA, 2006).

## 3 Increasing South Africa's export potential

### 3.1 What South Africa exports, and what it should export

The ability of a developing country to transform its export basket into a technologically complex one, rich in manufactures (or, as Hausmann and Klinger (2008) put it, moving from poor-country goods to rich-country goods), has been shown to be a strong determinant of sustainable long run growth (Hausmann, Hwang and Rodrik, 2007, Edwards and Alves, 2006), as well as an important driver of comparative advantage and associated competitiveness (Lall, 2000).

Unfortunately, there has been a lack of structural transformation across the sectors in South Africa (Hausmann and Klinger, 2008). We remain

an economy concentrated in (and dependant on) natural resources, particularly mining. Both Edwards and Alves (2006) as well as Hausmann and Klinger (2008) find that, although South Africa has seen a shift of its export sophistication towards high-technology products, this shift has been small in comparison to other middle-income and developing countries. While South Africa's manufacturing export growth averaged 6.9% between 1988 and 2002, the average for middle-income countries was between 8.6% and 9.5% (Edwards and Alves, 2006).

### 3.1.1 Product potential

As previously mentioned, South Africa remains an economy concentrated in mining; the only sectors with large net exports are gold, coal and other mining (Hausmann and Klinger, 2008). However, mining is an industry with a relatively fixed endowment, and therefore lacks the dynamism or potential of industries that have been latched onto by opportunistic countries, most notably the HPAEs (high-performing Asian economies) (Krugman and Obstfeld, 2003). Indeed, Van Seventer and Gibson (2004) find that South Africa has been relatively inept at shifting to industries with strong global demand potential. Edwards and Alves (2006) further this, showing that South Africa has maintained an export basket experiencing low world growth.

South Africa needs to latch onto markets with high growth potential, such as pharmaceuticals and renewable energy. Growth in dynamic industries such as these can be promoted through incentivising tertiary studies and research in

### 3.1.2 Connectedness of the product space

In restructuring a country's export basket, barriers may be met in shifting to new industries. These result from industry-specific learning (Arrow, 1962 - see Hausmann Klinger) and the high start-up costs associated with external economies of scale. Hausmann and Klinger (2006, 2007) and Hidalgo *et al.* (2007) find that these barriers are less applicable when moving to nearby products. The idea is that the setting up of any industry requires specific inputs, including knowledge, capital, labour training and infrastructure. Established industries have procured these start-up inputs, which are then available to any subsequent entrants in the same or similar industries. On the other hand, firms venturing into uncharted industries will find it far more difficult to secure the requisite inputs.

A country is therefore more likely to shift towards products similar to those it already produces. Furthermore, Hausmann and Klinger (2006) show a direct correlation between the connectedness of a country's export basket and its GDP. Hausmann and Klinger (2008) use a framework developed by Hidalgo *et al.* (2007) to show that South Africa has in the last 30 years remained in peripheral industries.

Ideally, we would like to identify industries that are nearby and possess high strategic value. Strategically valuable industries that are nearby include agriculture (specifically, tropical agriculture products, cereals and animal products), chemical products and machinery (Hausmann and Klinger, 2008); promoting these industries is therefore a good idea. Furthermore, given South Africa's peripheral position in the product space, new activities in connected industries must be set up farther from regions of current comparative advantage. This will require start-up inputs, likely through public provision as well as the importing of requisite skills and capital.

## 3.2 Constraints and policy measures

### 3.2.1 The exchange rate, and South Africa's competitiveness

An economy producing goods at lower costs than other countries is one with a strong export potential; this cost advantage gives it leverage in the world market. South Africa's relative unit labour cost (RULC) has improved since the 1970s (Edwards and Golub, 2004), making South Africa more competitive in the world market. Edwards and Golub (2004) show that further improvements in cost competitiveness in the 1990s positively affected employment through export growth. However, there is room for improvement (Edwards and Lawrence, 2008).

There are three direct ways in which RULC can be improved: by lowering wages, improving production productivity or a real depreciation of the currency. Lowering wages is an inferior option for both political and economic reasons. With regard to productivity, Aghion, Braun and Fedderke (2006) point to a lack of competition in the South African market as an obstacle to efficiency, showing that average margins in South Africa are around 50% higher than in other countries.

The exchange rate is a powerful tool in improving RULC: a depreciation reduces the cost of South African goods in terms of foreign goods, and therefore promotes foreign demand for SA goods. Indeed, a regression on the variables affecting exports in Edwards and Lawrence (2008) conclude that a competitive exchange rate would have a positive effect on South African exports. Hausmann (2008) suggests such a depreciation, arguing that an equilibrium exchange rate should be consistent with full employment and external balance. Thus, South Africa's high unemployment and large deficit are evidence that a depreciation is in order.

To achieve this, the SARB should be more responsive to deviations of the exchange rate, and should prevent excessive appreciation through more active intervention in the currency market. Stability is also important, though, and it should be careful to communicate any emphasis to the market, signaling its intentions so as to reduce expectations-driven volatility.

### 3.2.2 Tariffs

Furthermore, Lerner's symmetry theorem has long been recognized by economists: a tax on imports is a tax on exports (Lerner, 1936). By taxing the imports of intermediate products and factors of production used to produce exportables, the tax is merely passed onto the exporter, who suffers an increase in production cost and a decrease in competitiveness. This becomes even more of an issue when one considers the import-intensive investment-led growth policy proposed by ASGI-SA. Edwards and Alves (2006) show that the South African economy responded well to increased tariff liberalization in the 1990s, after decades of protectionist policies. The regression in Edwards and Lawrence (2008) shows too that exports would be benefited by liberalization. While not denouncing the use of tariffs entirely, it is important that South African exporters gain access to inputs at world prices, and thus it is suggested that tariffs imposed on these imported inputs be reduced.

### 3.2.3 Infrastructure and the business climate

A business climate conducive to entry into the export market is vital in promoting exports. Hausmann (2008) focuses particularly on infrastructure in this regard, finding that a lack of investment in transportation and energy since the 1970s has led to problems of shortages and congestion. This is especially relevant given the findings of Djankov *et al.* (2006) that each day of delay in exporting is associated with a 1% reduction in exports. It is clear that South Africa needs to expand its capacity in order for this not to become a constraint. However, as Hausmann (2008) warns, this spending must be accompanied by fiscal savings, so as to not place excessive pressure on the CA deficit.

In addition, legal barriers to entry, time-wasting bureaucracy and other technical constraints must be minimized.

## 4 Conclusions

In this report, we considered the case for an export expansion in South Africa. We found that South Africa's export performance has in the past been dismal, and showed that this is primarily due to a lack of structural transformation. We further showed that exports would soon become the most viable way to finance the imports associated with ASGI-SA's growth strategy. It was suggested that South Africa shift towards industries that are dynamic and connected, and at the same time aim for a stable, depreciated exchange rate. Decreased tariffs on inputs, as well as increased investment in infrastructure were also recommended.

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## 6 Appendix

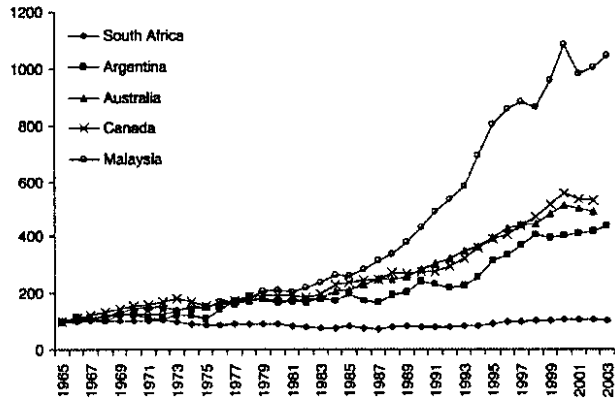


Figure 1: The real growth in exports of some resource based countries.  
Source: Hausmann and Klinger (2008)

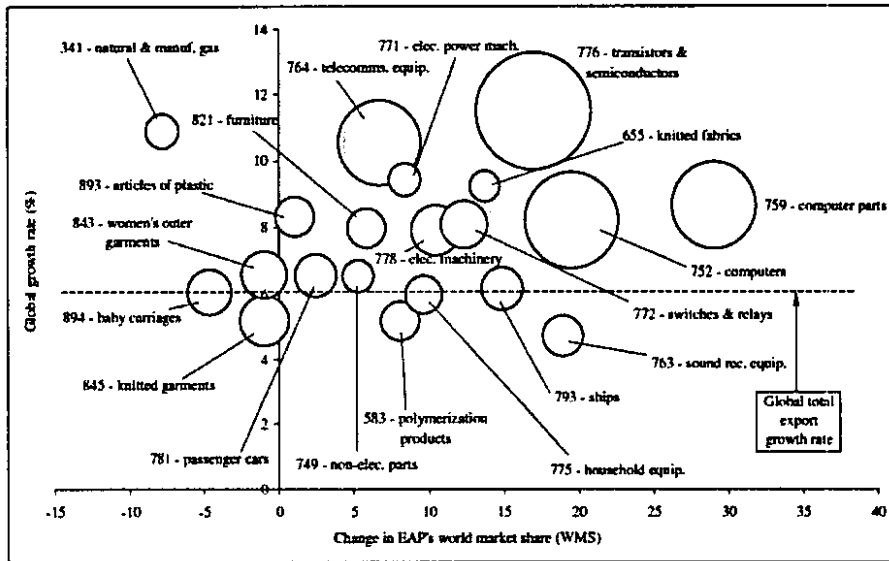


Figure 2: The placement of East Asia's top 20 products. Note the concentration in regions of increasing WMS and high global growth.  
 Source: Edwards and Alves (2006)

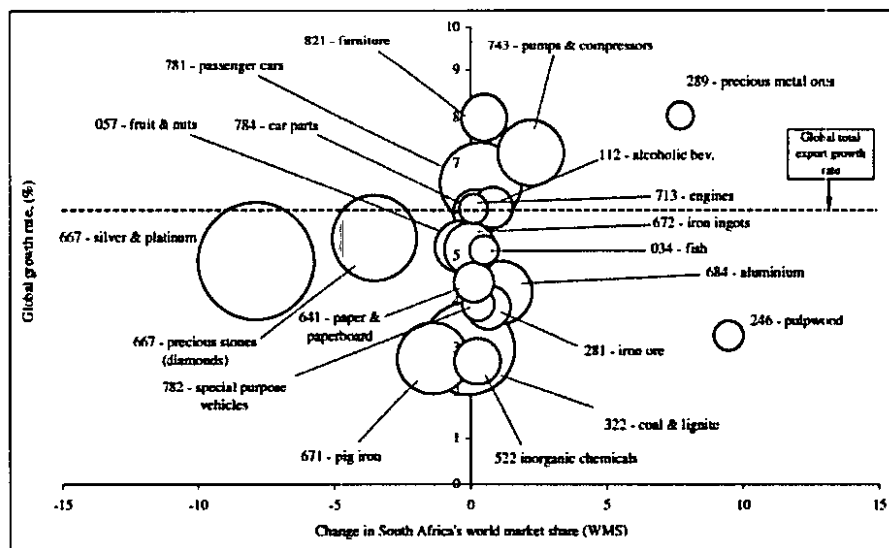


Figure 3: The placement of South Africa's top 20 products. Note the concentration in regions of stagnant global growth.  
 Source: Edwards and Alves (2006)

In Figures 4 and 5, the black squares represent a product produced by the country in question, with the size of the square indicating market share. Red lines indicate very strong 'nearby-ness', blue lines represent strong 'nearby-ness', while a beige line is drawn between industries that are far apart.



Figure 4: South Africa's position in the product space in 2000. Notice that most of South Africa's major products are in unconnected regions.

Source: Hausmann and Klinger (2008)



Figure 5: Malaysia's position in the product space in 2000. While Malaysia has not moved very extensively into densely connected areas, it has moved strongly into the closely connected electronics sector (top-right).

Source: Hausmann and Klinger (2008)