

South Africa Economic Update

Focus on Export Competitiveness



THE WORLD BANK



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Foreword

In its National Development Plan 2030 and its New Growth Path (2011), South Africa identifies the export sector as an engine for faster, more inclusive, and job-intensive growth. The National Development Plan is targeting export volume growth of 6 percent a year—to achieve an annual increase in real GDP growth of about 5.5 percent and to help generate 11 million new jobs by 2030. Despite successes in some subsectors, South Africa will need to greatly improve its export performance to meet these targets.

This report, *South Africa Economic Update 5: Focus on Export Competitiveness*, examines the performance of South Africa's export firms against that of peers in other emerging markets—and analyzes the challenges. It assesses South Africa's economic prospects in the context of the global economic environment and prospects.

With this Economic Update, we hope to enrich the ongoing debate on growing a sector critical for South Africa's economic growth. As with previous editions, this report is intended not to be prescriptive but to offer evidence-based analysis that will help bring South Africa's policymakers, researchers, and export stakeholders closer to finding innovative and sustainable ways to grow the sector.

The report highlights opportunities for growth, particularly with Sub-Saharan Africa being the largest market for nonmineral exports. It also explores strategic directions that can ignite export growth and help South Africa realize its goals of creating jobs and reducing poverty and inequality.

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Executive Summary

Recent economic developments

Global GDP growth is projected to accelerate gradually, from 2.4 percent in 2013 to 3.5 percent in 2016, mainly reflecting a slow but steady improvement in outturns among high-income economies. Growth in high-income economies is expected to rise from 1.3 percent in 2013 to 2.2 percent in 2014 and 2.4 percent in 2016. The recovery in Europe and the United States is expected to be supported by still very loose monetary policy, a diminished drag on growth from government and household budget consolidation efforts, and pent-up demand for consumer durables and investment goods. The baseline projection assumes a timely resolution to the debt ceiling debate in the United States, steady progress in economic rebalancing in the Eurozone, and some additional fiscal stimulus in Japan to help offset a drag from higher consumption taxes in 2014.

Sustained improvement in economic activity proved elusive in South Africa in 2013, as domestic factors continued to weigh on the recovery and offset the benefit of improving external conditions. Growth, already weakened substantially in 2012, continued to falter in 2013, as further labor unrest compounded long-standing structural constraints and reduced confidence. Growth in both consumer spending and private investment continued to moderate, reaching just 2.3 percent and 2.6 percent, respectively, in 2013q3 (quarter-on-quarter, seasonally adjusted and annualized), reflecting low confidence amid increasing uncertainty, tighter credit conditions, and persistently high unemployment.

Largely owing to the impact of labor unrest on exports from the automotive sector and rising imports related to public investment, net exports continued to weigh on headline growth. As a result, by the end of 2013q3 real GDP growth was still below potential, and the output gap had widened.

Lead indicators of economic activity suggest that while headline growth in 2013q4 should recover from the q3 lows, it will not reach the July 2013 growth forecast of 2013 real GDP growth. In manufacturing the Purchasing Managers' Index fell to 49.9 (seasonally adjusted) in December, halting the tepid recovery that started in October. The business activity subindex (output conditions) receded 4.7 points, whereas the new sales orders subindex (demand conditions) improved marginally. In addition, the employment index fell below the neutral threshold of 50 (from 50.8 to 45.8), a stark reminder of the fragile labor market for manufacturing. As a result, real GDP growth is projected to have reached 1.9 percent in 2013, a downward revision of 0.6 percentage points from the July 2013 Economic Update.

The medium-term budget policy statement, released in October 2013, recalibrated the timeline for fiscal consolidation. With the economy weaker than anticipated at the time of the 2013/14 budget, the policy statement had to balance the need to extend countercyclical support to growth while maintaining the commitment to consolidation over the longer term. For 2013/14 spending is expected to remain at the nominal level set in the original budget, helping offset

weak private sector growth, while revenues will be allowed to change with economic developments. But due to the fairly robust revenue collection through the first half of the fiscal year, as well as the transition to the Government Finance Statistics 2001 international reporting standard, the overall budget deficit is now forecast at 4.2 percent of GDP, unchanged from the 2012/13 outturn.

Over the medium term the budget deficit is expected to reach the target of 3 percent of GDP in 2016/17, one year later than originally planned. The budget deficit in the intervening years is also higher than previously forecast. As a result, government net debt will continue to rise and stabilize at about 44 percent of GDP only in 2016/17.

In the current environment of low growth and reduced fiscal space, South Africa is vulnerable to potential spillovers from disruptions in international capital flows as U.S. monetary policy shifts gears and international financial conditions tighten.

South Africa's flexible exchange rate should help cushion its adjustments. By end-2013 the rand had depreciated about 20 percent. But the overall trade deficit has so far been slow to respond. This in part reflects the large share of U.S. dollar-priced commodities in South Africa's export basket, the likely erosion of benefits of a more depreciated exchange rate by higher wage and input costs, and the role of supply-side constraints related to infrastructure bottlenecks and industrial action. As highlighted in this update's special focus on export competitiveness, South Africa needs to address the constraints that have kept export growth low in order to rejuvenate exports and create jobs to reduce the gap between domestic savings and investments—so that it can lower external vulnerabilities.

The medium-term outlook is for growth to improve gradually but for the recovery to be more subdued than previously forecast. Real GDP growth is projected to recover to 2.7 percent in 2014—from the estimated 1.9 percent in 2013—and reach 3.4 percent in 2015. The main reason for the downward growth projection for 2014 of about 0.5 percentage point relative to the July 2013 Economic Update forecast is the decline in domestic confidence amid fragile labor relations and persistently high unemployment.

South Africa's real GDP growth is projected to remain well below the average of 5.4 percent projected for Sub-Saharan Africa for 2014–16. Reflecting the subdued growth over the forecast horizon, the negative output gap that had opened in recent years (estimated at 2 percent of GDP in 2013) will not fully close over the forecast horizon.

Under the baseline forecast the recovery in growth is expected to be led by stronger exports, as the recovery in high-income economies gains pace and export capacity expands thanks to addressing local power constraints. Domestic demand is expected to improve gradually, but less strongly than in previous forecasts, reflecting low domestic confidence. Consumption growth remains fairly subdued, owing to persistently high unemployment, high household debt, and decelerating growth in government consumption as fiscal consolidation proceeds. But the easing of some key structural impediments over the course of the forecast—for instance, new power generation is expected to come on-stream in the second half of 2014—combined with favorable real interest rates over the medium term is expected to spur a recovery in private investment. The outlook has downside risks, however, relating to shifting global growth patterns that could lead to disorderly shocks in international capital and commodity markets and in domestic labor relations. Resolving the tensions in labor relations would boost confidence and improve growth prospects.

Export competitiveness

Policymakers are aware of the need to reignite export growth. The New Growth Path (2011), the National Development Plan 2030, the Industrial Policy Action Plan, and recent Monetary Policy Committee statements (2013) all identify export growth as a priority. Restarting the export engine is critical to reinvigorating growth—and to developing a more diversified export base to help reduce growth volatility. The National Development Plan aims to increase annual real GDP growth to about 5.5 percent, well above the 3.5 percent average in the decade preceding the crisis. Exports are expected to be a key driver of the faster growth, with the National Development Plan targeting export volume growth of 6 percent a year.

A stronger export sector also drives job creation. Increasing exports, particularly in manufacturing, may be crucial for the low-skilled job creation needed to substantially reduce high overall and youth unemployment. And exports are especially critical amid South Africa's widening current account deficit—and the external vulnerability arising from its reliance on volatile capital flows to fund the deficit.

Over the past decade South Africa's exports have underperformed. Export growth in real terms has stagnated, and South Africa's exporters have made only limited inroads into global markets. Be it in minerals, nonminerals, or services, South Africa's exports have lagged behind those of peers and not lived up to their potential.

A few super-exporters dominate South Africa's export sector in both minerals and nonminerals, coexisting with a large pool of small, occasional exporters. But despite their dominance, the super-exporters have been losing dynamism and competitiveness. Over the last decade some important products in South Africa's export basket have died out—a natural process. But new, high-value products have not emerged at the scale needed to replace them. Since the global financial crisis the super-exporters have become less experimental in both markets and products, underexploiting large emerging markets in both Africa and the BRICs. Super-exporters trade products that are technologically sophisticated and highly capital-intensive. This has positive implications for competitiveness but underutilizes South Africa's large pool of low-skilled labor, thus failing to create enough jobs to make the export sector a major direct contributor to employment growth and poverty reduction.

As trade patterns have shifted, particularly following the crisis, Sub-Saharan Africa has emerged as the key destination for South Africa's nonmineral exports. This has created greater market opportunities for newer and smaller exporters. So far, exports to Sub-Saharan Africa have remained somewhat smaller and shorter lived than exports to traditional markets, suggesting that lower

competitiveness in regional markets is allowing the less efficient firms to enter and exit opportunistically. This poses challenges in considering how best to support emerging exports.

Three areas present opportunities to promote the competitiveness and spur the growth in South Africa's export sector:

- *Boosting domestic competition* would increase efficiency and productivity. By opening local markets to domestic and foreign entry, South Africa would enable new, more productive firms to enter and place downward pressure on high markups. This would lower input costs and tip incentives in favor of exporting by reducing excess returns in domestic markets. Competition would also stimulate investment in innovation and, over time, condition the market to ensure that firms entering competitive global markets have reached the productivity threshold to support their survival and growth.
- *Alleviating infrastructure bottlenecks, especially in power, and removing distortions in access to and pricing of trade logistics* in rail, port, and information and communication technologies would reduce overall domestic prices and further enhance competitiveness. It would be especially beneficial for small and medium-size exporters and nontraditional export sectors, which these costs tend to hit harder.
- *Promoting deeper regional integration in goods and services* within Africa would generate the right conditions for the emergence of Factory Southern Africa, a regional value chain that could feed into global production networks. South Africa could play a central role in such a chain, leveraging the scale of the regional market, exploiting sources of comparative advantage across Africa to reduce production costs, and providing other countries in the region a platform for reaching global markets.

Progress on all three fronts would help catapult South Africa toward faster-growing exports, allowing it to realize the higher, more inclusive, job-intensive growth articulated in the National Development Plan.

SECTION I

Recent Economic Developments

Global economic developments and prospects

High-income economies are finally turning the corner on the global financial crisis

After several years of extreme weakness, high-income economies appear to be finally turning the corner on the global financial crisis—and a fragile recovery is taking hold (figure 1.1). The recovery is most advanced in the United States, where GDP has grown for 10 consecutive quarters, reflecting solid private demand, resilient business sentiment, and robust job creation. By the end of 2013q3 real GDP was 5.6 percent higher than in the precrisis period (though only 1.0 percent higher per capita). Japan's economy has responded to strong fiscal and monetary stimulus, and for a second year in a row it is expected to grow nearly 2 percent. As a result, output has reached 98 percent of precrisis levels. In the Eurozone growth finally turned positive in 2013q2—after six straight quarters of decline. Three of the five economies at the heart of the crisis (Ireland, Portugal, and Spain) have now exited recession, helped by strong export growth, while in the other two (Italy and Greece) the recession is easing. But the recovery remains fragile. Headline Eurozone growth slowed again in 2013q3, output remains well below precrisis levels, and long-term and youth unemployment remain high.

Developing countries have sustained their growth momentum, as strengthening exports to high-income countries has compensated for slower growth in China

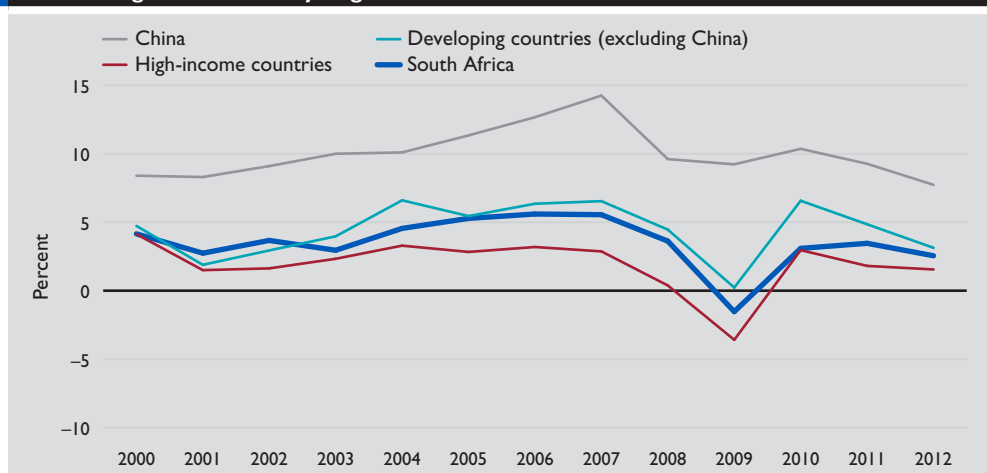
Growth in developing countries stabilized at an estimated 4.8 percent in 2013, similar to 2012. Following a weak start to the year, and financial market volatility mid-year, activity in developing countries strengthened in 2013q2 and q3, led by rebounds in China and India. In China growth accelerated to 9.3 percent (seasonally adjusted annual rate, or saar) in q3, helped by a “mini-fiscal stimulus” earlier in the year. While this should have been sufficient to sustain average growth around 7.7 percent in 2013, it was a marked drop from 2010 levels.

Strengthening activity in high-income economies in 2013 helped support growth in developing countries, which faced weaker prices for metal and agriculture exports (figure 1.2). In the three months ending in November 2013 growth in developing country export volumes accelerated to an annual rate of 17.7 percent, up from a 9.2 percent contraction in q2. The support from external demand has spilled into overall activity. Developing countries' GDP growth strengthened to 6.5 percent in 2013q3, up from 5.4 percent in q2. Business sentiment indicators for q4 signal that the strengthening of developing country real activity has likely been sustained. (Purchasing Managers' Indexes for developing countries in q4 were

Gross capital flows to developing countries fell by half between June and August 2013, and the currencies and stock markets of several major developing economies declined as much as 15 percent

Figure 1.1 Real GDP growth rates by region

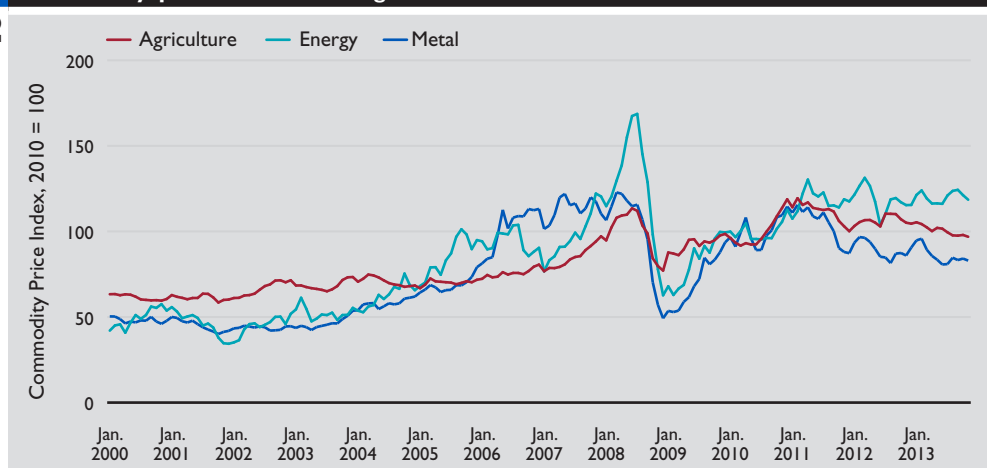
1.1



Source: World Bank DEC Prospects Group.

Figure 1.2 Commodity prices are declining as demand in China eases

1.2



Source: World Bank DEC Prospects Group.

higher than in q2 and q3 and remain above the neutral 50-mark.)

Capital flows to developing countries remain volatile as international financial conditions tighten

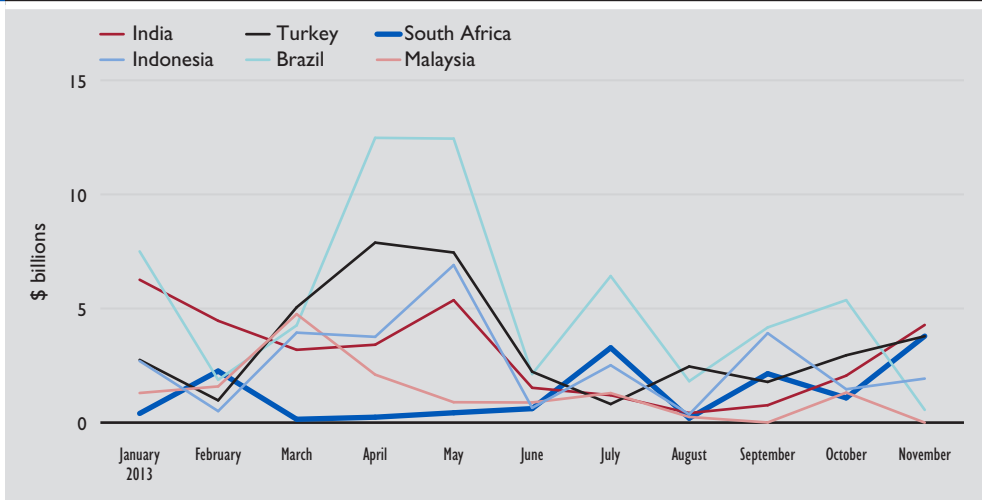
Speculation over when the U.S. Federal Reserve would begin to withdraw its extraordinary measures to support growth triggered a temporary but major reversal in capital flows from developing countries. On a cumulative basis investors withdrew a net \$64 billion from developing country mutual funds between June and August 2013. Gross capital flows to developing countries fell by half, and the currencies and stock markets of several major developing economies declined as much as 15 percent. The impact was most pronounced among middle-income economies, including India, Turkey, South Africa,

Indonesia, Brazil, and Malaysia (figure 1.3), thanks to market concern about growing external and domestic imbalances (including current account deficits, government deficits, and slowing growth; figure 1.4). Financial market conditions improved, buoyed by the delay in the Fed's tapering until January 2014. Nonetheless, as U.S. monetary policy changes further, an increase in yields on 10-year U.S. Treasuries can be expected, which should reduce capital flows to developing countries.

Prospects are for a gradual strengthening in global GDP growth over the medium term, driven by recovering activity in high-income countries

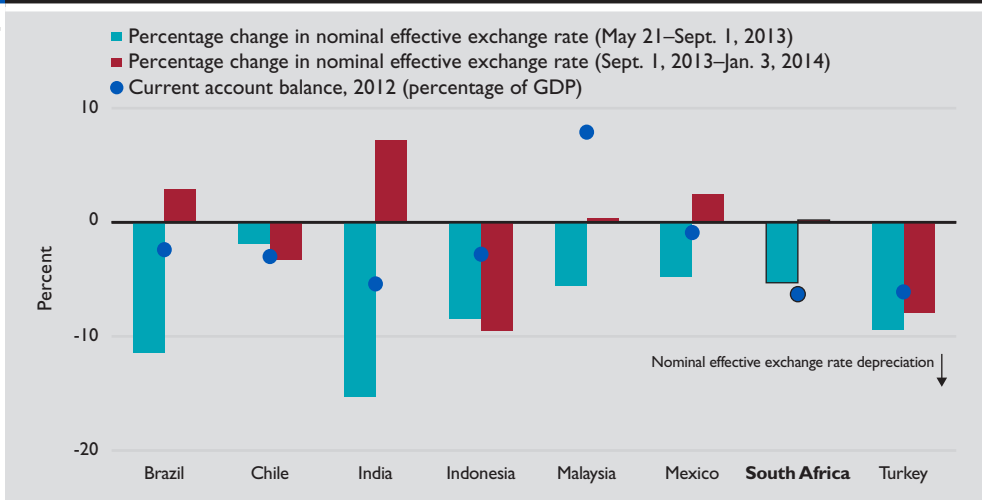
Global GDP growth is projected to accelerate gradually, from 2.4 percent in 2013 to 3.5 percent in 2016, mainly reflecting a slow but steady improvement in outturns among high-income

Figure 1.3 Capital flows to select countries



Source: World Bank DEC Prospects Group.

Figure 1.4 Nominal effective exchange rates and current account balances in select countries



Source: World Bank DEC Prospects Group.

Developing country GDP is expected to accelerate modestly, as weaker capital flows will somewhat offset better import demand from high-income countries

economies. Growth in high-income economies is expected to rise from 1.3 percent in 2013 to 2.2 percent in 2014 and 2.4 percent in 2016. The recovery in Europe and the United States is expected to be supported by still very loose monetary policy, a diminished drag on growth from government and household budget consolidation, and pent-up demand for consumer durables and investment goods. The baseline projection assumes a timely resolution to the debt ceiling debate in the United States, steady progress in economic rebalancing in the Eurozone, and some additional fiscal stimulus in Japan to help offset a drag from higher consumption taxes in 2014.

Developing country GDP is expected to accelerate modestly, as weaker capital flows will somewhat offset better import demand

from high-income countries. Growth is expected to rise from an estimated 4.8 percent in 2013 to 5.3 percent in 2014 and about 5.7 percent in 2016. Although broadly in line with potential, this growth would be nearly 2 percentage points lower than the 7.3 percent average during the precrisis boom years.

Recent trends in South Africa

Labor unrest continued to impede growth in 2013

Sustained improvement in economic activity proved elusive in South Africa in 2013, as domestic factors continued to weigh on the recovery and offset the benefit of improving external conditions. Growth, already weakened substantially in 2012, continued

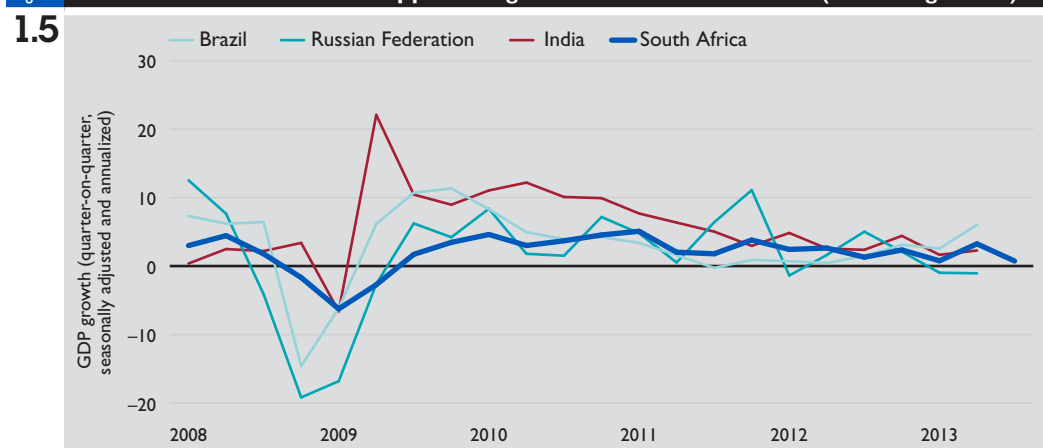
South Africa's growth performance since the crisis has generally been weaker than that of other BRICS

to falter in 2013, as further labor unrest compounded long-standing structural constraints and reduced confidence. As a result, by the end of 2013q3 real GDP growth was still below potential, and the output gap had widened. South Africa's growth performance since the crisis has generally been weaker than that of other BRICS (except for the Russian Federation; figure 1.5).

Growth fluctuated considerably in 2013, mainly reflecting the timing and impact of labor unrest. After a weak outturn in 2013q1, real GDP growth rebounded in q2 to reach 3.2 percent quarter-on-quarter (q/q) saar, only to slow to 0.7 percent in q3 (table 1.1). Growth in the primary and manufacturing sectors has been even more volatile than in headline GDP (figure 1.6). Following an 11.7 percent q/q increase in 2013q2,

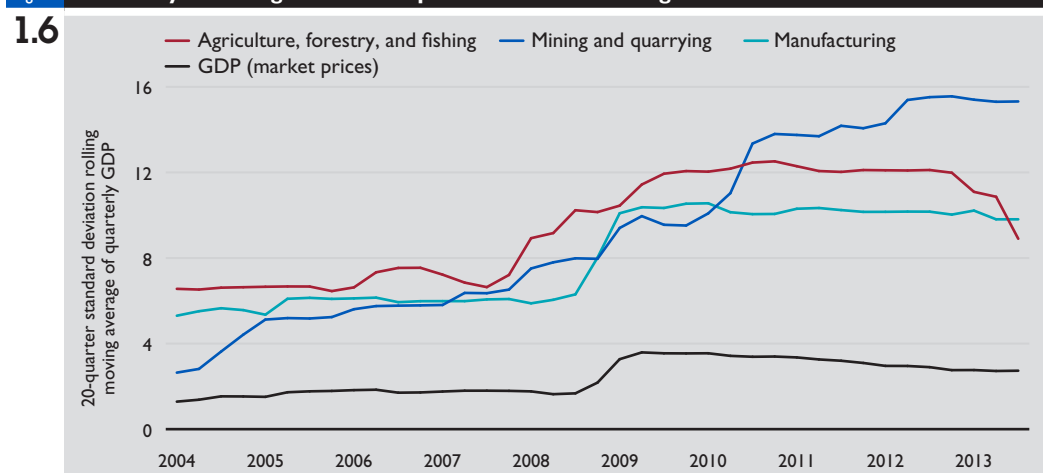
manufacturing activity contracted 6.6 percent in q3, on the back of labor unrest in the motor vehicles and auto parts sectors. According to Statistics South Africa, the labor strikes in August and September 2013 translated to a 47.3 percent and 69.9 percent year-on-year decline in motor vehicle manufacturing and a 3.9 percent and 46.0 percent year-on-year decline in parts and accessories production, respectively. Such declines more than offset the improvement in growth in the primary sector, where mining activity had rebounded in 2013q3 from the impact of work stoppages in q2. Alongside these stoppages, growth in the tertiary sector continued to moderate, reaching a 16-quarter low of 1.3 percent q/q saar in 2013q3. Although growth in transport, storage, and communications rose to 2.6 percent q/q saar, it proved

Figure 1.5 Growth in South Africa disappoints against that in other BRICS (excluding China)



Source: Federal Reserve Economic Data (database); staff calculations.

Figure 1.6 Volatility is rising in the components of real GDP growth



Source: Statistics South Africa (database); staff calculations.

Table Real GDP growth and economic performance, 2010–13**1.1**

Percentage change, seasonally adjusted and annualized

Sector	2010	2011	2012q1	2012q2	2012q3	2012q4	2012	2013q1	2013q2	2013q3
GDP at market prices	3.1	3.6	2.4	2.6	1.3	2.3	2.5	0.8	3.2	0.7
Primary sector	4.0	0.2	-7.9	20.2	-4.5	-2.6	-2.0	7.5	-4.7	8.9
Agriculture, forestry, and fishing	0.4	-0.1	4.4	9.0	7.1	9.9	2.0	-4.4	-3.0	3.6
Mining and quarrying	5.7	0.3	-12.8	25.4	-9.1	-7.7	-3.6	13.4	-5.4	11.4
Secondary sector	4.5	2.7	5.3	-1.2	1.2	3.8	1.8	-5.9	9.6	-4.5
Manufacturing	5.5	3.3	6.1	-1.1	0.9	4.4	2.1	-7.9	11.7	-6.6
Electricity, gas, and water	2.5	1.5	-2.1	-5.2	0.6	-2.6	-1.6	-2.8	5.1	3.8
Construction	0.7	0.3	5.7	0.3	3.4	4.6	2.3	2.5	2.3	2.1
Tertiary sector	2.5	4.1	3.0	2.1	2.0	2.7	3.2	2.0	2.2	1.3
Wholesale and retail trade, catering, and accommodations	3.8	4.4	4.0	2.9	2.1	1.8	3.8	2.1	3.1	1.3
Transport, storage, and communications	2.0	3.1	2.7	2.4	1.4	2.0	2.4	2.1	1.5	2.6
Finance, real estate, and business services	2.2	4.7	4.4	2.0	1.1	2.3	3.7	3.3	3.5	1.3
General government services	3.1	4.2	1.0	1.4	3.5	4.6	2.8	0.1	0.2	0.4
Personal services	0.4	2.3	1.7	2.2	2.4	2.4	2.1	1.2	1.6	1.6

Source: Statistics South Africa (database); South African Reserve Bank 2013.

insufficient to fully offset the deceleration in growth in trade (mainly motor vehicle trade) and finance, real estate, and business services.

From the demand side, gross domestic spending growth continued to decelerate (table 1.2). Low consumer confidence, tighter credit market conditions reflected in the slowdown in unsecured lending to households, high indebtedness, and persistently high unemployment all contributed to a further deceleration in household consumption spending. Nonetheless, reflecting its weight in overall GDP, household consumption still contributed 1.5 percentage points to

headline real GDP growth in 2013q3 and is likely to have been the main driver of growth in q4.

Growth in real gross fixed capital formation picked up in 2013q3, driven mainly by a substantial uptick in public investment. Private investment continued to moderate, reaching just 2.6 percent q/q saar in 2013q3, reflecting low business confidence, increasing labor costs, and uncertain external demand in key trading partners. Overall, gross fixed capital formation contributed 0.6 percentage point to headline growth in q3. But largely owing to the impact of labor unrest on exports from the automotive

Table Gross domestic spending, 2010–13**1.2**

Percentage change, seasonally adjusted and annualized, unless otherwise noted

Component	2010	2011	2012q1	2012q2	2012q3	2012q4	2012	2013q1	2013q2	2013q3
Total final consumption	4.4	4.7	3.1	3.4	4.2	1.9	3.7	2.6	2.6	2.1
Final consumption expenditure by household (PCE)	4.4	4.9	3.6	3.4	2.9	2.8	3.5	2.6	2.8	2.3
Durable goods	18.8	16.1	7.9	9.1	7.3	5.4	11.1	5.1	12.5	9.3
Semidurable goods	3.6	5.9	6.1	6.8	5.9	5.5	6.2	7.0	8.5	7.1
Nondurable goods	1.8	3.1	2.5	2.2	2.3	3.1	2.7	2.7	2.8	0.1
Services	4.0	3.6	2.7	1.9	1.4	1.2	1.7	0.6	-1.2	1.0
Final consumption expenditure by general government	4.4	4.3	1.7	3.6	8.3	-1.0	4.0	2.7	1.7	1.5
Gross fixed capital formation (investment)	-2.1	4.2	3.1	3.2	4.7	4.5	4.4	1.7	2.1	3.1
General government	-9.2	9.7	-0.1	4.3	5.3	0.2	6.2	2.7	2.5	9.7
Public corporations	-1.5	-0.6	7.4	4.1	10.4	10.3	4.9	-1.2	-0.8	0.1
Private business enterprises	-0.5	4.6	2.5	2.7	2.8	3.8	3.9	2.5	3.0	2.6
Domestic final demand	3.2	4.6	3.1	3.4	4.3	2.4	3.8	2.4	2.5	2.3
Change in inventories (R millions)	-1,988	7,865	15,123	14,647	13,703	-4,073	9,850	13,999	8,871	9,411
Gross domestic expenditure	3.9	4.6	4.6	3.7	4.2	-0.6	4.0	5.0	2.7	1.9

PCE is personal consumption expenditure.
Source: South African Reserve Bank 2013.

Even though the economy created 384,000 jobs over the last year, the unemployment rate remained stubbornly high

sector and rising imports related to public investment, net exports continued to weigh on headline growth, subtracting 1.3 percentage points from headline GDP growth in 2013q3.

Real GDP growth is projected to have reached 1.9 percent for 2013, a downward revision of 0.6 percentage point from the July 2013 Economic Update forecast

Lead indicators of economic activity suggest that while headline growth in 2013q4 should recover from the q3 lows, it will not suffice to reach the July 2013 growth forecast of 2013 real GDP growth. In manufacturing the Purchasing Managers' Index fell to 49.9 (seasonally adjusted) in December, halting the tepid recovery that started in October. The business activity subindex (output conditions) receded 4.7 points, whereas the new sales orders subindex (demand conditions) improved marginally. In addition, the employment index fell below the neutral threshold of 50 (from 50.8 to 45.8), a stark reminder of the fragile labor market for manufacturing. Job prospects remain weak for the manufacturing sector, which has shed some 250,000 jobs since the global financial crisis began.

Domestic demand conditions, mirrored by weak consumer confidence, are not conducive to employment generation. The 2013q4 First National Bank/Bureau of Economic Research Consumer Confidence Index shows that consumers expect the domestic outlook to weaken further over the next 12 months. As a result, real GDP growth is projected to

have reached an estimated 1.9 percent for 2013, a downward revision of 0.6 percentage point from the July 2013 Economic Update estimate but in line with updated estimates released in the November 2013 Monetary Policy Review.

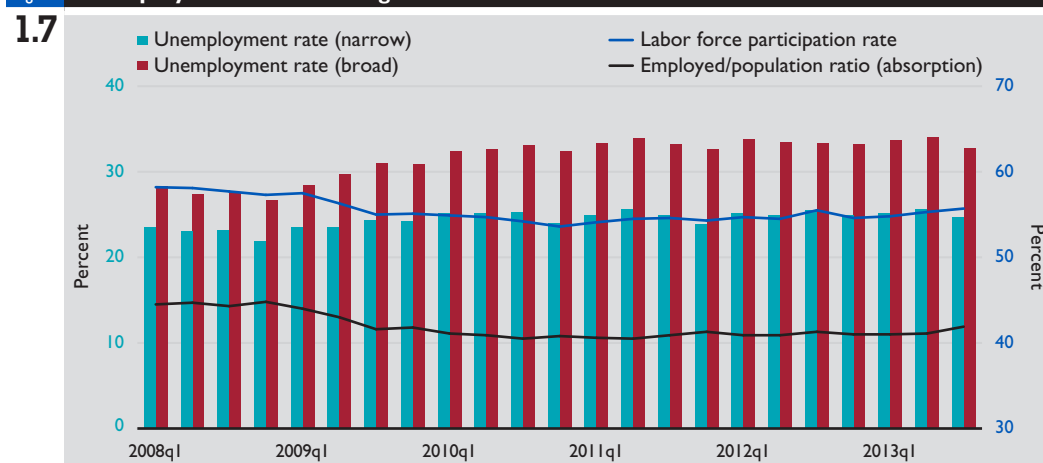
Labor markets

Over the next four years South Africa needs to create almost 1 million jobs to restore precrisis employment rates and employ new entrants to the workforce

Unemployment remains high amid weak growth and pressure from new entrants (figure 1.7). Even though the economy created 384,000 jobs over the last year, the unemployment rate remained stubbornly high, at 24.7 percent in 2013q3 (32.8 percent when including discouraged workers). Moreover, the absorption rate (the employment to working-age population ratio) remains well below its precrisis peak of 44.8 percent, despite recovering to a 17-quarter high of 41.9 percent in 2013q3. If the economy continues to generate jobs at its recent pace, it would still take four more years to close the “jobs gap” (estimated at about 967,000 jobs in 2013q3) and restore even the modest precrisis employment rate while absorbing new labor market entrants (figure 1.8).¹ Faster, more job-intensive growth is needed to make a larger dent in unemployment.

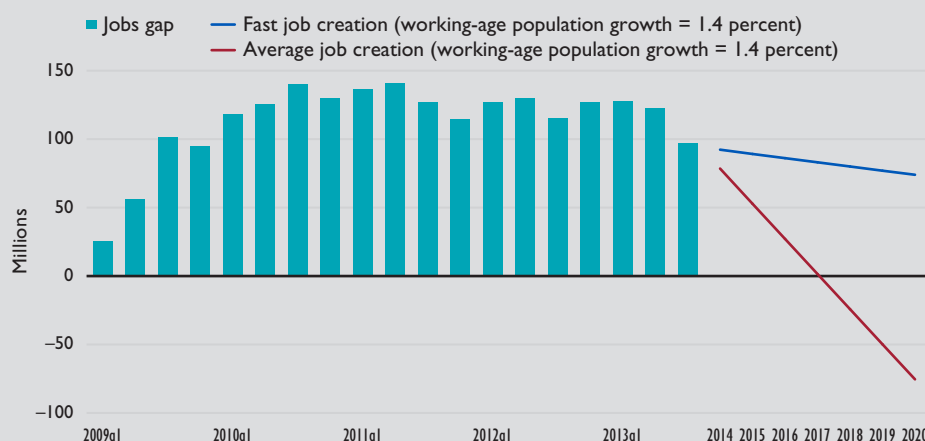
In terms of employment, the agriculture and manufacturing sectors were hurt the most by the crisis—and have yet to recover.

Figure 1.7 Unemployment remains high



Source: Quarterly Labour Force Survey (2008–13); staff calculations.

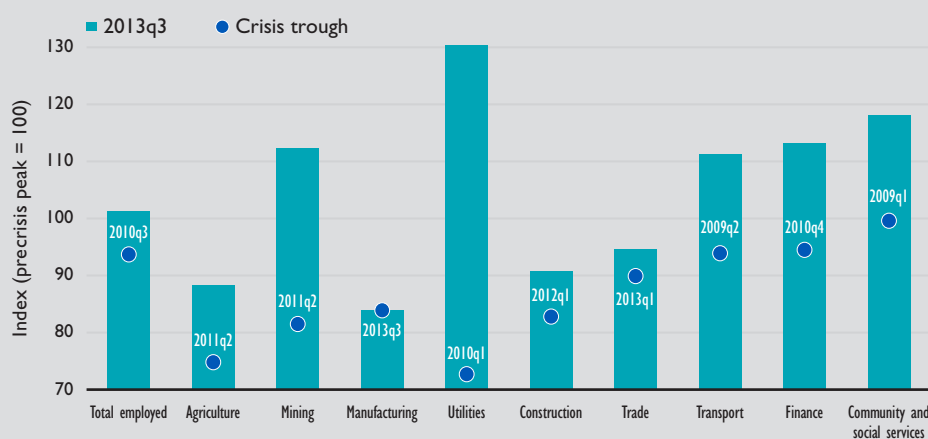
Figure 1.8 It would take four years to bring employment back to precrisis levels while absorbing new labor force entrants



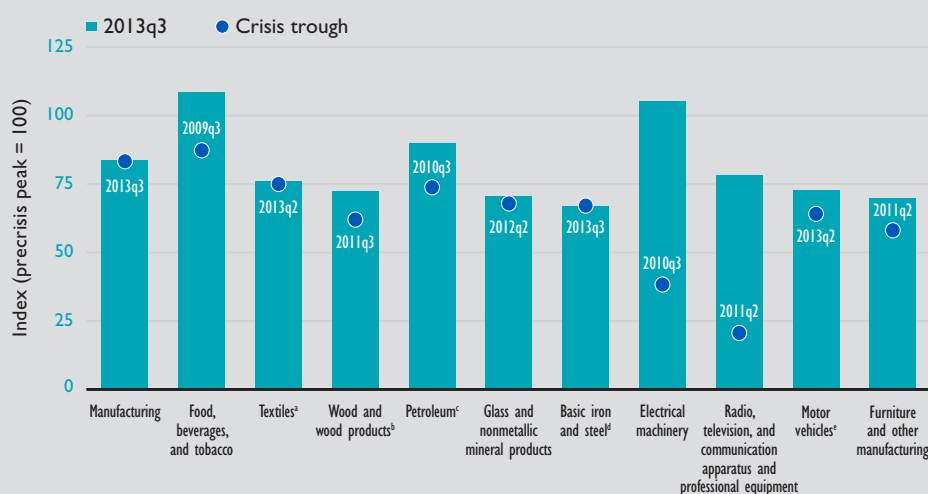
Source: Quarterly Labour Force Survey (2008–13); staff calculations.

Figure 1.9 Manufacturing employment has hit a new postcrisis low

Changes in employment, all sectors



Changes in employment, manufacturing



Note: The blue circle represents the lowest level of employment achieved relative to the precisis peak value of employment in 2008. The teal bar shows the level reached in 2013q3 relative to the precisis peak in 2008, so a level greater than 100 implies that employment has surpassed its precisis peak.

a. Includes clothing, leather, and footwear.

b. Includes paper, publishing, and printing.

c. Includes chemical products, rubber, and plastic products.

d. Includes nonferrous metal products, metal products, and machinery.

e. Includes parts and accessories and other transport equipment.

Source: Quarterly Labour Force Survey (2008–13); staff calculations.

In terms of employment, agriculture and manufacturing were hurt the most by the crisis

The overall budget deficit for 2013/14 is now forecast at 4.2 percent of GDP, unchanged from the 2012/13 outturn

In fact, manufacturing employment hit a new postcrisis low in 2013q3 (figure 1.9). Aside from food and beverages and electrical machinery, no manufacturing subsector has recovered to surpass its precrisis employment levels. With excess capacity in most manufacturing subsectors still high—for example, at 27.0 percent in the motor vehicles, parts and accessories, and other transport equipment sectors—job creation will remain subdued for some time.

Nevertheless, some recent developments in the labor market have been encouraging. The share of long-term unemployed in the labor force inched down in 2013—by 1 percentage point, to just over 16 percent—but the share of unemployed without a job for more than a year remains high, at 65.2 percent. Recent labor force survey data suggest that the probability of remaining in unemployment or the discouraged worker category after six months is slowly coming down from crisis peaks. The crisis made it more difficult to transition from unemployed or discouraged worker status into employed status, but the situation is slowly improving, at least for unemployed workers (figure 1.10). The share of discouraged workers in the broader labor force has continued to rise relative to the precrisis period, and once in this category workers are unlikely to return to the job search. Against this backdrop of high levels of long-term unemployment and discouraged workers, the new youth employment tax incentive is a welcome step that will provide a greater incentive for employers to hire new entrants and the unemployed.

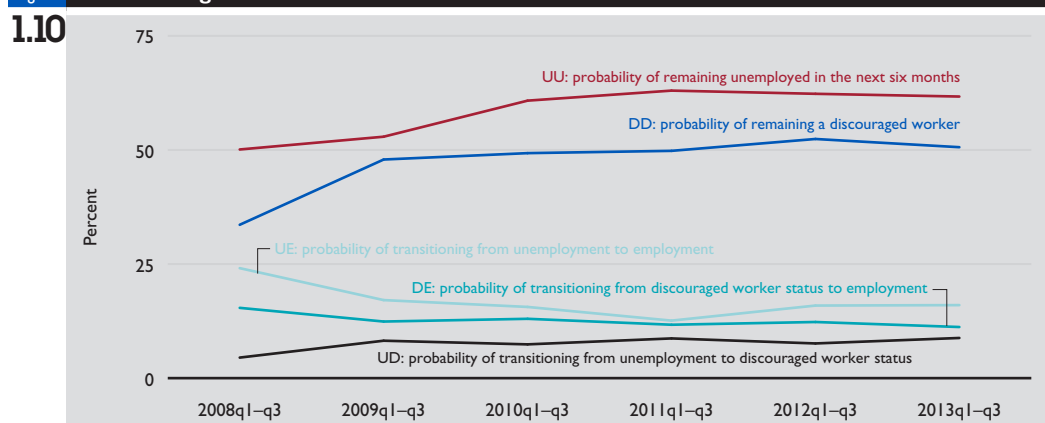
Fiscal policy

Amid a weaker growth outlook, the timeline for fiscal consolidation was extended, resulting in a more gradual decline in the overall budget deficit and debt burden over the medium term

The medium-term budget policy statement, released in October 2013, recalibrated the timeline for fiscal consolidation. With the economy weaker than anticipated at the time of the 2013/14 budget, the policy statement had to balance the need to extend counter-cyclical support to growth while maintaining the commitment to consolidation over the longer term. For 2013/14 spending is expected to remain at the nominal level set in the original budget, helping offset weak private sector growth, while revenues will be allowed to change with economic developments. But due to the fairly robust level of revenue collection through the first half of the fiscal year, as well as the transition to the Government Finance Statistics 2001 international reporting standard, the overall budget deficit for 2013/14 is now forecast at 4.2 percent of GDP, unchanged from the 2012/13 outturn.

Over the medium term the budget deficit is expected to reach the target of 3 percent of GDP in 2016/17, one year later than originally planned. The budget deficit in the intervening years is also higher than previously forecast. As a result, government net debt will continue to rise and stabilize at about 44 percent of GDP only in 2016/17. The consolidation in the budget deficit relies largely on the gradual recovery in growth to generate combined savings of about 1 percent of GDP

Figure 1.10 The probability of remaining in unemployment appears to have peaked but remains high



Source: Quarterly Labour Force Survey (2008–13); staff calculations.

on outlays on the wage bill, goods and services, and transfers. However, this will require that strict control be maintained over hiring. Growth in noninterest spending is to be contained in real terms at about 2.2 percent a year, a major deceleration from the average seen in recent years, to create space for higher growth in capital outlays in line with the National Development Plan priorities.

Inflation and monetary policy

Inflation pressures have receded in recent months, aided by lower food- and fuel-price increases, but rand depreciation and wage increases pose upside risks

Annual headline Consumer Price Index inflation has receded in recent months (figure 1.11). After breaching the upper 6 percent threshold of the target band in July and August 2013, it fell to 5.4 percent in December, helped by lower food prices (from 6.0 percent year-on-year in September to 3.5 percent in December) and petrol prices (from 12.8 percent to 10.0 percent). Consumer Price Index inflation averaged 5.7 percent in 2013, a decline of 0.1 percentage point from 2012. By contrast, core inflation has trended up since 2011. Producer price pressures have also eased from mid-year highs. The Producer Price Index for final manufactured goods, intermediate manufactured goods, mining and quarrying, and agriculture, forestry, and fishing all moderated from mid-year highs. Similar trends are observed in the Kagiso Purchasing Managers' Index price subindex, which

in November fell to its lowest level in 2013. This trend was interrupted in December, when the subindex rose 2.3 index points.

Although underlying inflation pressures appear to have been contained so far, recent wage settlements in excess of inflation and further weakness in the rand pose upside risks to the inflation outlook. The fact that there has been limited exchange rate pass-through to consumer prices so far likely reflects both the level of excess capacity and the fragile domestic economic outlook. With the weakening of the rand, the capital outflows, and the worsening of the current account balance in recent months—factors that could be subject to further deterioration as monetary policy in advanced countries gradually continues to normalize—the Monetary Policy Committee increased the repurchase rate from 5.0 to 5.5 in January. The Reserve Bank also signaled its willingness to take further action if inflation pressures were to rise, especially as a result of stronger second-round effects from exchange rate pass-through to wages and other input costs.

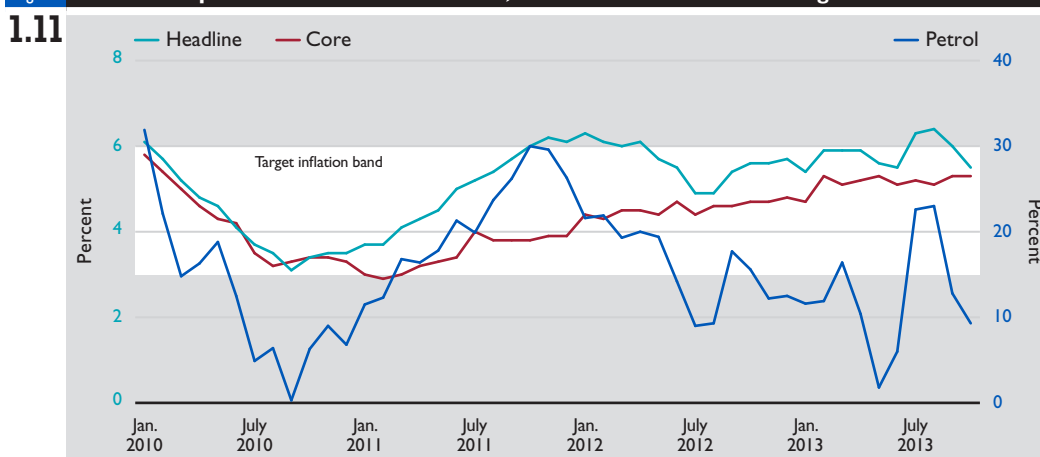
External sector

The current account deficit has continued to widen, leaving South Africa vulnerable to shifts in global market sentiment

The current account deficit widened to a post-crisis high of 6.8 percent in 2013q3, as imports continued to outpace exports (figure 1.12). Despite revisions to South Africa's international trade statistics to incorporate increased trade flows with Botswana, Lesotho, Namibia,

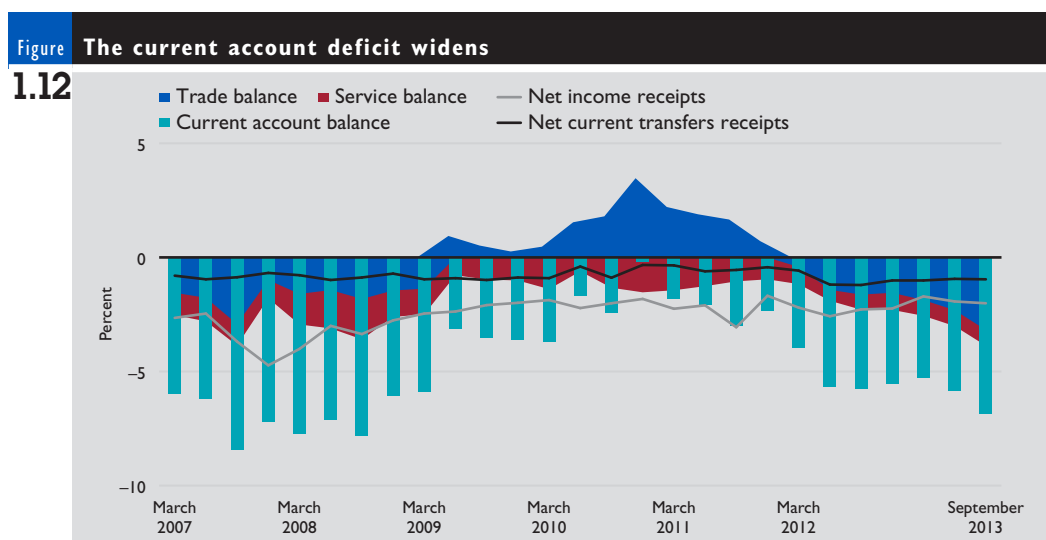
The current account deficit widened to a postcrisis high of 6.8 percent in 2013q3, as imports continued to outpace exports

Figure 1.11 Consumer price inflation decelerates, but core inflation is rising



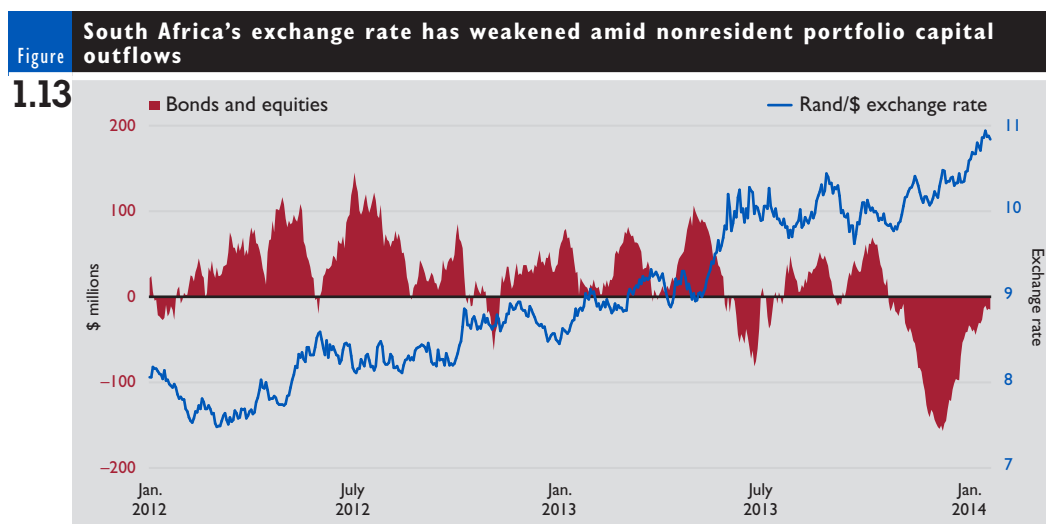
Source: Statistics South Africa (database).

High demand for capital inputs related to the public investment program, higher oil prices, and the impact of the depreciating rand lifted import costs substantially



and Swaziland (see box 2.4 in section 2), the trade deficit widened to 3.2 percent of GDP. High demand for capital inputs related to the public investment program, higher oil prices, and the impact of the depreciating rand lifted import costs substantially, with imports rising 7.7 percent q/q saar in 2013q3. Exports benefited from recovering demand in the United States and Europe and rising volumes of mineral exports, but the impact of labor unrest on manufacturing exports, among other things, left export growth at 6.1 percent q/q saar in value terms in 2013q3, trailing import growth. The impact of these trends on the overall current account was compounded by rising net dividend and interest payments to the rest of the world. This contributed to a widening in the deficit on the net services, income, and current transfer account to 3.7 percent of GDP in 2013q3.

South Africa's current account deficit continues to pose a serious macroeconomic vulnerability, especially given the role of short-term capital inflows in financing it. Nonresident activity in the domestic bond and equity markets was subject to large swings in 2013 in anticipation of the Fed's tapering of quantitative easing (figure 1.13). By end-2013 nonresident purchases of bonds and equity² totaled just over \$110 million, compared with total inflows of \$10.2 billion in 2012, though other flows like foreign direct investment and bank-related inflows compensated. In the current environment of low growth and reduced fiscal space, South Africa is vulnerable to potential spillovers from disruptions in international capital flows as U.S. monetary policy shifts gears and international financial conditions tighten.



South Africa's flexible exchange rate should help cushion its adjustments. By end-2013 the rand had depreciated about 20 percent. But the overall trade deficit has so far been slow to respond. This in part reflects the large share of U.S. dollar-priced commodities in South Africa's export basket, the likely erosion of benefits of a more depreciated exchange rate by higher wage and input costs, and the role of supply-side constraints related to infrastructure bottlenecks and industrial action. As highlighted in this update's special focus on export competitiveness, South Africa needs to address the constraints that have kept export growth low in order to rejuvenate exports and create jobs to reduce the gap between domestic savings and investments—so that it can lower external vulnerabilities.

Economic outlook for South Africa

Growth is projected at 2.7 percent for 2014, and medium-term growth prospects have been revised down, with the lack of domestic confidence impeding a stronger recovery in consumption and investment

The medium-term outlook is for growth to improve gradually but for the recovery to be more subdued than previously forecast. Real GDP growth is projected to recover to 2.7 percent in 2014—from the estimated 1.9 percent in 2013—and reach 3.4 percent in 2015 (table 1.3). The main reason for the downward growth projection for 2014 of about 0.5 percentage point relative to the July 2013 Economic Update forecast is the decline in domestic confidence amid fragile labor relations and persistently high unemployment. South Africa's real GDP growth is

projected to remain well below the average of 5.4 percent projected for Sub-Saharan Africa for 2014–16. Reflecting the subdued growth over the forecast horizon, the negative output gap that had opened in recent years (estimated at 2 percent of GDP in 2013) will not fully close over the forecast horizon.

Under the baseline forecast the recovery in growth is expected to be led by stronger exports, as the recovery in high-income economies gains pace and export capacity expands thanks to addressing local power constraints. Domestic demand is expected to improve gradually, but less strongly than in previous forecasts, reflecting low domestic confidence. Consumption growth remains fairly subdued, owing to persistently high unemployment, high household debt, and decelerating growth in government consumption as fiscal consolidation proceeds. But the easing of some key structural impediments over the course of the forecast—for instance, new power generation is expected to come on-stream in the second half of 2014—combined with favorable real interest rates over the medium term is expected to spur a recovery in private investment.

Risk to the outlook

The major downside risks to the outlook are tied to the external environment, as shifting global growth patterns have the potential to lead to disorderly shocks in international capital and commodity markets

International capital flows will be sensitive to how fast high-income countries withdraw their extraordinary monetary support measures. The baseline projection assumes that the United States will withdraw its

The easing of some key structural impediments combined with favorable real interest rates over the medium term is expected to spur a recovery in private investment

Table 1.3 Medium-term economic outlook

1.3

Percent, unless otherwise noted

Indicator	2011	2012	2013	2014	2015
Household consumption	4.9	3.5	2.8	3.2	3.8
Government consumption	4.3	4.0	2.1	1.6	1.0
Gross fixed capital formation	4.2	4.4	3.2	4.5	5.5
Exports	6.8	0.4	3.3	4.7	5.2
Imports	10.0	6.0	6.1	5.7	5.4
GDP	3.6	2.5	1.9	2.7	3.4
Headline inflation	5.0	5.6	5.7	5.7	5.5
Current account deficit (percent of GDP)	2.3	5.2	5.9	6.3	6.4

Source: National Treasury of South Africa; South African Reserve Bank (database); staff calculations.

If Chinese demand remains weaker than in recent years and supply continues to grow robustly, the commodity price drops seen over the past two years could extend further

quantitative easing fairly slowly. But markets could react sharply, as they did when speculation on tapering first emerged in May 2013, and such a scenario could be quite disruptive. World Bank analysis shows that in a scenario where markets react sharply, with rates rising by 200 basis points, capital flows to developing countries could weaken 80 percent or more for several months. Given its external imbalances, South Africa has the potential to be one of the countries hardest hit in such a scenario. Such a sudden capital outflow would require a sharp downward adjustment in domestic absorption, causing growth and investment to contract.

Lower commodity prices present another downside risk. If Chinese demand remains weaker than in recent years and supply continues to grow robustly, the commodity price drops seen over the past two years could extend further. Estimates of the impact of lower commodity prices—comparing average prices in 2013 with average prices in 2012—suggest that since 2012 South Africa has suffered a net export earnings loss of between 0.4 and 0.6 percent of GDP. With GDP growth already subdued, the downward pressure on metal prices could thus serve as an additional drag on the moderate recovery projected over the forecast horizon.

The baseline forecast anticipates continued recovery in high-income countries. But if the recovery fails to materialize, growth would be much weaker. In the Eurozone, one of South Africa's main trading partners, the banking sector is still weak, and pervasive youth and long-term unemployment are raising concerns about a permanent deterioration in job skills and the employability of the jobless. At the same time, continued sharp credit contractions raise the specter of deflation, which could exacerbate debt-overhang problems and result in a much more muted recovery. The U.S. federal deficit has also come down—mainly due to heavy spending cuts imposed by sequestration and rising tax revenues as the economy recovers. Nevertheless, little progress has been made toward a

medium-term plan for bringing the debt-to-GDP ratio under control. In the baseline a continued muddling through without significant additional brinksmanship or excessive tightening is assumed.

Domestic developments continue to represent a major risk, especially if labor relations do not improve, making it imperative to resolve these tensions to boost growth prospects

As stated in previous Economic Updates, domestic developments, particularly increased tension in labor relations, represent a major downside risk to the outlook. As witnessed in 2013, if labor disputes spread and become protracted, output would be at risk of contracting and business and consumer confidence would fall, negatively impacting investment, hiring decisions, and worker spending. At the same time, an effort to resolve these tensions has the potential to increase investor and domestic confidence, which in turn could spur more robust growth.

Notes

1. This follows the “jobs gap” methodology used by the Brookings Institution in the Hamilton Project. The jobs gap estimate here includes those who have stopped looking for work. Two scenarios are used to estimate how long it would take to close this gap. The first scenario assumes fast job creation (about 384,000 a year); the second assumes more moderate job creation (about 246,000 a year), in line with the 2011–13 average. The working-age population is assumed to grow 1.4 percent a year. Under the second scenario the jobs gap will not have fully closed by 2020.
2. Total dollar nonresident flows are computed using the total cumulative rand values for the calendar year and the average \$/rand nominal exchange rate (Johannesburg Stock Exchange; Citigroup; South African Reserve Bank database).

SECTION 2

Export Competitiveness

South Africa's exports have featured prominently in recent headlines, and the widening of the current account deficit over the last two years has brought the secular slowdown in export growth into sharp relief. Even as advanced economies are emerging from recession, South Africa's export growth continues to disappoint.

Following the lifting of sanctions in the early 1990s, exports expanded rapidly, but by the mid-1990s the pace of growth had begun to slow. This slowdown accelerated quickly in the first half of the 2000s, and more quickly still after 2005, with real export growth (in U.S. dollars) falling to just 0.6 percent annually between 2005 and 2011,¹ compared with the middle-income country average of 6.4 percent. The result is that South Africa's share in global export markets stagnated at a time when other emerging markets like China, India, and the Russian Federation were seeing major gains (figure 2.1).

Policymakers are aware of the need to reignite export growth. The New Growth Path (2011),² the National Development Plan 2030,³ the Industrial Policy Action Plan 2012/13–2014/15,⁴ and recent Monetary Policy Committee statements (2013)⁵ all identify export growth as a priority. Restarting the export engine is critical to reinvigorating growth—and to developing a more diversified export base to help reduce growth's volatility. The National Development Plan aims to increase annual real GDP growth to about 5.5 percent, well above the 3.5 percent average in the decade preceding the crisis.

Exports are expected to be a key driver of the faster growth, with the National Development Plan targeting export volume growth of 6 percent a year.

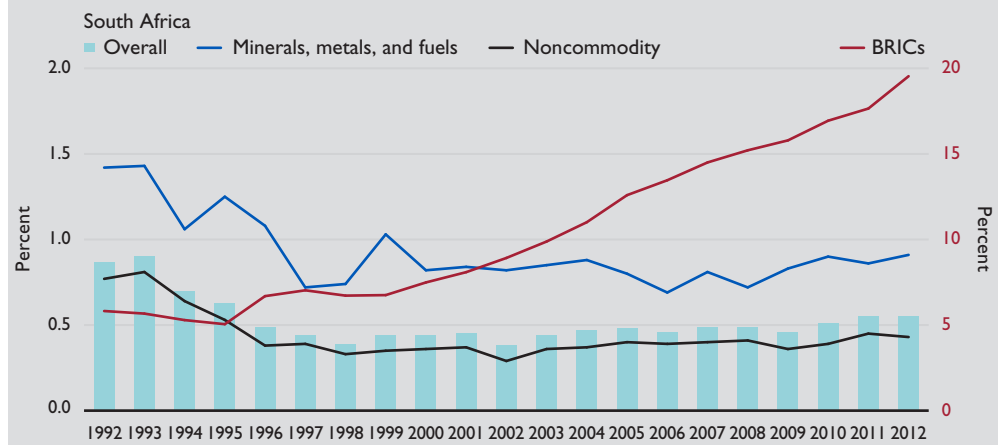
A stronger export sector also drives job creation. Increasing exports, particularly in manufacturing, may be crucial for the low-skilled job creation needed to substantially reduce high overall and youth unemployment. And exports are especially critical amid South Africa's widening current account deficit—and the external vulnerability arising from its reliance on volatile capital flows to fund the deficit.

This section aims to move beyond the headlines and assess the facts behind South Africa's export performance and competitiveness, by drawing not only on aggregate trade figures but also on a unique dataset containing information on the exports of some 20,000 South African firms spanning 2001–12. In so doing, the section places South Africa's export performance in a broader context, stripping out the impact of the large minerals sector⁶ where relevant and comparing the performance of goods exports with that of emerging market peers. This peer group includes South Africa's BRICS partners (Brazil, the Russian Federation, India, and China) and Chile,⁷ Colombia, Thailand, and Turkey (countries with similar populations, incomes, and export baskets). The section also examines the performance of services exports. See box 2.1 for an overview of the section's methodology, along with an acknowledgement of some limitations.

The fuels, minerals, and metals sectors make up around half of all exports and accounted for almost 90 percent of South Africa's export growth over 2007–12

Figure **Export performance is failing to keep pace**

2.1 South Africa's global export market share, 1992–2012



Source: UN Comtrade (database) via World Integrated Trade Solution.

Box **Methodology and limitations**

2.1

In analyzing export performance it is important to keep in mind that countries do not export—firms do. So understanding the dynamics of firms in export markets is critical for considering policy responses. This assessment's methodology is based on the World Bank's Trade Competitiveness Diagnostic Toolkit, which complements traditional aggregate trade analysis with firm-level techniques. The aggregate analysis draws data mainly from the United Nations Commodity Trade Statistics Database (UN Comtrade, via the World Integrated Trade Solution platform), supplemented by the International Monetary Fund, the United Nations Conference on Trade and Development, the International Trade Centre, the World Bank, and several South African sources (Statistics South Africa, the South African Revenue Service [SARS], and the South African Reserve Bank). The firm-level analysis draws on detailed customs transaction data received from SARS as part of the World Bank's Exporter Dynamics Database. The SARS data cover more than 20,000 exporters over 2001–12 and include data on individual export transactions (value and volume) by product and destination.

The analysis has a few limitations. First, it depends on the coverage and quality of the data available from UN Comtrade and SARS. In both cases key data (such as on exports to Southern African Customs Union member countries) are largely missing (see box 2.3 below). There may well be other data limitations—systematic or otherwise, such as on export unit values—that will impact the robustness of the findings. Second, while the customs transactions data provide valuable insights into how individual firms enter and exit export markets, expand, and diversify, these data provide no information on firms' other characteristics, including size, ownership, investment levels, and productivity. This update thus describes export performance and patterns but cannot test the determinants of the performance.

South Africa's exports—five stylized facts

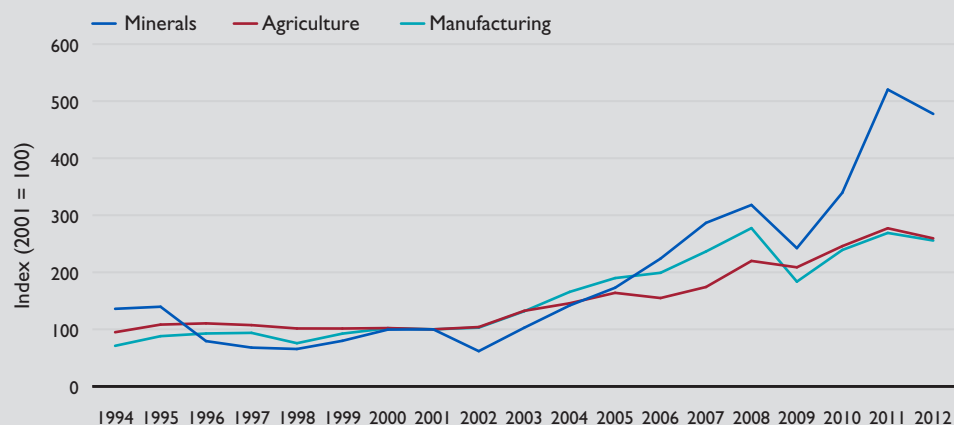
Fact 1. South Africa's exports—mineral, nonmineral, and services—are underperforming

South Africa's 20,000 exporters sell nearly 5,000 different products—covering more than 90 percent of all possible goods classified for trade.⁸ Yet just a small subset of these, encompassing the fuels, minerals, and metals sectors, make up around half of all exports by value and accounted for almost 90 percent of South Africa's export growth over 2007–12 (figure 2.2, top panel). But this growth resulted mainly from the pull of high global commodity prices. In fact, mineral export volumes have been virtually flat since 2001 (figure 2.2, bottom panel).

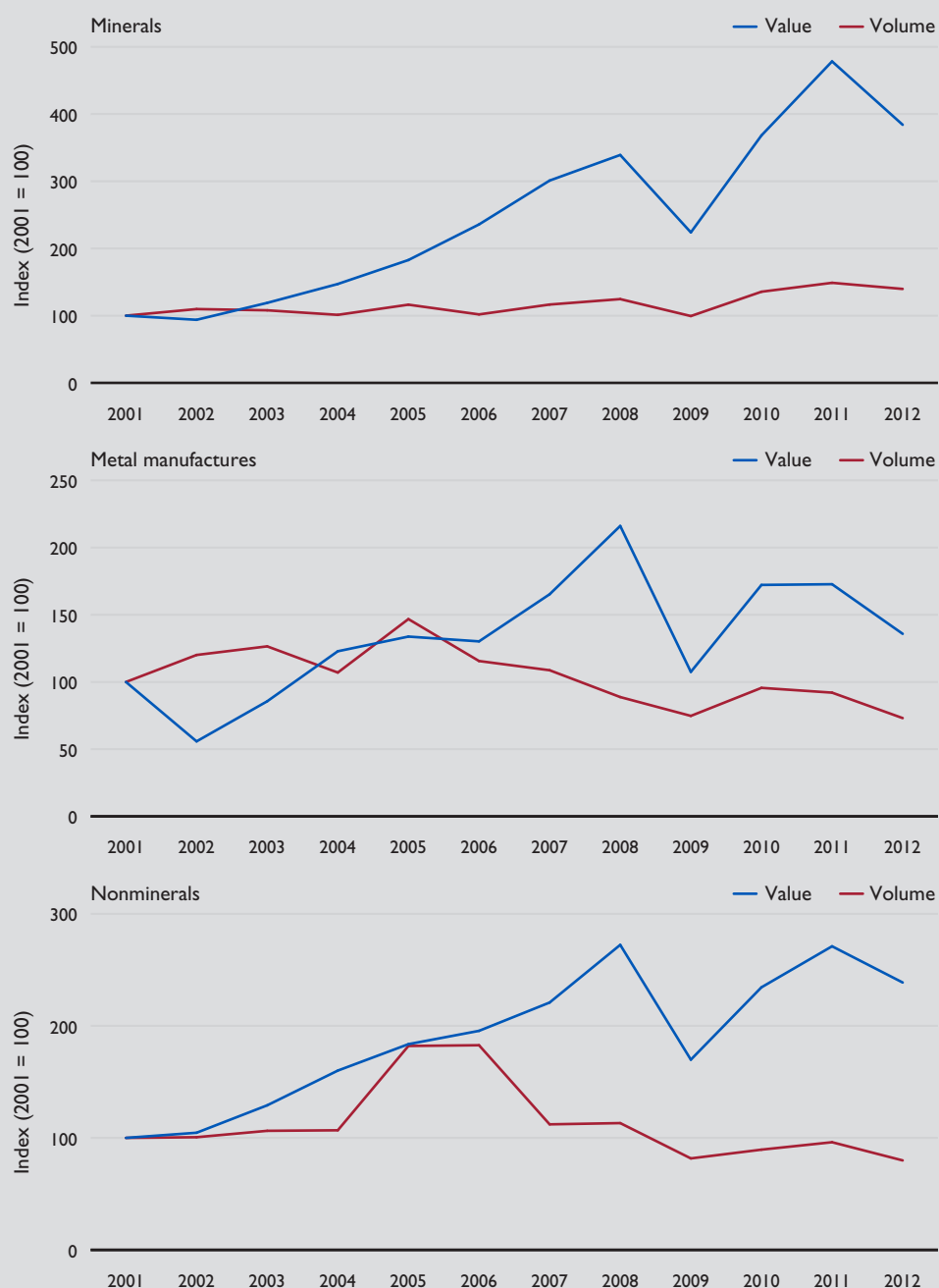
South Africa's nonminerals sector is underperforming and lagging behind that of its peers. Driven by chemicals, metal manufactures, and automotive and industrial machinery, with the latter aided by government support through the Automotive Production and Development Program (formerly the Motor Industry Development Program), nonmineral exports have grown more than 8 percent annually in nominal terms since 1999–2000 and have recovered from the crisis fairly well. But as with minerals, nonmineral volumes are flat, perhaps resulting from links to commodity prices in some sectors (metal manufactures and chemicals). But prices of differentiated goods have risen, which may reflect rising quality

Minerals are driving South Africa's export growth, with price growth and virtually flat volumes since 2001 across sectors

2.2 Index of merchandise export growth, 1994–2012



Decomposition of export growth, 2001–12



Source: UN Comtrade (database) via World Integrated Trade Solution.

As with minerals, nonmineral volumes are flat, perhaps resulting from links to commodity prices in metal manufactures and chemicals

South Africa's services exports are far below what its level of development would predict

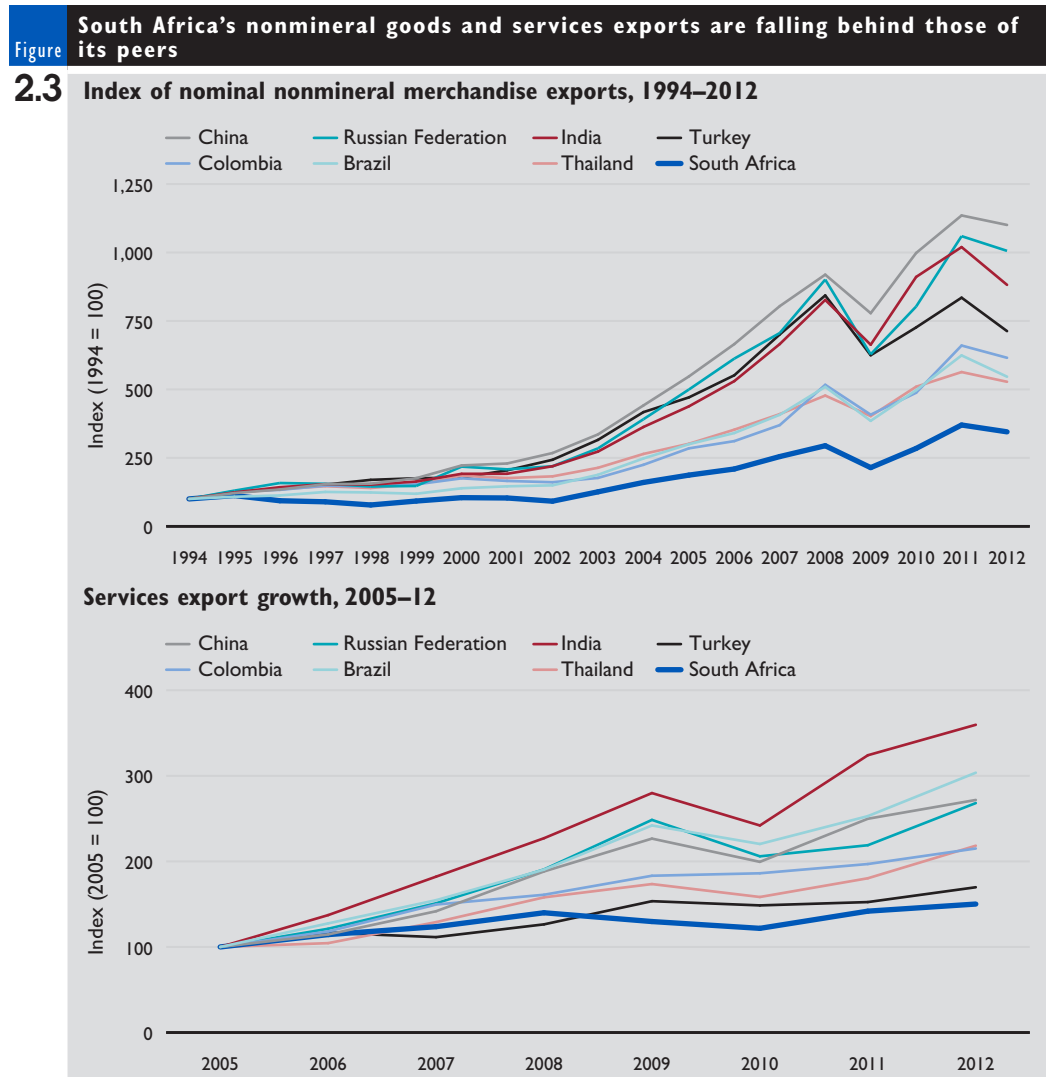
in others. Even so, since 1994 South Africa's nonmineral export growth has been far slower than that of its peers (figure 2.3, top panel). A simple cross-country model that controls for country characteristics like per capita income, population, and the cost of exporting suggests that South Africa under-exported nonmineral goods by about 9 percentage points of GDP, around \$34 billion, in 2011–12.⁹

Services exports are also falling short of potential. South Africa is top among its peers in the contribution of services to the domestic economy. Over 2000–11 services accounted for 66 percent of GDP and 75 percent of growth—and were the main source of formal employment. Yet the country's services exports are far below what its level of development would predict and have grown slowest among those of its peers since 2005

(figure 2.3, bottom panel), particularly in modern services like communications, finance and business, remote access services, call centers, and education. This weak performance seems surprising, given the proliferation of South Africa's services brands across Africa over the past decade. One explanation is that South Africa's outward foreign direct investment, most of which is in services, is acting as a substitute for direct exports—and that the data are not capturing the true extent of internationalization of South Africa's services exports.

Fact 2. Exporters are highly concentrated—a few super-exporters dominate 20,000 minnows

The top 5 percent of South Africa's exporting firms account for more than 90 percent of its exports. Among its peers, South



Note: Graphs refer to the index of nominal export growth in U.S. dollars.

Source: Top panel, UN Comtrade (database) via World Integrated Trade Solution; bottom panel, World Development Indicators (database).

Africa’s structure is more concentrated than all but Chile’s (figure 2.4, top panel). And this applies to more than just minerals. Compared with Brazil, Turkey, and Colombia, South Africa’s apparel and electronics sectors appear fairly diversified in their firm export structures (figure 2.4, bottom panel).

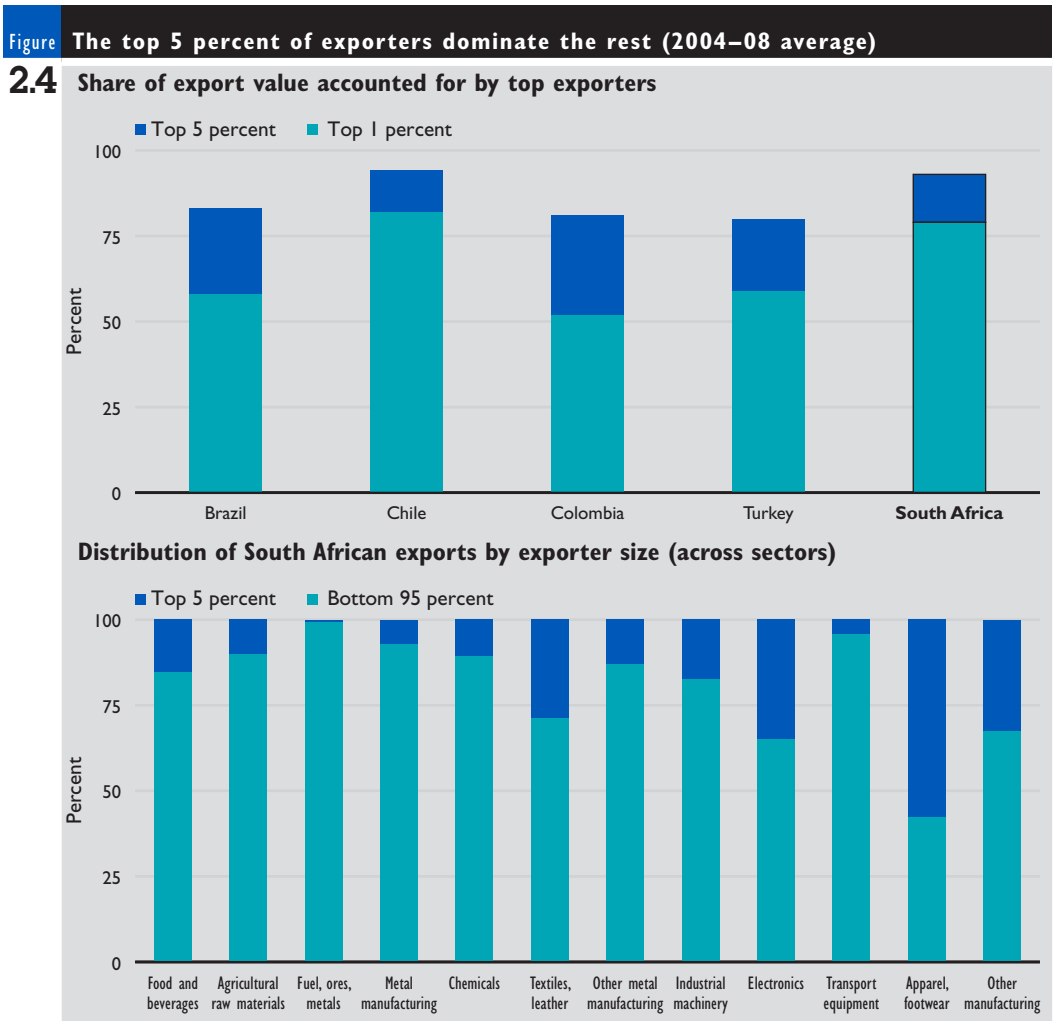
South Africa stands out for not only the concentration at the upper end of its export sector but also the long tail at the back. The vast majority of the more than 21,000 South African firms that exported in 2012 did so on a very small scale, with the median exporter earning just \$29,000 from exports, by far the lowest among the peer countries. While the average exporter among all incumbent firms has annual export earnings of around \$5 million, serving 5 destinations with 20–25 products, the average firm in the top 1 percent of South Africa’s exporters has annual export earnings of around \$400 million, serving more than 25 markets with 75–100 products.

This concentrated firm export structure is persistent. Over 2002–12 concentration increased slightly, with the share of the top 5 percent of exporters growing from 90 percent (85 percent for nonminerals) to 92 percent (87 percent for nonminerals). There was also limited movement across size categories—over the decade only around 100 of the nearly 7,000 exporters active in both 2002 and 2012 moved from the bottom 80 percent to the top 5 percent. South Africa has one of the lowest new firm entry rates into exporting among its peers (table 2.1).

Fact 3. Super-exporters are losing dynamism and competitiveness, but smaller, more dynamic exporters are not yet large enough to drive aggregate exports

The fairly strong experimentation, in the form of new product introductions and entry into new markets, that characterized South Africa’s export sector before the crisis

South Africa stands out for not only the concentration at the upper end of its export sector but also the long tail at the back



Source: Exporter Dynamics Database, based on data from the South African Revenue Service.

The largest exporters have grown the slowest, and some have declined

Table Export measures at the firm level for selected countries in 2006–08 and South Africa in 2012

2.1

Country	Number of exporters	Number of exporters per million people	Mean exports per exporter (\$ thousands)	Median exports per exporter (\$ thousands)	Ratio: mean exports to median exports	Share of top 5 percent of exporters (percent)	Number of products per exporter	Number of destinations per exporter	Entry rate (percent)	Survival rate (percent)
Brazil	19,375	161	8,539	233	37	82			22	54
Chile	7,314	430	8,317	49	170	94	4.5	3.4	38	35
Colombia	9,768	244	1,957	58	34	81	4.9	2.8	32	42
Turkey	44,570	586	2,204	105	21	80	9.6	3.9	32	55
South Africa	21,721	453	2,699	29	93	92	15	3.6	28	49

Note: Blue shading denotes where South Africa is among the two highest countries on that indicator; red shading denotes where South Africa is among the two lowest countries on that indicator. The entry rate is the number of new entrants as a share of the number of total exporters (new and existing); the survival rate is the number of entrants that did not exit the export market.

Source: Exporter Dynamics Database, based on data from the South African Revenue Service.

appears to have suffered more recently. As a result, the so-called intensive margin, which reflects the expansion of existing products into already-established markets, has become an even larger contributor to export growth, its share rising from 79 percent in 2006–08 to 88 percent in 2010–12. While the top 1 percent of exporters grew fastest across all regions in the precrisis years, the situation has since reversed. The largest exporters have grown the slowest, and some have declined, reflecting losses in existing products and markets and less success (or less ambition) with new product introduction. The top 1 percent of firms has seen a sharp drop in the contribution of new products to their markets in recent years (figure 2.5). Since 2010 the share of total exports (among the top 1 percent of exporters) coming from firms selling 10

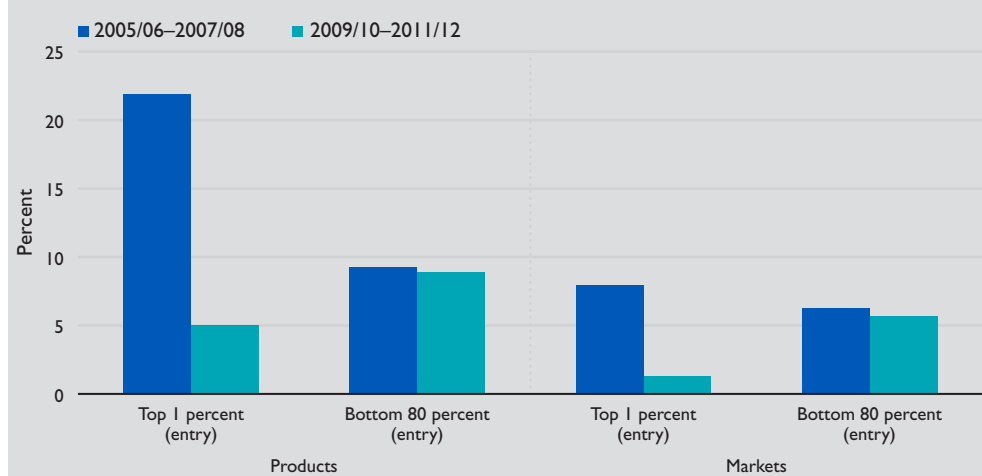
or more products has fallen from 73 percent to just 64 percent. By contrast, smaller exporters are expanding in both products and markets. However, the high concentration in South Africa's export sector means that the net impact of increased dynamism at the bottom end of the market fades into insignificance against the super-exporters' retreat from experimentation.

Declining dynamism is also evident in the size and reach of South Africa's export products. Over the last decade a number of high-value products that were exported to multiple markets—in many cases 20 or more markets—disappeared from the export basket (blue dots in figure 2.6, top panel). These include, for example, multi-ply paper and paperboard (HS480522 and HS482359) and bovine leather (HS410422). At the same time many new products entered the export

Figure Both the experimentation and competitiveness of South Africa's super-exporters are falling sharply

2.5

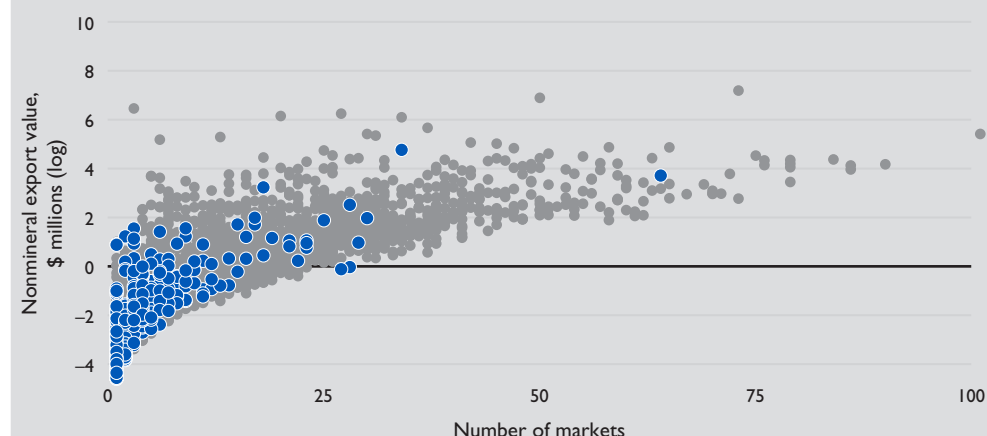
Average growth contribution from new product and market entry



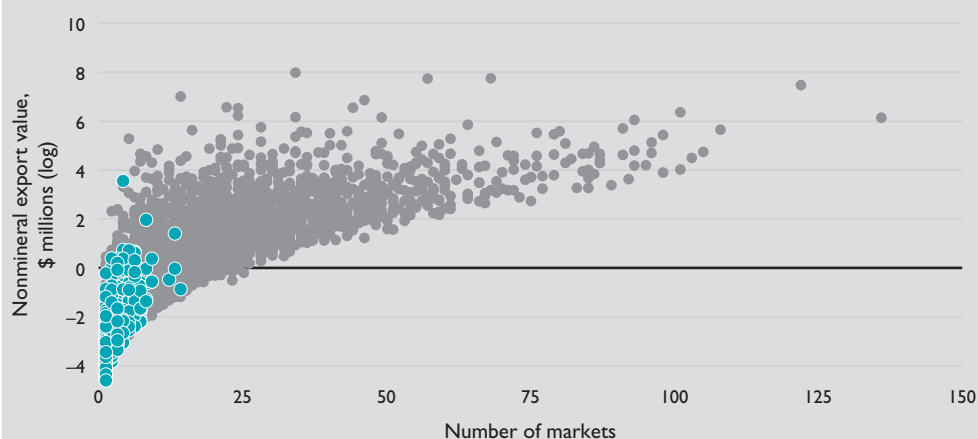
Source: Exporter Dynamics Database, based on data from the South African Revenue Service.

Figure “Big hit” exports are not being replaced, and key markets are underexploited

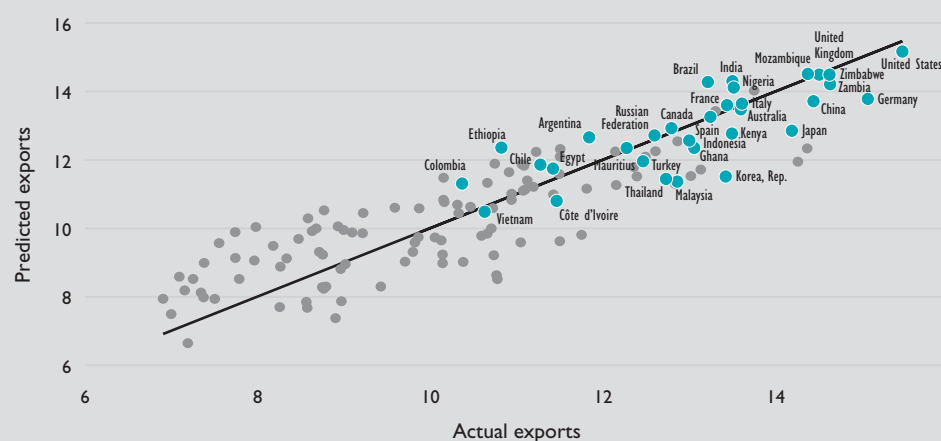
2.6 Value and reach of nonmineral exports, 2001/02^a



Value and reach of nonmineral exports, 2011/12^a



Gravity prediction of nonmineral exports, 2011/12^b



a. Data are at the HS six-digit level for exports with a value of at least \$10,000. Blue dots are exports active in 2001/02 (but not in 2011/12); teal dots are exports active in 2011/12 (but not in 2001/02); gray dots are exports active in both periods.

b. Regression results control for country selection bias and firm heterogeneity bias. Nonmineral exports are averaged between 2011 and 2012; values less than \$1,000 are treated as zero.

Source: UN Comtrade (database) via World Integrated Trade Solution.

basket (teal dots in figure 2.6, middle panel), but they were fewer than the products exiting, were lower in value, and reached substantially fewer markets.

Declining dynamism can also be revealed through the tepid expansion of South

Africa's large nonmineral exporters into new global markets. The most successful global exporters (like China and Germany) exploit up to 70 percent of their potential export relationships,¹⁰ but South Africa reached just 20 percent of its potential in 2012. South

Declining dynamism is evident in the size and reach of South Africa's export products

South Africa is not trapped in low-technology exports, giving it substantial scope for further upgrading and for competing on quality and price

Africa's level is increasing (up from 15 percent in 2000) but much slower than that of most of its peers. A gravity model of bilateral trade can show how export levels compare with expectations, given location, size, sector structure, language, trade agreements, and other predictors. In a graphical representation of this model (figure 2.6, bottom panel), countries to which South Africa underexports appear above the 45-degree line, and those to which it overexports appear below the line. The results for nonmineral exports indicate that South Africa exports more than would be predicted with neighbors like Zimbabwe and Mozambique, as well as with small European countries like Belgium and the Netherlands and East Asian countries like the Republic of Korea, Japan, and Malaysia. South Africa appears to export almost as much as predicted with China and the United States. However, it underexports to Brazil, India, and populous African countries like Nigeria, Ethiopia, and Egypt.

Fact 4. Super-exporters' sophisticated, technology-intensive exports play against South Africa's comparative advantage in low-skilled labor—with implications for jobs

Unlike many resource-rich countries, South Africa has a strong base in manufacturing, requiring strong technological knowledge. A common measure of the technological sophistication of exports—EXPY—shows that while South Africa's overall exports are slightly less sophisticated than what its income would predict, the story reverses when looking only at nonmineral exports (figure 2.7, top and middle panels).¹¹ South Africa's nonmineral exports are more sophisticated than those of all its peers except Turkey; services exports are also more sophisticated than would be expected.

Over time, exports have been shifting increasingly toward medium- and high-technology sectors, with corresponding demand for high skills and capital investment. In fact, the only two sectors in which South Africa has gained in both revealed comparative advantage and global market share since 2000 are among the most sophisticated—industrial machinery and transport equipment. In these sectors South Africa is competing largely on quality rather than price in global markets. By contrast, exports have performed

least well in manufacturing sectors that are labor- and (in some cases) material-intensive. The factor content of South Africa's exports reveals that exports are concentrated in products with human capital and especially physical capital intensity far beyond those in South Africa's endowments (figure 2.7, bottom panel).¹² For example, South Africa's export basket is associated with products produced by countries in which 67 percent of the employed labor force has postsecondary education, but less than 21 percent of the employed South African labor force has at least some tertiary education.¹³

The good news is that South Africa is not trapped in low-technology exports, giving it substantial scope for further upgrading and for competing on quality and price. The bad news is that the mismatch with endowments suggests that this positioning reflects a strategic response to domestic constraints rather than a strategy following comparative advantage. This raises concerns about the sustainability of South Africa's competitiveness in nonmineral exports, especially over the longer term, and whether the export sector (under its current model of competitiveness) can contribute much to inclusive growth (box 2.2).

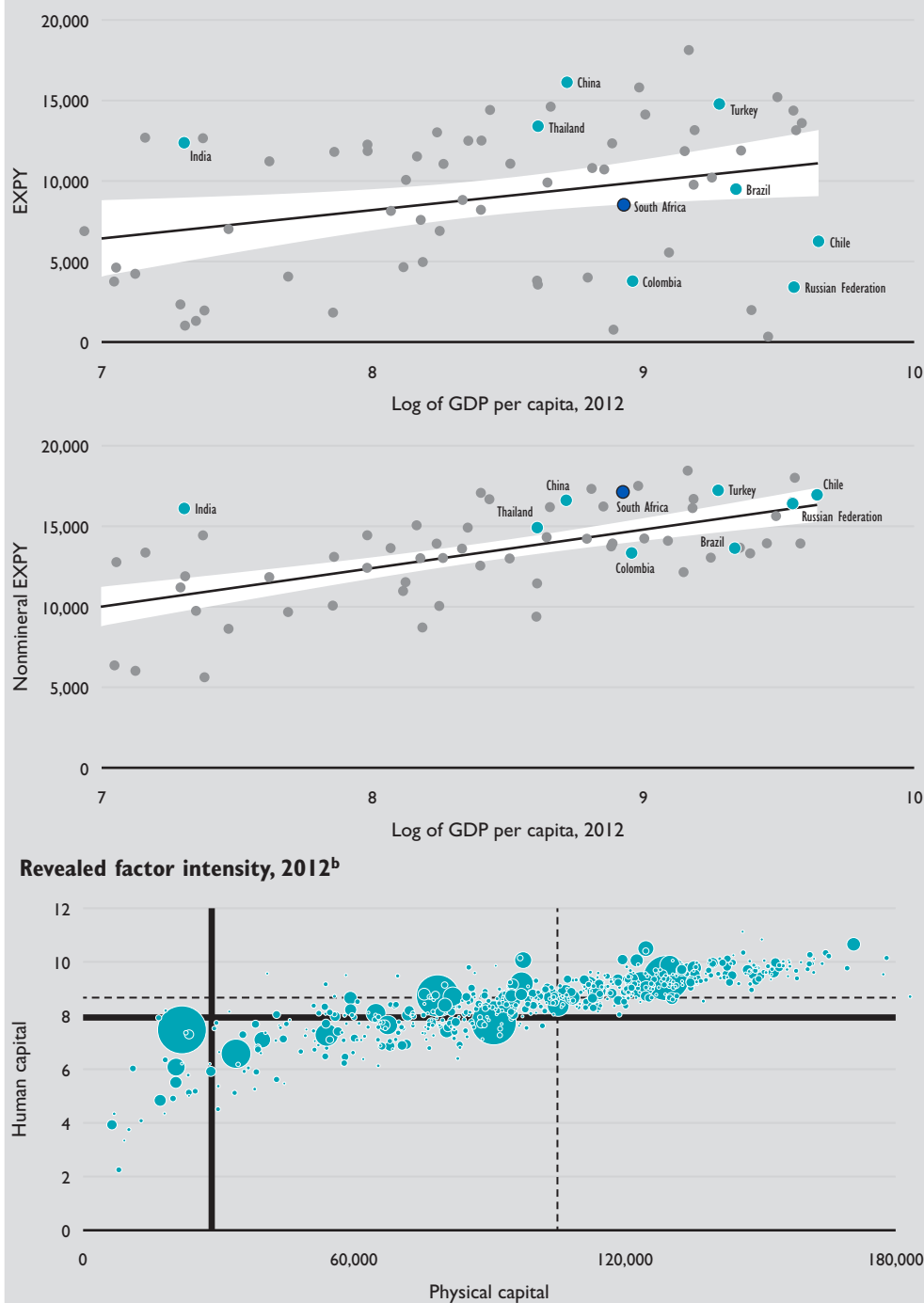
Fact 5. Sub-Saharan Africa has emerged as the dominant market for South Africa's nonmineral exports

At the beginning of the 2000s nearly 60 percent of South Africa's merchandise exports went to Organisation for Economic Co-operation and Development (OECD) countries, most of that to Europe. But over the next decade exports to EU and OECD markets stagnated, while exports to BRICs, most notably China, exploded on the back of the commodities boom. By 2011/12 the EU's share of South Africa's exports had fallen to just 21 percent, while the BRICs' share had grown from less than 5 percent to more than 19 percent.

But stripping out mineral ores, metals, and fuels reveals that the Sub-Saharan African market is where South Africa's real export dynamism lies. In nonmineral sectors the BRICs' share of exports has grown only from 5 percent to 9 percent since 2000. By contrast, Africa's¹⁴ share has grown from 19 percent to almost 29 percent, overtaking

Exports are concentrated in sophisticated sectors beyond South Africa's endowment base

2.7 Export sophistication^a



a. Export productivity and nonmineral export productivity are in current dollars based on PRODY values averaged for 2009–11. Only 66 low- and middle-income countries with more than 1,000 exports at the HS six-digit level and with per capita income of greater than \$1,000 in 2011/12 are included in this regression.

b. Bold lines are estimates of national capital endowments; dashed lines represent the factor content of median export.

Source: Top and middle panels, UN Comtrade (database) via World Integrated Trade Solution; World Development Indicators (database). Bottom panel, Shirotori, Tumurchudur, and Cadot (2010).

the European Union, which has fallen from more than 41 percent to just 28 percent, as South Africa's most important market. Indeed, including Southern African Customs Union exports, Africa now accounts for around half of South Africa's nonmineral

exports (box 2.3). The African market is also by far the most important destination for South Africa's services exports, with close to 60 percent going there.

The growth of Africa relative to Europe as a market for South Africa's nonmineral

The Sub-Saharan African market is where South Africa's real export dynamism lies

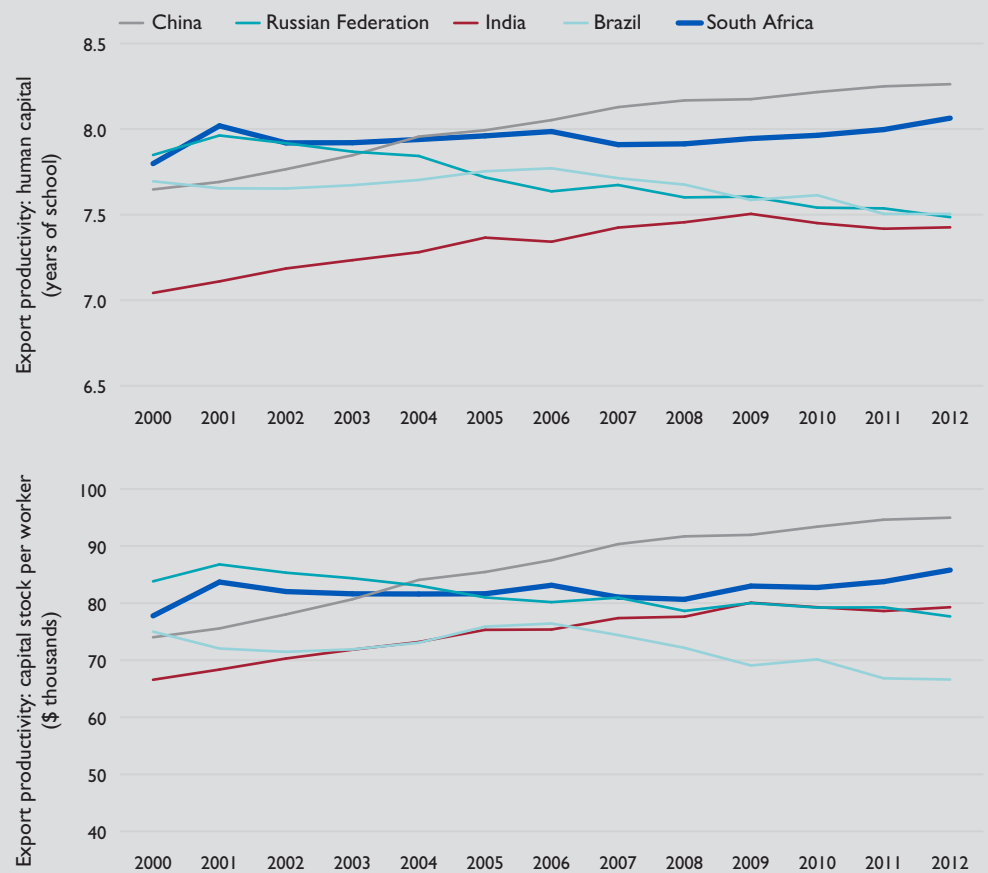
Box Exports, comparative advantage, and jobs**2.2**

How does the mismatch between South Africa's revealed comparative advantage and its factor endowments shape the prospects for exports to contribute to employment growth? The mismatch suggests that overall export growth is unlikely to have an especially large multiplier effect on employment and that demand would skew toward higher skilled employment. To assess this more specifically, this box tests two situations to see the potential implications on employment: competing with China in global markets; and shifting exports to Africa.

Competing with China in global markets

While South Africa's export basket is more physical capital- and human capital-intensive than that of most of its peers, China's has overtaken it on both counts (box figure 1). China's export basket is associated with products that pay lower wages but employ higher skills, more years of schooling, and greater physical capital. South Africa's inability to compete with China on wages means that it must move into higher quality products to achieve greater value added.

Box figure 1. Human capital (education) and capital stock per worker of exports: South Africa and its BRICS peers, 2000–12

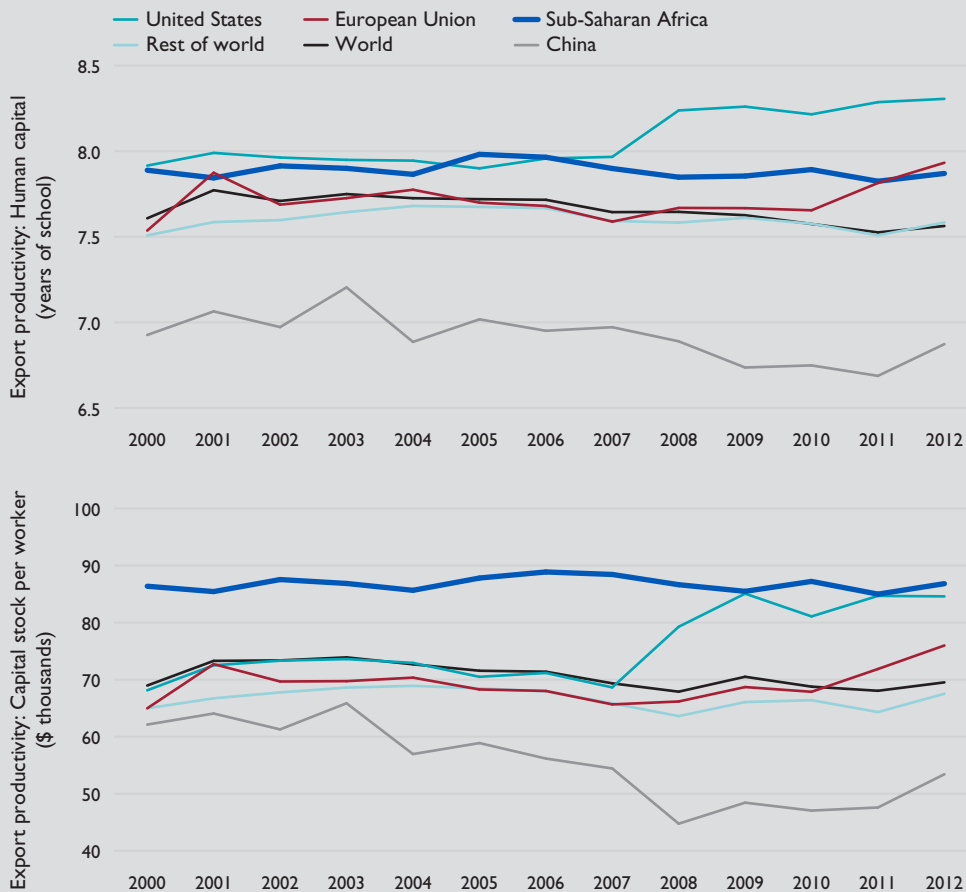


Source: Average years of schooling are from Barro and Lee (2010), and capital stock is constructed following the perpetual inventory method using investment series from version 6.2 of the Penn World Table (Heston, Summers, and Aten 2006).

Shifting exports to Africa

Despite being associated with a higher skills ratio, the recent rise in exports to Sub-Saharan Africa is associated with slightly lower wages, value added, and human capital (in years of schooling) than exports to traditional Organisation for Economic Co-operation and Development markets like the European Union and the United States (box figure 2), suggesting that the rise was accompanied by a relative increase in labor demand for lower wage workers. On the other hand the physical capital of goods destined for Africa is higher than those destined for the European Union, and is roughly on par with the capital intensity of exports to the United States. This suggests for goods destined to Sub-Saharan Africa a potential decline in overall labor demand in relative terms. Thus, the net labor impact of the relative increase in exports to Sub-Saharan Africa is unclear.

(continued)

Box figure 2. Human capital (education) and capital stock per worker for South Africa's exports to regional markets, 2000–12

Source: Average years of schooling are from Barro and Lee (2010), and capital stock is constructed following the perpetual inventory method using investment series from version 6.2 of the Penn World Table (Heston, Summers, and Aten 2006).

The shift to Africa has diversified markets, reducing aggregate risk from adverse shocks

exports is important because these markets are in many ways substitutes for each other. The mix of South African exports by sub-sector is very similar across the two markets, with African markets more important for machinery and chemicals exports and European markets more important for material-based manufactures. Africa has grown more than Europe since 2002, but the 2008–09 crisis brought a substantial shift—exports to the European Union fell 39 percent, but exports to Africa fell only 16 percent. And exports to Africa (53 percent) have recovered much more than those to Europe (22 percent) since the crisis (figure 2.8, top panel). As a nearby market, Africa is also a natural entry point for new exporters. While new firm entry into European markets is down some 40 percent since 2004–06 (three-year average), entry into African markets has remained robust

(figure 2.8, bottom panel). A new exporter is now more than three times as likely to start in Africa as in Europe.

The shift to Africa is a positive story for several reasons. It has diversified markets, reducing aggregate risk from adverse shocks; it cushioned the impact of the decline in Europe; and Africa's rapidly growing consumer class and infrastructure needs have provided ample opportunities for South Africa's exporters and investors. But the European market is still 30 times larger than the African market, and South Africa's market share in much of Africa is already higher than its share in Europe across most sectors. So even with a large market share there are some limits to the scale of growth possible in Africa relative to traditional markets.

The structure of South Africa's exporters to Africa differs substantially from the

South Africa's market share in much of Africa is already higher than its share in Europe across most sectors

Box Exports to countries in the Southern African Customs Union

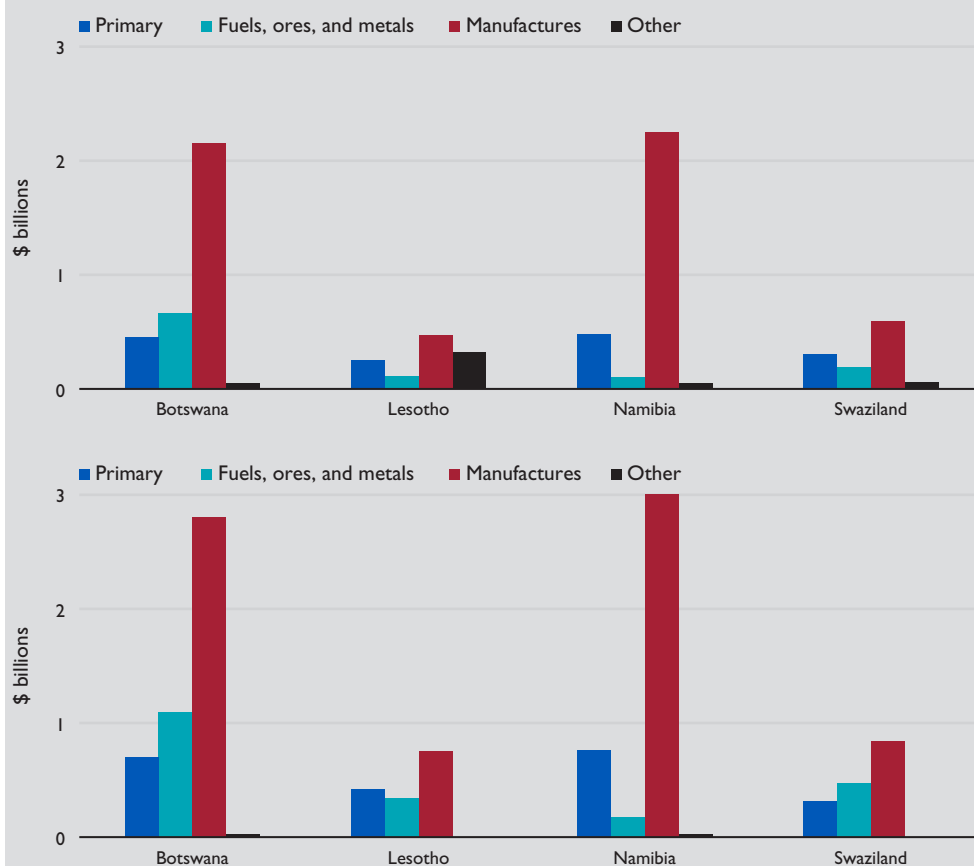
2.3

In November 2013 the South African Revenue Service revised its reporting of trade data to include exports and imports with its Southern African Customs Union (SACU) partners: Botswana, Lesotho, Namibia, and Swaziland. (Prior to this date, official balance of payments statistics included estimates of bilateral trade with Southern African Customs Union partners.) The effect was a deep cut into South Africa's reported trade deficit. The reason for the revision is that trade data reported by South African customs authorities—including both to the United Nations (through Comtrade, its Commodity Trade Statistics Database) and through the Exporter Dynamics Database, the two principal sources used for this analysis—grossly underreport trade with SACU partners (by between 96.0 percent and 99.7 percent across years compared with the figures reported in the SACU Statistical Database). So, most analytical work on South Africa's trade, including the analysis in this report, ignores trade with SACU partners. What is the nature of South Africa's exports with its SACU partners, and how does it affect the broader story outlined in this update?

In 2011/12 the total value of South Africa's exports to SACU partners was close to \$12.7 billion, with Botswana and Namibia together accounting for more than 72 percent (box figure). Including exports to SACU countries has major implications for the export storyline:

- It nearly doubles the value of exports to Africa, making Africa easily the largest regional market for goods exports, at more than 25 percent of South Africa's total.
- If fuels, ores, and metals are removed, SACU markets alone account for 19 percent of South Africa's nonmineral exports, and Africa overall accounts for more than 50 percent.
- Manufacturing dominates the basket of goods exports to SACU markets, at more than 63 percent of the total, but it accounts for just 39 percent of exports to global markets.

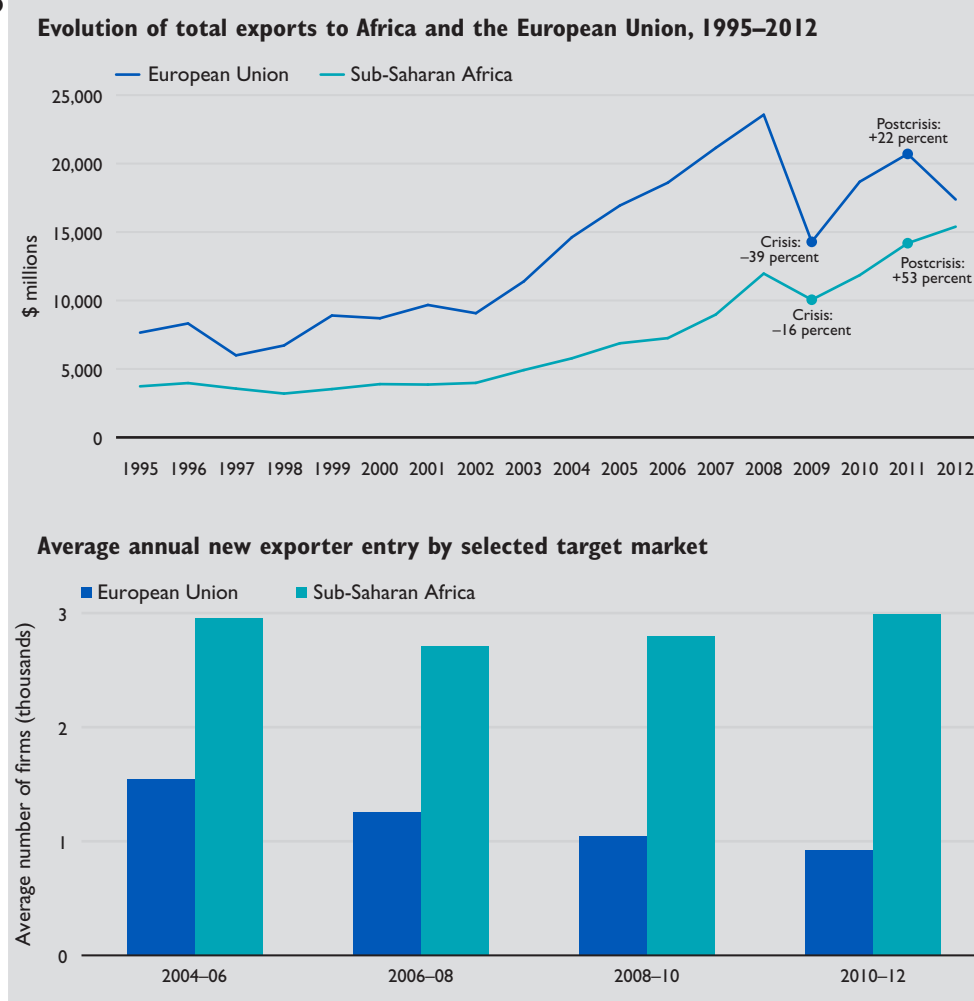
Box figure. Manufacturing dominates South Africa's exports to its Southern African Customs Union partners



aggregate structure described in Fact 2. The top 1 percent of exporters to Africa account for just 46 percent of exports there (versus

90 percent of exports to BRICS and 80 percent to the European Union). Nearly 85 percent of new exporters to Africa have no

Figure 2.8 Sub-Saharan Africa is displacing Europe as South Africa's nonmineral export destination of choice



Source: Top panel, UN Comtrade (database) via World Integrated Trade Solution. Bottom panel, Exporter Dynamics Database, based on data from the South African Revenue Service.

export experience outside the region. A new export relationship to Africa in its first year is on average only around half the size of new export relationships overall. Moreover, the average export spell is shorter in Africa than elsewhere.¹⁵ And the average annual growth rate of exporters to Africa surviving five or more years is lower than for exporters operating elsewhere (table 2.2). On the other hand, nearly a third of exporters that started in Africa expand to a new region within five years, comparable to the rate for firms that start elsewhere and later expand into Africa.

The data on survival rates give some interesting insights into how exporters use the African market. While the survival duration of individual product export spells is lower in Africa than in other regions, the survival rates of firms exporting to Africa

have risen well above the overall average in recent years.¹⁶ This finding, combined with the more modest growth and expansion trends for exporters to Africa, suggests that many firms use the African market in an ad hoc way—reacting when opportunities come rather than seeking them out. Given the fixed costs of entering export markets, this approach would normally cost firms too much. But the lower competitiveness in African markets may make this constraint less binding—even incurring higher costs exporters can still profit¹⁷—and implies that regional export markets are not as effective in ensuring that the most efficient (productive) South African firms enter. African markets are less likely than European markets to demand higher standards and quality of exporters. In the short term this partly explains how easily South African exporters

The survival rates of firms exporting to Africa have risen well above the overall average in recent years

Many causes shape firm and sector competitiveness, including deep, economywide structural factors that impact how exports respond to real exchange rate movements

Table Exporters to Sub-Saharan Africa differ in many ways, but not all

2.2

	Average 2004–07
Number of firms in new export relationships	17,160
Number (percentage) of firms in new export relationships with Sub-Saharan Africa and other regions	11,157 (65.0)
Number (percentage) of firms in new export relationships with Sub-Saharan Africa only	7,106 (41.4)
Number (percentage) of firms in new export relationships everywhere that survive five years or more	2,121 (12.4)
Number (percentage) of firms in new export relationships with Sub-Saharan Africa that survive five years or more	1,179 (10.6)
Number (percentage) of firms that begin a new export relationship with Sub-Saharan Africa only that also export elsewhere in the first five years	2,265 (31.9)
Number (percentage) of firms that begin a new export relationship outside Sub-Saharan Africa only that also export to Sub-Saharan Africa in the first five years	1,881 (31.3)
Weighted average annual growth rate (percentage) of export values in relationships that survive five years or more in:	
Sub-Saharan Africa	9.6
European Union	15.1
BRICs	18.1
United States	14.6
Other	11.9

Source: Exporter Dynamics Database, based on data from the South African Revenue Service.

have expanded in Africa. But over the long term it suggests that African markets may not compel firms to invest in innovation and productivity—and thus may not be an ideal springboard for preparing South African exporters for highly competitive global markets.

Three opportunities for unlocking South Africa's export potential

South Africa's exports have a two-tier structure along several dimensions: minerals versus nonminerals; super-exporters versus the rest; global exporters operating on the technological frontier versus regional exporters competing less on quality (though still with high capital intensity). In the past South Africa's top-tier exporters drove growth, but their competitiveness and dynamism appear to have stagnated. Smaller firms are struggling to grow, and new exporters are not emerging enough to offset declines at the top of the export sector, much less to drive aggregate growth.

Overcoming these export dynamics is not simple. Export success is not determined solely by trade-specific issues, such as tariffs and nontariff barriers, trade facilitation costs, and export promotion. Nor is it determined solely by the real exchange rate. Many causes shape firm and sector competitiveness, including deep, economywide structural factors that impact how

exports respond to real exchange rate movements.¹⁸ Indeed, addressing structural factors will be the key to ensuring a more competitive real effective exchange rate, by lowering domestic price levels and raising productivity.

In this respect government policy has an important role. The government's main policy documents, including the National Development Plan, the New Growth Path, and the Industrial Policy Action Plan, target competitiveness through a wide range of interventions. Under the Industrial Policy Action Plan, both cross-cutting and sector-specific programs and policies are designed to address some of the factors shaping export underperformance. Sector-specific interventions have long featured prominently in South Africa's policy toolkit—with mixed results. They have been at the heart of export growth in sectors like motor vehicles while having less impact in stemming decline in other sectors. The question is not whether to have sector-specific programs but about the relative investment in them and the specifics of how the programs are designed and implemented. But as the Industrial Policy Action Plan recognizes, the structural environment needs to be supportive for sector-specific interventions to be most effective.

This subsection looks at three opportunities that can help raise firm competitiveness

at both ends of the export structure—and unlock the potential for greater export growth.

Opportunity 1. Domestic market competition—to promote dynamism and the incentive to commit to export markets

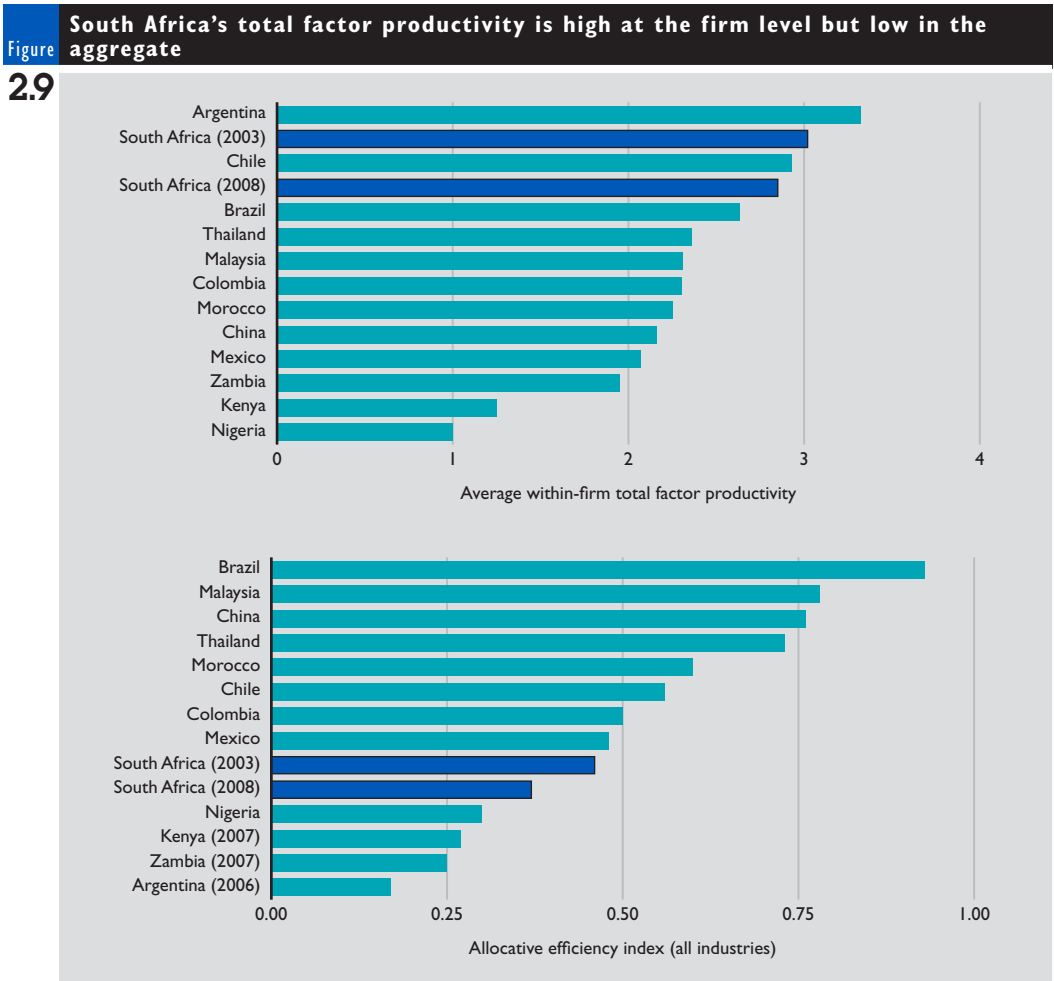
While the total factor productivity (TFP) of South Africa’s individual manufacturing firms places it among the leaders in a group of peer countries, the manufacturing sector performs poorly against these same peers in aggregate TFP (figure 2.9). This suggests that South Africa has low allocative efficiency in manufacturing—allocative efficiency is highest when the most productive firms in the sector have the highest market shares. But in South Africa the high domestic entry barriers in the various sectors documented by the South African Competition Authority and protection from imports preserve the market share of less productive and innovative firms in some sectors.¹⁹

The concentration of South Africa’s exports, along with the lack of extensive innovation, is consistent with the country’s higher concentration of export market share than that of its peers, and the higher price–cost margins associated with it.²⁰

Reducing industry concentration and improving allocative efficiency will depend in part on increasing competition. As the pool of new entrants includes operators that are potentially more productive than some incumbents, entry barriers generally weaken the link between a firm’s market share and its productivity. This is why the promotion of productivity growth has been a concern driving South Africa’s competition policy reforms.

Improving allocative efficiency also depends on trade and investment policy. It is through trade policy reforms that the South African government has probably had the biggest influence on competition.²¹ The trade and competition policy reforms of

Reducing industry concentration and improving allocative efficiency will depend in part on increasing competition



Note: Data are for 2008 unless otherwise noted.
Source: World Bank 2010.

**There is now a need
for a second wave
of reforms through
multilateral and
regional initiatives**

the 1990s reduced industry concentration, promoted greater competition, and drove growth in manufacturing TFP.²² However, progress on international trade liberalization has stalled while high nontariff barriers remain. Recent research estimates that nontariff barriers, in the form of restrictive rules of origin, import bans, and permit requirements, cover about a fifth of Southern African Development Community trade, with some of South Africa's neighbors raising the highest barriers.²³ There is now a need for a second wave of reforms through multilateral and regional initiatives.

How does insufficient competition undermine export competitiveness? First, it reduces the firms' incentives to focus on export markets, which may offer more growth potential but at a lower margin. In protected markets successful corporates grow by opening a new business line domestically, where profits are higher, rather than by expanding an existing business globally and facing tougher competition. One result is the emergence of conglomerates, which are prevalent in South Africa's export structure. Indeed, among the top 1 percent of South Africa's exporters the average number of products is 75.

A second way that insufficient competition hurts export competitiveness is by influencing the strategic commitment of firms to exporting. Most South African firms export at a very small scale, but whether these are actually small firms or larger ones exporting a very small amount of their production is unclear. It is likely the latter—data from the 2007 World Bank Enterprise Survey indicate that even for firms classified as exporters (firms that export at least 10 percent of output), the domestic market accounts for an average of 72 percent of total sales, well above the global average of just 46 percent. Anecdotes from industry provide numerous examples of firms that export mainly as a response to temporary declines in domestic demand or to the exchange rate impact on domestic competition.²⁴ This reactive approach to exporting is inefficient, as firms must incur fixed costs each time they re-enter the market. It also undermines firms' potential for becoming established as reliable suppliers.

Perhaps more important is the impact of insufficient competition on the distribution

of firms that choose to export. In efficient markets only the most productive domestic firms can absorb the fixed costs and greater competition in export markets. But if the domestic market fails to condition firm competitiveness (for example, by allowing higher profits through protection or collusion) and firms export only when their domestic margins are threatened, the least productive firms, not the most productive, will turn to export markets first. This bodes badly for survival and growth in export markets. And though the lower competition in African markets may cushion South Africa's exporters in the short to medium term, this cushion will not last forever.

Finally, because many large firms are upstream in the value chain (due in part to their starting as state-owned enterprises linked to resource sectors), inflated margins hinder the competitiveness of downstream (value-adding) industries that rely on these large firms for inputs.²⁵ This impact is compounded by trade policies that reduce the profitability of exporting and tend to favor established industries and firms, raising the cost of inputs (especially for downstream sectors).

The structure of export firms raises a question about how government can best support an effective export market structure to balance efficiency with equity and short-term priorities with longer term ones. While greater consolidation by the largest and most productive firms is probably good for efficiency and more conducive to raising export volume in the short term (which may be a priority for objectives like reducing the current account deficit), the development of sustainable medium-size exporters may be critical for longer term goals like diversification and innovation and may generate more jobs at home (per rand of export). Box 2.4 explores how the policy implications of helping small and medium-size firms start exporting differ from those for enabling medium-size and larger firms to survive and grow.

**Opportunity 2. Competitive inputs—
to promote small and medium-size
exporters and emerging sectors**

Reducing input and trade costs is a priority for South Africa to raise productivity

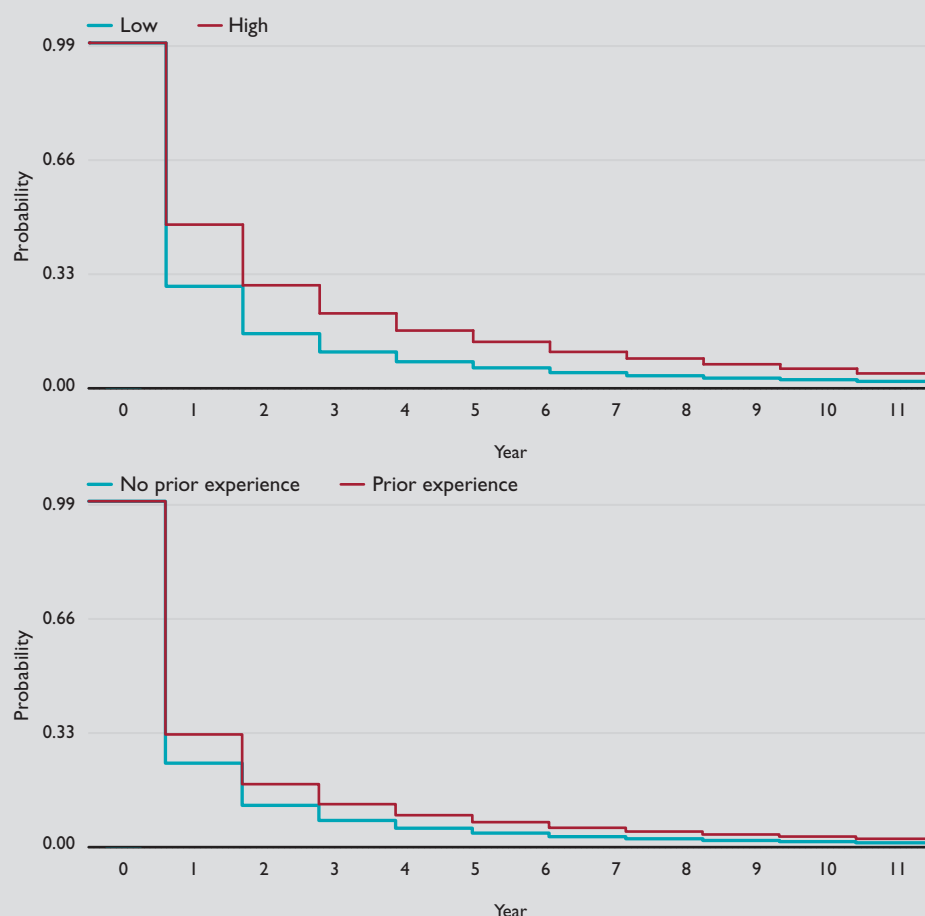
Exporting comes at a cost—firms must establish customer and distributor relationships, learn about changing market trends and regulations, and pay for licensing, customs, and shipping. This is why the survival rate of new export entrants tends to be low, particularly in developing countries. It is also why there is a sensible argument for government support in overcoming fixed costs and information asymmetries that act as barriers to entry and survival in exporting. But it is important to establish some criteria on which firms to support amid multiple priorities and limited resources.

The firm-level export data give some useful indications of the factors associated with the survival and growth of South African exporters. Two things seem to matter most: initial export value and experience (box figure):

- *Value of initial exports.* Export spells that begin with an initial export value of more than \$50,000 end up lasting much longer than lower valued shipments.
- *Exporting experience.* A firm having at least two years of experience more than doubles the chances that an export spell will survive at least two more years. This reflects the fact that firms and export relationships that have survived the first two years have overcome fixed costs, have proven themselves reliable and competitive, and are beginning to reap the benefits of learning by exporting.

What does this suggest about policies to support exporters? While there are sound reasons for helping small and medium-size firms export for the first time, many of these firms lack the scale or quality to compete in domestic markets let alone take on the added costs and uncertainties of exporting. It may be more efficient to focus on ensuring that firms that have already taken on the costs of entering foreign markets do not exit so easily—and that they have the incentive to invest in growth. Initial export survival can be seen as a market signal of firms that have the capacity to be future drivers of export growth and employment.

Box figure. Initial export size and experience matter most for firms' growth and survival



Source: Exporter Dynamics Database, based on data from the South African Revenue Service.

The structure of export firms raises a question about how government can best support an effective export market structure

Three areas of infrastructure need improvements to enhance export competitiveness: transport, electricity, and ICTs

and develop its export capacity. Three areas of infrastructure need improvements to enhance export competitiveness, particularly of smaller firms and less established sectors and products: transport, electricity, and information and communications technologies (ICTs; figure 2.10). Research in OECD countries suggests that protecting these crucial inputs places export-oriented manufacturing sectors at a competitive disadvantage.²⁶

Transport. While transport and logistics infrastructure has the potential to become an important source of competitive advantage for South Africa's exporters, the related access and pricing policies raise high barriers to many export sectors. Transnet, a state-owned enterprise, operates and controls South Africa's freight infrastructure, with a monopoly in several transport areas. Despite various reforms since the 2000s, South Africa's tariff pricing strategy for

freight still reflects support for import substitution and cross-price subsidization, placing smaller, labor-intensive exporters at a disadvantage.²⁷ For example, port tariffs on containers were 360 percent of the global average in 2012, while on bulk commodities they were 19–43 percent below the global average (table 2.3).²⁸ Rail freight has similar price distortions—rail tariffs on iron ore are somewhat below U.S. prices, while those on general freight business are 4–7 times higher.²⁹

These price distortions discourage the development of new mineral sectors (manganese, for example), agricultural exports, and processed manufactures like steel (box 2.5). They also impose a heavy cost on small producers. For example, smaller automotive producers do not qualify for volume discounts at ports.

The price distortions also are mirrored in the allocation of infrastructure investment. For example, the iron ore rail lines are world

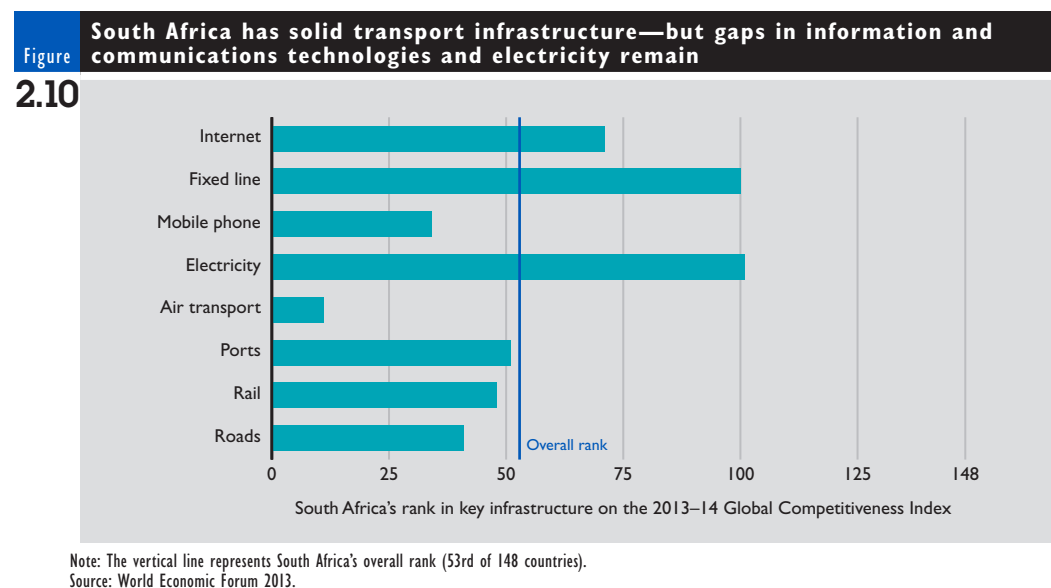


Table 2.3 Comparing port tariffs: South Africa against the global average

Tariff category	Tariff		South Africa's premium or discount on the global average (percent)
	Global average	South Africa	
Container	\$62,414.90	\$287,217.80	360.2
Container (with rebate)	\$62,414.90	\$245,913.20	294.0
Automotive	\$92,682.80	\$300,253.60	224.0
Automotive (with rebate)	\$92,682.80	\$289,560.70	212.4
Iron ore	\$257,113.20	\$208,489.90	–18.9
Coal	\$124,307.80	\$71,049.60	–42.8

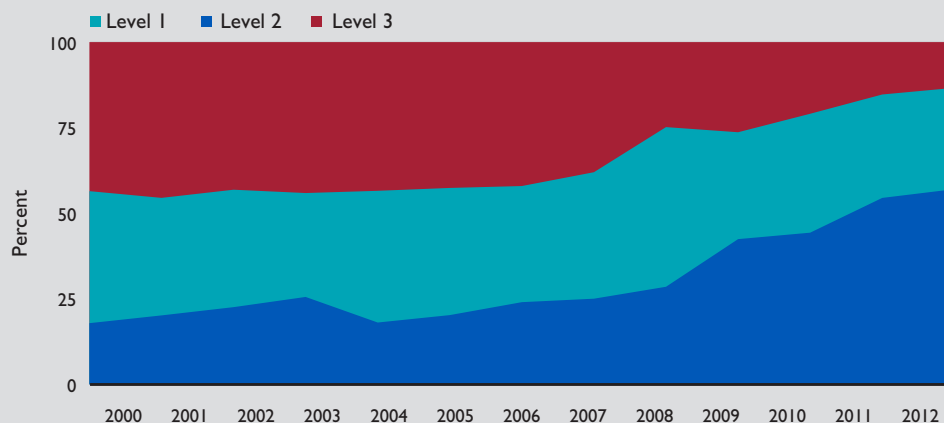
Note: Comparisons are based on a set of assumptions (standardized across ports included in the study) with regard to vessel size, load size, services, and the like.
Source: Ports Regulator of South Africa 2012.

As a major producer of minerals and exporter of metal-based manufactures, South Africa has opportunities for export expansion not only in processing more minerals and metals but also in raising the value of what is being processed. The average unit prices of metals exports vary widely, offering scope for countries to move to higher quality (and thus higher value) varieties, both across and within stages of production (Mandel 2011). Looking at the iron and steel value chain, however, South Africa's exports seem to be moving in the opposite direction—toward basic production and lower quality (box figure). In 2000 level 1 products (iron ore and concentrates) accounted for just 18 percent of exports (by value), but by 2012 their share had more than tripled to 57 percent. By contrast, the share of level 2 products (ferro-alloys) and level 3 products (semifinished/finished steel) in exports declined dramatically, with level 3 products falling from a 44 percent share to just 13 percent.

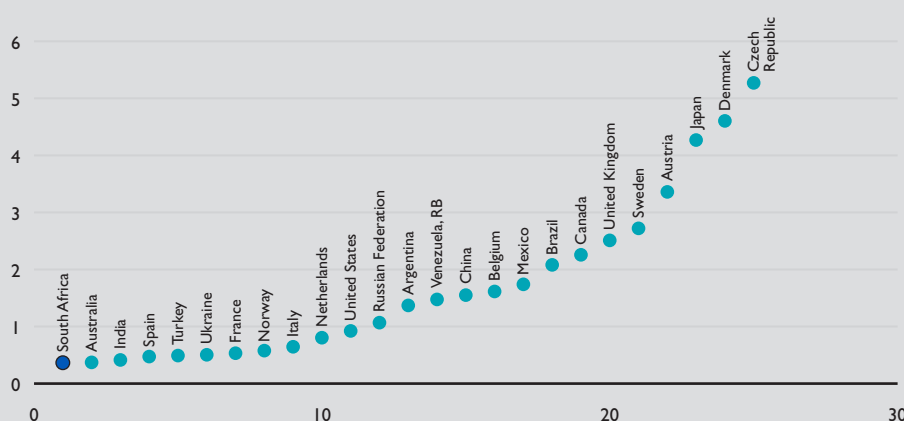
One reason for the shift was the growth in prices for basic commodities like iron ore. Another is that while participating in higher value-added segments should deliver a more stable premium over time, it also has costs—it requires investment in research and skills, access to raw materials, reliable and cost-effective power, access to imported technologies, and cost-effective, flexible transport to reach global export markets. Amid high transport costs for noncommodities (see table 2.3 above), rising costs and declining reliability of power, and import parity pricing on key inputs, the economics of adding value do not add up.

Box figure. South Africa's iron and steel exports are moving toward basic production and lower quality

Distribution of exports in the iron and steel value chain by level of processing, 2000–12



Quality ladder of ferro-alloy exports to German market, 2011^a



a. The quality ladder compares South Africa with other exporters to the German market in 2011. The x-axis plots the position of each country's exports from lowest to highest in quality (unit price), with the highest toward the right; the y-axis indicates the average unit value (dollar per kilogram). The ladder excludes countries with exports of less than \$100,000.

Source: UN Comtrade (database) via World Integrated Trade Solution.

Price distortions discourage the development of new mineral sectors, agricultural exports, and processed manufactures like steel

South Africa's major growth in exports to Africa over the past decade came in a region where the barriers to trade are among the world's highest

class, with handling volumes that meet or surpass global benchmarks. But the rest of the rail system is in relatively poor condition. Likewise, the Port of Richards Bay (which handles coal exports) and the Port of Saldanha (iron ore) are highly efficient, while the general terminal at Durban can handle just 17 containers (20-foot equivalent units) an hour, less than half the international norm of at least 35.³⁰

Electricity. Unreliable power supply has become a key constraint to growth and competitiveness. Even in 2007, 30 percent of exporters identified electricity as a major constraint, 50 percent higher than reported by nonexporters and by far the constraint noted most widely by exporters.³¹ Yet the situation has since become much more problematic.

Eskom, the state-owned power utility, estimates that current electricity prices are two-thirds the level needed to cover costs, including capital. At just over \$50 per megawatt hour for industrial users, South Africa's prices compare favorably with those of most middle-income and advanced countries,³² even though electricity prices have risen almost twice as fast as the overall Producer Price Index since 2008. Still, following a major power crisis that year, Eskom manages power supply tightly—including by restricting supply to key industries—which has negative implications for export growth. A lack of municipal investment in distribution maintenance and refurbishment has compounded the supply problems.³³ As a result of the constraints on power availability at multiple levels, South Africa now ranks 150th of 189 economies on the 2014 *Doing Business* indicator, "Getting Electricity."³⁴

Information and communications technologies. Efficient ICTs are an important prerequisite for developing modern services exports that provide skilled jobs (call centers, for example). While South Africa's telecommunications network is one of Africa's most advanced, regulatory constraints restricting competition have hampered the sector's growth.

South Africa's ICT availability now stands on the low end of that of its peers. On the

World Bank's Knowledge Economy Index, South Africa's rank on ICT infrastructure slipped from 55th in 2000 to 98th in 2012, due partly to low penetration. In 2011, for instance, South Africa had only 2 fixed broadband subscribers per 100 people, just one-sixth the level in China and the Russian Federation. The slippage also reflects a lack of access to key services, due partly to Telkom's monopoly in South Africa's communications industry. The telecommunications regulator is overburdened and restricted in its capabilities as handed down by the Department of Communications. Telkom has a monopoly on all international calls, excluding Voice over Internet Protocol, and all traffic over the SAT3 cable that provides most of South Africa's international bandwidth. South Africa ranks 88th (of 169 countries) on fixed broadband prices, with prices (in nominal terms) almost twice the level of those in Mauritius.³⁵

Opportunity 3. Deeper regional integration—to open export opportunities and build supply-side competitiveness

Regional integration also holds the potential to unlock nonmineral and services exports. South Africa's major growth in exports to Africa over the past decade came in a region where the barriers to trade are among the world's highest. The cost of trading across borders in Africa is more than twice the cost in East Asia and OECD countries,³⁶ and data from *Doing Business* show that in Sub-Saharan Africa it takes an average of 38 days to import and 32 days to export goods across borders, much higher than in other regions. This is the result of inefficient transport, border management, and logistics; cumbersome fiscal arrangements; poorly designed technical regulations and standards; and other nontariff barriers like import bans, permit requirements, and licensing.³⁷ These barriers may actually have given South African firms, with their relative proximity and local knowledge, an edge over international firms. But reducing trade costs would not just create opportunities to directly expand services and goods exports. It would also promote the development of competitive value chains of production across Southern Africa that would plug the region into global production networks.

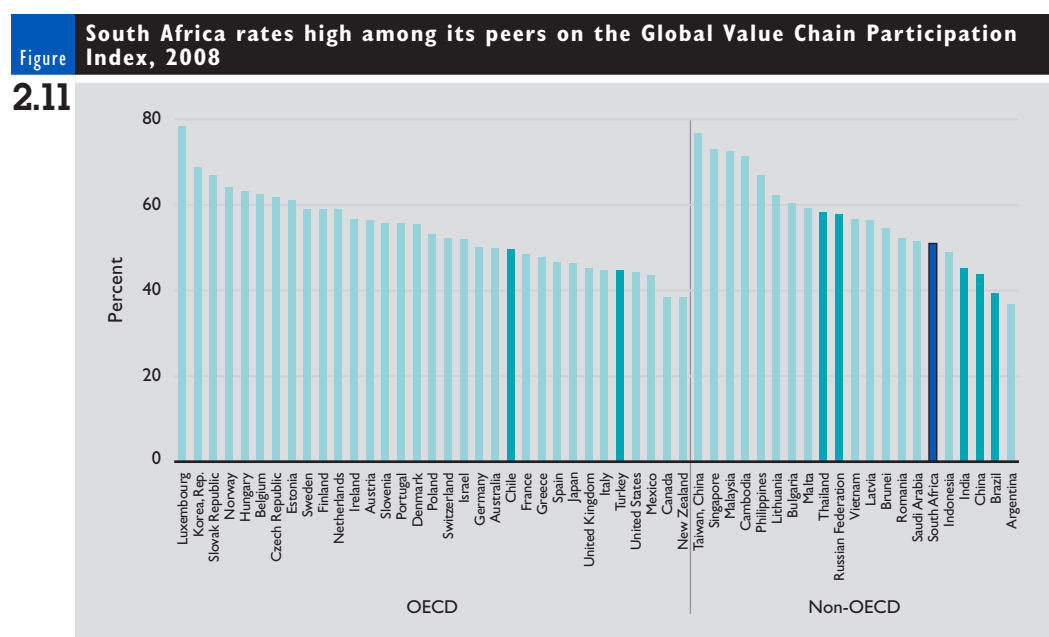
Expanding services exports. Services exports have perhaps the greatest potential to benefit from deeper integration. Even more so than for goods, the “gravity” of trade costs means that most services are traded with regional neighbors rather than across the globe. Up to 60 percent of South Africa’s services exports are estimated to stay in Africa. Given this regional emphasis, Africa’s trade barriers may explain why services export growth has been fairly weak. Professional services are a good example. South Africa has 48 accountants and 43 lawyers per 100,000 people; for Mozambique and Rwanda these figures are less than 1 and 5, respectively.³⁸ These differences, reflected in disparities in salaries and training costs across countries, suggest substantial scope for large gains from trade. Yet documented regional exports remain minimal, held up by barriers like education and professional qualification requirements, restrictions on business structure and on multidisciplinary activities, ownership limits and restrictions on foreign presence, and restrictive policies on the labor mobility of skilled workers. Most African countries have barriers in all these areas. For South Africa, unlocking these restrictions will require pursuing more services trade and investment agreements, including by concluding the extensive negotiating agenda underway in the Southern African Development Community. It will also require supporting regional

regulatory harmonization (for example, developing common standards in professional services activities and common criteria for professional qualifications).

Building supply-side capacity for Factory Southern Africa. Exploiting the untapped potential to develop a system of regional value chains, a Factory Southern Africa, in a world trading system increasingly dominated by global value chains that break down production processes and distribute them across countries in integrated production networks, may offer South Africa an important route to export competitiveness. Exporting in global value chains has been at the heart of East Asia’s success. With wages quickly rising in China, parts of these production networks are moving out. Indeed, over the next generation an estimated 85 million manufacturing jobs will leave coastal China.³⁹ South Africa, with its abundant natural capital, large labor surplus, decent infrastructure, and high-quality institutions, should be well positioned to benefit.

In fact, South Africa is already moderately integrated in global value chains. At 51 percent, South Africa is second among its peers on the Global Value Chain Participation Index,⁴⁰ after Thailand (figure 2.11). Some sectors have seen major increases in the foreign content of their exports, including transport (from 22 percent in 1995 to

Reducing trade costs
would promote the
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across Southern Africa



Three areas present opportunities to promote the competitiveness and spur the growth in South Africa's export sector:

38 percent in 2009), electrical equipment (from 16 percent to 27 percent), and chemicals and nonmetallic minerals (from 14 percent to 27 percent). In agriculture, food and beverages, and transport equipment, South Africa's share of foreign content in exports is near the highest among its peers.

But despite these increases South Africa remains a minor player on a global scale. It also operates at a long distance from final demand, not just geographically but also in production stages,⁴¹ suggesting that substantial scope remains for upgrading South Africa's value chain (and value-added) position. Figure 2.12, an auto sector global network map, puts this in perspective.

Taking South Africa's participation in global value chains to the next level—expanding its scope, increasing its scale, and upgrading its position—will entail raising competitiveness. Beyond domestic input costs, a key route to competitiveness can come through leveraging regional scale and exploiting the comparative advantages of regional economies—in natural resources, in key inputs, and in wages. This will not only reduce production costs but also allow firms to break up production processes and specialize in the processes where they can create competitive advantage, most likely in activities with higher knowledge and technology requirements and in facilitating services.

Turning South Africa's role as a regional hub from a one-way trade relationship into an integrated regional supply chain will require major improvements in the environment for cross-border trade and in the movement of capital and labor. East Asia's tightly integrated regional production networks stand in stark contrast to the situation in the Southern African Customs Union, whose production chains are among the world's least integrated. Realizing a Factory Southern Africa will require much deeper and more effective integration arrangements (encompassing both policy and infrastructure), so that production networks can operate seamlessly across the region, minimizing transaction costs and lead times.

Conclusion

Over the past decade South Africa's exports have underperformed. Export volume growth has stagnated, and South Africa's

exporters have made only limited inroads into global markets. Be it in minerals, non-minerals, or services, South Africa's exports have lagged behind those of its peers and not lived up to their potential.

A few super-exporters dominate South Africa's export sector, in both minerals and nonminerals, coexisting with a large pool of small, occasional exporters. But despite their dominance the super-exporters have been losing dynamism and competitiveness. Over the last decade some important products in South Africa's export basket have died out—a natural process. But new, high-value products have not emerged at the scale needed to replace them. Since the global financial crisis the super-exporters have become less experimental in both markets and products, underexploiting large emerging markets in both Africa and the BRICs. Super-exporters trade products that are technologically sophisticated and highly capital-intensive. This has positive implications for competitiveness but underutilizes South Africa's large pool of low-skilled labor, thus failing to create enough jobs to make the export sector a major direct contributor to employment growth and poverty reduction.

As trade patterns have shifted, particularly following the crisis, Sub-Saharan Africa has emerged as the key destination for South Africa's nonmineral exports. This has created greater market opportunities for newer and smaller exporters. So far, exports to Sub-Saharan Africa have remained somewhat smaller and shorter lived than exports to traditional markets, suggesting that lower competitiveness in regional markets is allowing the less efficient firms to enter and exit opportunistically. This poses challenges in considering how best to support emerging exports.

Three areas present opportunities to promote the competitiveness and spur the growth in South Africa's export sector:

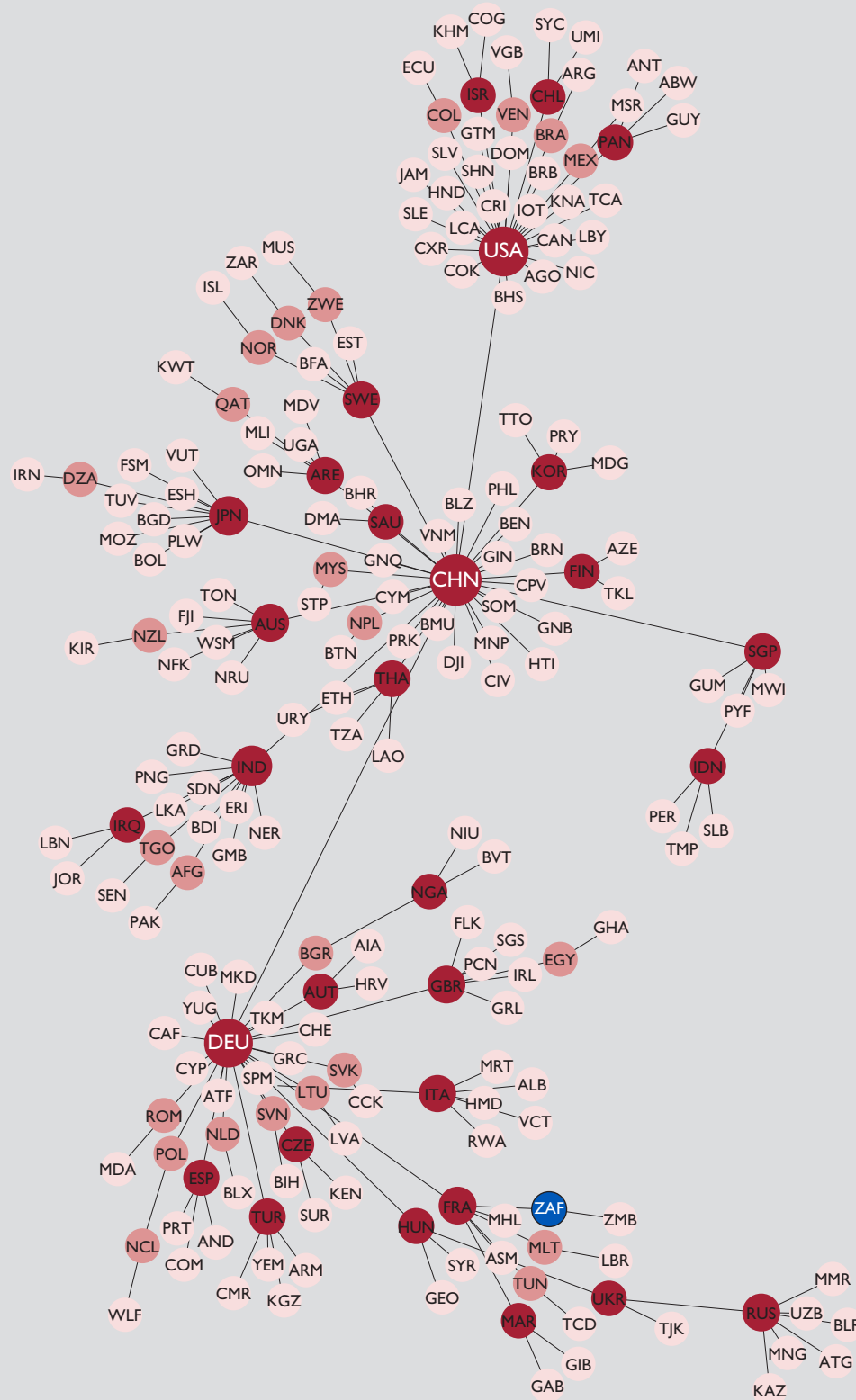
- *Boosting domestic competition* would increase efficiency and productivity. By opening local markets to domestic and foreign entry, South Africa would enable new, more productive firms to enter and place downward pressure on high markups. This would lower input costs and tip incentives in favor of exporting by reducing excess returns in domestic markets. Competition

Figure 2.12 South Africa: a regional hub but still somewhat peripheral

2.12

Global network map for road vehicles trade, 2010

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- Boosting domestic competition
- Alleviating infrastructure bottlenecks, especially in power, and removing distortions in access to and pricing of trade logistics
- Promoting deeper regional integration in goods and services

Note: 01-09 SITC rev. 3 classification. Larger bilateral trade flows are portrayed by closer distances between nodes. Hubs, which represent the main trading partner for several countries, are shown in larger circles with darker colors. Peripheral countries are shown in lighter colors.
Source: World Bank, International Trade Unit.

**Progress on all
three fronts would
help catapult South
Africa toward faster-
growing exports**

would also stimulate investment in innovation and, over time, condition the market to ensure that firms entering competitive global markets have reached the productivity threshold to support their survival and growth.

- *Alleviating infrastructure bottlenecks, especially in power, and removing distortions in access to and pricing of trade logistics* in rail, port, and ICTs would reduce overall domestic prices and further enhance competitiveness. It would be especially beneficial for small and medium-size exporters and nontraditional export sectors, which these costs tend to hit harder.
- *Promoting deeper regional integration in goods and services* within Africa would generate the right conditions for the emergence of Factory Southern Africa, a regional value chain that could feed into global production networks. South Africa could play a central role in such a chain, leveraging the scale of the regional market, exploiting sources of comparative advantage across Africa to reduce production costs, and providing other countries in the region a platform for reaching global markets.

Progress on all three fronts would help catapult South Africa toward faster-growing exports, allowing it to realize the faster, more inclusive, job-intensive growth articulated in the National Development Plan.

Notes

1. World Development Indicators (database), accessed January 27, 2014.
2. Republic of South Africa 2011.
3. National Planning Commission of South Africa 2013.
4. Department of Trade and Industry 2010.
5. South African Reserve Bank 2013.
6. Minerals encompasses minerals, fuels, and base metals.
7. Chile is introduced in the firm-level analysis given lack of comparable firm-level data on a number of the peers.
8. Measured by the HS six-digit level classification.
9. The gravity model of trade used here controls for country selection and firm heterogeneity, following Helpman, Melitz, and Rubinstein (2008). We regress the logged value of total non-mineral exports (averaged between 2011 and 2012) on the following bilateral characteristics with trading partners: distance, contiguity, common language, log of GDP, log of GDP per capita, and log of the Remoteness Index (computed by summing each country's distance with every other country, weighted by the latter's share in world GDP). We control for zero trade flows with the Heckman sample selection correction method.
10. As measured by the Index of Export Market Penetration. The index looks at a country's total number of exports and the number of markets that each export product reaches. Then, the number of countries in the rest of the world that import each product that the country of interest exports is counted. By pairing products and countries this way, the maximum potential number of export relationships a country can establish given its export portfolio can be obtained. The actual number of export relationships is then divided by the potential number to assess the proportion of export opportunities a country is exploiting.
11. EXPY measures the export baskets of countries by the incomes of all countries that produce similar products, weighted by the share of those exports in the national total. The concept is that more sophisticated products are, by and large, produced by richer countries. Hausmann and Klinger (2007) show that export sophistication is a good predictor of future economic growth.
12. This calculation uses a new United Nations Conference on Trade and Development database on revealed factor intensity for each good at the HS six-digit level (Shirotori, Tumurchudur, and Cadot 2010). This assessment looks at the underlying human capital (proxied by average years of schooling of the adult population, as per Barro and Lee 2010) and physical capital (capital stock, which is constructed following the perpetual inventory method using investment series from version 6.2 of the Penn World Tables) of a country's export basket.
13. Quarterly Labour Force Surveys; data as of 2013q3.
14. In this section "Africa" refers to Sub-Saharan Africa.

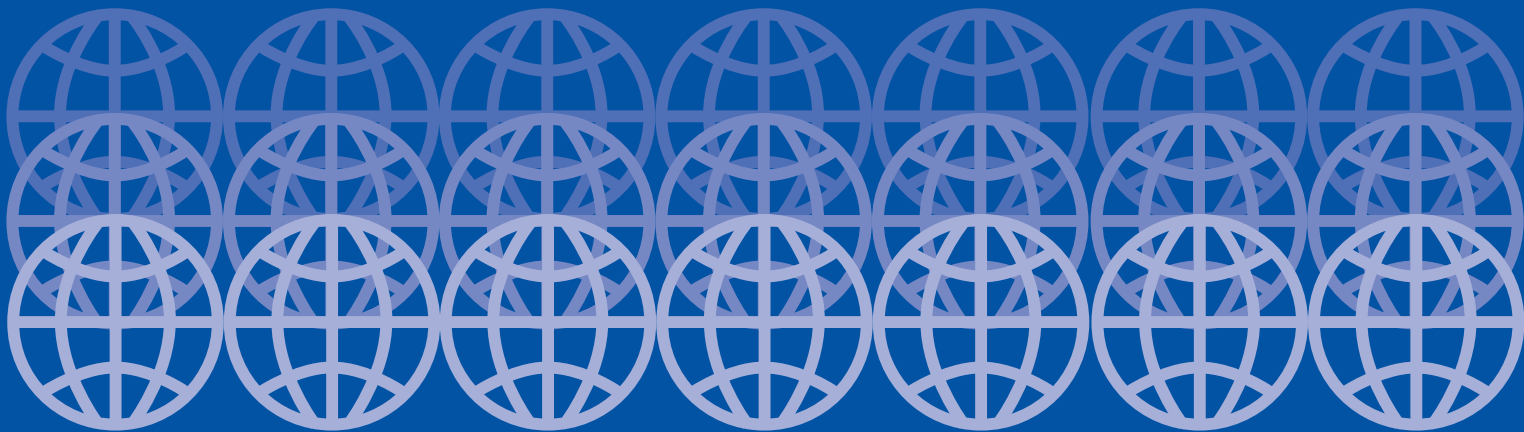
15. An export spell is a firm selling a specific product to a specific market. Over 2002–12 South African exporters were involved in at least 1.7 million export spells worth more than \$1,000 each.
16. For example, a firm starts selling apples to Nigeria. That export does not survive, but the firm itself is still exporting, perhaps now selling apples to Ghana or pears to Nigeria.
17. Rankin 2013.
18. See South African Reserve Bank (2013) for a comprehensive menu of factors that impact the response of exports to exchange rate movements.
19. The Competition Commission (2008) notes that most sectors of the economy remain highly concentrated, “with entrenched and dominant interests that are able to protect their position including by raising barriers to entry.” It also notes that “these barriers can be endogenous, that is the result of strategic behavior by dominant firms and of formal and informal links between potential rivals,” and it reviews barriers to entry, among other anticompetitive practices, in the agriculture and agroprocessing, infrastructure, telecommunications, and intermediate industrial products and forestry sectors.
20. The price–cost margin is the difference between price and marginal cost (a measure of profitability). The high price–cost margins (or “markups”) in South Africa are well documented. See, for example, Roberts (2004), Fedderke and Bogetic (2006), and Competition Commission of South Africa (2008).
21. Fedderke and Bogetic 2006; Harding and Rattsø 2005.
22. Aghion, Braun, and Fedderke 2007. The association among competition, trade, and productivity growth observed in South Africa and the role of allocative efficiency gains line up with the patterns documented for South Africa’s peers. Notable examples are Pavcnik (2002) for Chile, Ferreira and Rossi (2003) for Brazil, and Eslava and others (2004) for Colombia.
23. World Bank 2011.
24. Interestingly, these firms do not describe the shifts to export markets as a response to improved price competitiveness from a weaker rand.
25. Hirsch 2005.
26. See, for example, Francois and Woerz (2008).
27. Gumede and Chasomeris 2013.
28. See Ports Regulator of South Africa (2012).
29. OECD 2009.
30. OECD 2009.
31. World Bank and IFC 2007.
32. OECD 2013.
33. Steyn 2011.
34. World Bank 2013.
35. International Telecommunications Union 2013.
36. Dihel, Fernandez, and Mattoo 2011.
37. World Bank 2011.
38. Dihel, Fernandez, and Mattoo 2011.
39. Lin 2011.
40. Under this measure, developed by Koopman and others (2011), the higher the foreign value added in exports and the higher the value of domestic inputs exported to third countries and used in their exports, the higher a country’s global value chain participation.
41. See Antràs and others (2012).

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