Report of the UN-DESA Scoping Mission to South Africa[1]

8-16 September 2011

The Macroeconomic Advisory Capacity (MAC) initiative of UN-DESA fielded a scoping mission to South Africa on 8-16 September 2011. The mission was deployed at the request of Mr. Ebrahim Patel, the Minister for Economic Development. In April 2011, Minister Patel sent a formal request to Mr. Sha Zukang, the Under Secretary General of UN-DESA in April 2011, seeking DESA's technical assistance and capacity development support to review the macroeconomic policy framework of the New Growth Path (NGP) of South Africa. The South African Government adopted NGP in December 2010, aiming to create five million jobs by 2020.

The scoping mission was jointly organized by UNDP-South Africa and UN-DESA. UNDP-South Africa not only funded the mission, but also engaged substantively in all deliberations. This is perhaps one of the best examples of a partnership between UNDP and UN-DESA on policy advisory work at the country level. I would like to put on record the excellent support the mission received from Mr. Israel Dessalegne, Deputy Resident Representative, and Mr. Nii Moi Thompson, Senior Economist, in UNDP-South Africa.

During the mission, I held three meetings with Minister Patel. After the first meeting, the Minister decided to guide the program of the mission and his office scheduled all subsequent meetings. Mr. Thompson and I met a number of senior officials from different ministries, agencies and development banks. We met the Directors General of the Economic Development Department (EDD), the Department of Treasury, the Chief Economist of the Reserve Bank of South Africa and the CEO of the Southern African Development Bank and senior officials from the Reserve Bank, the Statistics South Africa, the National Revenue Service, and the Industrial Development Corporation (IDC). The mission also held discussions with the representative of the Confederation of the South African Trade Union (COSATU) in Cape Town. Minister Patel invited me to speak at the quarterly meeting of the Provincial Ministers of Economic Development (MiniMec). At the request of the Minister, I also presented a keynote speech at the EDD Policy Platform. The Policy Platform includes senior representatives from all economic and social Ministries.

I. The New Growth Path

The new Growth Path recognizes employment generation as the number one development priority for South Africa. It underscores the importance of implementing a policy package for job creation to enhance social equity. NGP puts a strong emphasis on the need for mobilizing domestic investments and adjusting the macro and micro economic framework for job growth. It is recognized that mobilization of domestic investments will require trade-offs between current and future consumption. It also recognizes that the Government did not utilize its resource rents effectively for economic diversification and productivity growth during the years before the current economic crisis. Weak public and private investments in human capital stagnated growth in labor productivity and real wages in South Africa. While sustaining the current level of consumption may be a politically desirable choice, it will inevitably limit growth in productive investments. NGP rightly recognizes that the level and quality of investments today will determine South Africa's competitiveness in the future.

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[1]The report represents the views of Hamid Rashid, Senior Advisor for Macroeconomic Policy in UN-DESA, and not the official position or views of the United Nations or its Member States. For questions or comments, please write to rashid12@un.org

The existing macro policies of South Africa – targeting a persistently low level of inflation and a corresponding strong Rand – support a consumption bias. These policies generally encourage import and hurt the export sector. The New Growth Path envisages a loose monetary policy and a restrictive fiscal policy to contain inflation and create jobs. This, however, assumes a weak linkage between fiscal and monetary policy tools. The net effect of a loose monetary policy and a restrictive fiscal policy on job creation is likely to be either negative or negligible. NGP underscores that the state must accelerate employment creation through direct employment schemes or targeted subsidies. This will require an expansionary fiscal policy as the monetary policy will not create direct employment schemes.

The policy objectives and instruments, as proposed in NGP, aims lower real interest rates, a competitive exchange rate and reduced inflationary pressures. This perhaps represents an impossible trinity, at least in the short-run. The desire to pursue a restrictive fiscal policy adds to the complexity and impossibility of the policy-mix. The pursuit of a counter-cyclical fiscal policy, large-scale investments in infrastructure development or implementation of targeted subsidies – as envisaged in NGP – will require, at the minimum, a moderately expansionary fiscal policy. Furthermore, the proposed sterilization of foreign currency inflows and the creation of an African Development Fund will also require a flexible fiscal policy approach. Fiscal expansion, however, should not necessarily need to mean fiscal deficits. The Government may explore other options – introduce new and additional taxes, including taxes on capital flows as well as cutting non-productive and wasteful public expenditures – to increase public investments for job creation.

A set of macro-prudential regulations and development-oriented financial market policies can also play a critical role in curbing consumption growth and enhancing private sector investments for employment generation. Fundamentally, the Government would need to make concerted efforts to change the consumption biases in the current macroeconomic policy framework to achieve the employment generation objectives of the New Growth Path. The consumption-investment trade-off underpins to a political economy debate that would need to be addressed in broad-based social and political dialogues.

II. South Africa: The State of the Economy

The South African economy has been hard hit by the economic crisis of 2008-2009. Among the BRICS (Brazil, Russia India, China and South Africa), South Africa has been the worst affected country, in terms of both depth and the duration of the negative shock to its growth rate (Char-I). The crisis affected the manufacturing the sector worst, with output shrinking by 15% since 2009. Export fell by 20% in 2009 and it is yet to reach the pre-crisis level. The South African economy experienced a consumption boom, especially since 2004, fueled by high commodity prices, household borrowing and an asset price bubble – both in housing and financial assets – that induced a wealth effect. The commodity boom and the asset price bubbles, also triggered by short-term capital flows, contributed to a Strong Rand, which led to a surge in import demand. In fact, the import increased exponentially since 2004. Export grew by an average rate of 2.9% while import grew by over 6% during 1994-2009 (Chart II). As imports increased, the share of agriculture, industry and manufacturing fell monotonically since 1994, while the share of services sector grew from 55% to 65%. In particular, the financial services grew faster than any other sector of the economy.

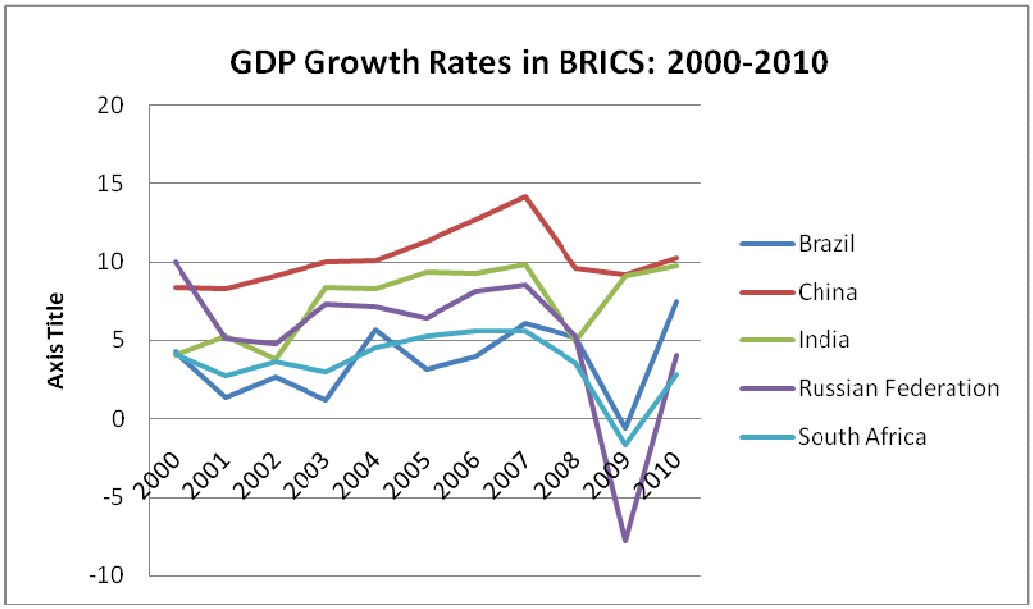

Chart I: GDP Growth Rates of BRICS Countries, 2000-2010

Chart II: Export and Import Growth in South Africa, 1990-2009

By some estimates, the South African economy lost over one million jobs since the onset of the financial crisis in 2008 and it is yet to reclaim the lost jobs. The unemployment rate is over 25%, the highest among the BRICS economies. According to a recent news report in the Economist, the South African economy did not add a single new job since 1994. While this may be an exaggeration, pervasive unemployment – especially youth unemployment and unemployment in former homelands – poses the single most critical development challenge to South Africa. The level of employment as percentage of the working age population is one of the lowest in the world (Chart III). In the first quarter of 2010, the unemployment rate for young people aged 16 to 30 was 40%, compared to 16% for those aged 30 to 65.

There is considerable disagreement as to whether South Africa presents a case of jobless growth. A number of empirical papers (Schussler, 2004) claim that the employment intensity of growth was

sufficiently large during the early 2000s. It showed that while the employment elasticity of growth was .16 during 1995-2000, it increased to .8 during 1995-2005. While this may be true, higher employment elasticity may mask the problems of stagnant real wages and the sectoral concentration of employment growth. For example, the average rate of employment growth in financial services was 6.8% per year, compared to 0.5% for all economic sectors during 1980-2008[2]. The estimates for employment elasticity of growth, therefore, need to take the weighted average elasticity for various sectors. On the other hand, there are studies (Mahadea, 2003) that show positive economic growth rates in South Africa have been associated with shrinking job opportunities in the formal sector during the past few years. A third strand of literature (Hirsch, 2004) argues, "problem is not "jobless growth" but rather that unemployment rises even as jobs are being created – and this is partly the result of the rate of increase of the economically active population."[3]

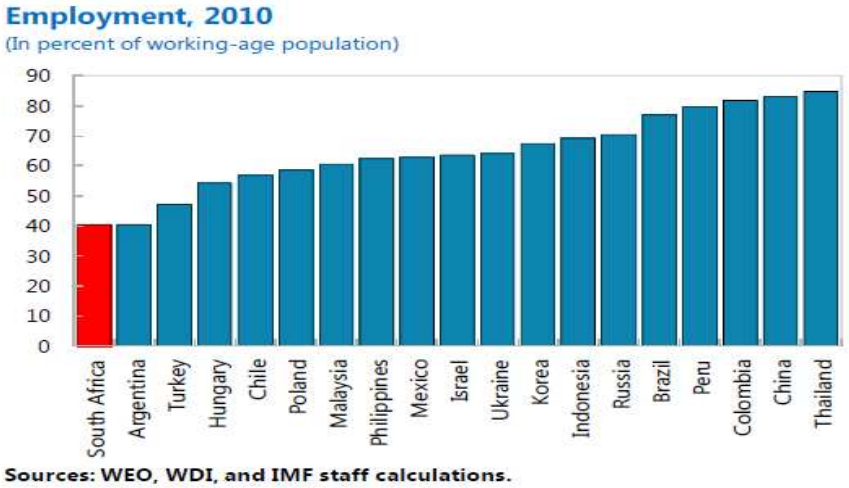

Chart III: Employment as Percentage of Working Age Population, Source: IMF Country Report, 2011

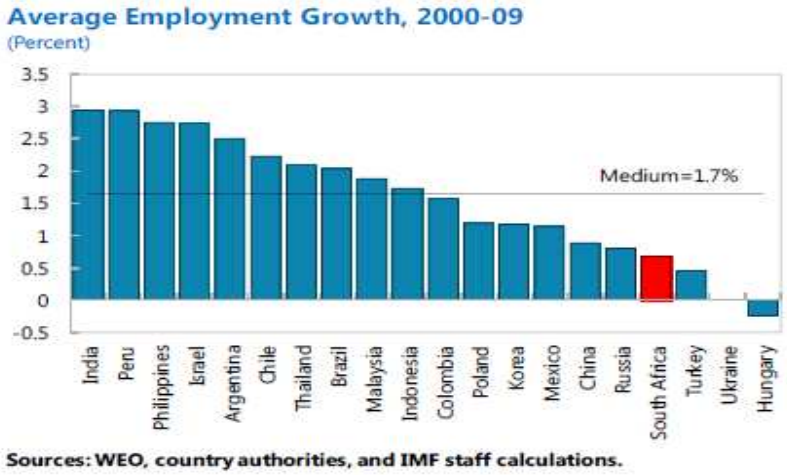

Chart IV: Average Employment Growth, Source: IMF Country Report, 2011

[2]Economic Sector Review: Financial Services, Insurance and Business Services, December 2009, British High Commission Pretoria and Trade and Industrial Policy Strategies

[3]Biyase, Mdu and Lumengo Bonga-Bonga, "South Africa's growth paradox", University of Johannesburg

There is a growing consensus that the high-level of unemployment persists because the South African economy created too few jobs to absorb the large numbers of new entrants to the labor market (Chart IV). Unemployment in the country is also a function of chronic skills deficits and skill mismatches among the job-seekers. Demographic factors, limited access to schooling and the poor quality of education are also critical determinants. The failure of the schooling system – including their ability to retain students in schools – results in excess supply of labor with chronic skills shortages. It is also argued that a very small informal sector – the smallest among the BRICS countries – explains the low employment intensity of growth in South Africa.

Closely linked to the high rate of unemployment is the high level on inequality in South Africa – one of the highest levels of inequality in the world (Chart V). According to some EDD officials, South Africa's Gini coefficient is as high as 0.74. The problem of inequality has been exacerbated by persistent unemployment and stagnant real wages, even before the crisis hit the country in 2008.

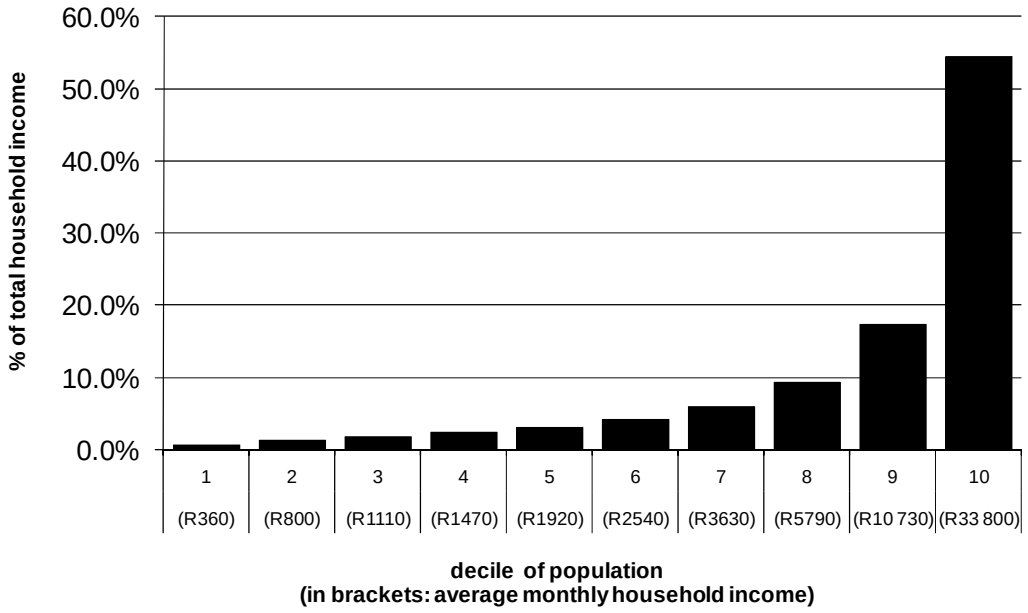

Chart V: Income Distribution by Deciles, source: EDD

III. Financial Development, Financialization and Growth

It is generally believed that financial markets facilitate growth through efficient allocation of scarce resources. Exactly a century ago, Schumpeter (1911) argued that financial intermediation played a pivotal role in economic development through allocation of savings, contributing to higher productivity, technological change and the rate of economic growth. Others have (e.g. Lewis, 1955) argued that financial markets and institutions develop as a consequence of economic growth, and in turn act as a stimulus to growth. A strand of more recent literature (e.g. Levine, 1997) makes financial development and financial liberalization as pre-conditions for economic growth and development. They argue that financial intermediation stimulates economic growth: by mobilizing savings, allocating capital funds, monitoring the use of funds and managing risk.[4]Stiglitz (1994)[5], on the other hand, argued that financial

[4]Green Christopher J., Colin H. Kirkpatrickand Victor Murinde How does finance contribute to the development process and poverty reduction?, Finance and Development: Survey of Theory, evidence and policy, 2005

[5]Stiglitz, J. (1994), 'The role of the state in financial markets', in *Proceedings of the World Bank Conference on Development Economics*, Washington, DC: World Bank, pp. 19–52.

market failures, which mainly arise from market imperfections, asymmetric information and the high fixed costs of small-scale lending, limit the access of the poor to formal finance, thus pushing the poor to the informal financial sector or to the extreme case of financial exclusion.

A number of economists show that a high level of financial development can allow the financial sector to extract larger rents from non-financial corporations. Crotty (2003)[6], for example, presents evidence that the payments that the US non-financial corporations made to financial markets more than doubled as a share of their total cash flows since the 1970s. As non-financial corporations face higher intermediation costs, they typically cut jobs and squeezed wages and benefits – a trend observed in many developed and developing economies. Stiff competition in the product market and lower profitability can force non-financial firms to move into financial operations[7], reducing their investments in the real sector. This is perhaps one of the critical channels through which high level of financial development can affect employment and job growth.

The interactions between the financial development and the growth of the real sector of are complex. The US economy, for example, registered remarkable growth during the 1960s without much growth in financial intermediation. On the other hand, while the share of the financial sector grew rapidly significantly during 1980s, growth of the economy stagnated. The East Asian Miracle economies – China, Korea, Malaysia and Thailand – registered spectacular growth without large-scale financial development. Economists have argued that the income share of the financial sector should remain constant on the balanced growth path[8]. For a given interest rate, the financial sector's share of national income should be independent of the growth rate of the economy. This suggests that the size of the financial sector should approach zero when its efficiency is either very small or very large. Conversely, one could argue that a large and growing financial sector is a sign of increased inefficiency of the sector, reflected in increased intermediation costs. A large financial sector is, therefore, neither necessary nor sufficient for development of the real economy.

Since the 1980s, many developed countries witnessed a structural shift in their economies, a phenomenon termed as "financialization", which can be considered an extreme state of financial development. A process of liberalization of interest rates, exchange rates, credit ceilings and other prudential de-regulations, privatization of state-owned banks and removal of barriers to entry paved the way for financialization of these economies. Financialization is associated with large and well developed financial and capital markets, marking significant increases in financial transactions, real interest rates and higher profitability of financial firms and a larger share of income accruing to the financial sector and the holders of financial assets. While financialization spread to developing countries with increased financial globalization by the 1990s, the emerging Asian economies, especially Korea, China, Malaysia and India, successfully resisted the financialization of their economies.

The South African financial market was liberalized in the early 1980s. Interest rates were liberalized in 1980 while the practice of directed credit and credit controls were abolished in 1985. Barriers to entry to the financial sector were lifted in 1994. The actual process of financialization process began in 1995 with the abolition of South Africa's dual exchange rate system, the unification of the rand exchange rates and the end of capital controls on non-residents. As the part of the deregulation process, the sector witnessed the emergence of a number of financial conglomerates, following the removal of

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[6]Crotty, James, "The Neoliberal Paradox: The Impact of Destructive Product Market Competition and Impatient Finance on Nonfinancial Corporations in the Neoliberal Era" July 2003 , Research Brief 2003-5

[7]EpsteinGerald A: Introduction to *Financialization and the World Economy*

[8]Philippon, Thomas: Why Has the Financial Sector Grown so Much? The Role of Corporate Finance, New York University, NBER and CEPR, July 2008

regulatory distinctions between banks and building societies. There is no restriction on banks to engage in securities or insurance related activities. The financial sector also grew as large insurance companies became more broadly based financial services groups. By these measures, the South African financial sector is more liberalized than the financial sectors of other BRICS countries (Chart VI) and also that of Korea, Turkey, Malaysia, Thailand, Singapore, Mexico or Poland[9].

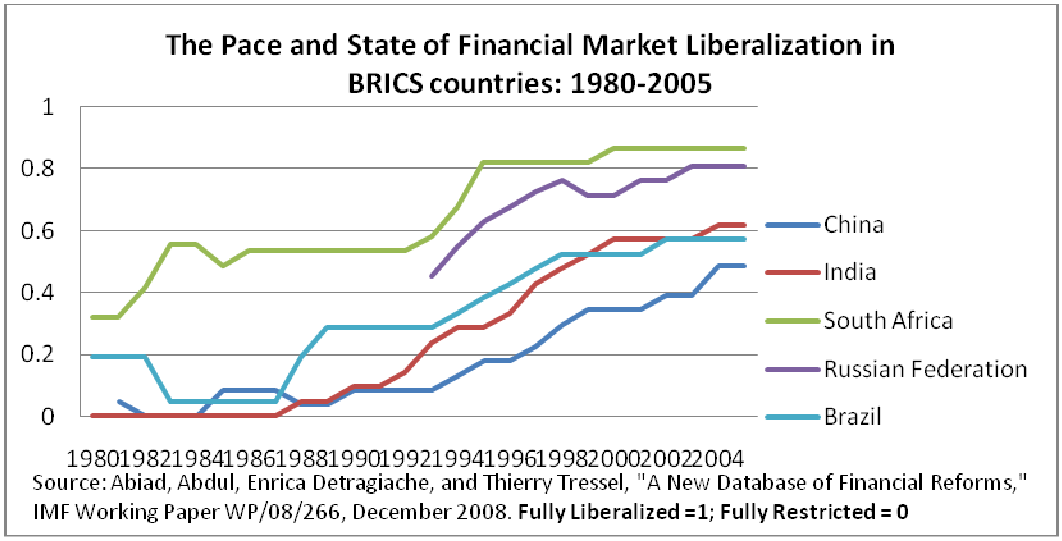

Chart VI: The Pace and State of Financial Market Liberalization in BRICS countries, 1980:2005

Financial services[10] accounted for over 21% of GDP in 2010 – the largest among the BRICS countries and other emerging economies (Chart VII). Financial services sector is, in fact, the single largest sector of the South African economy in terms of its contributions to GDP. Overall, the sector has grown twice as rapidly as the overall service sector and three times as fast as the manufacturing sector. The rate of growth in value-added between financial services and all economic sectors begins to diverge by the mid-1990s, as growth in the former accelerated at a faster pace. During 1995-2008, financial service sector growth reached 8.1% whereas growth in all economic sectors is 5.6%.The size of the financial sector puts South Africa in the league of large financial centers – Jersey, Guernsey, Cayman Islands etc.

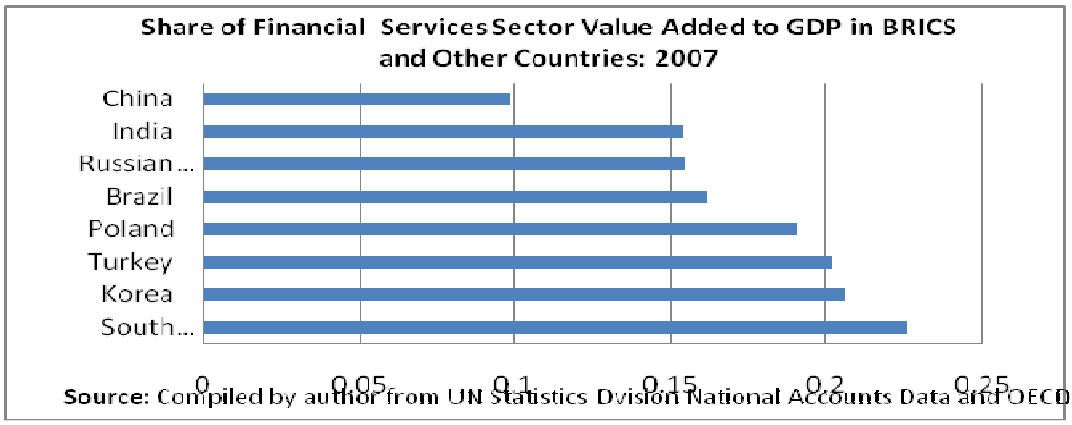

Chart VII: Share of Financial Services in GDP

[9]Abiad, Abdul, Enrica Detragiache, and Thierry Tressel, "A New Database of Financial Reforms," IMF Working Paper WP/08/266, December 2008

[10] Financial services generally include finance, insurance and real estate intermediation services

While the share of financial services grew, the share of mineral rent also increased from 1% of GDP in 1994 to 3% of GDP in 2009. The unusual combination of a large financial sector and excessive dependence on mineral rents make South Africa a unique economy in the world.

IV. Consumption Boom: Household Debts Crowding Out Investment

The household consumption growth – though perhaps limited to wealthier 20% of the economy - was driven by the wealth effect of a housing boom and subsequently by an asset price boom. During the boom years, household final consumption expenditure increased faster than any other major indicators. The average consumption growth during 1990-99 was 1.4% but it increase to over 4% during 2000-09. The growth in consumption sharply accelerated during 2004-2008 (Chart VIII).Gross domestic savings fell from 23% in early 1990s to 16% in 2010 (Chart IX).

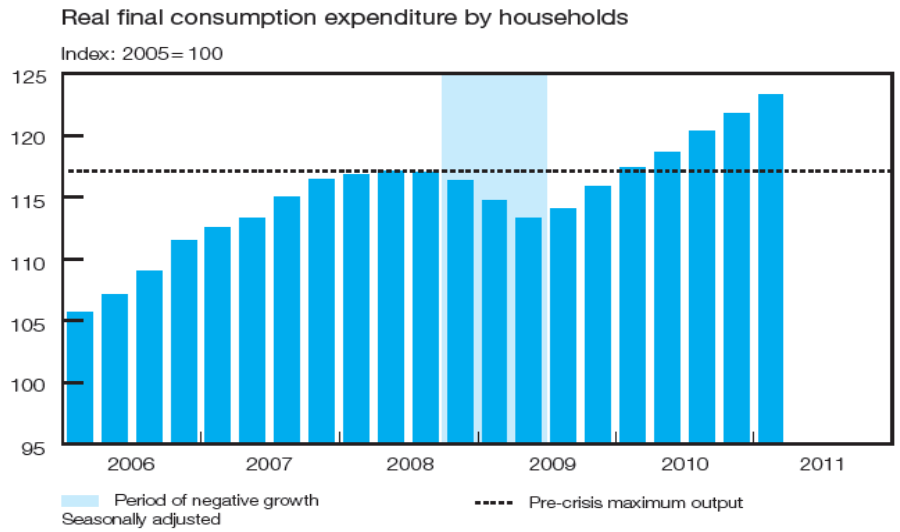

Chart VIII: Household Final Consumption Expenditure: 2006-2010, Source: SARB Annual Report 2011

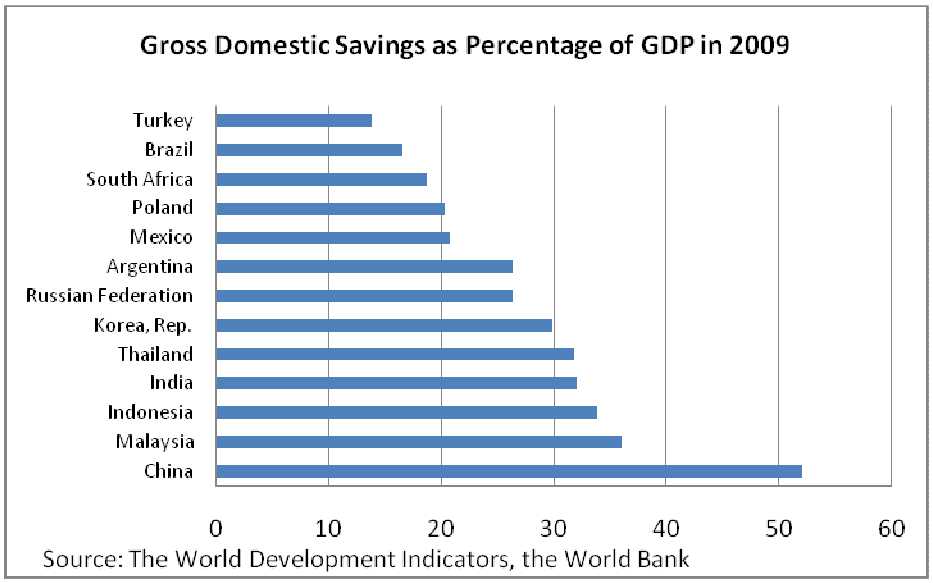

Chart IX: Gross Domestic Savings as Percentage of GDP in BRICS and Other Emerging Economies

Higher asset prices inflated the capacity of households to borrow more, which in turn, fuelled further consumption. Total household debt, which includes mortgages and consumer loans, nearly doubled from Rand .7 trillion in 2006 to Rand 1.3 trillion in 2011 (Chart X). During the same period, household mortgage debt also nearly doubled. South Africa is also the only BRICS country where loans and advances to the household sector exceed the loans to the corporate sector. Mortgage accounts for nearly 55% of all outstanding bank claims in South Africa. The household debt in South Africa is the highest among the BRICS countries and accounts for nearly 60% of outstanding bank credits (Chart XI).

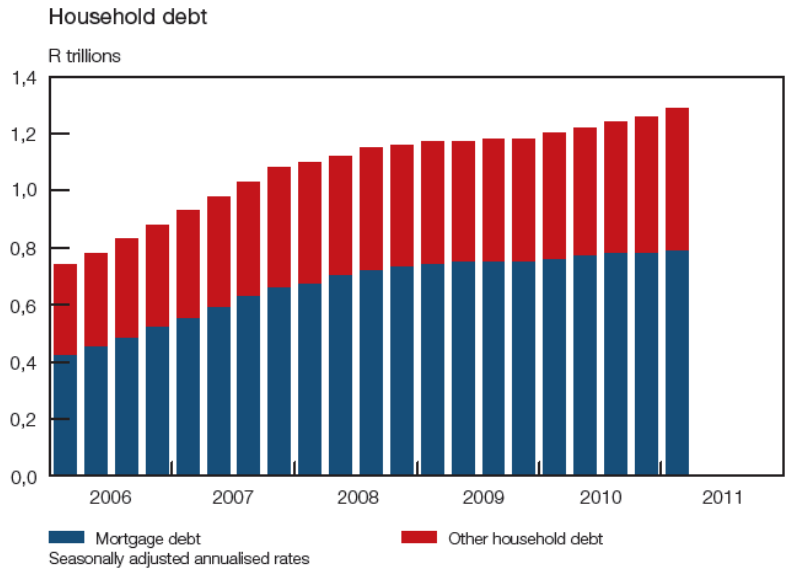

Chart X: Household Debts in South Africa, Source: SARB Annual Report 2011

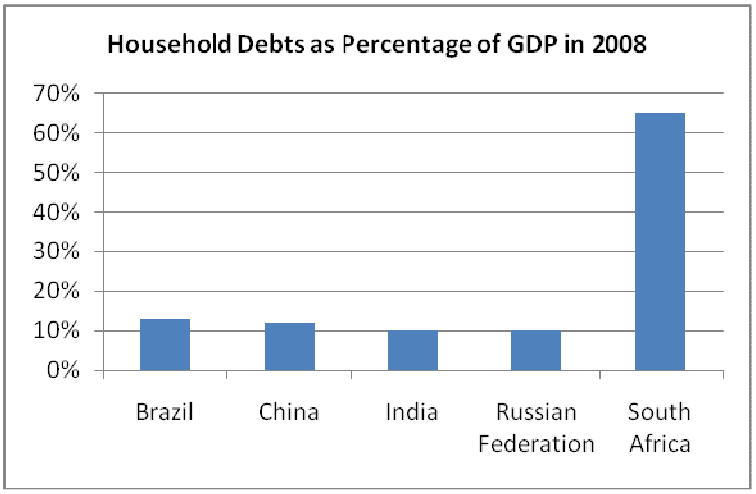

Chart XI: Household Debts in BRICS countries, Source: concerned central bank annual reports

It is reasonable to assume that the interest rate on credit to household, especially on consumer credit, is considerably higher than the interests banks can earn on industrial credits or credit to SMEs. The large share of household and consumer credits makes the South African Banks one of the most profitable banks in the world (Chart XII). Their return on equity was as high as 29% in 2008. It would be worthwhile to look at the disaggregate sources of profits for banks in South Africa. It is highly like that the large

share of profit comes from high-interest loans to households. The high rate of return on household loans distorts the incentives for banks to lend to the productive sectors, especially to small and medium sized enterprises and new business ventures. While there is no shortage of liquidity in the banking sector, it is likely that SMEs and new enterprises are severely credit constrained in South Africa. While the South African banks are highly profitable, they are less efficient than their counterparts in BRICS economies. The share of compensation of financial sector employees as percentage of the financial sector value added is very high, signaling inefficiency and lack of competition in the largest sector of the economy (Chart XIII). It is clear that a highly profitable household debt portfolio is crowding out potential credit to small and medium sized enterprises. There is a need for specific policies to reduce the dominance of household debts in banks' balance sheets.

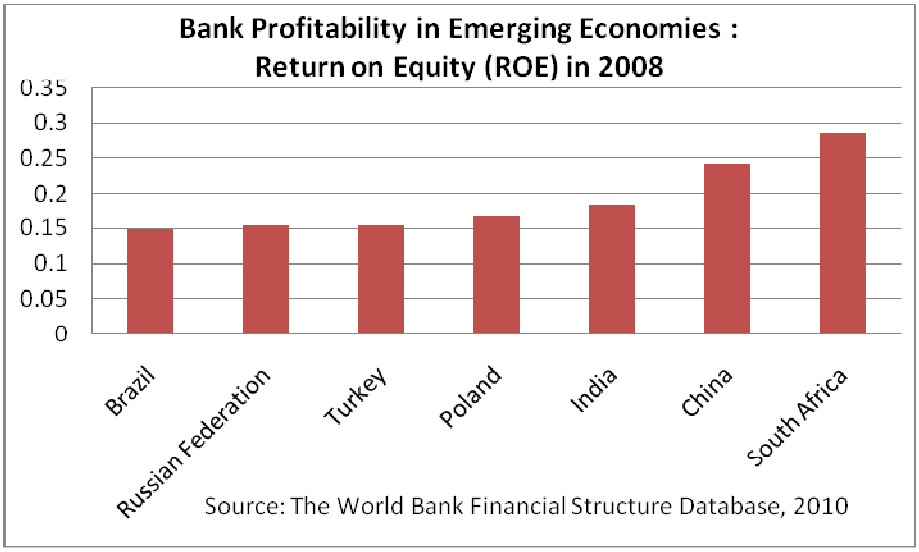

Chart XII: Banks' Return on Equity in BRICS and other comparable countries

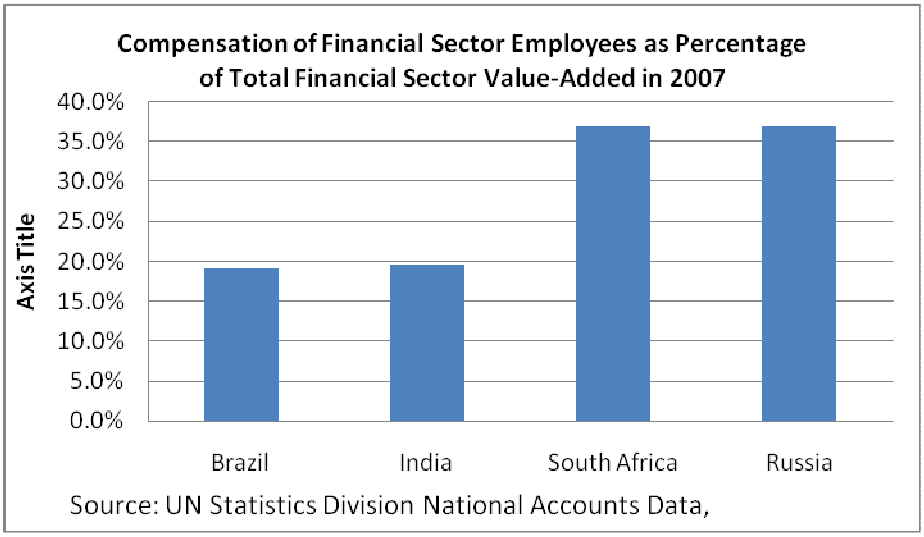

Chart XIII: Compensation as Percentage of Total Financial Sector Value Added to GDP

V. A Large Capital Market: Portfolio Investments Crowding Out Fixed Investments

According to the financial integration database developed by Schindler (2005), the South African capital market is significantly more liberalized than that of other BRICS countries[11]. Given its very well developed and fully liberalized capital market, South Africa is an attractive destination for portfolio investments, both for domestic and foreign investors. Relative to the size of its GDP, South Africa's stock market is the largest in the world, significantly larger than the stock markets of the United States, United Kingdom and other developed countries (Chart XIV).

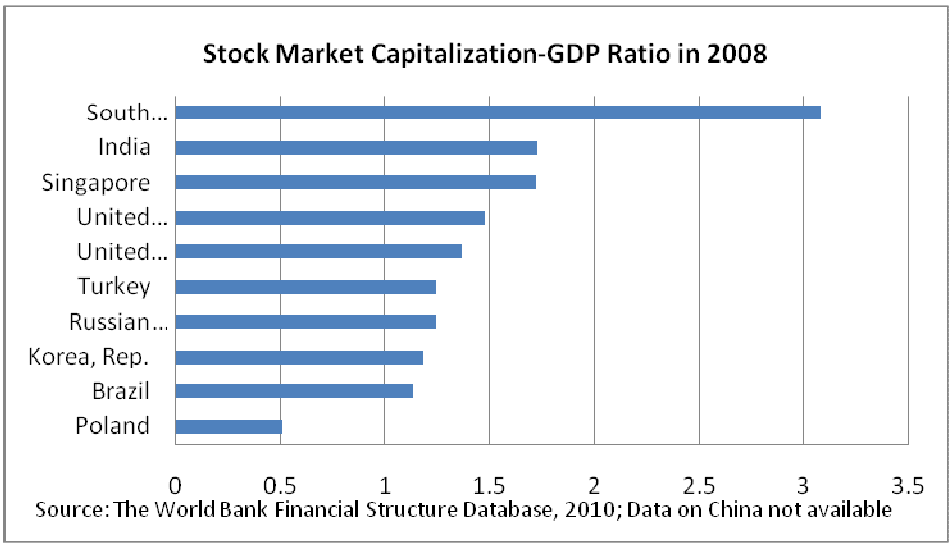

Chart XIV: Stock Market Capitalization-GDP Ratio in BRICS and Other Economies

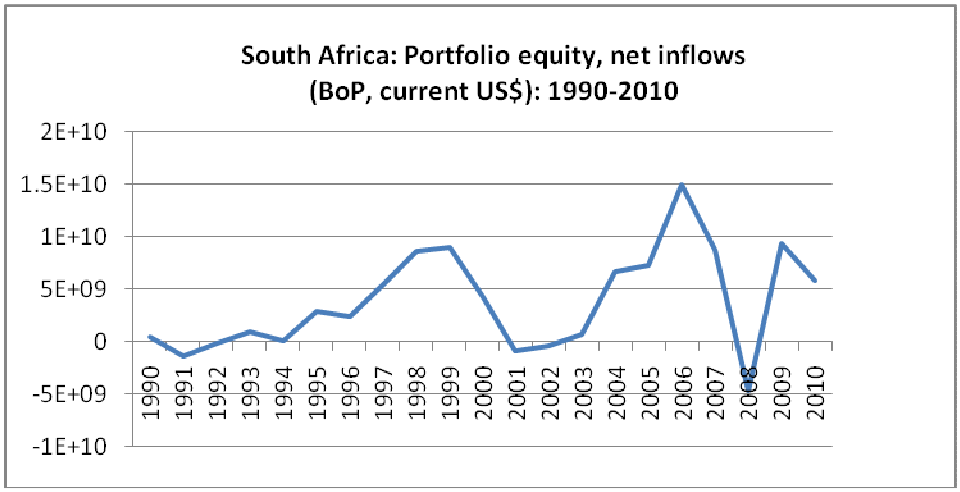

Chart XV: Net Portfolio Inflows, Source: The World Development Indicators, the World Bank

South Africa is the only large emerging economy (and the only BRICS country) where net inflow of portfolio investment is higher than FDI inflows. In 2010, the ratio of portfolio investment to FDI was nearly 10 (SARB sources). The aggregate data shows that portfolio investments to be highly volatile (SARB, however, maintains that portfolio investments in South Africa is fairly stable) (Chart XV). While

[11] Schindler, Martin "Measuring Financial Integration: A New Data Set" IMF Staff Papers, Vol. 56, No. 1, 2009, pp. 222-238

the net inflow of portfolio investment was USD 9.4 billion in 2008, the net outflow of portfolio equity was USD 4.7 billion – a swing of USD 14.1 billion in one year (Table I). The swing was as high as 5% of the South African GDP in 2009, with considerable impact on liquidity and credit. The portfolio investment is largely pro-cyclical, which typically worsens the boom-bust cycles.

	Net Inflow of Portfolio Equity in 2008 (USD billion)	**Net Portfolio Equity Inflows as Percentage of GDP in 2008**
China	28.2	0.56%
Brazil	37.1	2.32%
India	21.1	1.53%
Korea, Rep.	24.8	2.98%
Russian Federation	33.6	0.28%
South Africa	9.4	3.31%
Turkey	2.8	0.46%

Table I: Portfolio Inflows in BRICS and Other Countries, Source: the World Bank

Large inflows of portfolio capital keep Rand relatively strong. In fact, portfolio inflows prevent adjustment on the trade account as they offset the effect of the "automatic stabilizer". Trade deficits typically force the currency to depreciate, make the exchange rate more competitive, increase export and restore balance in the current account. Furthermore, by keeping Rand strong, portfolio inflows make FDI unattractive. A strong rand makes the cost of labor and other inputs high, making inward FDI unattractive. The strong Rand also perpetuates the import bias. Finally, large inflow and outflow of portfolio investments increase the volatility in the exchange rate, further discouraging FDI. Foreign investors typically prefer a stable and predictable exchange rate, allowing them to make reasonable forecasts about their operating costs. The portfolio investments – both from domestic and foreign sources - keep the equity prices relatively strong in South Africa, inducing a wealth effect among richer households, which propels the consumption boom.

It is reasonable to assume that if returns from portfolio investments outperform the returns from real sector investments, both banks and large investors will have little incentives to extend credit to the productive sector. This is particularly true when banks face no restrictions on capital market activities. A well performing capital market, with high degree of sophistication, makes fixed investment unattractive. In other words, we could argue that portfolio investments are crowding out fixed capital investments, including FDI, in South Africa.

The high return from equity market activities increases the opportunity cost of lending to the real sector. This is reflected in the high lending rate in South Africa. The weighted average cost of lending in South Africa is one of the highest in the world – it remained around 15.5% during the last 20 years or so. The existing inflation targeting framework favors a relatively high interest rate and discourages fixed investments. The standard monetary framework – targeting the repo rate – does not necessarily affect the long-term rate, which is a key determinant for investments. Even when the Reserve Bank lowers the Repo rate, it may not lower the average lending rates. Banks may simply tighten their screening criteria and choose a different distribution of borrows – the effective lending rate may remain unchanged or even go up. Also, a lower interest rate may encourage banks to divert more of their resources to capital market activities.

VI. Portfolio Inflows Are Not Necessary to Finance Current Account Deficits…

It is a generally held belief that South Africa needs the short-term capital flows to fund its current account deficits. The New Growth Path suggests, "The A persistent balance-of-trade deficit funded with short-term capital inflows (essentially foreign investment in equities and in 2009/10 increasingly in interest-bearing assets), attracted largely by interest rates that were high by international standards. In effect, the country borrowed abroad to sustain Government spending, investment and household consumption which remained heavily biased toward the well off. Both investment and domestic savings remained below the levels required for sustained growth."

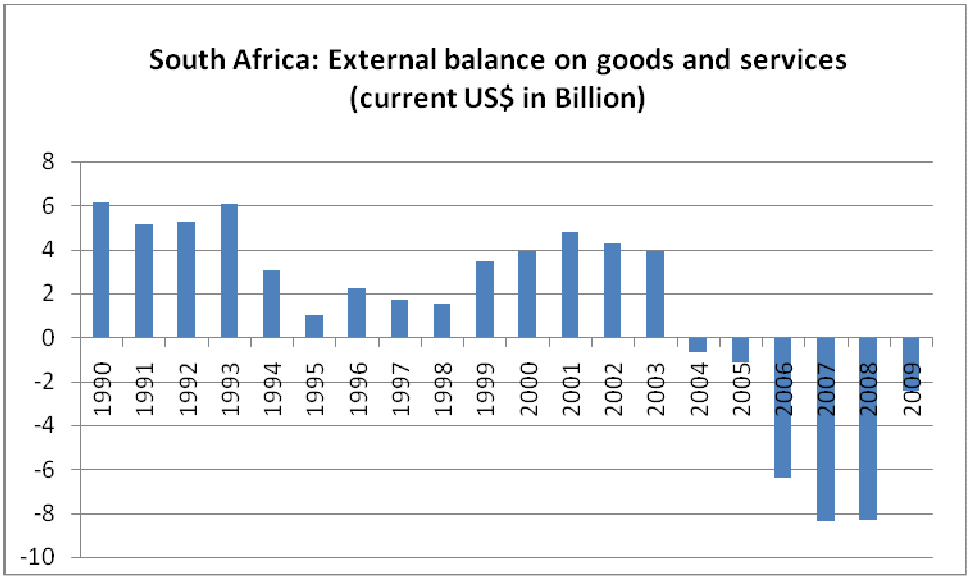

Chart XVI: South Africa's External Balance in Goods and Services, Source: The World Bank

A closer scrutiny of the external accounts of South Africa suggests that deficits on trade in goods and services account for only half of the current account deficits. South Africa ran a positive external balance on trade in goods and services until 2003. The external trade balance shifted from +3.92 billion in 2003 to -0.65 billion in 2004. In one year between 2003 and 2004, merchandise imports increased 35% - the largest increase in any given year. The increase was nearly 100% between 2002 and 2004.[12] South Africa's trade imbalance is not structural or systemic – it is a more recent phenomenon, driven by a surge in import demand (Chart XVI).

While the trade balance deteriorated since 2004, the current account balance deteriorated further because of increased remittances of dividend income. Among the BRICS, South Africa and Russia are the two countries that consistently ran negative net transfers from abroad since 1990 (in case of Russia, since 2000). Other non-BRICS emerging economies – e.g. Turkey and Thailand – also registered positive net transfers from abroad. The negative net current transfers of dividends account for the other half of the current account deficits. It appears that South Africa needs more inflows of portfolio equity to meet the increasing burden of repatriating profits these short-term portfolio inflows earn in South Africa.

[12] Data used in this note are taken from the World Development Indicators database of the World Bank and the South African Reserve Banks Annual Economic Report, 2011.

VII. The Absence of an Explicit Deposit Insurance also Impedes Credit to the Real Sector

While the South Africa has a very well developed and liberalized financial sector, it is yet to adopt an explicit deposit insurance scheme. Protecting the savings of small and medium-level depositors is a prerequisite for a stable and well-functioning banking sector. Explicit deposit insurance is a safety net that regulatory authorities use to prevent and mitigate the costs of bank failures. The IMF Country Report (2010)[13]takes note of the slow progress made in establishing an explicit deposit insurance scheme. The Basel Committee on Banking Supervision also expressed concerns that the absence of explicit deposit insurance regulation may have an adverse effect on the South African banks. With the passage of the Cooperative Bank Act in 2008, Savings and Credit Co-operative (SACCO, or credit union) are now mandated to have explicit deposit insurance schemes. While this is a move in the right direction, it disadvantages Credit Cooperatives vis-à-vis large commercial banks that are not required to pay for explicit deposit insurance (they are implicitly guaranteed to receive bailouts in case of bank failures). International experiences show that explicit deposit insurance can increase the risk-taking behavior of banks and encourage banks to lend to small and medium sized enterprises[14].

VIII. The Excessive Reliance on Foreign Banks Makes Credit Flows More Pro-Cyclical

The South African economy has a very large presence of foreign banks – a presence larger than in any other BRICS or large emerging economies. According to the World Bank financial sector database[15], banks that are 50% or more foreign-owned controlled nearly 30% of the banking sector assets[16]. There is no restriction on foreign bank entry into South Africa through acquisition, subsidiary or branch operation. As a percentage of GDP, claims of foreign banks vis-à-vis the South African private sector increased from 14% to 42% between 2004 and 2007 (Chart XVII). This meant a credit expansion of over USD 90.0 billion in three years, exhibiting a strong pro-cyclical pattern of lending. As the economy was hit by the financial crisis in 2008, foreign banks reduced their exposures in South Africa by about USD 20.0 billion between December 2007 and December 2008. As a percentage of GDP, the contraction in credit from foreign banks was as large as 7% of GDP, compared to 2.5% and.87%, .89% contraction in foreign bank lending in Brazil, China and India respectively (Table II). Given that there is no geographic diversification requirement for foreign banks or domestic banks, it is likely that foreign banks concentrate their operations in large urban centers. Also, as banks are allowed to make loans abroad, foreign banks – with better knowledge and network outside South Africa – are, in all likelihood, using South African deposits to extend credit overseas. The credit from foreign banks in South Africa is largely local-currency denominated, which suggests that they are funded with domestic deposits.

It is generally true that foreign banks tend to be more risk averse and engage in pro-cyclical lending compared to their domestic counterparts. It is also true that foreign financial firms generally avoid lending to small and medium sized enterprises in the host country because of the problems of information asymmetry. They prefer consumer and trade credits, especially credit for imports of consumer goods. Given that the banks in South Africa do not face any restriction in capital market activities, it is very likely that foreign banks extensively engage in equity trade, reaping higher return

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[13]IMF Country Report (2010) - South Africa: Report on the Observance of Standards and Codes on Banking Supervision, Insurance Supervision, and Securities' Regulation

[14] Charles C. Okeahalam, Tudor Maxwell, (2001) "Deposit insurance design and bank regulation in South Africa", Journal of Financial Regulation and Compliance, Vol. 9 Iss: 2, pp.136 - 150

[15]Barth, James R. Gerard Caprio, Jr. and Ross Levine (2001, updated 2008). "The regulation and supervision of banks around the world - a new database". The World Bank Policy Research Working Paper Series, 2588

[16] This is contrary to the data report in the 2011 Annual Report of the South African Reserve Bank, which claims that foreign banks and their branches control only 6.1% of the banking sector assets

from non-lending activities. In order to reduce the consumption and import biases in the economy, the South African Government needs to effectively regulate the operations of foreign banks in the country.

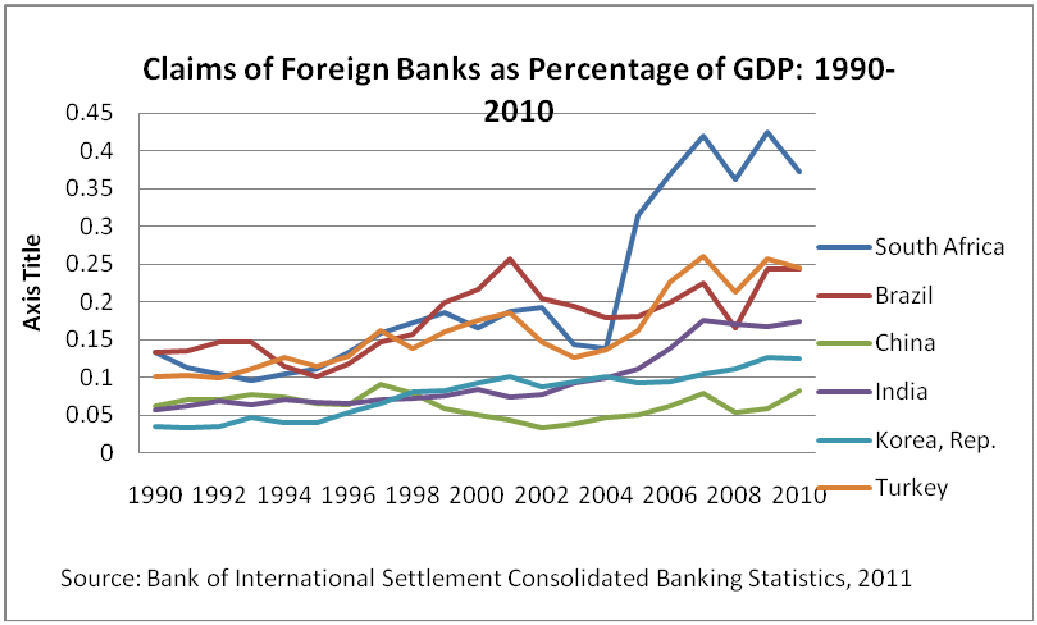

Chart XVII: Claims of Foreign Banks as Percentage of GDP in BRICS and Other Economies

	Net Reduction in Foreign Bank Claims (USD Billion) between Dec 2007 and Dec 2008	**Net Reduction as % of Total Foreign Bank Claims in Dec 2007**	**Net Reduction of Foreign Bank Claims as % of GDP in 2007**
South Africa	20.17	16.82%	7.05%
China	30.42	11.02%	0.87%
India	11.06	5.07%	0.89%
Russia	1.48	0.65%	0.11%
Brazil	34.22	11.12%	2.51%

Table II: Net Reduction in Foreign Bank Claims in BRICS economies

IX. Political Economy of the Financial Sector Policies

The political economy debate in South Africa can be summarized in two mutually reinforcing claims. The first claim suggests that the real problem of the South African economy is its highly inflexible and unionized labor market. It is argued that even when legislation supports a flexible labor market, institutional infrastructure and interpretation of laws may make the legislation rigid. Industrial relations, specifically measured by the strength of employer and employee organizations, actually shape the nature and extent of labor regulation, almost independent of the regulatory environment.[17] One could, however, argue that the loss of over one million jobs during the crisis do not support the claims of a highly inflexible labor market. Given the relative high wages, it is likely that the unit labor cost in the

[17]Bhorat, Haroon: Unemployment in South Africa: Descriptors and Determinants, Director, Development Policy Research Unit and Professor School of Economics, University of Cape Town

manufacturing sector is rather high in South Africa. But this is likely to driven by labor market conditions as much as by other policies such as exchange rate policies and a strong Rand, which affect the competitiveness of the South African labor market. The second claim, which is common in other African countries as well, suggests that while banks are ready and willing to lend, there are not enough creditworthy borrowers in the economy. This claim is further corroborated by suggestions that the regulatory framework, labor market rigidity and uncertainty in public policy make long-term credit and investments unattractive in South Africa. In reality, this view serves as the justification for short-term, consumer credit that banks find more profitable than long-term credit to the real sector.

One should expect considerable political influence of the financial sector given the sector's share of national income in South Africa. It is almost universally true that larger the share of a particular sector in the economy, the more deferential the economy is likely to be to the demands of that sector. The political economy can become more complex when a financial sector is very large and dominated by foreign financial institutions,. Typically foreign banks promote the interests of the non-residents. Foreign financial institutions, for example, prefer a strong currency in the host country which typically favors non-residents and hurts the interests of the residents and the exporter of the economy.

The political influence of the financial sector is reflected in the adoption of the voluntary "Financial Sector Charter of South Africa" in August 2002. It was clearly aimed at preventing a binding and development-oriented financial sector policy. In the Charter, the financial sector committed itself to "promoting a transformed, vibrant, and globally competitive financial sector that reflects the demographics of South Africa, and contributes to the establishment of an equitable society by effectively providing accessible financial services to black people and by directing investment into targeted sectors of the economy." The document recognizes that the sector is characterized by the presence of a few very large institutions but no suggestion is made as to how the sector could be made more competitive. It adds that the sector responded inadequately to the increased demand for access to financial services and yet recommends no specific measures on how to expand credit to entrepreneurs and small businesses. The exemptions and loopholes –in paragraphs 4.6.1 through 4.6.5 – defeat the critical 'access to credit' objective of the Charter. The Charter also does not take into account the strong preference for consumer loans and how that deters investment, employment and growth. It is expectedly remiss on the issue of macro-prudential regulations of the financial sector.

The political economy factors tend to ensure that the developmental role of financial institutions is ignored in key policy documents. The Accelerated and Shared Growth Initiative for South Africa (AsgiSA), for example, does not address the role and responsibilities of the financial sector for employment generation and growth. While National Industrial Policy Framework (NIPF) recognizes the role of the financial sector as a crucial cross-cutting intermediary for allocation of capital resources, the Framework falls short on specific policies and regulations that would make the financial sector more responsive to the needs of the real economy. The New Growth also largely remains silent on the role of the financial sector for employment generation and growth. The South African Government would need to carefully balance the political economy dynamics to ensure that the financial sector shifts its priorities from short-term consumption to long-term investments, employment generation and growth. The financial sector structure and incentives must be changed, with appropriate macroeconomic and regulatory framework, to meet the developmental needs of the South African economy.

X. Policy Instruments and Options for Realizing the Objectives of the New Growth Path

The economic performance of South Africa during the last decade presents largely a consumption driven growth. It is also exhibits diminishing labor intensity in key economic sectors. Both financial and mineral sectors are capital intensive and the labor absorption rate in these sectors is typically low. South Africa could sustain its consumption-led and import-driven growth if its economy managed a sufficiently large productivity gain over the years. It could possibly afford such an economic model if the Rand was a major Reserve currency of the world and South Africa's trading partners were willing to lend indefinitely. Unfortunately, neither condition holds true for South Africa.

There is a clear need for the South African economy to reverse the consumption trend. The employment-driven new growth should come from large scale public and private sector investments in productive capacities. A set of fiscal and monetary policy instruments should enable the Government to gradually shift the economy towards investment. In the short-term, fiscal interventions would be necessary to jump start public investment for employment generation. South Africa would also need to pursue macroeconomic and industrial policies that would increase the labor intensity of economic growth. While the labor intensity would be increased, the policies would also need to address how the economy would increase its total factor productivity.

It is unlikely that targeting and lowering interest rates alone will boost investment and job growth. Likewise, devaluing Rand alone will also not create jobs as it will not necessarily change the risk appetites of banks and increase credit to productive sectors. The lower interest rate, without corresponding credit guidelines and macro-prudential regulations, will encourage banks to channel their resources to the capital market, which will increase stock prices, exacerbate the asset price bubble and further strengthen the consumption boom.

a. Introducing a Financial Sector Policy for Employment Generation

A lower interest rate and a weaker Rand will require tolerance for a higher level of inflation. The current inflation target between 3-6% is too restrictive and limits the availability of policy options for job growth. While the Government may encourage SARB to lower interest rates, it may also work with it to introduce a set of macro-prudential regulations to enhance credit for employment generation. In particular, the Government would need to consider specific steps to reduce the consumption biases in current lending practices. The introduction of Statutory Liquidity Ratio (SLR), requiring banks to hold a certain portion of their liquid assets in government securities, could limit the amount that banks could lend to the household sector. SLR will give the Government access to funds for investments in infrastructure and employment generation. A portion of SLR could also be used to scale up development finance in South Africa. It would also be important for the Government to identify a few priority sectors – both in large and SME categories – for expansion of credit. Following the practices of other emerging economies, South Africa can introduce Priority Sector Lending (PSL) requirements for banks. The Government could increase taxes on dividends to encourage banks to reinvest their profits. These policies will help to reduce the adverse effects of the financialization of the South African economy and ensure that banks perform their core lending function.

To ensure that portfolio investment opportunities do not crowd out investments in the real economy, there needs to be specific regulations, restricting banks' trading and equity market activities to prevent diversion of deposits to the capital market. There is also a clear need to review the type and level of restrictions on:

- Inflows and outflows of equity and bonds;
- Purchase/sale of equity/bonds in home/abroad by non-residents;

- Inflow and outflow of money market instruments;
- Inflow/outflow of financial credit.

The last two factors can significantly impact the availability of credit in the domestic market. The Government may also reconsider policies that allow the South African banks to hold reserves in foreign currencies. This can dry up domestic credit or distort incentives for banks to extend credit to domestic enterprises. There could be also restrictions on the amount of loans that banks can make overseas to increase lending within South Africa. The Government could consider specific capital control measures, including financial transaction taxes and reserve requirements on capital inflows, to encourage long-term investments. There could be specific regulations, restricting non-financial corporations from engaging in equity trade. The Government could introduce geographic diversification and branching requirements to expand credit flows to under-served communities. The issue of explicit deposit insurance could be addressed with the broader financial sector policies. There could be more effective regulations to enhance competition, limit bank profitability, ensuring that banks reinvest their profits. The issue of compensation of the financial sector employees would also need to be addressed. As agreed during the scoping mission, UN-DESA, in partnership with EDD and UNDP, would develop a research brief and policy note, recommending appropriate macro-prudential regulations for reversing the trend of financialization and generating employment and economic growth in South Africa.

b. A Comprehensive Investment Policy for Employment and Growth

The Government may review the FDI policies, especially the macroeconomic policy framework, of other BRICS countries to develop a comprehensive investment policy – both for FDI and domestic investments – to encourage investments in productive sectors. There needs to be a careful consideration of the employment elasticity of FDI in South Africa and design policies that will encourage FDI with high employment intensity. South Africa has significant outward FDI in the rest of the continent. While there is considerable unmet investment demand in the economy, the Government may selectively restrict outward FDI by large South African corporations. EDD, UNDP and UN-DESA will identify and deploy a team of experts to develop a comprehensive policy note on investment policy for employment generation and growth.

c. Expanding the Role of Development Finance

The Government may review the scope and role of development banks in South Africa. It appears that the South African development banks operate more like commercial banks and they have little incentives to undertake risks. It is important that DFIs use a different approach to measure creditworthiness of the borrowers. DFIs should also work with credit bureaus, EDD, trade unions and entrepreneurs to expand the pool of creditworthy borrowers. It will be useful to develop a comparative analysis of the role of development finance in other BRICS economies, and also in Korea, Turkey and Brazil. The Government may further explore the possibility of creating local cooperative and community banks to reduce constraints to finance. Large national banks may be required to serve under-banked communities, either through branch banking or independent subsidiaries. As agreed during the scoping mission, EDD, UNDP and UN-DESA will commission an expert team to prepare a research brief on expanding the role of development finance for job growth in South Africa.

d. Making the Exchange Rate More Competitive

Exchange rate is a critical instrument to improve South Africa's export competitiveness, which is closely linked to growth in productive employment. This will require the Government to develop a framework for a stable, predictable and competitive exchange rate. The exchange rate policy should seek to

manage portfolio inflows, especially short-term inflows. The Government may consider a tax on the volumes of inflows or capital gains taxes on outflows. Alternatively, there may be a reserve requirement for short-term capital flows. Following the examples of Korea or Indonesia, the Government may also limit the foreign borrowing by banks. As agreed during the scoping mission, EDD, UNDP and UN-DESA will collaborate to identify relevant experts and develop a research brief on exchange rate management, with a clear focus on export competitiveness and employment generation.

e. Exploring Fiscal Options for Employment Generation

Given that the net domestic debt is only about 35% of GDP, there is room for fiscal expansion to boost aggregate demand and generate employment. There is a need for comprehensive study on the level of debt that the South African Government could assume to implement the New Growth Path and generate five million jobs in nine years. Given that there is excess liquidity in the economy, it is unlikely that additional government borrowing will crowd out private investments or put significant upward pressure on inflation. The study should also explore other fiscal policy options - including taxes on financial transactions and capital inflows, dividend taxes and transfer programs – that the Government could pursue to generate new revenues for employment creation. There should be serious consideration of increasing dividend taxes to make sure banks and corporations reinvest their profits to create employment. EDD, UNDP and UN-DESA will jointly identify a team of experts to undertake the study on fiscal policy options and opportunities for employment generation in South Africa.

f. Developing a Macro-Industrial Policy for Growth in Real Wages

The real political economy challenge in South Africa is to ensure a steady growth in real wages driven by improvements in labor productivity. This would be essential to ensure that the economy can increase labor intensity of new investments, without a fall in real wages. It will require a robust macro and industrial policy framework that will allow South Africa to identify manufacturing sub-sectors with high productivity dividends. A team of experts identified by EDD, UNDP, UN-DESA, will develop a comprehensive research brief, identifying the set of macro and industrial policies that will achieve the twin objectives of high labor intensity and growth in real wages.

g. Establishing a Productivity-Skills Development Fund

The Government may consider setting up a Productivity or Skill Development Fund to boost labor productivity. The Fund would channel resources to universities and vocational training institutions to retain secondary and tertiary students in school and delay their entry into the job market. There could be also specific tax and non-tax incentives for employers to invest in skills development of their workers. South Africa may look at the experiences of Malaysia, Singapore and other countries on how these funds work and how they contribute to growth in real wages. The Government may consider a small corporate tax to create the Productivity Fund. As agreed during the scoping mission, EDD, UNDP and UN-DESA will identify experts to work on this topic and develop a policy brief.

h. Strengthening Economic Modeling Capacity in EDD

Given the strong interest of the Minister for Economic Development, UN-DESA will strengthen the capacity of EDD to develop a CGE model, assisting EDD to analyze the employment impacts of various policy options. With a micro interface, the model will help capture the effects of various policies on poverty and inequality at the household level. A strong modeling capacity will enable EDD to choose and pursue optimal policy options to generate investment, employment and growth. This will also help strengthen the policy position of EDD vis-à-vis other Ministries, especially the Department of Treasury

and the South African Reserve Bank. UN-DESA will deploy a modeling expert to work with EDD officials during the first Quarter of 2012.

XI. Next Steps

a. UN-DESA and UNDP will identify and deploy an expert to be based in Pretoria to coordinate the proposed activities with the Minister of Economic Development and his staff at EDD. The expert will work under close supervision and guidance of the Senior Advisor for Macroeconomic Policy in UN-DESA. As agreed during the scoping mission, UNDP-South Africa will fund the expert. The MAC team in DESA has already started looking for a suitable expert. The selection of the expert will be finalized during the follow-up mission in November 2011;
b. The MAC Senior Advisor will consult with, and seek guidance from, Rob Vos, Jomo Sundaram, Joseph Stiglitz, Kemal Dervis, Jose Antonio Ocampo, Y.V. Reddy and others to identify different experts/resource persons who would help develop the policy notes/research briefs as outlined in the previous sections. The process has already started. The outcome of these consultations will be discussed during the follow-up mission. The research briefs/policy notes, as discussed in the previous section, will be developed with guidance from these renowned experts;
c. As agreed during the scoping mission, the Minister for Economic Development will identify the South African experts who work with the experts identified by UNDP and UN-DESA;
d. UN-DESA and UNDP will work closely to organize at least 6 (six) policy dialogues to disseminate the findings of the research briefs/policy notes to generate support for necessary policy reforms during the next 2 (two) years. This will conform to the approach envisaged in the New Growth Path, which called for, "Strong social dialogue to focus all stakeholders on encouraging growth in employment-creating activities."
e. As requested by the Minister of Economic Development, the Senior Adviser for Macroeconomic Policy in UN-DESA will undertake a follow-up mission to South Africa during the week of 21 November to meet with the South African experts and also to finalize the work-plan with UNDP South Africa;
f. During the follow-up mission, UN-DESA and UNDP-South Africa will identify the resource requirements and commit necessary financial and human resources;
g. During the follow-up mission, the UN-DESA will secure guidance from the Minister on the timing and sequencing of the policy dialogues during 2012. The policy dialogues will serve as forums to disseminate the findings of the policy papers.