24 April 2002

BUSINESS SOUTH AFRICA RESPONSE TO THE DEPARTMENT OF TRADE AND INDUSTRY DOCUMENT ENTITLED "ACCELERATING GROWTH AND DEVELOPMENT: THE CONTRIBUTION OF AN INTEGRATED MANUFACTURING STRATEGY" AS RELEASED ON 19TH APRIL 2002

INTRODUCTION

Business South Africa (BSA) welcomes the release of the revised Department of Trade and Industry (DTI) document on the contribution of an Integrated Manufacturing Strategy to Accelerating Growth and Development. The document represents progress made in the NEDLAC discussions on the issue and is a significant improvement on previous drafts.

South Africa stands at a ***critical economic threshold*** whereby the economic growth trajectory of the economy needs to be raised to a significantly higher level through a massive expansion in the growth of economic opportunity and investment. Failure to raise the growth trajectory from the current two and a half per cent per annum rate, given South Africa's 7.8 million unemployed people, may result in the likelihood of social and political turmoil in South Africa in the not too distant future. BSA rejects the latter scenario as unacceptable. But we must understand the dangers of not raising the economic growth trajectory.

BSA has committed significant expertise and capacity to negotiating and debating Industrial Strategy, Micro Economic Reform Strategy and ultimately factors that impact on the Growth and Investment Summit to ensure as far as possible agreement between the social partners on what needs to be done to raise the growth trajectory. An Integrated Manufacturing Strategy located within the context of Macro Economic Policy, Micro Economic Reform Policy and the Growth and Investment Summit, forms an integral part of addressing ***critical factors that impact on investment decisions at the firm level***. Unless the investment environment provides a substantial improvement in the ***Risk and Cost Adjustment Rate of Return*** to private enterprise, there will not be a higher level of investment and the current economic growth trajectory will not change. Similarly, unless there is a significant increase in the entrepreneurial skills in the broader population – the increase in economic opportunity may be wasted.

BSA's input continues to demonstrate the serious commitment of organised business to guiding, facilitating and ultimately producing the type of environment which will lead to a massive expansion of economic opportunity, significantly higher investment levels, lower unemployment and an inclusive participatory economy for all.

GENERAL COMMENTS

- The DTI document does not give an adequate explanation of what drives economic growth and development. From the BSA perspective the key to economic growth in developing countries is the ***accumulation of human, physical and financial capital*** which in turn is driven by ***investment***.

- Unless the Integrated Manufacturing Strategy makes a significant contribution to dealing with the issues that affect investment it will serve no useful purpose.

Investors lay out capital in order to achieve positive returns. Returns equal total revenues less total costs, all adjusted for risk and other imponderables. Provided that the benefits of doing business exceed the costs (including the cost of capital itself) and the risks then investment will occur, other things equal.

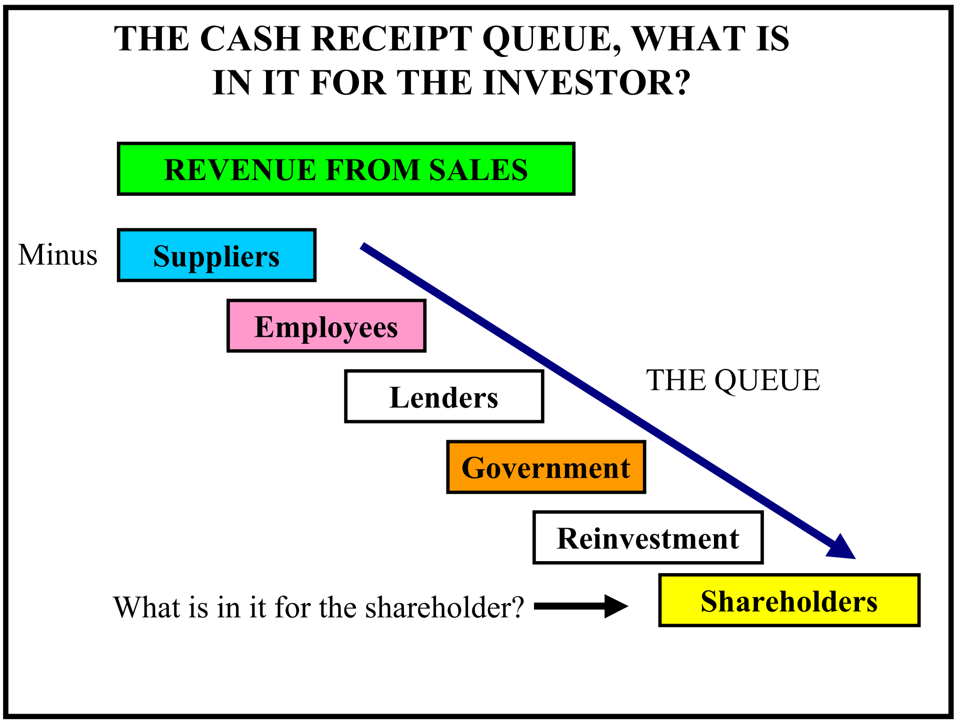
INVESTMENT DECISIONS ARE DRIVEN BY THE RISK AND COST ADJUSTED RATE OF RETURN RELATIONSHIP

RISK & COST ADJUSTED RETURNS	=	REVENUE	–	COSTS:	–	RISKS:
		Economic growth Market contestation		Cost of capital Cost of labour Cost of technology Cost of intermediate products Costs of logistics		business & financial risks Property rights Legislative Political Security Labour market Marketing

The investment hurdle rate = rate of return required by an investor after covering the risks and costs of a project over the long-term.

Other things are seldom equal. With limited supplies of investable funds other (national) destinations may be less costly to operate in than South Africa. If the costs and risks of investing in South Africa are too high versus competitor countries then investment will not materialise. It is the contention of BSA that South Africa's low levels of domestic and foreign direct investment are indicative of a poor investment environment where the costs and risks are too high and thus undermine investment.

The principal mechanism through which political, social and policy uncertainty influences investment is the perception amongst investors that future events will place in jeopardy their future share of income streams from a particular investment (i.e. a shift in transport policy results in increased prices, taxes are raised, volatile currencies). Any factor that creates uncertainty regarding future income streams and property rights will tend to discourage investment. The following chart illustrates that the investor stands last in line to benefit from the revenues accruing from an investment after labour, suppliers, bond holders, the taxman and retained earnings have been accounted for.



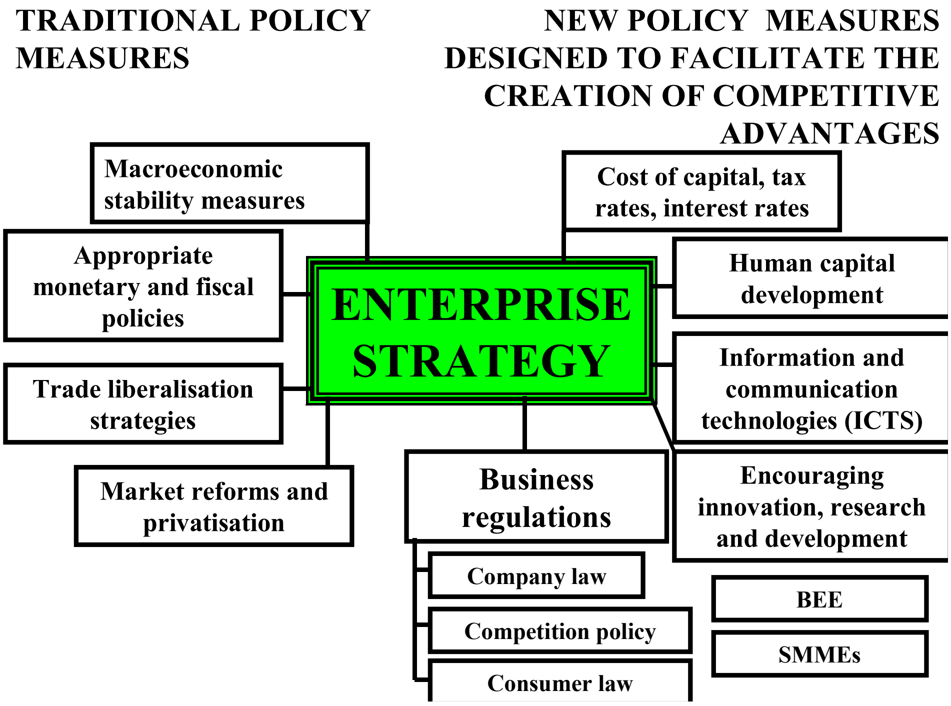
The investor stands last in the cash receipt queue, and thus any factors which undermines the certainty regarding the distribution of the benefits of an investment will raise investment hurdle rates and reduce investment.

- Government's continued focus on Economic Policy co-ordination through the Economic, Investment and Employment Cluster in government is strongly supported.

- BSA supports the contention that the traditional comparative advantage and dynamic comparative advantages are no longer the key drivers of investment and growth in the international context and that increasing focus is being placed on competitive advantages which relate to the ability of firms to really compete in the global market place. This is not to say that traditional/dynamic comparative advantages are unimportant, and that a lot can be done to use these as a foundation for investment and growth - but the location of investment is increasingly being determined by competitive advantage factors. In particular, factors influencing the investment environment, the cost of capital, the certainty of contract, the rule of law, size of the domestic market, access to the global market, etc., are driven by competitive advantage.

Over the past two decades the overwhelming majority of countries around the world have introduced measures that promote macroeconomic stability whilst also opening up markets to competition through liberalisation and privatisation. The traditional policies such as sound macroeconomic management, trade liberalisation and market competition are now considered ***the absolute minimum*** for generating investment. Increasingly countries are focusing on a second set of policies, which encourage differentiation from a competitive advantage perspective. The following chart emphasises the traditional policy measures whilst also integrating the new policy measures designed to facilitate the creation of competitive advantages at the firm level.

Chart 1: Traditional economic policy measures coupled with new competitive advantage policy measures

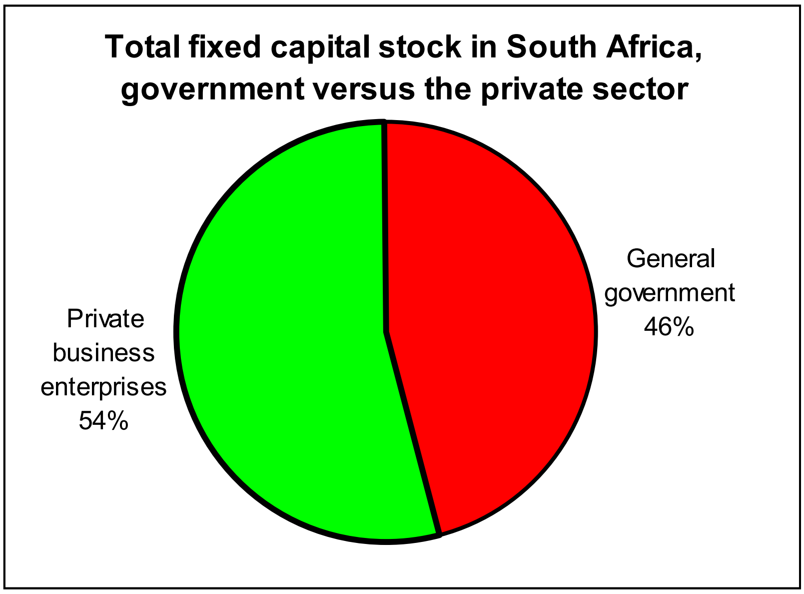


The choice of countries for the multinational investor is now greater than ever. There are increasing challenges for government's regarding the development of policies that generate competitive advantage. Whilst it is important that there is not a "race to the bottom" in terms of trade off around tax policy and the like, it is absolutely critical for government's to ensure that the traditional policies are firmly in place and that policies that develop competitive advantages are adopted. For South Africa the choice is no different.

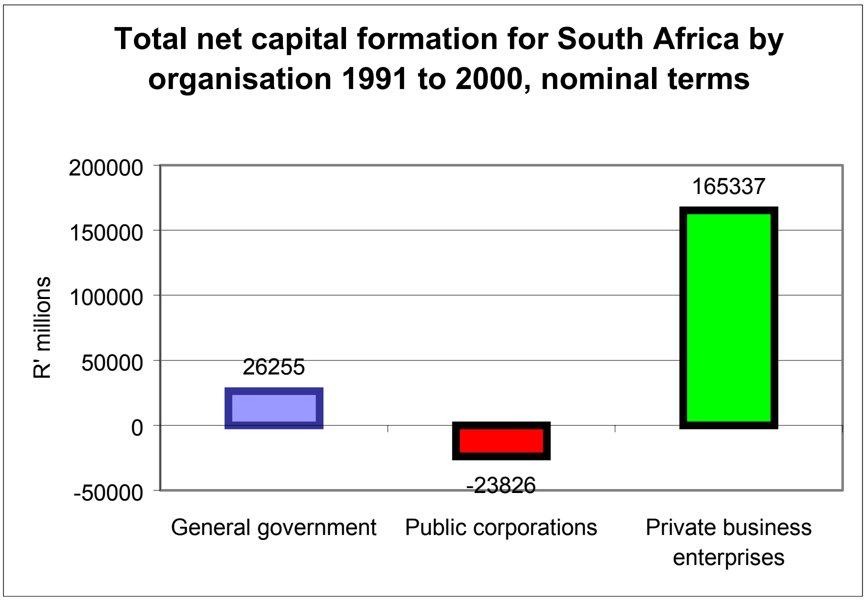
- BSA welcomes the DTI's view of benchmarking and performance assessment. BSA proposes the establishment of an independent **"Cost Benefit Analysis Unit".** Such a unit would not only look at industrial strategy but all government policy with the critical "litmus test" as the impact of such policy on investment, employment and economic growth.

- BSA welcomes the focus in the document on the input cost and service efficiency factors affecting the competitiveness of South African business. In particular, the South African government is the sole shareholder in a number of monopoly industries (telecommunications, ports, electricity, rail transport, etc.,) which have a significant impact on the efficiency and scope of services and products offered to the private sector and on the input costs of the private sector. Examples of poor service delivery include the container congestion at the port of Durban. In addition, ***administrative price setting*** by key parastatals in the areas of port charges, telecommunications, rail transport and electricity (i.e. the prices are not determined in a competitive market) raise the inflation rate which then increases the upward pressure on interest rates. Higher interest rates mean an increase in the cost of capital, higher investment hurdle rates, lower investment, lower growth and lower employment. Contestable competitive markets are crucial for lowering inflationary pressures and for providing investors greater certainty regarding the future pricing of input costs.

The government controls a significant portion of the fixed capital stock of the economy (46 percent) and yet the investment performance is poor and continues to drag down the growth of the entire economy.



Despite controlling 46 percent of the total fixed capital stock of the economy, the net investment performance of state assets (i.e. investment over and above the provision for depreciation) over the past decade has been dismal. While it is important to recognise that many parastatals were inherited in poor shape – the lack of progress in introducing competition and real private sector ownership in these industries has had a major effect on input prices to the private sector and on investment and growth in the economy. Real competitive markets result in constant drives for efficiency, new product development, development and adoption of appropriate technologies and realistic pricing which creates certainty for investment in activities that use such goods and services. The economic vibrancy effect of real competition will have a significant impact on the delivery of reasonably priced services to all entrepreneurs and consumers throughout the economy.



It is interesting to note that the private sector has accounted for over 98 percent of all net capital formation in South Africa over the past decade despite only owning 54 percent of the fixed capital stock of the economy. The negative pricing, inefficient service, and poor investment performance of state parastatals will be a key theme of the business input on microeconomic reform and industrial/manufacturing strategy.

- BSA is concerned that not enough attention is placed on the institutional performance of government. Delays in applications to the courts, the Masters office, the Registrar of Companies, the Deeds Office, not to mention compliance with tax and labour market legislation place a huge compliance cost and burden on business. The institutional performance of government in these areas requires constant assessment and evaluation.

Specific Comments

- Page 2, under the heading Introduction. First paragraph, BSA is of the opinion that what South Africa desperately requires is a massive expansion in economic opportunity and investment in order to raise the current low growth trajectory to a higher more meaningful level. A massive push to develop skills, capacity and entrepreneurship in order to allow all people to participate in this expansion and economic opportunity is required. The key questions relate to how to break the ***"shackles***" that constrain opportunity in South Africa. Much of this relates to the economic and investment environment and the ability of firms, both big and small, to make sustainable rates of return which adequately cover the costs and risks of investing.

- Page 2, under the heading Introduction. Second paragraph, sentence starting "a concerted effort is therefore required by Government and all other economic actors to address these constraints and place the economy on a path that can achieve high growth, employment and equity" is strongly supported by Business.

- Page 8, top paragraph which refers to factors effecting enterprise development under the previous regime should also capture the apartheid government's "command, control" type economy and the lack of property rights given to historically disadvantaged people.

- Page 8, last paragraph dealing with factors that lead to the concentration in the ownership of industry should include the key factor of the impact of exchange controls, trade sanctions and financial sanctions. In particular, mining companies unable to globalise their mining operations were forced to invest surpluses from mining in South Africa in other non-related industries. The ending of apartheid resulted in a significant unbundling of these non-core assets.

- Page 9, last paragraph, the sentence starting "this emerged in the National Economic Forum …", refers only to the activities of the ANC and COSATU. It does not capture Business' active participation in the NEF or the work done in organised Business on trade, industrial, labour market and general economic policy at that time.

- Page 10, penultimate paragraph, sentence starting "investment decisions also increasingly depended on the degree of predictability …". BSA welcomes the increasingly attention paid to investment specific issues. What this paragraph does not capture is the impact of South Africa's "emerging market status" on its risk profile and hence investment performance.

- Page 14, second paragraph, BSA is of the opinion that Government's do not create jobs, but rather create the conditions that enable entrepreneurship, investment and then jobs (as a consequence of the actions of entrepreneurs). In the past 30 years, in the skilled and highly skilled categories the South African economy has been remarkably successful in creating employment opportunities as firms have moved up the skills curve and investment has followed suite. A key challenge is therefore to increase the level of skills in the areas where growth and investment are taking place.

- Page 15, second paragraph, sentence reading "however, many constraints to accelerated levels of growth and equity in the economy remain, and have now become the focus for Government policy." This sentence lacks the critical word "investment".

- Page 16, under the heading Integration into the global economy, sentence starting "much of the growth …" does not capture the fact that whilst manufacturing exports have increased, most are based on beneficiated minerals.

- Page 16, last paragraph, sentence starting "we need to intensify our analysis…". It is important to point out that for an economy of South Africa's state of development, investment in the supply side of the economy to service export markets is likely to be the most dominant factor generating a high growth rate. Only once the benefits of an investment-in-exports-boom flow through will disposal incomes rise and the consumption side of the economy improve (the same point applies to the fourth paragraph on Page 17).

- Page 16, last paragraph, sentence starting "of particular importance is the efficiency, cost and capacity for intermodal transfers in our infrastructure system". BSA believes that the high level of State involvement in South Africa's economy has a major impact on not only input prices and the efficiency of services to business, but also in dragging down the investment performance of the South African economy. In the areas of transport, telecommunications, port operations, etc., State monopolies represent significant shackles on investment efficiency, market determined pricing (especially stability in pricing) and on the reliability and scope of service levels.

- Page 18, second paragraph, sentence starting "it is therefore important for us to develop an understanding of what is happening to multi-factor productivity…". BSA strongly supports a more in depth analysis of factors influencing productivity.

- Page 19, second paragraph, which refers to the low survival rate of small businesses within South Africa. BSA is of the opinion that the low 20 per cent survival rate of small business in South Africa versus the greater than 50 per cent survival rate in the USA is indicative of a poor investment environment in South Africa.

- Page 19, last paragraph, which refers to progress on the Black Economic Empowerment (BEE) front in terms of the market capitalisation of the BEE Firms on the JSE. The DTI document should capture the significant growth in BEE in unlisted companies, in the areas of employment equity, in procurement by private companies from BEE companies, and in terms of rural development. For example, over R5 billion in BEE projects (which are successful companies have taken place in the mining industry over the last few years). Some 12,5 per cent of the management staff in the mining industry are from historically disadvantaged backgrounds versus a zero percentage ten years ago. On an annual basis, some R4 billion is spent by mining companies on goods and services procured from BEE companies.

- Page 21, second paragraph which starts "second, cheap labour is no longer a sustainable advantage." Whilst it is agreed that cheap, unskilled labour is no longer a source of advantage in the global sense, the point is that South Africa does not have cheap, unskilled labour.

- Page 22, under the heading New Sources of Competitiveness, second paragraph with the sentence starting "with the development of Information and Communication Technologies…" whilst Business firmly agrees that ICT is a major driver of competitive advantage, it must be pointed out that the key shackle to the expansion of ICT's in South Africa remains State Ownership of Telecoms and the total lack of competition in this sector.

- Page 23, second paragraph, where the discussion centres on multi-national companies (MNCs). BSA is concerned that the document does not recognise the need for world class South African MNCs. The document tends to focus on foreign MNC's as opposed to South African MNC's.

- Page 24, top paragraph, sentence on "further economic marginalisation is a very real threat. The changing basis of competitiveness away from South Africa's traditional competitive advantages poses a huge challenge, especially if we continue to fall behind with regard to ICT's." Firstly, "traditional competitive advantages" should read "traditional comparative advantages". Secondly, BSA reiterates the point that State Ownership in the fields of telecommunications and the lack of competition in this market continues to retard South Africa's standing in the field of ICT's.

- Page 25, top paragraph, sentence starting "the economy has become more attractive for direct investment…" can be construed untrue in a relative sense. Whilst SA has made significant progress at the macroeconomic level, on a microeconomic and investment level, the pace of reform in South Africa has been slower than our major international competitors. So whilst South Africa's reform has been positive, it has been at a slower pace than our competitors, with the result that South Africa's rate of investment has been low and its attraction of foreign direct investment has been minuscule. For example, Brazil, an economy four times the size of South Africa attracted 33 times the amount of foreign direct investment than South Africa did in 2001.

- Page 27, top paragraph, sentence starting, "South Africa's industrial development has been characterised by an active state providing leadership to the economy, the nature of the State's leadership role has changed from the establishment of parastatals like ESKOM to focussing on, the provision of coherent economic policy, …" BSA firmly supports a government role of facilitation of investment through coherent economic policy as opposed to a government actively participating in the economy. Again, BSA reiterates that large State ownership of the South African economy continues to shackle investment and growth in the country.

- Page 28, last bullet starting "a four pronged approach has been adopted by Government towards BEE …" BSA requests that deliberations on BEE and Transformation in the South African economy - and in particular, the Governments policy perspective be discussed and finalised to promote certainty on the issues. Currently Government's BEE perspective is characterised by constantly changing "goal posts".

- Page 29, penultimate paragraph, sentence reading "another fundamental component of competitiveness is efficiency of economic input sectors." BSA reiterates that the State's ownership of critically important economic sectors continues to shackle growth and investment in South Africa.

- Page 31, top paragraph, sentence reading "the efficiency of input centres represents another fundamental component of competitiveness. Three critical input sectors, namely, transport, energy and telecommunications are firmly within the ambit of the State's control…" BSA not only reiterates its view on the negative impact of the State's ownership of key input industries, but also reiterates the point that administrative price increases have a major impact on inflation which pushes up interest rates, raises the cost of capital, raises investment hurdle rates which then lowers investment to the detriment of growth and employment.

- Page 31 second paragraph starting "Five sectors of the economy that have considerable potential….will receive focused attention from the state." A significant body of research points to the fact that governments are notoriously bad "pickers of winners". BSA recommends a broad approach whereby the overall investment environment is improved for all sectors so that no unsustainable distortions creep in to investment decision making.

- Page 32 top paragraph starting "A key objective of the Microeconomic Reform Program..."Again BSA believes that parastatals and the state have performed dismally on the investment front.

- Page 39 title "Integrated Value Matrices" BSA supports the concept but with the proviso that the government (in all the relevant departments) is willing to change the investment environment for the better.

- Page 43 last bullet point sentence reading "Certain of these offerings to enterprises seek to benefit the economy in a collective sense, namely appropriate policy, legislation and regulation, by creating policy certainty and stability." Whilst the objective of policy certainty and stability are crucial to investment decision making – the reality is that the business regulatory environment has been in constant turmoil and change with over 500 changes to regulation and legislation in the past six years. Businesses and investors require a degree of certainty and stability that ensures that the distribution of the benefits of an investment is guaranteed. Any factors which impinge on the distribution of the benefits will raise the risk profile, raise investment hurdle rates to the detriment of investment, growth and employment. South Africa's current low investment and foreign direct investment rates is indicative of a poor investment environment which raises the risks and costs of investment.

- Page 44 entitled: "Customised Programmes" Do these programmes address the critical issue of factors affecting investment at the firm level? If not they will not contribute to investment and growth!

- Page 50 entitled "Investment Promotion" The statement that "The promotion of domestic and foreign direct investment is critical given the low savings and investment rates in the economy" does not deal with the critically important issues affecting domestic and foreign investment. Foreigners will only invest in an economy if that economy and its domestic market are already growing. In order to attract FDI SA needs to propel domestic investment to a higher level. Structural constraints such as the low domestic savings rate, which results in high interest rates and which, contributes to a higher cost of capital can be dealt with through appropriate measures that encourage domestic savings.

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