

**Industrialization in the Eastern Cape; an analysis of development, opportunities and constraints
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	Page
Contents	i
Executive summary and recommendations	ii
A. Introduction to the scope and objectives of this study	
1. The terms of reference for this study and the timing	1
2. What is industrialisation?	2
B. The past and present	
3. The legacy of apartheid - industrialisation and industrial policy to 1994	3
4. Lessons in industrial policy from the HPAEs (High-Performing Asian Economies)	8
5. Industrialization, growth and industrial policy in South Africa - the last ten years	12
6. The Eastern Cape - past and present growth and industrial development	19
C. The Future	
7. Structural and macro-economic constraints to growth and industrial development in the Eastern Cape	30
8. The potential for industrial development in the Eastern Cape; other, recent studies	45
9. An industrial strategy framework in the Eastern Cape - the way forward?	56
Appendices	
A. Extracts from the Terms of reference for this study	69
B. Structural and macro-economic constraints to growth and industrial development in South Africa	72
C. The automotive industry in the Eastern Cape	93
D. Industrial Development Zones	98
E. List of acronyms	99
References	100

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Executive summary and recommendations

As stated in **section 1**, this is an Industrial Strategy Framework report produced for ECSECC in accordance with the terms of reference as set out in **Appendix A**. The research for this report started in November 2005. The time input into the study was set at two months but it has taken five months partly because of the difficulties with poor statistics and partly because of the desire to include the results of four other studies (see Andersen et al 2006², McIntosh and Xaba Associates 2006, Russell 2006 and Urban-Econ 2006) which were completed between March and May 2006.

‘Industrial’ is usually defined as including manufacturing, mining, construction and utilities, but this study includes tourism and business services (see **section 2**).

Section 3; in understanding development in contemporary South Africa, it is essential to understand the legacy of apartheid. One obvious legacy of apartheid in South Africa is the huge inequality. Measured by the Gini coefficient of income distribution, South Africa is one of the six most unequal countries in the world. But not only was apartheid inhumane, it was also inefficient. One consequence was the creation of a huge reserve army of unemployed distantly separated from the centres of work. Nowhere is this more evident than in the Eastern Cape.

In addition to the inequality, there are three aspects of apartheid policy which have a direct influence on the prospects for industrialisation in the post-apartheid era. These are;

- the development of a minerals-energy complex (MEC) which was capital-intensive and, in terms of ownership, highly concentrated;
- the extremely active economic role played by the state, a major aim being to eliminate the disjuncture between Afrikaner political and English economic power which was apparent in the 1930s but sharpened with the election of the National Party in 1948;
- the particular relationship which was promoted between financial capital and industry. The financial system became, like the British system, retail-based.

In the period leading up to 1994, industrial development outside the minerals-energy complex was promoted behind tariff protection but not geared to exports and producing for the narrow band of the population who wielded effective demand. This development included some attempts at decentralisation but with most of the attempts being an expensive failure. Thus, writing in 1996, Fine and Rustomjee claim that little had changed between the 1960s and the early 1990s in the problems hampering the manufacturing sector.

² . All references are given in full at the end of the report following the Appendices

As far as the prospects for industrial development are concerned, the legacy of apartheid was appalling. In the ten years to 1994 when the Government of National Unity took over under the Interim Constitution, economic growth averaged only 1.2% pa; the industrial sector outside the MEC was inefficient and the agricultural sector was small and crisis-ridden.

Section 4 looks at the possible lessons from eight High-Performing Asian Economies (HPAEs) in East and Southeast Asia. This seems sensible given that between 1965 and 1990, GDP per capita in these eight countries grew ten times as fast as that in South Africa.

There are three factors which played an important role in the development of the HPAEs. These were;

- a relatively equal income distribution
- favourable geo-political conditions
- considerable state intervention in the economy.

In 1994, South Africa faced major disadvantages on the first two counts. South Africa had a highly unequal income distribution of income and it faced much less favourable geo-political conditions. Furthermore given its relatively high ratio of land to labour, South Africa might be expected to specialise in land-intensive goods. Of course to some extent it does, as shown by its high reliance on mineral production and exports, but it has a 'backward' agricultural sector in the sense that in 2003 only 4% of South Africa's GDP came from agriculture compared to an average of 12% for all lower middle income countries.

Thus, in spite of the relatively disadvantageous geo-political conditions faced by South Africa, it was in a position to correct the 'backwardness' of agriculture, the inequality of income and to promote industrialization through various forms of state intervention.

Section 5 points out that one advantage that South Africa faced in 1994 was that there had been a long history under apartheid of state intervention in industrialization. Equally however the industrial sector outside the minerals-energy complex was widely reckoned to be highly inefficient behind protective barriers.

The industrial policy which was followed by the post-apartheid South African government in the second half of the 1990s was one of trade liberalisation accompanied by a restrictive macro-economic policy. Not surprisingly, over the post-apartheid decade, the growth of the economy as a whole has been slow and growth in the manufacturing sector has been particularly slow.

Between 1994 and 2005, South African GDP grew at only 3.4% pa and although statistics on employment are weak, we can say with confidence that total employment (formal *and* informal) grew even more slowly - certainly at no more than than 2% pa. Between 2001 and 2005 total employment grew by 1 million but unemployment fell by only 0.1 mn and in

September 2005, the unemployment rate (even on the narrow definition - that is people actively looking for work) was 27% - a total of 4.5 million. The most important factor behind this slow rate of growth was the low ratio of investment to GDP. Between 1995 and 2004 this averaged only 17%. This compares with more than 25% from the mid-60's to the mid-80s. The fall is accounted for by a sharp drop in public sector investment.

Statistics on the manufacturing sector in South Africa are poor. Nevertheless we can say with some confidence that between 1994 and 2005, value added in the manufacturing sector grew at 2.9% pa whereas employment grew at less than 1.5% pa. Thus far from being a driving force behind economic growth the manufacturing sector in South Africa has been a laggard over the last ten years.

The same is true in the Eastern Cape (see section 6). Between 1996 and 2004, total value added in the Province grew at an even slower rate than in South Africa and in September 2005 unemployment in the Eastern Cape was even higher (at 30%) than in South Africa (27%). In September 2005, unemployment (again on the narrow definition) in the Eastern Cape totalled 575,000.

Not surprisingly, the rate of net out-migration from the Province has been increasing from 0.6% pa of the population between 1992 and 1996 - to 0.8% pa between 1996 and 2001 - to 1% pa between 2001 and 2006. Over the past five years, the net out-migration from the Province is estimated at 65,000 a year. This is a contributory factor to the Province's share of the total population in South Africa falling between 1996 and 2005.

The Provincial Growth and Development Plan of the Eastern Cape Province has a target of cutting unemployment between 2004 and 2014 by half. To achieve this, employment will have to increase by between 55,000 and 60,000 a year. Roughly half of this is the estimated annual increase in the labour force, the other half is the backlog of half the present unemployment. Of course it could be that net-out-migration will do the job. On past performance the jobs are unlikely to be created in the Province.

Certainly the record of the manufacturing sector in the Eastern Cape seems to be about the same as that in South Africa although the statistics are confusing (see table 6.7 on page 27).

The Eastern Cape has a low level of industrialisation (in 2004, only 8% of the country's industrial output compared with a 15% share of the population) and an even more backward agricultural sector than South Africa. In 2004 the agriculture, forestry and fishing sector in the Province accounted for only 2% of Gross Provincial Product.

Half of the output of the manufacturing sector in the Eastern Cape and at least half of the employment in the formal manufacturing sector are accounted for by the automotive sector (including components). Since all of this is in Amatole District and Nelson Mandela Metro, it is not surprising that

about 90% of manufacturing value added is in those two Districts. The four poorest Districts (Chris Hani, Ukhahlamba, OR Tambo and Alfred Nzo) are estimated to account for less than 6% of the Province's manufacturing value added in spite of containing 51% of the population. And even though the majority of the population in these four Districts is based in rural areas, they account for less than half of the Province's value added from agriculture.

Thus the performance of the economy as a whole and of the industrial sector in particular over the past ten years has been poor, both in South Africa and the Eastern Cape. Is the situation likely to change?

As far as the economy as a whole is concerned, the answer is yes but even so only slowly. The reason is that there are substantial structural constraints to development and macro-economic policy has been and continues to be overly cautious in South Africa (see **section 7.4**).

The structural constraints are a backward agricultural sector, a monopolistic private and public sector and a highly unequal income distribution.

Agriculture in South Africa is backward in the sense of accounting for only about 4% of GDP, compared to double that in other countries of similar per capita income. Admittedly few countries have developed rapidly with agriculture as a driver but few countries have developed without agriculture being a strong sector. Increased support for agriculture particularly in the so-called second economy would increase the scope for agro-processing, improve income distribution, soak up under-employed labour and reduce wage costs through reducing the costs of subsistence.

Monopolistic pricing is alleged to exist in both the public infrastructural services and in parts of the private sector (especially in steel and chemicals).

There is a clear economic case for further redistribution of income towards the poor. All of the High Performing Asian Economies had much more equal income distributions than present-day South Africa and their relative equality is widely thought to have been a major factor behind their rapid economic growth. South African sources support the view that income equalisation promotes economic growth and in addition, it is likely that greater income equalisation would reduce crime and reduce the huge, unproductive expenditure on security. As a result there is a strong case for the implementation of a Basic Income Grant as recommended by the Taylor Commission in 2002. The net costs of such a Basic Income Grant are estimated to be between 2% and 3% of GDP but such a grant would increase the income of the poorest 40% by between 50% and 100%.

It has been recognised in a DTI industrial policy which was in draft form in November 2005 that state intervention in the micro-economy is necessary and desirable to achieve industrial growth (**see section 7.5**). However at present, in South Africa, there seems to be insufficient awareness of the

importance of macro-economic management in connection with industrial policy nor indeed with economic growth in general.

A major obstacle to industrial development in South Africa has been volatile movements in the Rand against other currencies and in the past three years a sharp appreciation in the Rand. There is considerable evidence that a depreciating exchange rate is a major stimulus to economic growth in general and to industrial growth in particular, as is a stable exchange rate. It is in this context that the Ricardo Hausmann (who heads the panel of external economic advisers to the South African government) argues that the South African government should commit itself to a policy of a stable exchange rate. In his view, the government's fiscal and monetary policies should be set with an eye to the competitiveness and the stability of the real exchange rate.

Another aspect of government macro-economic policy that needs changing is the fiscal deficit. In the late 1970s public sector investment was 16% of GDP but by the early 2000s it had fallen to just 4%. Hirsch points to the drop in public investment as being due to the cautious conservatism of the ANC government. Certainly the government has been running a very low budget deficit in the past ten years and between 2000 and 2004 it averaged only 1.6% of GDP, compared with 3.8% pa between 1995 and 1999.

In the same way as there is a link between fiscal and industrial policy so there is also a link between monetary and industrial policy. Monetary policy (like fiscal policy) has been unnecessarily restrictive in South Africa but this has been made worse by the concentrated structure of banking in South Africa. The failure of South Africa's financial markets to serve the poor has long been acknowledged.

Hopefully macro-economic policy change is in train with the launch of the Accelerated and Shared Growth Initiative (ASGI) in January 2006. This aims to ensure that South Africa's economy grows by 4.5 percent pa over the five years from 2005 to 2010 and by about six percent pa between 2010 and 2014. However this does not seem to represent a radical change in economic policy.

Thus even after ASGI-SA, the major criticisms of the Government's macro-policy remain. What is needed is an increase in the budget deficit from 2% to 5%, an increase of 2% in the target for the tax-to-GDP ratio, and reductions in real interest rates. In addition a policy structure with a commitment to a stable exchange rate is required

The essential point being made here is that economic and industrial growth has been slow in South Africa and in the Eastern Cape over the past decade. During the past three years, the rise in commodity prices has been very much a mixed blessing for South Africa. It has improved the external terms of trade but at the same time the exchange rate has risen sharply and this is

a major deterrent to industrial growth and probably to a lesser extent to tourism.

Thus it is not surprising that there are no obvious contenders for industrial growth in South Africa. Even in the more advanced Provincial economy of the Western Cape, there are no obvious drivers. Thus the Western Cape's Micro-Economic Development Strategy (MEDS) recently reported that; "*our researchers were able to identify only a few productive sectors that hold promise for the direct creation of significant new unskilled and semi-skilled opportunities*" (see section 7.2). Unsurprisingly in the Eastern Cape, few major opportunities have been identified by a variety of recent studies as 'drivers' for the industrial sector (see section 8).

As stated, this is not surprising. Growth over the past ten years has been slow and few things have changed. The Government has announced its intention to increase infrastructure expenditure sharply and over the past five years social grants have increased but against this, the 48% real appreciation of the Rand against the dollar since 2003 will have been a deterrent to industrial development.

What can the Provincial Government do in this situation? Its powers are very limited. Government in South Africa is highly centralised and the Provinces have relatively small autonomous expenditures (see section 7.6). In addition, the Provinces have to work in something of a vacuum since there is no national socio-economic plan. Injections of aid into the Province exist but are small. For example the EU's LED programme amounts to less than 0.2% of the Eastern Cape's GDP.

As a result, there are few prospects of significant growth in the manufacturing sector of the Eastern Cape (see sections 8 and 9). It is likely that the DTI's review of the Motor Industry Development Programme (MIDP) which is underway will lead to continued encouragement of the automotive industry but any further expansion of this industry is unlikely to result in many new jobs. The potential for the textiles and clothing industry is also limited at the current exchange rate although the reinstatement of the duty credit certification programme (DCCS) in April 2006 will have helped.

The best potential in the manufacturing sector is in agro-processing and in particular in the forestry sector. But it seems unlikely that the additional jobs that would be generated from a further 60,000 to 120,000 hectares of Eastern Cape land planted to forest areas and some further beneficiation will be greater than 30,000. To put this into perspective, this is as many as those employed in the automotive industry (*excluding* components) in the Eastern Cape and less than 6% of the total unemployed in the Province.

Moving outside the manufacturing sector, tourism is widely thought to have huge potential in the Eastern Cape. Statistics on the industry are weak but we estimate that it contributes 10% of the Gross Provincial Product and between 90,000 and 130,000 jobs. This is probably just a little below the total *formally* employed in the manufacturing sector in the same year. The

tourist potential is considerable not least because it is less sensitive to the present high exchange rate especially as half of the tourist revenue is estimated to come from domestic tourists.

Another rapidly developing sector and again one that is relatively less affected by the exchange rate is the construction structure, but it has been beyond the scope of this study to look at this in detail.

Thus the scope for action at the Provincial level and below is limited. This is not to say that it cannot make any difference. It is just that the **prime (but not sole) responsibility for the slow growth in industrialisation in the Eastern Cape Province lies with the National and not the Provincial government.**

Where then does the scope for Provincial action lie? **It lies in three C's - namely;**

- **Coordination** (building up knowledge banks on industry in general and on particular industries, building up profitability profiles of priority sectors, and developing cost-benefit analysis of infrastructure and land use);
- **Cluster-promotion of investment** (detailed analysis facilitating investment and greater efficiency and aiming to reduce search costs on the part of private investors);
- **Cajoling** (lobbying and bargaining with the national government. This should include making a fuss about the impossibility of meeting national targets - for example of halving unemployment by 2014 - without radical changes in policy, especially of macro-economic policy).

A further important role for the Provincial Government is to promote agriculture in the Eastern Cape and particularly in the former homelands. It may seem odd in an Industrial Strategy Framework to emphasise the development of agriculture but it is important not just on grounds of equity but also on the grounds of providing a stronger basis for industrial development (on the supply side in the form of a basis for agro-processing and lower wage costs to other industrial sectors).

Nevertheless there are relatively small funds available at the Provincial level and below so that **the action has to be limited mainly to coordination and cajoling.**

We have said little here about the organisation of institutions at the Provincial level. There are important questions to be raised and answered as to what the roles of DEAT, ECSECC and ECDC should be in relationship to the National Government and the District and Local Municipalities. It has been beyond the scope of this study to look at these in detail.

But **cajoling** is, at the moment, the most important role that the Province can play. A June 2006 study of South Africa by Pollin et al for the UNDP

stated that meeting the national target of halving unemployment by 2014 will require;

“an aggressive employment-targeted programme that increases both the rate of economic growth and the labour intensity of growth. However even under such an aggressive programme such as this report describes, the unemployment rate as of 2014 is still likely to be in the range of 15 per cent. This means that other measures besides employment growth are need to improve living conditions for the poor. We therefore support significant increases in government social expenditures and income transfers even while recognizing the large fiscal commitments that the government is already making in these areas. We show how increased spending in these areas can be achieved through only modest increases in the conventional sources of tax revenue” (see Pollin et al June 2006, 4).

Pollin’s report for the UNDP calls for a fiscal stimulus, a monetary stimulus, controls on the exchange rate and external capital flows, an end to the use of high interest (and exchange) rates to control inflation, a (modest) rise in the tax/GDP ratio and a switch in the pattern of public expenditure to labour-intensive activities.

Similarly we see all of these policies as necessary and desirable. In addition we call for a switch towards the promotion of agricultural growth particularly in the second economy if the ASGI-SA targets are to be achieved. The same applies to the targets set out in the Eastern Cape’s Provincial Growth and Development Programme (PGDP). The apartheid policies were radically evil and inefficient. Radical policies are now needed to undo the legacy of apartheid.