

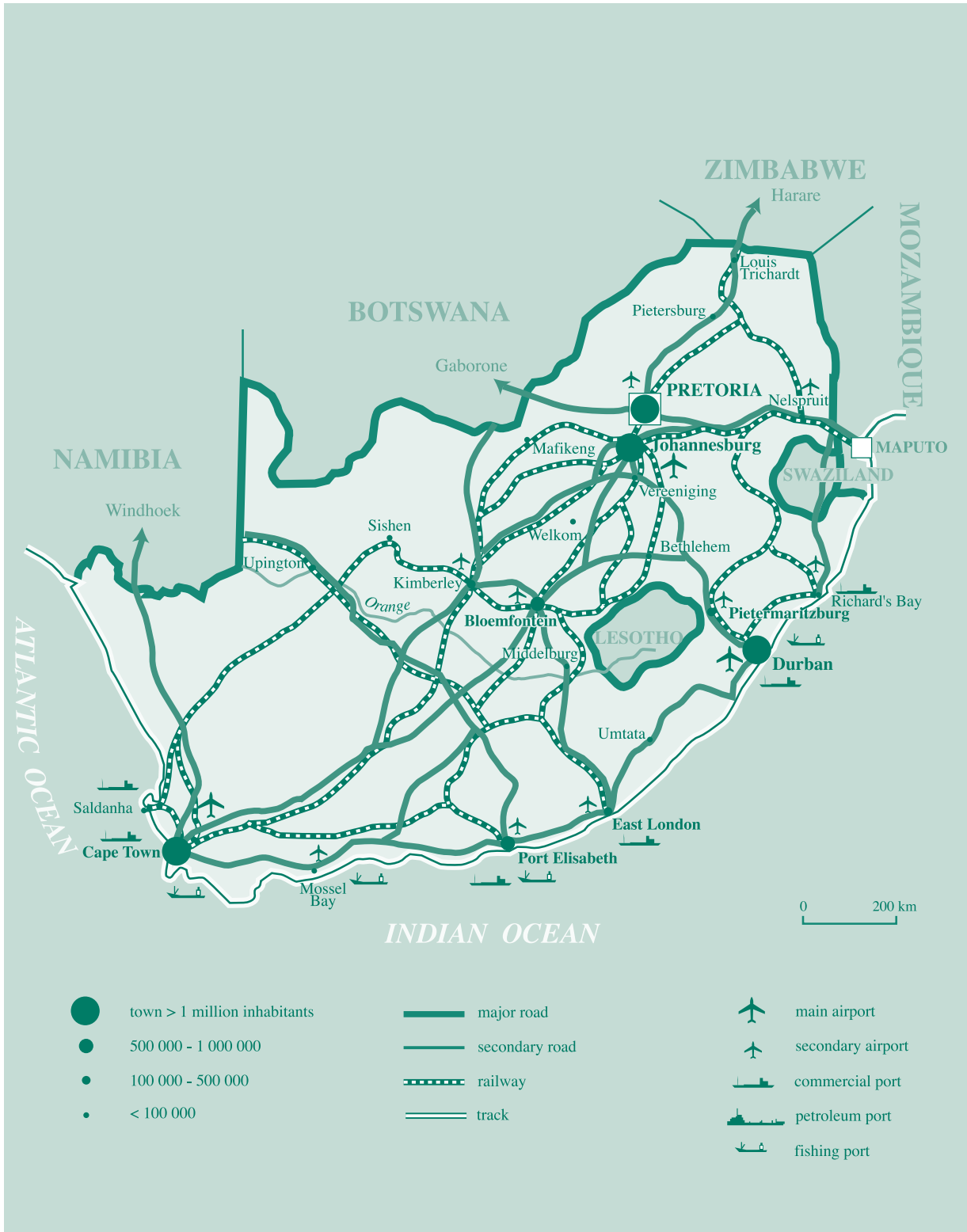
South Africa



key figures

• Land area, thousands of km ²	1 221
• Population, thousands (2007)	48 577
• GDP per capita, USD at constant 2000 prices (2007)	3 657
• Life expectancy (2007)	49.3
• Illiteracy rate (2007)	12.2

South Africa



AFTER PRIVATE CONSUMPTION FUELLED by easy credit resulted in a 5.4 per cent increase in real GDP in 2006, growth in 2007 is estimated at 4.9 per cent following slower consumption due to monetary tightening. Economic activity is expected to slow further to 4 per cent in 2008 as a result of the continued deceleration of private consumption and energy shortages. In 2009, growth is expected to remain strong although investment will replace consumption as its principle driver. Inflation, which rose sharply in 2007 to 6.5 per cent due to oil and food price increases, is expected to increase further to almost 7 per cent in 2008 before edging back into the target band of 3 to 6 per cent in 2009.

Macroeconomic policies remained prudent, with a budget surplus of 0.8 per cent of GDP in 2007/08

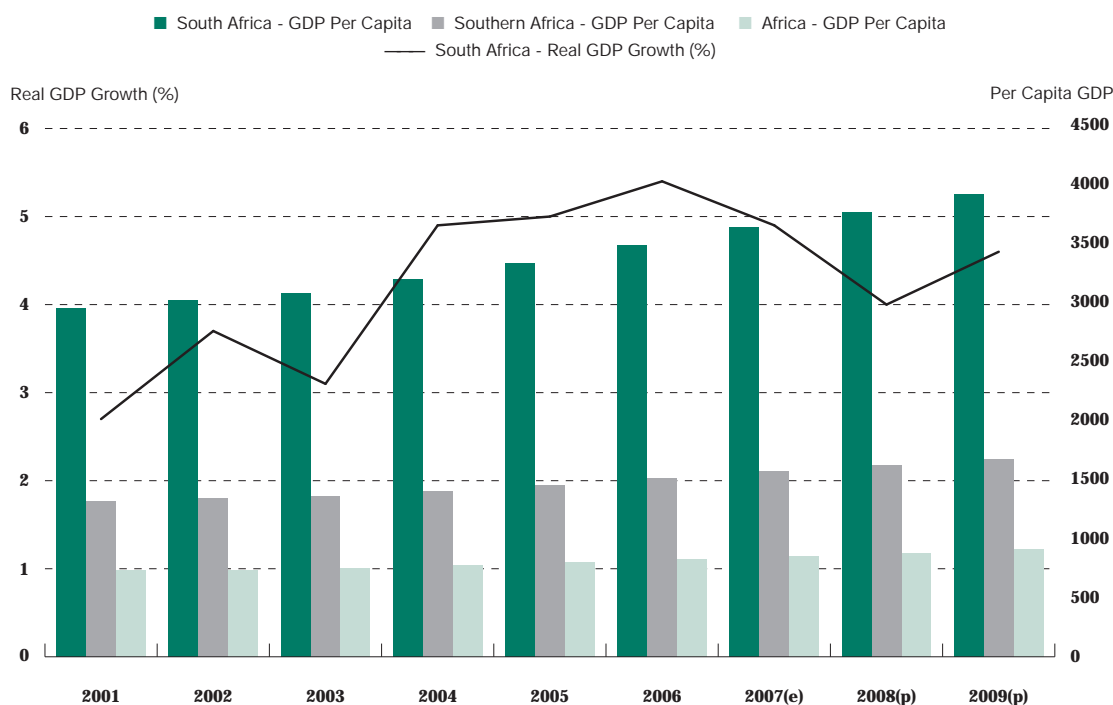
and a credible monetary policy. Growing revenues have permitted a strong expansion in public expenditure, especially investment in infrastructure and social services. Preparations for the FIFA 2010 World Cup are boosting construction, while private investment is rising in manufacturing and mining. This shift from consumption to investment puts growth on a more sustainable basis, and is easing capacity constraints.

However, the resulting increase in imports of capital goods, along with the recent appreciation of the Rand, is putting pressure on the current account.

Growth is threatened by a more challenging international environment and by energy shortages.

South Africa exhibits a high structural current account deficit (higher than in most other emerging

Figure 1 - Real GDP Growth and Per Capita GDP
(USD at constant 2000 prices)



Source: IMF and local authorities' data; estimates (e) and projections (p) based on authors' calculations.

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countries) and this is financed mainly by potentially volatile portfolio inflows. Concerns about vulnerability to changes in the global environment, which seemed to have eased in 2007, emerged once again towards the end of the year. Despite progress on the macroeconomic front, South Africa remains confronted with enormous structural and social challenges. Infrastructure and human capital have suffered from 20 years of under-investment and lack of competition. In addition, unemployment, lack of skills, and poverty remain dire problems.

The Accelerated and Shared Growth Initiative for South Africa (AsgiSA) launched in 2004 aims at halving unemployment and poverty by 2014. However, despite substantial funding, weak capacity and lack of co-ordination among the various responsible ministries and agencies have limited the results. Social discontent contributed to the defeat of President Mbeki by his former deputy Jacob Zuma in elections for the ANC party leadership in December 2007. As ruling party leader Zuma is now the front-runner for the presidential elections due in 2009.

Recent Economic Developments

In 2007, although the economy continued to grow solidly at 4.9 per cent this was not balanced. Construction and services, including real estate, finance and business services expanded strongly, while the export-oriented sectors grew more slowly. After an 8 per cent fall in agricultural output in 2006/07, prospects for 2007/08 improved slightly thanks to good and timely rains. Beginning in late 2006, rising prices spurred planting and led to an expansion of cultivated areas, particularly in horticulture, but with the exception of wheat. Although minor as a share of GDP, the agricultural sector is important in terms of employment. It is one of the priority sectors of the AsgiSA strategy, in particular the promotion of biofuel production. A new Land Use Management Bill, designed to simplify the regulatory framework for land use, was finalised in 2007 and it is expected to make investment in agriculture more attractive.

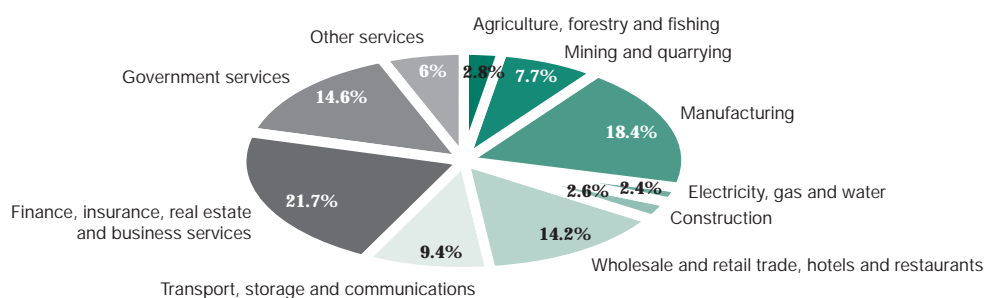
The mining sector, the main source of exports, has not been able to take full advantage from the strong rise in international metal prices since 2001. Investment in the sector, which had risen by a real 7.8 per cent per annum in the period 1994 to 2003, slumped in 2004 and 2005 due to the strongly appreciating exchange rate, infrastructural constraints (rail) and the application of new mining laws. Nevertheless, mining investment staged a strong recovery, increasing by 42.8 per cent in 2006 and 20.9 per cent in 2007. However, higher levels of investment have not yet translated into increased production, and mining output actually declined by 0.3 per cent in 2007. A number of issues, including stoppages related to improving safety in the industry, had a negative impact on production. While gold and diamond output continues to decrease, platinum, iron ore and coal are on a moderately rising upward trend, both in terms of production and exports. The industry was hardly hit by severe power cuts which occurred in early 2008. Lower electricity supply might jeopardise investment, export growth and employment in the sector.

The construction sector is booming because of infrastructure projects. These projects include new soccer stadiums for the 2010 World Cup and the Gautrain rapid rail line. On the other hand, residential building has slowed with the rise in mortgage rates and shortages in skilled labour and material.

Robust demand, accompanied by insufficient investment in new manufacturing production capacity, has resulted in the manufacturing sector operating at the highest levels of production capacity in more than three decades. Capacity constraints are being experienced in the cement and wood industries, as well as in iron and steel manufacturing, petroleum refinement and electricity generation. This presents investment opportunities for local enterprises and private investment is expected to rise by an annual average rate of 11 per cent from 2007 to 2010, spurred also by more generous investment depreciation allowances.

Manufacturing is one of the priority sectors of the National Industrial Policy Framework (NIPF), which aims at fostering and diversifying exports, in particular

Figure 2 - GDP by Sector in 2006 (percentage)



Source: Authors' estimates based on National Institute of Statistics data.

1 2 <http://dx.doi.org/10.1787/317181762732>

for the automotive sector. However, exports continue to be hampered by relatively poor productivity growth in the tradables sector, which since 2001 has not been reflected in the trend decline in the real effective exchange rate as would be expected. Manufacturing output in 2007 increased by 4.1 per cent over 2006. Higher production was reported by several sub-sectors, with just the automotive sector posting a decline. The automotive sector's difficulties are also linked to uncertainty surrounding the 2007 review of the Motor Industry Development Plan. The lack of clarity over the continuation and duration of incentives has discouraged investors from embarking on long-term investments. Lower consumer confidence and prolonged

strikes also adversely affected the industry with sales recovering only in the very last part of 2007.

During the 2004-06 period, economic growth was driven by buoyant household spending stimulated by increased disposable income. In 2007, there were signs of rebalancing, with private consumption slowing as a result of higher interest rates, rising consumer indebtedness, and the implementation of a new National Credit Act that reduced the ease of obtaining credit. Investment is expected to grow by almost 11 per cent on average from 2007 to 2009, underpinned by preparations for the 2010 World Cup and large infrastructure projects. In 2007, public investment was

Table 1 - Demand Composition

	Percentage of GDP (current prices)		Percentage changes, volume			Contribution to real GDP growth		
	1999	2006	2007(e)	2008(p)	2009(p)	2007(e)	2008(p)	2009(p)
Gross capital formation	15.8	21.3	10.5	9.7	10.8	2.3	2.3	2.6
Public	4.7	4.9	19.0	15.0	16.0	1.0	0.9	1.0
Private	11.1	16.4	8.0	8.0	9.0	1.4	1.4	1.6
Consumption	81.6	82.0	5.0	3.4	4.8	4.2	2.8	4.0
Public	18.4	19.5	8.4	5.0	4.9	1.5	0.9	0.9
Private	63.2	62.5	4.1	2.9	4.8	2.7	1.8	3.1
External demand	2.6	-3.3				-1.6	-1.0	-1.7
Exports	25.3	29.6	1.2	1.9	2.0	0.3	0.5	0.6
Imports	-22.7	-32.9	5.5	4.4	6.5	-1.9	-1.5	-2.3
Real GDP growth						4.9	4.0	4.9

Source: Statistics South Africa data; estimates (e) and projections (p) based on authors' calculations.

1 2 <http://dx.doi.org/10.1787/320640563064>

led by the investments of Eskom and Transnet, which increased by over 30 per cent. Private investment, which represents more than 70 per cent of total capital investment, was also dynamic, especially in services, mining, construction and manufacturing. The external sector continued to be a drag on what otherwise would have been an overall good performance. Imports are buoyed by very dynamic domestic consumption along with supply constraints, while exports, especially gold, lag.

A first evaluation of AsgiSA was produced in 2006. The strategy aims at developing the non-commodity tradable sector in order to create jobs and reduce dependence on minerals. This is also crucial to sustaining ambitious public investment without exacerbating the current account deficit. While the target of average GDP growth above 4.5 per cent for 2004-09 will most probably be achieved, the 6 per cent growth objective for 2010-14 appears more challenging. The obstacles identified by AsgiSA include: currency volatility; the cost efficiency and capacity of the national infrastructure network, including energy production and distribution; skills shortages; a weak business environment and low competitiveness; a weak regulatory framework and difficult environment for SMEs; and, weak public administration.

Macroeconomic Policies

Fiscal Policy

Rising national income coupled with prudent fiscal policy resulted in a further improvement in the fiscal balance, with a deficit below 1 per cent of GDP since 2005/06 and slightly decreased debt to GDP ratio from 30.5 per cent at the end of March 2007 to 29.4 per cent at the end of September 2007. The country continues to enjoy a positive credit standing: Moody's revised the outlook for South Africa's foreign-currency denominated debt from stable to positive in the second quarter of 2007, and Standard & Poor's kept the country's sovereign credit rating unchanged at BBB+. Reflecting the turmoil in financial markets, the country risk premium on South African government bonds nevertheless widened from 197 basis points in January 2007 to 288 basis points in November.

The National Treasury's Medium Term Budget Policy Statement (MTBPS) released in 2007 confirmed the priorities for macroeconomic policy set in 2004: boosting economic growth and employment, and providing poor and marginalized communities with the capabilities and physical infrastructure to participate in the formal economy.

The 2007/08 budget surplus was 0.8 per cent of GDP, up from a 0.3 per cent surplus in 2006/07. The surplus will be maintained at around 0.7 per cent of GDP over the next three years. Continued fiscal surpluses would mitigate pressures on the current account, inflation, and interest rates, thereby providing a stable backdrop for addressing structural constraints to growth. However, the structural balance, i.e., the conventional balance adjusted for cyclical factors, continues to show a deficit of -0.6 per cent of GDP.

The strong economic performance coupled with improved management of public finance resulted in a sharp increase in revenue collection, in particular from personal income taxes. Total revenue increased to 28.6 per cent of GDP, up from 27.6 per cent in 2006/07. Fiscal reforms have broadened the tax base, allowing reductions in corporate taxes. The tax system is also being simplified in order to encourage compliance.

Expenditure increased in the 2007/08 national budget from 27.3 per cent of GDP to 27.8 per cent, with a real increase of more than 10 per cent in non-interest expenditure and a reduction of debt servicing costs. The greatest share of the current expenditure increase was allocated to the public wage bill (16 per cent of the increase). The budget priorities outlined in the MTBPS strongly emphasise the delivery of and access to public services, entailing an increase in investment in both human and fixed capital and a strengthening of the capacities of national, provincial and local governments.

Despite an overall budget execution of 93 per cent in 2006/07, execution is still erratic at local and provincial levels, especially for capital investment, with huge underspending as well as overspending. In order

Table 2 - Public Finances (percentage of GDP)

	1999/2000	2004/05	2005/06	2006/07	2007/08(e)	2008/09(p)	2009/10(p)
Total revenue and grants	24.8	25.1	26.3	27.6	28.6	28.7	28.4
Tax revenue	24.2	24.6	25.8	26.9	28.0	28.1	27.8
Total expenditure and net lending	26.9	26.6	26.7	27.3	27.8	28.0	28.0
Current expenditure	26.3	26.6	27.8	28.5	28.0	28.1	28.0
<i>Excluding interest</i>	<i>22.0</i>	<i>23.1</i>	<i>24.5</i>	<i>25.5</i>	<i>25.4</i>	<i>25.8</i>	<i>25.9</i>
Wages and salaries	10.4	9.4	9.8	9.7	9.8	10.0	10.0
Interest	4.4	3.5	3.3	3.0	2.6	2.3	2.1
Capital expenditure	1.5	1.2	1.7	1.8	2.0	2.1	2.3
Primary balance	2.2	2.1	2.9	3.3	3.4	3.0	2.6
Overall balance	-2.1	-1.5	-0.3	0.3	0.8	0.6	0.5

Source: South African National Treasury data; estimates (e) and projections (p) based on authors' calculations.

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to improve the efficiency of public expenditure, a monitoring and evaluation system will be introduced in 2008, requiring national departments to report on their budget in a transparent manner.

Tax revenue is expected to increase by 12.1 per cent in 2008/09, bringing overall revenue to almost 29 per cent of GDP. With increased corporate investment allowances and more sluggish consumption, this is expected to contract in subsequent years. In 2007, the New Mineral and Petroleum Royalty Bill was introduced and will come into effect in 2009, bringing new revenue from the extractive industry.

Public finances are expected to continue to benefit from sound expenditure management, falling interest on the public debt, efficiency gains in revenue collection and a broadening tax base. Public expenditure is expected to grow by 12.7 per cent in value in 2008/09 whereas in real terms it will slow to a still substantial 6.1 per cent a year over the 2008/09 to 2010/11 period, with spending increasing on infrastructure, social grants and public sector wages. Increasingly, spending is being devolved to local administrative bodies (municipalities and provinces). In 2007, 12.4 million people benefited from social assistance grants, with the grant programme's share of GDP rising from 2.9 per cent in 2003 to 3.2 per cent in 2007. The strong fiscal situation has allowed the government to start planning a comprehensive social security system that will be introduced by 2010.

Monetary Policy

The inflation outlook deteriorated sharply in 2007 due to a combination of negative factors, including the surge in world oil prices and the rise in international as well as domestic food prices. The rise of above 6 per cent of administered prices was an additional factor, together with a wage bill greater than productivity growth. The weaker rand as well as buoyant demand and capacity constraints have further broadened inflationary pressures, indicating the need for more balanced growth. The outlook is not positive, since food and oil prices are expected to remain high and energy prices are expected to continue to rise. The CPIX, the target inflation measure, which excludes mortgage costs, breached the 6 per cent upper limit of the inflation target band for the first time in almost four years in April 2007. After reaching 6.5 per cent in 2007, the CPIX is expected to remain above the upper bound of the central bank's target at least for the first half of 2008. It is expected to average 7 per cent for the year, before falling back to around 5 per cent in 2009.

The challenge for the authorities will be to sustain growth and investment while controlling inflation. In order to avoid a hard landing for the economy, household spending must not drop sharply. This poses a challenge given record high household indebtedness of 77 per cent of disposable income in 2007 and rising consumer lending interest rates, particularly for mortgages. In order to lower inflation, monetary policy

became restrictive in mid-2006 and was further tightened in 2007, with the repurchase (repo) rate increasing from 7 to 11 per cent by the end of the year and other money-market interest rates also rising.

Although on a decelerating curve, private sector credits remained strong in 2007 and lending is not expected to slow significantly, despite the increase in both nominal and real interest rates. The growth of credit contracted to 24.5 per cent in October, down from 27.7 per cent in June. Most of this decrease is related to household loans, which still constitute the biggest share of private sector debt. The impact of the implementation of the new National Credit Act introducing stricter prudential rules was also limited. Rapid growth of the broad money supply (M3) reflects an increase in risk aversion towards security markets as well as higher interest rates on bank deposits.

The rand has been quite volatile and remains vulnerable due to the large South African current account deficit. Despite the support provided by a strong accumulation of reserves and a more solid macroeconomic framework, the rand deteriorated by around 20 per cent on the US dollar and euro between November 2007 and February 2008. This indicates that South Africa has experienced a greater deterioration in investor confidence than most similar economies.

External Position

South Africa joined the negotiating body of the Southern Africa Development Community (SADC) Economic Partnership Agreement (EPA) with the EU as a full negotiating partner in February 2007. This was facilitated by the recognition that South African access to the EU market would remain distinct from that of the rest of the SADC group owing to the country's status as a more developed economy. South Africa's trade with Europe is currently governed by a bilateral trade, development and co-operation agreement. In negotiating the EPA, South Africa strongly resisted the inclusion of the so-called "new generation" issues, such as services trade, investment, competition policy, and government procurement in the agreement. By the interim deadline of mid-December, all members of the

SADC group except South Africa and Angola had signed the interim EPA. South Africa's stance, however principled, represents a substantial threat to regional unity and integration in the region.

The South African and therefore the Southern African Customs Union's (SACU) tariff structure remains complex. In 2004 there were 100 most-favoured nation (MFN) tariff bands and 6 697 tariff lines. Two further, equally complicated tariff schedules also existed for the free trade agreements with the European Union and the SADC. Finally, the MFN schedule is subject to a bewildering variety of drawbacks and rebates, adding further complications. Under the aegis of the new NIPF, a review of the tariff structure is underway. This exercise is focused on reducing tariffs on upstream inputs into sectors identified as strategically important. Such a strategy will increase effective rates of protection for final goods, but may exacerbate the complexity of the system. Textiles, leather, footwear, clothing, motor vehicles, vehicle parts and accessories, and food processing are already highly protected. About half of South Africa's imports enter duty free, and the unweighted average applied tariff (excluding rebates) was only 8.2 per cent in 2004. However, over 20 per cent of tariff lines are classified as tariff peaks (exceeding 15 per cent), and 9 per cent are more than three times the average applied rate.

The trade liberalisation programme pursued by South Africa since 1994 has resulted in a much more open economy. Total exports and imports of goods and services amounted to 31 per cent and 35 per cent of GDP in 2007, respectively. Between 1994 and 2002, import penetration and export orientation ratios rose in all 28 sectors of the standard industrial classification; in ten of these export orientation more than doubled. On the other hand, South Africa has not experienced a long hoped for export-led growth boom driven by labour-intensive manufacturing, nor has it succeeded in attracting high levels of foreign direct investment (FDI).

Exports have suffered from the relatively slow growth of productivity in the tradable goods sector. The trade deficit has also increased since 2004 because of rising

Table 3 - Current Account (percentage of GDP)

	1999	2004	2005	2006	2007(e)	2008(p)	2009(p)
Trade balance	3.0	-0.1	-0.4	-2.4	-2.7	-3.6	-4.4
Exports of goods (f.o.b.)	21.4	22.3	22.9	25.0	25.7	25.3	23.9
Imports of goods (f.o.b.)	18.4	22.3	23.3	27.4	28.4	28.9	28.3
Services	-0.4	-0.3	-0.4	-0.9	-1.2	-1.1	-1.1
Factor income	-2.4	-2.0	-2.0	-2.1	-1.7	-1.6	-1.3
Current transfers	-0.7	-0.8	-1.2	-1.1	-1.2	-1.3	-1.3
Current account balance	-0.5	-3.2	-4.0	-6.5	-6.9	-7.6	-8.0

Source: South African Reserve Bank data; estimates (e) and projections (p) based on authors' calculations.

1 2 <http://dx.doi.org/10.1787/322308811026>

demand for imports, fuelled by high consumer spending and fixed capital investment, while exports have lagged. Rising oil prices have further driven up the import bill. However, export values improved in 2007 and are expected to stabilise further in 2008, thanks to high gold and platinum prices and a weaker rand. Mining products, such as platinum, iron and coal, have benefited from high demand from Asian countries. Exports of some manufactured goods, notably automobiles, chemicals and mining machinery have also increased.

Given the rapidly rising imports, the trade deficit is nevertheless expected to continue to widen.

The current account balance has progressively deteriorated since 2003, reflecting the movements in the trade balance. In 2006 the deficit reached 6.5 per cent of GDP, and widened further in 2007 to an estimated 6.9 per cent of GDP. The services and net factor income balances were also both negative. In the medium term, the current account deficit is not expected

Figure 3 - Stock of Total External Debt (percentage of GDP) and Debt Service (percentage of exports of goods and services)



Source: IMF.

1 2 <http://dx.doi.org/10.1787/318266007410>

to recover and it is forecast to reach 8 per cent of GDP in 2009. This is attributable to both low domestic saving and lack of export competitiveness. Capital inflows financed a record 37 per cent of gross investment in the third quarter of 2007.

Foreign capital has been forthcoming to finance this deficit, due to the strong domestic performance and high commodity prices stimulating the global demand for South African bonds and equities. In fact, capital inflows have more than offset the current account deficit so the overall balance of payments remains in surplus. Portfolio capital inflows can be volatile, however, as witnessed by their sharp decrease in the last part of 2007, and thus FDI is preferable. FDI inflows increased in 2007 and the net FDI balance is positive. The government hopes to attract more FDI into industrial development zones. The huge investments needed for the 2010 FIFA World Cup and upgrading of infrastructure will entail an upsurge in FDI between 2008 and 2011.

The surplus in the balance of payments enabled a rise in international reserves to USD 33.6 billion at the end of January 2008, more than double the country's foreign-currency denominated external debt maturing within one year.

South Africa's total outstanding foreign debt increased from USD 59.4 billion at the end 2006 to USD 66.2 billion at the end of the second quarter of 2007. The ratio of rand-denominated debt to total debt increased slightly in 2007, passing from 39.7 per cent to 40.2 per cent.

Structural Issues

Recent Developments

Since 1994 government reforms have focused on macroeconomic stabilisation and trade liberalisation. South Africa now needs to address its deeper structural constraints in order to increase potential growth and reduce unemployment and poverty. These constraints include: *i)* inadequate infrastructure resulting from

20 years of under-investment; *ii)* lack of competition in key sectors; *iii)* social and economic distortions inherited from the Apartheid regime; and *iv)* the very low skill levels of much of the labour force. These obstacles partly explain the lack of competitiveness of labour intensive export manufacturing and the disappointingly low level of FDI. High crime levels remain another important negative factor. South Africa's ranking in World Economic Forum's Global Competitiveness Report, although still one of the highest in Africa, slipped to 44th out of 131 countries in 2007, from 36th in 2006 due to a deterioration in the national business environment. In recent years increased public spending, both from government and State Owned Enterprises (SOEs), has been allocated to infrastructure development. Investment in infrastructure rose 24.6 per cent in real terms in the first half of the year, up from 19.4 per cent a year previous.

Transport infrastructure improvement is a particular priority. The links between the production sites and ports are particularly important. In 2006, only 9 per cent of the 745 million tonnes of freight transported in the country was carried by rail, with 88 per cent transported by roads at higher cost. The development of rail shipping for primary products would almost halve the transport bill. Following harsh criticism, the transport SOE Transnet has been undergoing deep restructuring since 2006, with the aim of integrating the port, rail and pipeline systems. Thanks to the sale of non-core assets, in 2007 the company posted a surplus of ZAR 1.9 billion (South African rand), up from a deficit of ZAR 1.6 billion in 2006. Overall, Transnet plans to invest ZAR 78 billion over the next five years to modernise its freight-related infrastructure.

Transnet is also focused on improving passenger transport, particular in preparation for the 2010 World Cup. An integrated national transport agenda was adopted, aiming at the efficient and safe transport of spectators. The main projects are the expansion and upgrade of airports and the connections between airports, stadium and towns. Work has started for the multi-billion rand Gautrain fast rail link from Johannesburg to Pretoria as well as on projects in Cape Town and Durban.

The capacity, efficiency and safety of the ports in the country also must be improved, and new generation vessels must be accommodated. Ocean freight accounts for 60 per cent of export costs and 66 per cent of import costs. Container volume growth in the ports has been about 12 per cent a year over the last five years and this rapid growth is expected to continue over the medium term. Several projects to raise port capacity and improve operations are at hand.

The energy SOE Eskom produces 96 per cent of the electricity generated in South Africa and owns and operates the national transmission grid. In 2007, rising demand, coupled with lack of investment in generation and an obsolete distribution infrastructure led to increased power cuts over the course of the year. Independent power producers (IPPs) are expected to provide approximately 1 000 MW of new generation capacity by the beginning of 2009. Eskom will purchase electricity from the IPPs through long-term contracts. Further significant increases in generation will not result in additional production until 2012, however, so the government hopes to cover the deficit by increasing imports and curtailing demand for power.

The NIPF incorporates the ambitious trade and industrial reforms favoured by the Department of Trade and Industry. Capital goods, automobiles, chemicals and timber are designated as four priority clusters. The budget for 2008/09 supports the Plan through an additional ZAR 2.3 billion investment over the next three years and tax incentives of ZAR 5 billion for industrial investment and employment creation. The NIPF intends to improve international competitiveness by reducing input costs through an activist industrial policy. This position gave rise to heated controversy with the treasury, which favours continued trade liberalisation and is sceptical of industrial targeting.

Additional reservations about the NIPF concern the choice of prioritised sectors, their true potential and the nature of the structural constraints underlying their difficulties, including lack of competition and labour

market rigidities. Some argue that addressing these constraints would be more effective than introducing distortions through costly incentives and trade barriers, and government capacity constraints are likely to prevent effective implementation.

Lack of competition in key sectors, including transport, steel and chemicals, is another factor contributing to high input costs. The legal framework remains weak and uncompetitive behaviour cannot be easily identified and sanctioned. A new Competition Law is expected to be implemented in 2009, and progress towards this is being made. The Competition Commission is monitoring the building materials and construction sectors to identify any anticompetitive practices that might be driving up the costs of the public sector's infrastructure investment programme.

Liberalisation of telecommunications in particular has been long delayed. Telkom, in which government holds a 39 per cent direct stake and a further 17 per cent through the Public Investment Corp, still has a monopoly of fixed telecommunications, while just two operators exist with their own networks¹. Consequently, the telecommunication costs are extremely high, preventing the development of potentially dynamic service activities, such as call centres. However, the 2005 Electronic Communications Act establishes a new regulatory and policy environment that will result in a radical liberalisation of the telecom sector in the next few years. The prospective opening is already leading to incipient competition for Telkom, which has lost several big contracts in recent months and is experienced declining profits. In early 2008, Internet providers were scheduled to be granted licences to construct their own networks by the Independent Communications Authority of South Africa (Icasa).

The Black Economic Empowerment (BEE) policy was created after the end of the Apartheid regime to redress the inequities in economic opportunities. The first phase of BEE required all firms in South Africa to grant a share of ownership to black South Africans (the

1. Two further service providers operate in the country without owning networks: Virgin Mobile and Cell-one.

extent of this share varies by sector). While this phase certainly contributed to the creation of a black middle class (the so called Black Diamonds), it remains very small, and concerns were raised about the selection criteria of beneficiaries. In order to create a larger number of beneficiaries from the BEE, a new broad-based initiative was defined in 2003 and is currently being implemented. This new initiative puts greater emphasis on affirmative action and corporate social responsibility. Codes of good practices common to all sectors were formulated in 2007, providing for precise criteria and methods to measure corporate compliance efforts. Compliance with the code will be a condition for accessing public procurement contracts. A balanced scorecard measures progress in achieving the seven objectives of BEE policies². Each scorecard needs to be certified by an accredited agency. Although necessary, this new policy appears costly, complicated and difficult to comply with to the private sector, especially for small and medium-sized enterprises (SMEs) with no assistance towards compliance being offered by the government. SMEs are obliged to comply with four criteria out of seven, while micro enterprises are exonerated.

The banking system in South Africa is sound, although highly concentrated, with four large banks dominating the sector. At the time of writing, against a backdrop of higher interest rates, the principle risk for the sector remained increasing household debt, particularly related to mortgage advances. However, despite the increase in borrowing costs since June 2006, non-performing loans increased only marginally over the first three quarters of 2007, rising from 2 per cent in December 2006 to 2.2 per cent in September 2007. A new National Credit Act was introduced in 2007, introducing stricter prudential rules in compliance with Basel II regulations. The Act also entailed a rise in interest rate ceilings. However, the contraction in credit to the private sector was smaller than expected and was attributable more to the general tightening of monetary policy than to the introduction of the new Act.

Technical and Vocational Skills Development

Despite the focus on skills development since 2001 with the launch of the first National Skills Development Strategy (NSDS), the most recent Labour Force Survey recorded only a slight decrease in unemployment between 2001 and 2006: from 29.5 per cent to 25.6 per cent, respectively³. Over the same period, skills shortages remained widespread across all sectors of the economy.

The Department of Labour (DoL) has identified and quantified scarce and critical skills across all economic sectors, both formal and informal. Overall, South Africa has a major shortage of engineers and scientists, financial personnel and project managers, and skilled technical employees such as artisans and IT technicians. In 2007 there was a shortage of around 300 000 skilled workers while Sector Education Training Authorities (SETAs) could only train 7 000 new workers a year.

The education system has yet to recover from the legacy of Apartheid. In particular, the poor quality of maths and science taught at schools is responsible for a chronic shortage of students in polytechnic and scientific universities. In addition, the 50 Further Education and Training (FET) colleges educate less than 5 per cent of the secondary school population; until recently they were highly criticised for their inability to respond to labour market needs with only about a third of their students finding jobs.

In the short run, a more flexible immigration policy could address the shortage of high-skilled workers, while the unskilled could be supported by the social grants system and public works programmes. In the longer term, however, raising skills is crucial for the development of an equitable and efficient labour market.

The current institutional framework for skills development is shaped by the 1998 National

2. BEE is measured according to seven criteria: ownership, management, employment equity, skills development, preferential procurement, enterprise development and socio-economic development.

3. Unemployment reaches 40 per cent if discouraged workers are included.

Development Act which established the SETAs: 23 sectoral training funds administered by a board comprised of employers' and employees' representatives. Originally intended to promote on-the-job skill development in the formal sector, the SETAs are now responsible for promoting skills within various economic sectors and for facilitating the implementation of a National Qualification Framework (NQF). The informal sector on the other hand, is serviced by a National Skill Fund (NSF) also established by the National Development Act.

Overall the DoL, SETAs and the NSF have operated in a fragmented and unco-ordinated manner, leading to administrative inefficiency, poor responsiveness to labour market requirements and uneven quality controls.

According to a review carried out by the DoL and the German Technical Assistance (GTZ) in 2007, one of the main challenges facing the SETAs is their expanded role in relation to different target groups. Crucially, this significant increase in responsibilities has not been accompanied by a commensurate increase in institutional capacity. Moreover, quality in many of the SETA programmes is poor leading to high dropout rates. This poor quality is largely the result of pressure on SETAs, employers, government departments and Further Education and Training colleges (FETs) to increase the number of positions open to learners.

The planning process carried out by SETAs is also constrained and often imprecise. SETAs do not have sufficient data pertaining to the skills demanded in their sector, nor is there data about the training available.

A variety of changes have been introduced in the skill development system since the launch of the second phase of the NSDS for the 2005-10 period (NSDS II). The strategy emphasises a demand-driven training model, thus signalling a move away from provider-driven training in which large numbers of the unemployed received training without assurances that it was aligned to an identified need in the labour market. Instead, the concept of "learnerships" has been introduced, adding a workplace-based learning component to classroom instruction.

An important further element of the NSDS II was the introduction of a 1 per cent levy on all corporate payrolls of ZAR 500 000 or more, to provide dedicated funding for skills development both in the workplace and in the broader labour market. As much as 80 per cent of the levy is given to SETAs to be allocated to contributing firms in the form of mandatory grants or discretionary funds. The remaining 20 per cent goes to the NSF to support basic adult education, and to help disadvantaged individuals and the unemployed acquire skills.

The SETA system of grants is perceived to be cumbersome and inefficient. Recent audit reports revealed that a significant proportion of the funds earmarked for training employees was unspent. This negatively impacted the SETAs, raising concerns about mismanagement and corruption.

According to the DoL and GTZ reviews, the allocation of resources within the levy grant system – whereby most of the revenue raised is returned to employers to train their existing workers – is not necessarily compatible with the government's goal of assisting the unemployed and underemployed. Whether the 20 per cent that remains with the NSF after SETAs are funded is sufficient for pursuing the developmental agenda remains a subject of debate.

In addition, there are concerns that the NSF is not meeting the needs of the informal sector. Field interviews suggest that both the unemployed and individuals engaged in informal activity lack information about the NSF funding process. These deficiencies are also a consequence of the exclusion of the informal sector and unemployed from the policy elaboration process.

In response to a persistent skills shortage, the government made education and skills development a major pillar of AsgiSA, introducing several measures intended to halve unemployment and poverty by 2014. Key educational measures include a ramping up of the Adult Basic Education and Training programme, based on a model developed in Cuba and New Zealand, and a massive upgrade of the FET colleges.

The 2007 Further Education Training (FET) Reform

FET colleges provide vocational education and training during the post-compulsory period, namely after grade 9, up to pre-higher education learning. A major ZAR 1.9 billion 3-year programme was launched in 2006 to recapitalise the colleges, tackle vital and long neglected curriculum reform, and invest in staff training and development, infrastructure and equipment. The new system of FET colleges began in the 2007/08 school year, with major innovations including the delivery of a National Certificate (Vocational) (NCV), the promotion of institutional autonomy, and the introduction of institutional monitoring systems. More than 25 000 students, only 2 000 short of the set target, enrolled in the 2007-08 school year and the national objective is to reach 1 million students by the 2014-15 school year. A total of 1 861 college lecturers were trained to offer the new programmes and examiners were appointed to start preparing for the first NCV examination at the end of 2007. FET colleges are financed 80 per cent through the national budget and 20 per cent through the payment of enrolment fees, which in many instances can be covered by bursaries awarded to the students.

Thus far at the time of writing, progress in redressing the huge geographical disparities in the quality of teaching and equipment of FETs remains limited. In addition, the system does not explicitly foresee partnerships with companies and ensure that colleges are responsive to industry demand. Practical training takes place through simulations carried out in workshops within the colleges, while co-operation with companies to set up on-the-job training is left to the initiative of individual colleges. In addition, although FET colleges can be providers of training under the NSDS and can receive accreditation under the NQF, they do not collaborate with SETAs, suggesting a lack of co-ordination between the education/initial training sphere and that of continuing training.

Efforts are still needed to raise the status of FETs, which are usually regarded as appropriate for less talented students and low status occupations. The poor reputation of the colleges is also due to uncertainties concerning access to higher education from the FET colleges, and SETA recognition of the National Certificate (Vocational). According to the OECD Education Review of South Africa, in order to make FETs more attractive, companies should be represented in the colleges' governing boards, and should be actively involved in awareness campaigns highlighting how vocational training can help in creating employment. With a view to ensuring flexibility of the system, the Review suggests that the Provincial Education Department establish mechanisms to monitor the impact of training offered by FETs on the local labour market, following the pathways of the learners through tracer studies.

Another key intervention within AsgiSA is the Joint Initiative for Priority Skill Acquisitions (JIPSA), introduced by the Deputy President in 2006. It aims to address priority skills shortages through a variety of means including: organising special training programmes and exchange programmes with other countries, bringing back retirees or South Africans and other Africans working outside Africa, and attracting new immigrants where necessary.

Currently, the JIPSA joint task team has set a target to train 50 000 new artisans by 2010, and to increase the number of new engineers, by importing them in the short to medium term. A major criticism of this initiative is that despite the substantial overlap between the objectives of the NSDS and JIPSA, there is no co-ordination between JIPSA, and the DoL. Overall, despite these positive developments and initiatives, much work remains to be done to integrate education

policies, poverty alleviation and job creation strategies into a comprehensive system for human resources development.

Political Context

In December 2007 the elections for the ANC party leadership took place in a tense climate in which the incumbent Thabo Mbeki, president of the country, was pitted against his former deputy Jacob Zuma, who had been dismissed in 2005 on charges of fraud and corruption. Zuma was victorious by a large margin, although allegations of corruption erupted shortly after. As ruling party leader Zuma is now the front-runner for the Presidential elections in 2009, when Jacob Thabo Mbeki steps down. The acrimonious battle between these two leaders is likely to continue through the elections.

Immediately following the elections, Zuma was once again charged with major corruption. Although it is highly unlikely that the Court will come out with a verdict before the elections, these allegations have rendered the Zuma presidential ambitions uncertain. Zuma's supporters include trade unions, the Youth league of the ANC and the party's left wing. Although the market-friendly policies of the Mbeki administration are likely to remain in place, the prospect of a Zuma presidency remains unsettling to investors.

Social Context and Human Resources Development

The favourable economic growth has been supported by the progressive improvement in political and social stability throughout the last decade. Nevertheless, tensions have increased since 2006, with frequent strikes and discontent over the slow pace of improvement in poverty and unemployment.

Crime remains endemic, with an increase in the number of violent crimes, despite the decrease in the overall crime rate. Big cities are particularly affected by the phenomenon. The causes of such high levels of

violence are not fully understood. What is certain is that the police force needs to be strengthened. The population perceives the entire criminal justice system as part of the problem, due to its inefficiency and corruption. The task is admittedly difficult due to the lack of legitimacy the system inherited from Apartheid.

Jobs remain the Achilles heel of the economy. Only recently has unemployment begun to edge down, with the creation of about 1.2 million jobs since 2005. Nevertheless, according to the Human Research Science Council, attaining the AsgiSA goal of bringing employment down to 13 per cent by 2014 will require the creation of 5 million net new jobs. A poverty line of ZAR 3 000 per year (about USD 2 per day) suggests that 43.2 per cent of South Africans were poor in 2006, while the Gini coefficient was 0.68. Undeniable progress has been achieved by the broad-based grant system but these do not reach the long-term unemployed or informal sector workers, who number more than 2.5 million.

The government is prioritising access to and quality of basic public services. The 2007 Community Survey showed remarkable improvement in housing, primary education and access to basic utilities, such as water and electricity. However, more remains to be done, especially concerning the quality of these services.

Rural land redistribution is advancing at a very slow pace with just over 5 per cent having been redistributed, well short of the 30 per cent target. Although the government has built 2.4 million urban residences since 1994, most of the poor black population remains confined in the cheaper remote suburbs. As a result, cities and towns still reflect the geographic and racial separation of Apartheid. Despite the undeniable social progress brought by the widespread provision of decent housing (71 per cent of people live in formal dwellings), the poor remain *de facto* excluded from the economic opportunities of the cities.

The measures recently implemented by the government include the creation of a Housing Development Agency, which acquires well-located land for housing from State Departments, SOEs and the

private sector, then releases it to the private sector and municipalities to build low-income housing. The government also intends to establish a Land Fund to buy well-located land for residential purposes. In addition, efforts are being made to revitalise the centres of the main cities, which suffered from large-scale exodus at the end of Apartheid due to high crime rates. Some city centres have low building occupancy rates, business having fled to safer districts such as Sandton, in northern Johannesburg. Tax rebates and other local incentives are starting to reverse urban decay in some centres.

Although South Africa justifiably allocates a fifth of its budget (6 per cent of GDP) to education, which is high by international standards, the current system still struggles to address huge geographical and quality imbalances inherited from Apartheid. The largest problem is the shortage of qualified teachers. Despite funding reallocations there remain stark differences between more and less privileged schools, for example there are almost 30 teachers with 4 years of post high school education per 1 000 pupils in formerly white schools while in formerly black schools the ratio is 21 to 1 000. South African schools perform worse than most of their international and African counterparts. According to a 2005 international test comparing the reading skills of children across 40 countries, almost 80 per cent of primary school pupils in South Africa did not reach the lowest benchmark.

Secondary education is characterised by high drop out and repetition rates. In 2007, the pass rate for final year high school students fell to 65.2 per cent, from 66.5 per cent in 2006. Poor maths and science teaching resulted in only 40 per cent of students passing maths and less than a third passing science. For the 2008 school year, a new curriculum has been designed which makes one of two mathematics options mandatory – mathematics or mathematics literacy as well as life orientation and two South African languages, one of which is the language of teaching and learning. The Medium Term policy statement for the 2008-10 period foresees an average annual growth of 11 per cent in education spending mainly for school buildings, textbooks, school nutrition programmes, and higher

education funding. Nevertheless, additional efforts are needed to identify and support underperforming schools.

Public expenditure on health increased by 15 per cent in value from 2006/07 to 2007/08 and is expected to attain an average annual growth of 11.4 per cent in the medium term. However, despite increasing funds, quality differences between public and private systems are huge, with the public health system suffering from widespread inefficiency, lack of funds, and a chronic shortage of qualified medical staff. In this sense, rising migration of healthcare professionals from rural to urban areas, and even worse, to other countries, contributes to the shortage. Substantial geographical disparities in facilities and medical staff persist. The National Human Resources for Health Strategic framework was launched in 2006 to guarantee a steady supply of qualified and appropriately remunerated professionals.

Although limited, some progress has been recorded in the health status of South Africans. Progress has been made in creating the building blocks – legislation, financing and health information systems – that are vital to the provision of good quality care, and in reducing costs for patients. There is also a sense of sustained progress for components of a number of programmes. For example, in 2006, South Africa was declared polio free by the Africa Regional Certification Commission and the incidence of malaria has been reduced by 18 per cent from 2005 to 2006, surpassing the target of 10 per cent. The government aims to extend child immunisation coverage from 82 per cent in 2005/06 to 90 per cent, and to further reduce maternal mortality.

Despite the stabilisation of prevalence, the main health challenge remains the HIV/AIDS epidemic, with AIDS remaining the leading cause of death among adults and in part reversing progress in child and maternal mortality. Prevention efforts do not seem to be effective in inducing testing: in 2006 only 10 per cent of men went for voluntary testing. Despite the free ARV distribution programme in place since 2005, the goal of ARV treatment for 80 per cent of the infected population by 2012 is falling short, with only

40 per cent obtaining treatment. Lack of access to ARV medication contributes to the continued high number of AIDS-related deaths. To respond to these challenges, 20 addition ARV treatment sites were installed at clinics and major hospitals around the country by June 2007 and wage incentives were introduced to retain practitioners.

An improved National Strategic plan for HIV/AIDS and Sexually Transmitted Illnesses was issued in 2007. The plan, which aims for universal access to ARV, is the outcome of consultations with a wide spectrum of stakeholders. The challenge lies in its effective implementation, as targets for 2007 have not been attained.

