François Groepe: Structural reform to promote economic growth

Address by Mr François Groepe, Deputy Governor of the South African Reserve Bank, at the Economics and Beyond Seminar, University of South Africa, Pretoria, 5 August 2013.

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Introduction

The Bank for International Settlements' 2013 Annual Report released in June this year argues that monetary policy has provided space and time for governments to undertake structural reforms to raise growth and productivity. The key structural reforms, they argue, relate to enhancing labour and product market flexibility and reforming the financial sector. Both the IMF, in the 2012 Article IV report on South Africa and the OECD, in their 2013 Report on South Africa raised labour and product market rigidities as the main constraints to faster economic growth and employment creation.

When talking about structural economic reforms, there is generally universal agreement that we require deep structural reforms to improve our economic performance but there are a myriad of different interpretations of what is needed. There is however little consensus on which reforms are needed and should be implemented and how these should be implemented. There is furthermore a robust debate about what the key structural impediments are to higher growth and employment. This is not just the case in South Africa where the debate takes on a distinctly ideological tone, but globally too.

Global economic developments

Before I expand on the structural constraints to higher growth, allow me to present a short overview of the issues facing the Monetary Policy Committee (MPC) and the South African Reserve Bank (the Bank) in general. The global economic environment remains weak, with most of the major advanced economies growing below potential. While there are signs of positive economic growth and rising employment in the US, this growth is still too low to significantly close their output gap. Furthermore, a number of downside risk to their growth outlook remain, particularly in the form of further fiscal consolidation, the debt ceiling levels, and the impact of rising long-term bond and mortgage interest rates in response to expectations of a tapering of asset purchases by the US Federal Reserve.

The Eurozone continues to experience recessionary conditions, with real output contracting by 1,1 per cent in the first quarter of 2013. The IMF has reduced its forecast for Eurozone growth by 0,2 percentage points to –0,6 per cent, with a weaker recovery than previously forecast in 2014.

The Japanese economy recorded strong growth in the first quarter of 4,1 per cent, but it remains too soon to assess the efficacy of the various stimulus measures that were adopted.

Furthermore, growth in developing countries, for some time the mainstay of the world economy, is also slowing and contributing to the recent downward revision of global growth by the IMF in the order of 0,2 per cent to 3,1 per cent and 3,8 per cent for 2013 and 2014, respectively.

South Africa is affected by these international developments in three ways. Firstly, our ability to export to our major trading partners is weakened. For example, our major manufactured export sector is the motor vehicle sector and most of our car exports go to Europe. The Eurozone has just had its worst quarter for car sales in 17 years. Secondly, lower global growth lowers commodity prices. This has the benefit for lowering global inflation, but as a major commodity exporter, it affects our terms of trade and our ability to earn foreign exchange. Finally, monetary policy and changes in monetary policy in advanced economies is causing excessive volatility in the rand exchange rate. During the early periods of

quantitative easing, the country was able to attract significant capital inflows. This assisted the financing of the current account deficit but it also led to a period of strength for the currency which impacted on exporting sectors. The anticipated reversal of quantitative easing have contributed to a slowdown in capital inflows and a depreciation in the exchange rate, which is likely to add further upward pressure on inflation due to pass through effects.

Domestic economic developments

On the domestic front, lower output from the mining sector and electricity constraints are limiting growth and contributed to the widening of the current account deficit. The Bank has recently lowered its growth projection for 2013 to 2 per cent. The official unemployment rate increased from 25,2 per cent in the first quarter of 2013 to 25,6 per cent in the second quarter of 2013. Of some concern is the increase in the youth unemployment rate to 52,9 per cent during the first quarter of 2013.

The inflation outlook continues to deteriorate and is expected to be higher on average by 0,1 and 0,3 percentage points at 5,9 per cent and 5,5 per cent in 2013 and 2014, respectively. Inflation is projected to temporarily breach the target range in the third quarter of 2013, at a slightly higher average level of 6,3 per cent. This results in conflicting policy choices relating to rising inflation against the back drop of weak growth.

It is however important to note that South Africa's growth performance has lagged that of Asia and more recently a number of countries on the continent. It is imperative that the question of growth is addressed satisfactorily if we wish to tackle the triple challenges of unemployment, poverty and inequality in a cohesive and sustainable manner. This will require deep and courageous structural reform.

The Monetary Policy Committee is mindful of these challenges and at the previous MPC meeting decided to keep interest rates unchanged. Our primary mandate is to keep inflation within the target band. The forecast for inflation at the previous MPC meeting was for targeted inflation to return to the target band in the 4th quarter, following a temporary breach in the third quarter of 2013. If, however, inflation remains sticky and evidence emerge of second round effects, the Bank would take appropriate measures in keeping with our mandate. At present, we are however confident that inflation expectations remain anchored, albeit at the upper end of the inflation target range, thus allowing for a continuation of accommodative monetary policy at this time.

Structural reform

Returning to the topic of structural reform, I shall attempt to summarise the key debates around which structural reforms are most pressing for South Africa and I shall be drawing on a theoretical framework provided by Dani Rodrik in a recent paper entitled *"The past, present and future of economic growth"*.

Rodrik argues that for countries to raise incomes and living standards, they need to do two broad things, namely to build fundamental capabilities and to undertake structural transformation. Fundamental capabilities cover a range of issues such as macroeconomic stability, the credibility of economic and other institutions, the rule of law, quality of education, sound infrastructure and a competent bureaucracy. Investing in these fundamental capabilities often have long lags in impacting on economic growth, for example improving the quality of the education system takes a long time to feed into the performance of the economy.

Structural transformation refers to the process of change in the pattern of what an economy produces, and in particular, what it exports. In order for a country to progress, it has to move up the value chain and consistently increase the complexity of its products. For example, an economy producing just apples is likely to grow by a limited amount unless there is diversification into producing processed foods from those apples.

The process of structural transformation is more complex. It requires investment in capital to move up the value chain; research and development; functional financial markets; and a state capable of playing a coordinating role to address market failures to assist the progress of an economy into higher value added goods and services.

Rodrik further argues that while fundamental capabilities are important, countries can achieve structural transformation in a relatively short period of time even without strong fundamental capabilities. China is a good example of structural economic change without a number of the elements that we often associate with fundamental capabilities. Despite these weaknesses in fundamental capabilities, they have been able to achieve a noteworthy level of structural transformation over the past two decades. In order to sustain the pace of development, they would have to invest in fundamental capabilities but these requirements are not mutually exclusive or sequential and the skills and attributes required to invest in one is not necessarily the same as those required to invest in others.

There have also been several cases where countries have sound fundamental capabilities but have not been able to engineer structural change associated with rising incomes. New Zealand is such an example.

The structure of the economy in general, in the literature, refers mainly to the pattern of what is produced. How big is the primary sector in relation to the manufacturing sector? What manufactured goods are being produced? How complex are these products? How diverse is the economy? What is the productivity level of various sectors? What are the principle exports? These are critical questions.

In South Africa, the phrase ‘structure of the economy’ also has a broader distributional connotation. The question, ‘Who benefits from what is produced?’ is frequently asked. Debates often revolve around who owns what and how this has changed. It also revolves around the share of labour remuneration in GDP relative to the gross operating surplus and therefore the relative returns from growth to labour and capital. The skewed income distribution frequently features in debates about the structure of the economy.

Apart from sectoral patterns of growth and the distribution of benefits that accrue from growth, there is a third area of focus when discussing structural reform in South Africa. This area relates to the efficiency or lack thereof of various markets. High unemployment is clearly the most glaring example of a mismatch in supply and demand. There are other types of market inefficiencies. Monopoly pricing, cartel-like behaviour and high cost structures, all impact on the structure of the economy and indeed all warrant attention from economic policy makers. For example, high prices in the telecoms sector impacts on costs in other sectors, thereby reducing their size and productivity.

Market inefficiency impacts on the structure of the economy, for example a lack of competition often translates into higher prices and higher profits and the latter may lead to greater complacency and hence a slower pace of new product development and innovation. Profitable firms also tend to attract capital from the capital markets resulting in a situation where capital is not necessarily flowing to the most efficient or innovative firm but to the one making the biggest profits.

Often, the presence of large and persistent profits is a sign of market inefficiency, and not of the quality of the entrepreneurs running the firms. According to Fedderke, Kularatne and Mariotti (2007), manufacturers in South Africa enjoy relatively high mark-ups, yet investment levels are fairly low. This pattern is evident in other sectors too, with high mark-up and large profits not necessarily translated into higher rates of fixed investment.

There are of course several proposed approaches to prioritising economic reforms and these are often underpinned by ideology. Some would argue that markets are best at allocating resources and that state intervention and regulation should be removed to enable markets to allocate resources to the most efficient sector or firm within a sector. Except from general redistribution through taxation and fiscal policy; it is argued that subsidies, incentives, tax

breaks or special taxes are distorting and reduce economic efficiency. This group can largely be categorised into what had become known in the 1980s as the Washington Consensus. Their prescription was privatise, liberalise, deregulate and shrink the state.

Others argue that the market often fails to allocate resources efficiently and that left to their own devices, markets often end up highly concentrated and uncompetitive, with distorting effects on the economy. A classic example of this globally, is a situation before the financial crisis where the financial sector made large profits, taking on undue risks and attracted a disproportionate amount of graduates; arguably at the expense of other sectors in the economy. This group argues that there should be more state intervention and regulation to curb anti-competitive abuses by market players.

A middle ground approach is to look empirically at which constraints are the most binding and to address these one at a time. If the problem is concentration, then the implementation of anti-trust legislation may assist in solving the problem. If however, the problem is government regulations that limit access to the market, such as telecoms or broadcasting for example, then a relaxation of the regulations may be deemed appropriate.

In general, South Africa has not made sufficient progress in tackling our many constraints, which include a shortage of skills, infrastructure blockages, the structure of the labour market, the volatility of the currency, barriers to entry that limit, new entrants into product markets, the regulatory burden on small business and the capacity of the public service.

South Africa's track record in implementing the microeconomic reforms required to achieve structural change has been patchy. A key symptom of the problem is South Africa's poor export performance. South Africa's per capita export growth since 1980 has been less than 1 per cent a year, compared with rates of 3 to 5 per cent a year for countries such as Malaysia, Chile and Australia.

South Africa continues to be reliant on a relatively small number of key export items – platinum, gold, coal and iron ore. Outside of the mining sector, there have only been a few export success stories; such as fruit, wine and motor vehicles, with the latter benefiting from large indirect subsidies. In general, growth in exports of these items has been insufficient to drive much higher aggregate export growth. So in addition to our poor export performance a further concern is the lack of diversification of the country's exports despite significant resources flowing into industrial policy.

We have seen growth in the services sector, which is positive. We have also seen rising productivity in the services industry and a rise in the complexity of services produced. This has enabled some economic growth and expansion of the employment. An increasing number of firms in South Africa are benefiting from the export of management services or the export of knowledge-based services. This type of exports in telecoms, retail, banking, mining and IT has provided South Africa with a growing share of service export earnings. This positive trend however, has not translated into much higher aggregate export earnings.

There is considerable conjecture as to why the South African economy has not diversified its export basket more since its readmission to the global economy. Reasons forwarded include our distance from markets, inefficient logistics systems, the volatility of the exchange rate, the cost of labour in the manufacturing sector, skills constraints in the services industry, the lack of a venture capital culture and questions of economic policy certainty that detract from long-term investment. Without passing judgement on the validity of any of these specific claims this list of possible reasons provides policy makers with a list of structural impediments to faster and more inclusive growth.

A recently published paper by David Faulkner and Konstantin Makrelov from the National Treasury and Christopher Loewald from the SA Reserve Bank entitled "*Achieving higher growth and employment: policy options for South Africa*" argues that the "core requirements for rapid and sustained growth are greater savings, investment, more productive use of capital by better skilled workers, reduction in the skill constraint and moderation in unit labour

costs". They estimate that the combined effect of reducing transport and communications costs, reducing the skills constraints, and increasing foreign direct and domestic investment, can increase potential growth to close to 8 per cent and create an additional 1,7 million jobs beyond the number that would be created without policy adjustments (by 2025).

Allow me to illustrate their methodology with an example. "Transport, logistics and communications are network industries and are important determinants of an economy's underlying cost structure and competitiveness." Reducing these costs by 30 per cent pushes potential GDP growth up by 1,2 percentage points a year. Gross fixed capital formation increases to 26 per cent of GDP and 620 000 additional jobs are created by 2025.

Another area where minor microeconomic reforms could boost growth and employment is in immigration policy. Allowing firms to hire skilled foreigners has several benefits. Firstly, it enables firms to raise productivity and to use the capital employed more efficiently. Secondly, it reduces the premium on skilled labour, lowering wages for skilled people and thereby contributing to lower inequality. Behar (2008) estimates that for every skilled worker employed, one semi-skilled job and 0,5 low skilled jobs are created. The National Planning Commission estimates that this multiplier is even higher. While South Africa has about 4,7 million unemployed people, it is estimated that there are about half a million vacancies in the economy in positions requiring skilled workers. Naturally, a country must improve the quality of its education system, but with the best will in the world, this will take time to feed into the supply of skills. Importing more skilled workers whilst addressing this constraint, would appear to be a sensible economic strategy.

Except in exceptional circumstances, structural economic reforms do not occur in a neat, smooth and sequential manner. They are often the result of a laborious process of experimentation, negotiation and responses to pressure. This pressure can come from lobby groups or vested interests that do not necessarily have the interests of the broader society at heart. Pressure can also come from crises. When faced with a crisis, countries have to be bold and proactive to restore confidence. A now repeated lament from central bankers is that economic policy makers across the world have not used the present global financial crisis to address the structural reforms required to drive higher growth.

Many economists ask the question 'why does the country not introduce seemingly obvious structural reforms to boost growth and employment?' The answer to this question is complex and relates to the power dynamic in a country. Structural reforms often have winners and losers. The losers are often diffused and dispersed, and therefore not able to mobilise to demand structural change. Conversely, the winners are often easily identifiable, powerful and well-organised. The recent debate about tariffs on imported chickens is a good example. This is however not a uniquely South African phenomenon. The Common Agricultural Policy in the EU provides huge benefits to European farmers at the expense of European consumers and producers from developing countries. This problem challenges economists and economic policy-makers to improve the analysis that they use to support their arguments and to think more carefully about how these are communicated to society. Many structural reforms are difficult to implement precisely because of the political economy of a society.

The last theme that I wish to touch on today is to argue that inequality itself is a structural impediment to faster and more inclusive growth. Even after adjusting for differences in income per capita, unequal countries generally have the following features: high levels of crime, poor health outcomes, lower levels of education and low levels of trust between social partners. Probably, the single most important problem in unequal societies is that social trust is hard to build and maintain. In countries with low levels of trust, investment decisions tend to focus on short-term returns rather than on long-term rewards. This skews the economy away from fixed investment and from investments in infrastructure or research and development that have long-term payoffs. The simple explanation is that unequal countries are generally more unstable and therefore long-term investment is more risky and hence impact negatively on capital flows.

To counter this phenomenon, countries need strong institutions, the consistent application of rules and legal frameworks that protect investors over the long-term. They also need policy certainty and capable public services able to collect taxes and spend it effectively. These capabilities are what Rodrik refers to as fundamental capabilities. While these capabilities are difficult to develop in highly unequal countries, they are even more critical in unequal countries to foster sustained growth and development.

Conclusion

South Africa's transition from apartheid to democracy is a remarkable success story. Our challenge today is to develop an economy that is more inclusive. This requires higher levels of growth and improved employment creation. Macroeconomic policies are only part of the answer to these economic objectives. In order to achieve higher and more inclusive growth deep structural reforms are required.

While there are hundreds of potential economic problems that require solutions, the most critical short run issues relate to product and labour market inefficiencies that keep insiders happy and outsiders out. Longer-term reforms include the need to improve the supply of skills and raising national savings.

Implementing structural reforms are never easy. Policy-makers on the one hand need solid evidence and research to justify their actions. On the other hand, they need political will and political nous to get them through. South Africa has to build on its solid institutions developed since 1994 to embark on a new set of reforms aimed at making South Africa work for all its people. The speedy implementation of some of the key recommendations and proposals contained in the National Development Plan would be a good start.

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